

# Growth with Equity Through Microfinance Network: A Conceptual View

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## Abstract

As one of the largest poverty interventions microfinance has been covering a significant proportion of people in poverty for a long period of time. In recognition of its poverty alleviation potentiality and bringing peace in borrowing households and their community, microfinance has been awarded with world famous awarding bodies. Besides recognitions, microfinance has been facing strong criticism for the adverse implications of this development program on different economic and social aspects of the community it serves. This paper depicts the development concept of microfinance and its genesis. It identifies the claimed positive impacts and the criticisms that the conventional microfinance has been facing, and proposes an alternative approach of equitable development through microfinance network for the economically and socially marginalized community that can avoid most of the adverse consequences of conventional microfinance.

**Keywords:** Conventional Microfinance, Impact, Drawback, Equitable Development Model

## Introduction

Since time immemorial a significant proportion of world population has been subject to poverty which is still considered as one of the largest problems of the globe (UN, 2015). Microfinance is one of the largest development programs to address poverty that covers more than 200 million households in developing world (Reed, 2015). It is claimed that microfinance helps generate self-employment, alleviate poverty, empower women, bring peace in the households and drive traditional moneylenders from the society (Khandker, 1998; Pitt and Khandker, 1998; Simanowitz, 2003; Khalily, 2004;

Bertaux and Crable, 2007). Because of the achievements claimed, United Nations proclaimed 2005 as a year of microcredit and Nobel Peace Prizes for 2006 awarded to the achievers of this development program. However, besides recognitions, microfinance has been facing strong criticism for its adverse social and economic implications (Ahmad, 2002; Chavan and Ramakumar, 2002; Karim, 2008; Bateman, 2010). The core objective of this paper is to propose an alternative approach to alleviate poverty with equitable growth for the economically and socially marginalized community using the network of microfinance intervention that may help overcome the drawbacks of conventional microfinance.

## The Basic Concept and Genesis of Microfinance

**The Concept:** Microfinance is a development program that provides small amounts of credit to the economically and socially marginalized people, in most cases to the women. The overall belief behind the concept of microfinance is that, using this credit, the borrowing households are enabled to break out of the cycle of poverty through the creation of self-employment (Yunus and Jolis, 1998). Unlike traditional lending systems, microfinance does not require *documentary* or *physical collateral* from the borrower against the credit as they do not have the ability to provide such type of collaterals. Instead, it is based on trust, *social-collateral* (other borrowing members of the community collectively provide assurance for the credit) and the use of intensive monitoring mechanisms. Microfinance is a 'semi-formal' financial service in between formal financial institutes and informal moneylenders, and is dedicated to the unbanked people to grant their right of access to finance (World Bank, 1997; Yunus and Jolis, 1998). As per design, besides providing small amount of credits, microfinance program

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intervention includes collecting regular and special savings from the borrowing members. In some cases it also provides insurance coverage, and involves members with a process of social development.

**Genesis:** Although the words *microfinance* or *microcredit* did not exist before the mid-1970s, the concept of helping the poor through the means of a small loan without collateral is not new. This was practiced in different parts of the world even in previous centuries in different forms, unlike the present systemized and structured version of microfinance (Nath, 2004; Seibel, 2005). Instances of providing small-scale credit and savings within the community by the members of the community, in an informal way were present under different names such as *hui* in China, *chit fund* in India, *arisan* and BPR in Indonesia, *paluwagan* in The Philippines, and *esusu* in Nigeria, West Africa and Caribbean Islands (after the slave trades), to name but a few examples (Seibel, 2005). Movements of providing financial support among the poor in the form of collateral-free credit in Europe also existed. Particularly noteworthy are the credit union initiated by author Jonathan Swift in Ireland that emerged in 1720 and covered about 20% of Irish households, and the *thrift society* initiated by Friedrich Wilhelm Raiffeisen in Germany. The latter started in 1778 and was followed by the *Sparkasse*, *Darlehnskassen-Vereine* and *Raiffeisenkassen* movements that finally tuned into banking law in 1934 with the gradual increase in coverage and the need for regulation (Seibel, 2003).

In Bangladesh, the practice of helping the poor to build sustainable livelihoods in agriculture and self-employment through collateral-free loans was established before the era of Muhammad Yunus and Grameen Bank. During the early 1900's, the Nobel laureate poet Rabindranath Tagore used to provide collateral-free small loans to the poor farmers in the Patisher area of Naogaon district and the Shilaidaha estate of Kustia district of Bangladesh as a philanthropic activity (Nath, 2004). In the early 1960s, a famous civil service officer and social scientist Dr. Akhtar Hameed Khan practiced it in the Comilla district of Bangladesh, and founded the Pakistan Academy for Rural Development (now Bangladesh Academy for Rural Development - BARD). The initiative is known as the Comilla Model or the Comilla Approach within the literature of development studies.

During mid-1970s, Kazi Faruque Ahmed, the founder of Proshika started providing collateral-free credit integrating with other development programs to the rural poor in some parts of Bangladesh. Fazle Hossain Abed, the founder of BRAC also transformed its relief program into collateral-free credit for the poor (BRAC, 2009). These efforts were also informal, casual, unstructured and non-systemized. However, both development organizations eventually transformed their informal practices into a structured and systemized version of the lending process; this development stemmed from an action research project conducted in Zobra village by Muhammad Yunus, an academic in economics at the Chittagong University of Bangladesh, as a response to the intense poverty around him (Yunus and Jolis, 1998). As a result of this successful experiment, Muhammad Yunus was inspired to alleviate world poverty using his model, and he coined the term *microcredit*. He built the Grameen Bank in the early 1980s to implement his model across the country, and started spreading out the model throughout the world with the help of other activists, international donors and advocates including world political leaders. The present version of *microfinance* around the world is mostly the replication of that model.

## Methodology

The arguments and the conceptual model developed in this paper are based on a literature review of microfinance arena and a fieldwork for PhD study on microfinance. Author conducted a literature survey on the economic and social impacts of microfinance and developed arguments from the review on the pros and cons of conventional microfinance intervention. Besides literature review, author conducted field study in the working areas of six microfinance organizations namely ASA, BRAC, TMSS, UDDIPAN, DBS and SJK in Bangladesh. From a non-positivist epistemological stance, the study conducted semi-structured interview, focus group discussion (FGD), and participant observation with the staff members and borrowing community of these microfinance organizations. This conceptual paper has been written with the information and idea gathered from the part of the PhD fieldwork, and literature review conducted focusing the main thematic area of this paper.

## The Claimed Benefit and Drawback of Conventional Microfinance

Activists and the advocates of microfinance claim that this development program brings four major benefits to the society. They claim that - 1) it helps reduce poverty through generating self-employment, 2) it helps increase circulation of money within the rural community, 3) microfinance minimizes the influence of traditional local moneylenders who charge extreme interest rates and enjoy social domination, and 4) not least-microfinance improves social development and peace through empowering women within traditional male-dominated societies. In recognition of its contribution in bringing peace in the households and society the Nobel Peace Prize for 2006 was awarded to microfinance sector. However, no clear evidence yet exists that microfinance programs have positive impact on society (Armendariz de Aghion and Morduch, 2005; 2010). Some of the major reviews examining the impacts of microfinance such as Sebstad and Chen (1996), Gaile and Foster (1996), Goldberg (2005) and Odell (2010) concluded that advocates those who disseminate the inspiring stories about microfinance are based on anecdotal data and about the young cases. Rigorous quantitative evidence on the nature, magnitude and balance of microfinance impacts on a long-term perspective is still scarce and inconclusive. No well-known study robustly shows any strong positive impact of microfinance on a long-term perspective (Armendariz de Aghion and Morduch 2005, pp. 199-230).

Besides, a growing body of critics identifies the adverse implications of conventional microfinance interventions (Ahmad, 2002; Chavan and Ramakumar, 2002; Karim, 2008; Bateman, 2010). Critics of microfinance argue that it does not alleviate poverty; rather it creates and maintains poverty, and maintains the environment of deindustrialization with petty trade-based microenterprises. They argue that microfinance is hype and with no exception, it is neoliberalism where unaware needy people are targeted to make money. In a study on 50 communities across Tamil Nadu, it was found that 99% of the borrowers failed after 3 years and plunged into deeper poverty (Bateman, 2010). Basically, poorest people can do little with credit; those who can they do not need credit with very high interest rate. In the economic circumstances where the target people live, it would be

very difficult to find economic enterprises from where more than 30% interest could be paid back on capital. In most cases, the people are in poverty take credit and spend full or part of the credit for consumptions and repayment of other credits, and eventually become more vulnerable with vicious cycle of credits. Even in the Jobra village in Bangladesh where the conventional microfinance started, is still under trapped of deep poverty. Microfinance program is run with the expectation that the poor must be made of paying the full cost of credit supply, cost for inefficient operations, cost of loan losses, and even generating capital for Microfinance Institutions (MFIs) to expand the credit activities in new areas.

Almost all of the microfinance providing organizations create pressure on the frontline management and operational staffs for disbursing maximum amount of money for maximizing their profits. Because of this, microfinance becomes a supply-driven credit system where a strong tendency of overlapping and over-indebting loan disbursements with information asymmetry prevails in the borrowing community (Akerlof, 1970). In consequence, *adverse selection* and *moral hazard* create epidemic social and economic problems in the borrowing community. In many cases repayments prioritize over development in microfinance arena. Because of on-time realization (OTR) priority MFIs ignore poor households in disbursing loans and the poverty-outreach does not happen in this development program of poverty alleviation (Coleman, 2006). It is claimed that microfinance intervention empowers women in the borrowing households. However, antithesis is also there that microfinance intervention puts women borrowers in trap (Mayoux, 1998; Rahaman, 1999; Johnson, 2000; Littlefield et al., 2003; IFAD, 2009). In most cases credits are allocated to women but the users of the credits are husbands or other male members of the households. In that way women are in between credit providers and credit users with full liability of the credits. If the repayment cannot be made for any reason the women become in a vulnerable position rather than being empowered.

Basically, the present form of conventional microfinance started and spread out in country and abroad with the charismatic presentation of its advocates, strong national and international campaign with the support of world leaders, and the financial supports from international donor community for establishing MFIs. It was a hype that does

not bring positive impact for the community it covers. It may help economically marginalized households with some instant money at the beginning of being borrowers, but in a long term perspective it may bring several financial and social negative consequences for the households and community. The reasons for which the microfinance still exists are - 1) the providers (MFIs) can earn money depending on the operational performance, and 2) the receivers (borrowers) can get some collateral free instant money without thinking its negative financial and social consequences. In a long term perspectives, in almost all cases, the above discussed negative consequences arise with microfinance; and as discussed, this development program is not supportive in bringing persistent and equitable growth for the community it serves.

## An Equity-Based Approach of Development

Despite all the negative consequences of microfinance intervention, the microfinance organizations have strong networks with the economically and socially marginalized people at community level. Using this network and through developing capabilities of the organization, the targeted underdeveloped community members could be brought under a sustainable equity-based development framework that might help avoid the above stated economic and social adverse implications of conventional microfinance. For that the microfinance organization would form mid-size economic ventures at the local level with the involvement of the community members. Microfinance organizations would develop the capacity of conducting feasibility study, starting a mid-size economic venture which is feasible with the available resources and opportunities of specific area, and managing all primary and supporting value-chain activities of the economic venture. With the leadership of microfinance organization and active support from the equity shareholders of the local community, the economic ventures such as small to medium size industry, medium to large scale agriculture project, food processing, fisheries or livestock farm which is feasible in that area would be established.

In conventional microfinance intervention, a regular mandatory savings and an optional savings from borrowing members are imbedded. The interest rate on these savings

is very low in compare to the interest rate of corresponding credit. In case of Bangladesh the interest rate of savings is about 1/5 of the interest rate of corresponding credit. In most cases these savings are used for paying credit installments rather than using it for building capital of the borrowers or investing it to productive ventures. It is another way of exploiting unaware borrowers and to generate capital for the microfinance organizations to invest to the same borrowers with huge interest gap. In order to alleviate poverty in a sustainable way, microfinance organizations would form a capital with its own fund combining with the accumulated savings fund of the borrowing members of the community on the basis of equity.

Because of the only work of providing credits and collecting installments microfinance organizations did not build the capacity of forming and managing med-size economic ventures with the resources and opportunities of local community. In order to form and operate the equity-based economic ventures involving community members, the microfinance organization working at the community level would develop following capabilities.

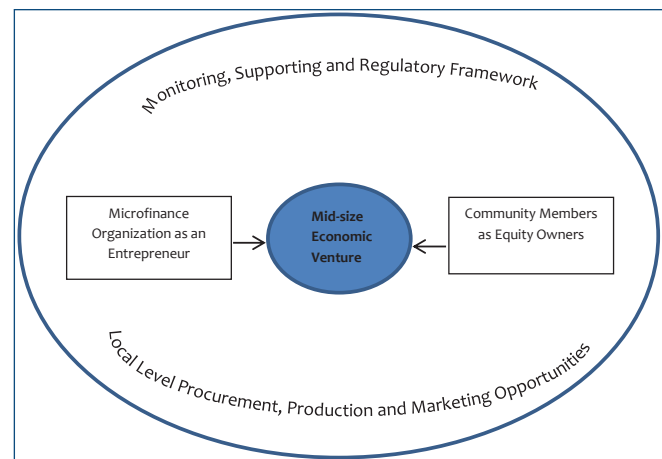
## Capabilities that Microfinance Organization Needs to Develop

*Skill for Conducting Feasibility Study:* In principle, before disbursing loan microfinance organization must do a feasibility study for the microenterprise on which the loan is sought. Although it is rare in practice, microfinance organizations are familiar with the process of feasibility study for microenterprises. For this proposed mid-size enterprise, much more rigorous feasibility study needs to be conducted before commencing the enterprise. In the feasibility study the microfinance organization would see the type of enterprise feasible with the participation of community members in that area, availability of raw materials, abilities of transforming the raw materials into finished products, possibilities of marketing and selling products, and the overall business prospect of that specific business in that area. The microfinance organization would acquire knowledge and skills on the methodology and conducting the feasibility study at the community level.

**Entrepreneurial Skill:** After conducting the feasibility study microfinance organization needs establish the feasible mid-size business venture involving the community members. For establishing and running the business venture the microfinance organization needs to develop entrepreneurial skills. It needs to develop skills for planning and managing long-term investment, and finding and managing people. It needs to have resilient and focused. It has to be self-reflecting and learning attitude to be a successful entrepreneur in a long-term perspective. Because of the involvement of the community members having low educational and awareness profiles the organization needs to have the skill to management them with positive and development attitude.

**Leadership:** In order to run the enterprises involving the community members, the organization needs to have leadership quality. From top to community level management most of the employees of microfinance organizations usually bear some sort of leadership qualities that are mostly related to financial management such as loan disbursement, recovery, managing people from financial perspective. They usually do not have the leadership quality for establishing and managing people and process of business ventures. The management of microfinance organization needs to develop the leadership quality beyond financial management. It needs to develop the quality for leading various challenging aspects of whole business venture such as establishing the business at community level involving local people, managing people in the organization and managing the total business process successfully.

**Value-Chain Management Skill:** In order to operate the whole business process of the venture successfully the organization needs to acquire the value-chain management skill. It needs to develop the skill of managing all *primary activities* such as inbound logistics, operations, outbound logistics, marketing and sales, services, and *support activities* such as procurement, technology, human resource management, and managing the infrastructure of the firm. The organization should be able to analyze every steps of value-chine of the business venture and perform all activities from beginning to end of the value-chine process involving physical, financial and supporting roles of the community members.



**Fig. 1: An Equity-based Development Model through Microfinance Network**

### Role and Rights of Community Members

Community members will own the venture, provide local support, may work in the organization for procurement, production, marketing and other activities as they are able to perform on a salary or wages basis, and after a certain period of time they would receive dividend as an equity shareholder of the business venture. In this model the organization and the involved community members would grow on the basis of proportionate equity of the business venture in a win-win arrangement. The economic venture would run under the management of microfinance organization with the engagement and support of local equity shareholders following a set rules and procedures. A strong regulatory authority from government would monitor, regulate and provide policy support to the venture so that it does not go beyond the set rules and most importantly ensure the rights and benefits of equity shareholders. The local level administration can also be involved for regular monitoring of specific indicators regarding activities of the venture and rights of the community members. The specific industry sector such as agriculture, food, poultry and livestock which is relevant to the venture would provide technical supports for the development of the economic venture so that it can continue with new innovation and can scale-up of the business venture for the benefits of community members and other stakeholders within the monitoring and regulatory framework.

## Expected Outcome

This approach of development is expected to be able to avoid most of the shortcomings of conventional microfinance stated above. Microfinance organization and the disadvantage community people can grow with equity breaking the barriers of African style microenterprise or petty-trade based economy. Combination of entrepreneur knowledge and skills of microfinance organization with the support and participation of local community may help increase the productivity-growth potentials and equitable development of the community. Women of economically and socially marginalized households would be able to come out from the borrowing trap between loan provider and loan user as discussed earlier. Because according to this model they would not be used to take loan from the loan providers. Women would also be involved with the business venture at community level, and can also be empowered with the economic benefits and social development in the journey with the community owned economic venture. With this movement the microfinance organization would gradually come out from the conventional microfinance intervention and the community people would continue their involvement with the economic ventures as equity shareholders, may be very small in size at the beginning. They would grow together with their organization on the basis of equity with the entrepreneurship and management proficiency of the organization, the support and participation of community people with an ownership feeling with the monitoring and regulatory framework of particular industry and government authority. With this development approach the local level tangible and intangible resources would be used in a better economic way contributing to the local and national level development. However, this conceptual model of development should go through a rigorous pilot study with the initiative of the microfinance regulatory authority or apex financing body in which the fine-tuning of the conceptual model would be possible before replication.

## Conclusion

In the long run the conventional microfinance is less potential for alleviating poverty. Rather, in most cases, it causes resource erosion, deeper poverty, over indebtedness

and consequently social destruction. Although some activities and advocates of microfinance try to promote the program with some success stories saying about economic growth and social empowerment but most of those cases are based on anecdotal data. Some of the cases that are seen as successes are mostly young cases or uplifted by factors functioning with the borrowing households which are not related to microfinance. With proficient financial and operation management microfinance organizations may increase their capital keeping the target community in poverty or in bonsai style surviving. Microfinance intervention may put woman of borrowing households in a borrowing trap in between the credit provider and credit user rather than empowering them in the household and society. The conventional microfinance does not offer growth with equity or productivity potentials of the community. Using the microfinance network, an equity-based approach using the synergy potentials of microfinance organization and local targeted community members may help break the cycle of poverty avoiding the borrowing trap of women and over indebtedness of the household, and go beyond the microenterprise level development thinking with the productivity and market potentials. A pilot study initiated by the microfinance regulatory authority or apex financing body may help fine-tuning of the conceptual model before replication.

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