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MICROFINANCING: A BURDEN OR BLESSING

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ABSTRACT

Consultative Group to Assist the Poor (CGAP) defines microfinance as “the supply of loans, savings and other basic financial services to the poor”. Financial services of microfinance usually involves small amount of money (loan, savings etc) therefore the term microfinance helps to differentiate these services from those which formal banks provide. On the supply side of microfinance, there are whole sort of institutions generally known as Microfinance Institutions (MFIs). These institutions include local, national and international, non profit, governmental and non governmental organizations, plus microfinance specialized banks and other commercial banks. These institutions (MFIs) provide microfinance services that are small loans to poor borrowers. The idea of microfinance started in the 1950s when government and various donor organizations started providing subsidized agricultural credits to small farmers. During the 1980s attention shifted to women small entrepreneur such that they could establish their small business and therefore raise their household income and welfare. During these times there emerged various non-governmental organizations (NGOs) specializing in providing loans to poor. In 1990s these NGOs turned themselves into formal financial institutions now known as MFIs. It is estimated that there are now over 7000 MFIs serving some 16m poor in LDCs. The total cash turnover of MFIs world wide is estimated at US $2.5b and potential for growth is very high.

1. MICROFINANCE DEFINED

Consultative Group to Assist the Poor (CGAP)[1] defines microfinance as “the supply of loans, savings and other basic financial services to the poor”. Financial services of microfinance usually involves small amount of money (loan, savings etc) therefore the term microfinance helps to differentiate these services from those which formal banks provide.

On the supply side of microfinance, there are whole sort of institutions generally known as Microfinance Institutions (MFIs). These institutions include local, national and international, non profit, governmental and non governmental organizations, plus microfinance specialized banks and other commercial banks. These institutions (MFIs) provide microfinance services that is small loans to poor borrowers. The idea of microfinance started in the 1950s when government and various donor organizations started providing subsidized agricultural credits to small farmers. During the 1980s attention shifted to women small entrepreneur such that they could establish their small business and therefore raise their household income and welfare. During these times there emerged various non- governmental organizations (NGOs) specializing in providing loans to poor. In 1990s these NGOs turned themselves into formal financial institutions now known as MFIs.

It is estimated[2] that there are now over 7000 MFIs serving some 16m poor in LDCs. The total cash turnover of MFIs world wide is estimated at US $2.5b and potential for growth is very high.

2. WHY POOR NEED FINANCIAL SERVICES AND WHY THEY DO NOT GO TO BANKS?

This question seems odd that poor are in need of financial services. But the fact is that often poor are already utilizing financial services even though in some what different manner. Poor need financial services when they save and therefore invest their money. They invest in various assets including gold, domestic animals, building materials etc. They may save wheat to be sold at later stage. Similarly they save in groups by contributing a small amount of cash each day, weak or month and then distribute the same successively to each person on rotation basis. But these informal methods of savings have limitations.

For example, if investment is made in domestic animals then in case of emergency nothing could be done if need is of small amount. Similarly if saving is in kind then it is prone to destruction by insects fire, thieves and so on. Group savings is also subject to various problems including fraud and mismanagement etc. So if informal methods of savings and investment are not reliable then why do not the poor use formal financial institutions, in particular banks for the same.

There are various reasons. Firstly, the working of modern economies prevents people without assets from securing loans in commercial banks. The rationale the poor can't avail the services of banks because normally they do not have enough money to open their account, do not have any collateral to secure a loan, do not have credit record and so on. Secondly, for the lender the risk associated with loaned out money are disproportionately high in relation to profit in the on going interest rates.

Microfinance addresses and fills this gap. The microfinance tackles this serious draw back of our modern financial system which prevents poor (no assets) from securing loans from banking system.

3. THE SUCCESS OF MICROFINANCE

The success of microfinance can be judged by looking at its achievements particularly related to improvements in the daily lives of poor people. Proponents of microfinance say that it not only benefits the immediate borrower, economically but also the whole household. Eradication of poverty has been as the main achievement of micro financing. According to Littlefield et al[3], Sam Paley-Harris[4], UNCDF Microfinance[5], micro financing has recorded significant improvement in lives of micro financing borrowers as opposed to non borrowers. For example according to Littlefield in Bolivia 2/3 of borrowers experienced an increase in their income. In Indonesia the increase in income was about 13% for borrowers and only 3% for non borrowers[6]. Even some studies have claimed that 50% borrowers of microfinance have actually risen above the poverty threshold[7].

Another area of success claimed by advocates of microfinance is education particularly children's education. They believe that extra income earned through micro financing is likely to be spent on education of children. For example in Bangladesh, the educational achievement of children aged from 11-14 years (whose families took microfinance loan) doubled to surpass the control group (children of non- borrowers) by almost 80%[8]. Third area where micro financing has helped is healthcare. It is reported[9] that borrowers have shown improvement in immunization, breast feeding practices and rehydration therapy for children with diarrhea in countries like Ghana, Bolivia and Bangladesh.

Consultative Group to Assist the Poor (CGAP)[10] adds more benefits for microfinance borrowers. Firstly poor people with access to savings, credit, insurance and other financial services are more resilient and better able to cope with everyday crisis(sudden death, illness, loss of assets) they face. Secondly, access to credit allows poor people to take advantage of economic opportunities whenever they arise and accordingly plan and expand business activities. Few studies have shown that over a larger period of time many clients do actually graduate out of poverty. Thirdly, by reducing vulnerability and increasing earnings and savings, financial services allow poor to make the transformation from every day survival to planning for future-send children to school, better nutrition plus better living, better health care services.

4. FAILURES OF MICROFINANCE

Policy makers[11] in UDCs are increasingly critical of the high interest rates that MFIs charge. The nominal interest rates charged by most MFIs range from 30% to 70% a year. However, effective interest rates are even higher because of commissions and fee charged by MFIs. Other factors such as compulsory deposits for obtaining loan, frequency of payments and system adopted to collect repayments, also raise the effective interest rates[12]. In fact in some cases interest rates could go as high as 200% per year[13].

High interest rates charged have been defended by MFIs and others[14]. They argue that in order to make microfinance operationally sustainable, interest rates charged should be high enough to cover all costs. The problem is that the administration costs are higher for small lending than for normal bank lending. For example, lending out a million in 100,000 loans of $100 will require a lot more in staff salaries than making a single loan for the total amount. In fact there are three types of costs the MFI has to cover while making small loans[15]. The first two types, cost of money it lends and the cost of loan defaults, are proportional to the amount lent. But the third type of cost, transaction cost is not proportional to the money lent. The transaction cost of $100,000 is not much different from that of 10,000. In short proponents of MFIs justify the high interest rates charged due to high costs associated with micro lending.

Despite the high costs associated with micro lending, exorbitant interest rates charged by MFIs can't be justified. If the purpose of MFIs is to help the poor then millions are excluded from micro financing due to very high interest rates of 100% to 200%. This mean if micro financing was meant for poor then very poor particularly in rural areas are excluded because of very high costs associated with borrowing. Those who dare to borrow should be able to generate a sufficiently high surplus of funds such that to cover high interest rates. More specifically, a borrower's realized rate of return on investment must be greater than the interest rate to service the loan. The question is where do such enterprises exist with potentially such a high margin?

In a typical UDC, the best available business opportunities for majority of the poor people involve those with moderate returns. This means most of the people in poor countries simply can't afford to service loans taken at such high interest rates. Moreover, in UDCs poor need credit to meet expenditure on health, education, marriages and many other life cycle events. So under these circumstances what is the solution? How could we help poor in the provision of funds? How could we provide money to the poor for business but involving no interest?

5. INTEREST AS THE ROOT CAUSE OF PROBLEM

What we stated in the above few pages can be summarized in few words that are interest is the root cause of problem. High interest has given rise to two problems.

a. Commercialization: Due to higher interest rates in micro financing, MFIs have increasingly gained a commercial nature with investment banks obtaining a larger share of the micro credit sector. The higher returns to MFIs have come at the expense of the poor borrower.

b. High delinquency rates of MFIs: Very high interest rates have made the poor borrowers unable to pay interest in time never mind the original capital borrowed. This has led to delinquency and liquidity problems for many MFIs[16] .

Increasing commercialization accompanied by exorbitant interest rates only hurts the poor and benefits the rich. "Unless the fundamental of micro financing are transformed to not-for-profit basis, in the long run we may see this potentially valuable institution simply withering away to another form of aggressive capitalism[17]".

6. **MICRO FINANCING: AN ISLAMIC SOLUTION**

Islam rejects the charging of interest out rightly whether the rates are low or high. In other words Islam rejects interest in any form, type and rate: Interest on money or commodities, nominal interest rates (normal interest rate) or very high interest rates (usury). Islam uses one word *riba* to cover both interest and usury. Islam's view on *riba* is well documented in the following two verses from the Holly Quran.

> O ye who believe!
> Fear Allah, and give up
> What remains of your demand
> For usury, if you are
> Indeed believers
>
> If ye do it not
> Take notice of war
> From Allah and His Messenger:
> But if ye repent
> Ye shall have your capital sums:
> Deal not unjustly, and ye shall not be dealt with unjustly
>
> (2:278-79)

This is one of the most stern and toughest warnings given by the Holy Quran to those involved in the business of interest. These words in fact refer to the attitude of Islam towards interest and interest based businesses. This is not war for opinions, but an ultimatum for war for the liberation of debators unjustly dealt with and oppressed. If interest is forbidden in Islam then we have to solve the problem of micro financing involving no interest. Two solutions are presented.

One solution is provision of small loans to deserving entrepreneurs provided a group of persons guaranties that the borrower will return borrowed funds in time. And if they are not returned the guarantors will do that. In fact this model is no different from that of already persuade by MFIs. The only difference is that the funds maybe provided by the government or some department/ agency appointed by the government for the same. Moreover the funds provided are free of interest. In fact many governments are already providing money to MFIs which in turn is distributed by the MFIs at very high interest rates[18]. What we suggest here is that instead of providing funds to MFIs at nominal interest rates and then letting them charge interest rate from 100% to 200%, governments may provide the same to poor borrowers directly with guarantee of return of money provided by a group of people from the same community. This way we can provide funds to poor entrepreneurs who in return can contribute to the development of their country.

Second solution is provision of funds on the basis of *mudarba*. This *mudarba* is slightly modified version of the actual or true *mudarba*. In this form of *mudrba*, both men (or women) with money (capitalist) and men (or women) with skill (worker) can register their names with certain department indicating the capital they wish to invest(in case of capitalist) and preference for particular type(s) of business. Similarly the worker can also tell his skill(s) and preference for the types of business. If some parties like each others preferences, they could contact each other through the said department. If after meeting the parties decide to join hands in *mudarba* then they can do so on the general terms and conditions already laid down in the literature. Money will be handed over to the worker by the capitalist on surety of at least 4 to 6 persons. These guarantors will provide written guarantee for the original amount invested. In case of loss of this money the guarantors will ensure that the worker pays others wise guarantors will be liable to pay. In this whole operation the concerned department will act like an employment exchange that is facilitating the two parties to meet and then help in the writing of agreement.

CONCLUSION

Microfinance began with a noble cause of helping the poor by providing increased economic opportunity to them. But the practice of microfinance is far from its original goal. Increased commercialization coupled with very high interest rates only reinforces the working of global economic system to benefit the rich and hurt the poor. Unless fundamental change is brought the micro financing (no interest), this institution will wither away in near future.

If a blessing
makes us forget Allah,
it is indeed a
chastening.

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[1] CGAP, website http:// http://www.cgap.org
[2] Estimated by World Bank, from data snap shots on micro finance- the virtual library on micro credit.
[3] Elezabeth Littlefield, Jonathan Morduch, and Syed Hashemi (2003), "Is Micro Finance an Effective Strategy to reach Millennium Development Goals". CGAP.

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[5] UNCDF Micro Finance.
[6] Elezabeth Littlefield, Jonathan Morduch, and Syed Hashemi (2003), "Is Micro Finance an Effective Strategy to reach Millennium Development Goals". CGAP.

[7] As stated by A. Kadir Yildirim (2009) Micro Finance for Poor: Burden or Blessing, Fountain Issue 70, July-August 2009. See Role of Micro Credit in Poverty Alleviation (2005). First Quarterly Report SBP 2004-2005.
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[11] Ugandan President attacks high interests rates of MFIs, www.
[12] Fernando (2006) Understanding and Dealing with High Interest rates on Micro Credit, ADB P1.
[13] Master level study (thesis) of FJWU Show that AKRDP people are charging as high as 200% interest rates in Northern areas.
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[18] See Ugandan President attacks high interests rates of MFIs