Re-thinking Microfinance Practices: Lesson Learned for Sustainable Islamic Microfinance Institutions

Zahoor Khan
Shafiullah Jan
Karim Ullah
Centre for Excellence in Islamic Finance, Institute of Management Sciences, Peshawar-Pakistan

Abstract

The last decade witnessed the popularity and appreciation of microfinance practices, against poverty alleviation, all across developing and underdeveloped countries. However, there is still deficiency of rigorous studies, to affirm the claims of microfinance products and services against the alleviation of absolute poverty. Over three decades have been passed yet even the champion of microfinance could not prove the effectiveness of microfinance services across their different operational regions consistently. This paper aims to investigate what are the fundamental flaws resulting in unsuccessful or ineffective microfinance operations against poverty. There are numerous psychological, experimental and empirical studies suggesting that poor are often involved in excessive borrowing behaviors. Thus the demand of the poor for credit and recovery rates as a proxy of successful operations are misleading indicators resulting from the psychological behaviors and 'social and peer pressure' respectively. The literature further suggests that irrespective of the financing methodology (whether conventional or Islamic) there is less chance of success for microfinance due to many technical reasons. Moreover, microfinance often result in destroying social capital and solidarity, pushing the poor to pay the full cost of credit supply and promoting the financers' interest while less attention is paid to transfer the benefits of microfinance institutions to financially excluded class. Findings of the study caution stakeholders to rethink about poverty alleviation models which should be feasible and sustainable to alleviate poverty effectively on a wider socioeconomic scale.

Keywords: Microfinance, Poverty, Financial Exclusion, Financial Services.

Background of Microfinance

Microfinance refers to the provision of financial services (including micro insurance and micro savings) to the poor and near-poor household on a wider scale and permanent basis(Christen, Rosenberg, & Jayadeva, 2004). The idea of microfinance was materialized as a decent substitute for informal credit. It was believed as one of the strongest instruments to be used against the absolute level of poverty and for the generation of self-employment (Qayyum & Ahmad, 2006; Shirazi, 2012). However, it is worth mentioning to note that microfinance is not equally beneficial to all classes of the poor. The instrument can help skillful and active poor who have the energy to work but lacking economic resources to realize their intentions (Morduch, 2002; Shirazi, 2012; Shirazi & Khan, 2009). The success behind the microfinance programs reveals that broader coverage of financial services like the provision of loans, deposits and insurance to the poor can help the skillful and active poor on a higher scale.

Among the many efforts, historically recorded to combat poverty, fortunately microfinance got the maximum attention across the globe (Morduch, 2000). The idea of microcredit and subsequently microfinance emerged and flourished in Bangladesh. After individual successful operations of microcredit and (later on) the emergence of Grameen bank widely attracted the attention of stakeholders in other countries to replicate the innovative idea of microfinance and combat poverty in respective regions (Khan, Bahari, & Hassan, 2014).

Considerable research evidences exist representing significant role of MFIs in improving the socioeconomic conditions of the poor and marginalized communities in different countries (Khandker, Koolwal, & Samad, 2010; Shirazi, 2012; Shirazi & Khan, 2009). The South Asian countries have been actively pursuing the policy of setting up a formal network of microfinance institutions. These Institutions include NGOs and government sponsored programs (Dichter, 1999; Khan, Farooq, & Fawad, 2011; Morduch, 2002).

The impact results of microfinance programs are not unanimous. Can the provision of microcredit to the poor and financially marginalized communities alleviate poverty? There is no consensus of the mainstream economists on the productivity of microcredit rather in some cases they report contradictory results[1].

[1]Khandker (1998); Khandker (2005) using quasi experimental and panel data techniques respectively. He investigated the impact of microcredit on poverty. He affirms positive impact of microfinance for clients in

The idea of credit (at micro level) was initiated for a social cause – the socioeconomic uplift of the poor- and not necessarily commercial cause. Today the number of commercial microcredit institutions is increasing by the entry of commercial players (conventional international banks local commercial banks) and so called institutional development of microfinance institutions (the transformation of MFIs to microcredit banks). This process has commercialized the microfinance industry where the major concerns of the banks are "maximization of profit" not "alleviation of poverty" (Nieto, 2009; Pantelić, 2011). Numerous researchers justify the performance of MFIs on the basis of their financial efficiency and self-sustainability however financial efficiency or self-sustainability is not the ultimate objective of these institutions. The ultimate objective is to provide financial and other related services to the poor at affordable and sustainable basis. Although average self-sufficiency of globally large and small MFIs is 118% and 109% respectively but still the lending rate is charged between 30-70% across the globe (SBP, 2011).

The credit of the existing model of microfinance goes to Muhammad Yunus, the founder of the Grameen bank and Nobel Laureate. In 1974, Muhammad Yunus lent an amount of USD 27 to the poor villagers of Bangladesh as a trial. This experiment became successful and thus he continued the process of provision of loans to the poor villagers (Yunus, 2007). In 1983 he formed the Grameen Bank (GB) to extend the facility of credit on a wider scale. The existing microfinance services came into existence because the formal financial institutions' were reluctant to lend to the poor without physical collateral (Qayyum & Ahmad, 2006).

The Structural Shift in Microfinance

Microfinance products have changed from microloans to various financial services such as micro savings and micro insurance. The current development trend of microfinance products corresponds to two paradigm shifts in the microfinance field. Initially microfinance focused on agricultural credit offered by

terms of poverty alleviation especially for women and extreme poor. Morduch (1999); Roodman and Morduch (2009) reinvestigated the results of Khandker (1998 and 2005) and concluded that he has exaggerated the results. For some important variables (women and extreme poor) they found negative signs.

governments or donors. Since the second half of the 1980s, there has been a paradigm shift in financial policy from subsidized credit to financial sustainability (Envision, 2006)

The first paradigm shift focuses on the building of cost-efficient MFIs, reducing high transaction costs and risks caused by moral hazard, adverse selection, and strategic default (Zeller, 2006). The second paradigm shift begins around 2005. This shift was from microfinance to financial inclusion (Jeanneney & Kpodar, 2011). Inclusive finance involves that a wide range of financial providers working within their comparative advantages to serve poor and low-income people, as well as micro and small enterprises.

The second structural change can be observed from a product orientated approach to a client orientated approach. However, in the second structural shift, microfinance institutions shifted and they started the provision of all micro financial services due to increasing competition and withdrawal rates of clients. Microfinance experts realize that increasing competition not only allows clients to take multiple loans at a time, but creates the risk of defaulting loans on some of their microcredit(Dunn, 2002).

Understanding the philosophical underpinnings

The roots of microfinancing, to facilitate the poor by providing small loan for productive utilization and self-employment, can be traced back from philosophical concern of conceptualizing poverty as lacking of access to financial capital (Engberg-Pedersen & Ravnborg, 2010; Hulme & Shepherd, 2003). According to this concept poor are assumed to be productive, capable of running their own small businesses and creditworthy to payback their loans. This idea initiated the extension of microcredit to the poor at different formal and informal levels (Ledgerwood, 1999). Informal credit have been remained a more dominant source for the poor who were not able to produce physical collateral to conventional financial institutions (Rhyne & Christen, 1999). In nutshell, conceptualization of poverty as lacking of access of the poor to financial capital, the extension of financial capital for self-employment and productive utilization of credit, marginalization of poor by the traditional banks due to lacking of producing physical collateral, exploitation of the poor by informal credit sources and alleviation of poverty by business model are some of the factors which initiated microfinance activities across the globe.

The problem with this approach is that poverty does not has a single face but many. Conceptualization of poverty as lacking of access to financial capital is a capitalistic viewpoint[2]. The idea may be good from a business point of view to generate money from those who are traditionally unable to access to traditional financial institutions. As this view has been supported by Bateman (2010) while writing "*Too much money being made! Investors in western countries making fantastic profits from microfinance in developing countries, so why rock the boat"*

The Back Front of Microfinance

The declaration of the year '2005' as microfinance by United Nations and the award of peace Nobel prize in '2006' to Dr. Muhammad Yunus and Grameen bank jointly further accelerated the speed of microfinance as a belief- magical solution of poverty- across the countries(Armendáriz & Morduch, 2010). International donor community, especially US government and World Bank, loved the idea and supported it wholeheartedly. The idea took off globally, and microfinance became a hugely importantantanty-poverty policy(Bateman, 2010). Many subsequent awards offered, including Nobel Peace Prize in 2006 and thus Yunus and Grameen bank widely recognized as major pioneers in poverty alleviation and development. Sooner microfinance institutions started facing the problem of commercial loans and limited government subsides. This helped World Bank and USAID to reveal their interest by suggesting commercial operation of microfinance to cover full cost of *credit supply* and provide *Wall Street style incentives* to employees. Two key US institutions took the lead such as Boston-based ACCION (Americans for Community Co-operation in Other Nations) and the Harvard Institute for International Development (Bateman, 2010)

"Later on, numerous so called '*rigorous studies*' were carried outby World Bank and USAID to purport the success of microfinance. Microfinance industry, advocates and friendly media publicized lots of individual heart-warming success stories, which convinced many that the concept surely 'works" (Bateman, 2010). Independent and neutral research institutions and researchers were suspected about the magnificent success stories of microfinance as

---

[2] For more study please see "A Comparative Analysis of Poverty in Capitalism and Islam; the Philosophical Foundations and Further Extensions. The 2nd International Conference on Islamic Economics and Economies of the OIC Countries (ICIE 2013) 29-30 January, Kuala Lumpur.

anti-poverty tool. Thus *rigorous studies* conducted by World Bank such as Khandker (1998); Khandker (2005) based on quasi experimental and panel data techniques respectively reported significant impact of microcredit on poverty and women borrowers. In contrast, while re-evaluating the impact of the same studies Morduch (1999); Roodman and Morduch (2009) reinvestigated the results of Khandker (1998 and 2005) and concluded that he has exaggerated the results. For some important variables (women and extreme poor) they even found negative signs.

It is interested to note why microfinance did not appear as a failure? The reason is simple for many years impact evaluations done by MFIs and their supporters such as CGAP, USAID, ADB, DFID etc., made uplifting claims for these evaluations, which they provide 'the evidence' that microcredit works significantly against poverty alleviation and women empowerment but all pretty much false (Bateman, 2010; Khan et al., 2014).

A Psychological Look at the Face of Poverty

It is important to study the behavior of the poor. It will help us understanding their approach to access credit and repayments. The Poor often engage in behaviors, such as excessive borrowing, which in turn reinforce the conditions of poverty. How certain behaviors stem simply from having less?Shah, Mullainathan, and Shafir (2012)suggest that scarcity changes how people allocate attention: It leads them to engage more deeply in some problems while neglecting others. The study further shows that scarcity leads to attentional shifts that can help to explain behaviors such as over borrowing(Shah *et al.*, 2012).

Resource scarcity creates its own mindset, changing how people look at problems and make decisions. To understand this hypothesis, consider how people manage expenses. When money is abundant, basic expenses (e.g., groceries, rent) are handled easily as they arise. These expenses come and go, rarely requiring attention and hardly remaining in the mind. But when money is scarce, expenses are not easily met. Instead of appearing routine, they feel urgent. The very lack of available resources makes each expense more insistent and more pressing. A trip to the grocery store looms larger, and this month's rent constantly seizes our attention. Because these problems feel bigger and capture our attention, we engage more deeply in solving them. Having less elicits greater focus. This view is not bound to the specific circumstances of poverty, nor does it make assumptions about the dispositions of the poor. This mindset stems from the most fundamental feature of poverty: having less. Indeed, just as expenses capture the attention of the poor, researchers have found that people who are hungry and thirsty focus more on food- and drink-related cues (Dijksterhuis & Aarts, 2010; Radel & Clément-Guillotin, 2012). Across many contexts, we see a similar psychology. People focus on problems where scarcity is most salient(Shah *et al.*, 2012).

Now connecting the behavior of the poor with success indicators of microfinance such as disbursement of credit among the poor does not necessarily mean that poor have good entrepreneurial skills to optimally utilize credit and generate income from it. Rather it shows that poor communities are lacking money, as long as any program can provide access to money the poor will be part of it. So it is safe to conclude that 'it is not the benefit of the program which attracts their attention to such programs rather it is scarcity which makes them enforce to be a part of such programs to satisfy their urgent needs'. Thus the demand of the poor for credit and recovery rates as a proxy of successful operations are misleading indicators resulting from the psychological behaviors and 'social and peer pressure' respectively.

Giving another Look to Microfinance

The main secular solution of poverty is advocated through microfinance and microcredit. But it is important to know whether provision of credit to the poor and financially marginalized communities can alleviate poverty? This is by itself and big controversial question. There is no consensus of the mainstream economists on the productivity of microcredit rather in some cases they report contradictory results (As shown in earlier section of this paper). Then how the usefulness, universality and efficiency of microfinance are propagated?

Second, the idea of credit (at micro level) was initiated for a social cause – the socioeconomic uplift of the poor- and not necessarily commercial cause. Today the number of commercial microcredit institutions is increasing by the entry of commercial players (conventional International banks local commercial banks) and so called institutional development of microfinance institutions (the transformation of MFIs to microcredit banks). This process has commercialized the microfinance industry where the major concerns of the banks are “maximization of profit” not “alleviation of poverty”. How the issue of poverty can be alleviated with commercial attitude? This is another important question which needs to be addressed.

Third, numerous literature justify the performance of MFIs on the basis of their financial efficiency and self-sustainability- if we think out of the box that whether financial efficiency or self-sustainability is the ultimate objective of these institutions? Definitely no, the ultimate objective is to provide financial and other related services to the poor at affordable and sustainable basis. Although average self-sufficiency of globally large and small MFIs is 118% and 109% respectively but still the lending rate is charged between 30-70% across the globe. How the success of these programs in terms of poverty alleviation is possible?

Lesson Learned for Islamic Microfinance Institutions

1. Poverty should not be conceptualized as a lacking of access to financial capital as misunderstood by the capitalists paradigm(Engberg-Pedersen &Ravnborg, 2010; Hulme & Shepherd, 2003). As this concept will also mislead Islamic microfinance programs to extend loan via Islamic mode i-e Qard-e-Hasna) irrespective of its utilization and usefulness.
2. Availability of credit for small enterprises is not the core problem rather it is the lack of institutions that can promote productive entrepreneurship. Islamic MFIs should adopt the role of such an institution that can quickly scale up small business project into those capable of growth via skill up gradation, technology transfer and innovation.
3. As per the evidences from numerous studies the poor are more conscious about current needs rather than expected benefits(Shah *et al.*, 2012). Helping the poor for self-employment and income generating activities by Islamic MFIs via Qard-e-Hasna may increase the probability of use of loan other than promised. Probably that is one of the important reasons why Islamic microfinance could not replace as a viable poverty alleviation tool.
4. As per research studies the conventional MFIs focus and promote microcredit rather micro savings so

Islamic MFIs should promote and establish community owned and controlled endowment funds to strengthen local capital accumulation while IMFIs itself should adopt a role of observer and regulator so to address any loopholes in the system.

5. Poverty is a consequence not a cause. A whole community may suffer from poverty but its reasons may be very different and diverse (Khandker, Koolwal, & Samad, 2010; Shirazi, 2012; Shirazi & Khan, 2009). Provision of Qard-e-Hasna may not be an appropriate solution of poverty for the entire community but for some of them.
6. Anti-poverty programs must be integrated with social safety net programs and *Zakat* and *Infaq* programs to attack poverty from various dimensions. As poverty is a multidimensional problem which needs to be addressed while addressing its different dimensions.

Conclusion

This paper summarizes the fundamental flaws resulting in unsuccessful or ineffective microfinance operations against poverty. There are numerous psychological, experimental and empirical studies suggesting that poor are often involved in excessive borrowing behaviors. Thus the demand of the poor for credit and recovery rates as a proxy of successful operations are misleading indicators which are resulting from the psychological behaviors and 'social and peer pressure' respectively. The literature further suggests that irrespective of the financing methodology (whether conventional or Islamic) there is less chance of success for microfinance due to many technical reasons. Moreover, microfinance often result in destroying social capital and solidarity, pushing the poor to pay the full cost of credit supply and promoting the financers' interest while less attention is paid to trickle down the benefits of microfinance institutions to financially excluded class.

Independent studies shows no consensus among the researchers to conclude microfinance as a success against poverty, successful self-employment generation tool, effective women empowerment's tool, sustainability of the model and establishment of microenterprises (Hulme, 2000; Khan & Sulaiman, 2015; Khan, Yasin, & UIIah, 2011). However, it cannot be concluded as a failure of microfinance model at all. There are also numerous studies (Chakrabarti, 2004; Hulme, 2000; Hulme & Moore, 2006; Khan & Sulaiman, 2015) realizing partial success of microfinance across the different regions.

Notwithstanding, studies which believe in microfinance as a strong anti-poverty instrument but correlate with other political and macroeconomic factors are also wide in range (Armendáriz de Aghion & Morduch, 2000; Benzing, Chu, & Kara, 2009; Crabb, 2008; Hartungi, 2007). Though, microfinance literature varies from partial success to no success at all, however the success of microfinance institutions depend on the definition of 'success' by itself (Hartungi, 2007), impact assessment methods (Khan *et al*., 2014), country and region of practice, macroeconomic and political factors (Benzing *et al*., 2009; Crabb, 2008), number, model and scale of operations and status of MFIs (Farooq & Khan, 2014).

Findings of the study caution stakeholders to rethink about poverty alleviation models which should be feasible and sustainable to alleviate poverty effectively on a wider socioeconomic scale. These findings are important for Islamic microfinance institutions as they are trying to serve the poor community through *Shariah* compliant micro loans products which do not seem much different in terms of social impacts of these products.

References

Armendáriz, B., & Morduch, J. (2010). *The economics of microfinance*: MIT press.

Armendáriz de Aghion, B., & Morduch, J. (2000). Microfinance beyond group lending. *Economics of transition, 8*(2), 401-420.

Bateman, M. (2010). Why doesn't microfinance work. *The Destructive Rise of Local Neoliberalism. London*.

Benzing, C., Chu, H. M., & Kara, O. (2009). Entrepreneurs in Turkey: A factor analysis of motivations, success factors, and problems. *Journal of small business management, 47*(1), 58-91.

Chakrabarti, R. (2004). The Indian Microfinance Experience. *Integrating the rural poor into markets*, 137.

Christen, R. P., Rosenberg, R., & Jayadeva, V. (2004). *Financial Institutions with a" Double Bottom Line": Implications for the future of Microfinance*: Consultative group to assist the poorest (CGAP).

Crabb, P. (2008). Economic freedom and the success of microfinance institutions. *Journal of Developmental Entrepreneurship, 13*(02), 205-219.

Dichter, T. W. (1999). NGOs in microfinance: Past, present and future.*Microfinance in Africa*, *2*, 12-37.

Dijksterhuis, A., & Aarts, H. (2010). Goals, attention, and (un) consciousness. *Annual review of psychology, 61*, 467-490.

Dunn, E. G. (2002). It Pays to Know the Customer: Addressing the Information Needs of Client-Centered MFIs. *Journal of International Development, 14*(3), 325-334.

Engberg-Pedersen, L., & Ravnborg, H. M. (2010). *Conceptualisations of poverty* (No. 2010: 01). DIIS Reports/Danish Institute for International Studies.

Envision, G. (2006). The history of microfinance. *Retrieved, January, 22*, 2012.

Farooq, M., & Khan, Z. (2014). The Social and Financial Performance of Conventional and Islamic Microfinance Institutions in Pakistan: Al-Idah.

Hartungi, R. (2007). Understanding the success factors of micro-finance institution in a developing country. *International Journal of Social Economics, 34*(6), 388-401.

Hulme, & Shepherd, A. (2003). Conceptualizing chronic poverty. *World development, 31*(3), 403-423.

Hulme, D. (2000). Is microdebt good for poor people? A note on the dark side of microfinance. *Small Enterprise Development, 11*(1), 26-28.

Hulme, D., & Moore, K. (2006). *Why has Microfinance been a policy success in Bangladesh (and beyond)?* : Economic and social research council (ESRC). Global poverty research group (GPRG).

Jeanneney, S. G., & Kpodar, K. (2011). Financial development and poverty reduction: Can there be a benefit without a cost? *The Journal of Development Studies, 47*(1), 143-163.

Khan, Z., Bahari, Z., & Hassan, S. M. (2014). SWOT Analysis of Contemporary Microfinance Impact Assessment Approaches. *Pakistan Journal of Social Sciences (PJSS), 34*(2), 485-499.

Khan, Z., Farooq, M., & Fawad, M. (2011). Analysis of the Performance of Islamic and Conventional Banks in Pakistan. *Journal of Managerial sciences, 5*(1).

Khan, Z., & Sulaiman, J. (2015). Does Microcredit Help the Poor and Financially Marginalized Communities? Experience of

Pakistan *Poverty Reduction Policies and Practices in Developing Asia* (pp. 31-52): Springer

Khan, Z., Yasin, H. M., & UIIah, A. (2011). Is Cooperative Microfinance1 a Myth or Reality? An Economic Analysis of the Welfare of Marginalized Segments. *The Journal of Humanities and Social Sciences, 19*(2), 61.

Khandker, S. R., Koolwal, G. B., & Samad, H. A. (2010). *Handbook on impact evaluation: quantitative methods and practices*: World Bank Publications.

Ledgerwood, J. (1999). *Microfinance handbook: an institutional and financial perspective*: World Bank Publications.

Morduch, H. (2002). Analysis of the Effects of Microfinance on Poverty. *Working paper 1014*.

Morduch, J. (1999). The role of subsidies in microfinance: evidence from the Grameen Bank. *Journal of development economics*, *60*(1), 229-248.

Morduch, J. (2000). The microfinance schism. *World development, 28*(4), 617-629.

Nieto, B. G. (2009). Social efficiency in microfinance institutions. *Journal of the Operational Research Society*, 104-119.

Pantelić, A. (2011). A comparative analysis of microfinance and conditional cash transfers in Latin America. *Development in Practice, 21*(6), 790-805.

Qayyum, A., & Ahmad, M. (2006). Efficiency and Sustainability of Micro Finance Institutions in South Asia. *South Asian Network of Economic Research Institutes (SANEI)*.

Radel, R., & Clément-Guillotin, C. (2012). Evidence of motivational influences in early visual perception hunger modulates conscious access. *Psychological science, 23*(3), 232-234.

Rhyne, E., & Christen, R. (1999). *Microfinance enters the marketplace*: USAID.

Roodman, D., & Morduch, J. (2009). The impact of microcredit on the poor in Bangladesh: Revisiting the evidence. *Center for Global Development Working Paper*, (174).

SBP, M. D. (2011). Strategic Framework for Sustainable Microfiance in Pakistan. Karachi: State Bank of Pakistan.

Shah, A. K., Mullainathan, S., & Shafir, E. (2012). Some consequences of having too little. *Science, 338*(6107), 682-685.

Shirazi, N. S. (2012). Targeting and Socio-Economic Impact of Microfinance: A Case Study of Pakistan1. *Islamic Economic Studies*, *20*(2), 1-28.

Shirazi, N. S., & Khan, A. (2009). Role of Pakistan poverty alleviation fund's micro credit in poverty alleviation: a case of Pakistan. *Pakistan Economic and Social Review*, 215-228.

Yunus. (2007). *Creating a world without poverty: Social business and the future of capitalism*: PublicAffairs Store.

Zeller. (2006). *'Is there a difference in poverty outreach by type of microfinance institution? The case of Peru and Bangladesh.* Paper presented at the Global Conference on Access to Finance: Building Inclusive Financial Systems, organised as part of the annual conference series of The World Bank and the Brookings Institution, Washington, DC, 30-31 May.