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Irresponsible Financial Inclusion via Conventional Microfinance – A Lesson Islamic Microfinance Could Learn

On 11th November 2013, the World Bank has released a global financial development report on financial inclusion. Simply financial inclusion means the use of financial services by proportion of individuals and firms. The focus of this report is on how financial inclusion can significantly reduce poverty and boost shared prosperity. This report highlights that financial inclusion must be carefully designed as promotion of credit without careful monitoring would likely to result to crisis. This irresponsible financial inclusion due to overextension of credit to the poor has led to a number of crisis, for instance India's microfinance crisis in 2010 and Bosnia and Herezegovina's crisis in 2008 (World Bank, 2014). Though Islamic microfinance has yet to made its mark in such a report, it is timely for Islamic microfinance to ponder on lesson that could be learnt from such crises and assess its performance.

Commercialisation of microfinance institutions (MFIs) with excessive profit-orientation had been cited as the main cause for the problems in the conventional microfinance industry. The move to maximize profit drives unhealthy intense competition within the industry. This in effect causes interest rate to go up hence heavily burdening the poor borrowers (Lützenkirchen and Weistroffer, 2012: 5). Muhammad Yunus (2010) who founded the Grameen Bank in Bangladesh states in the New York Times that:

"Commercialization has been a terrible wrong turn for microfinance, and it indicates a worrying "mission drift" in the motivation of those lending to the poor. Poverty should be eradicated, not seen as a money-making opportunity."

The case of Banco Compartamos in Mexico and SKS in Andhra Pradesh, India are classic examples of the perilous effect of excessive profit-orientation. Even though Banco Compartamos succeeded in increasing its numbers of borrowers, its financial success raised serious concerns over its balance between its social and commercial objectives. For example, it lends small amounts at very high interest rates of up to 80% in nominal terms and even reaches to 130% effectively according to some estimates. One fourth of the interest income is retained as profit which allowed Compartamos to increase equity capital on average of 53% per year. When this company went public, it was revealed that a substantial transfer of wealth was taking place into the pocket of its shareholders (Lützenkirchen and Weistroffer, 2012: 6).

Andhra Pradesh is being one of the most saturated and competitive microfinance markets in the world. Over time and in order to strive in this type of market, the industry made a big shift in its approach – from a social mission to an aggressive commercialisation approach. Incentives for the microfinance staff were set accordingly. People from the top management to the loan officers were strongly incentivised to achieve fast growth and raise profits. As a result, its loan book expanded whereby an average debt outstanding per household was more than eight times higher than the national average, with 84% of households taking out more than two loans the median household four. At the heights of its boom and due to the mounting criticism, the government of India published a report listing names of 123 victims of private MFIs and investigated 76 cases where loan officers were blamed to have driven over indebted borrowers to suicide (Lützenkirchen and

Weistroffer, 2012: 10). According to Microfinance India: Social Performance Report 2011 (Desai et al, 2011: 9), there were 9 million households in Andha Pradesh on the defaulters list of the National Credit Bureau. In response, the government imposed strict regulations which led to temporary freeze of the market.

Lack of transparency is another major issue in the conventional micro financing industry as the past crises indicate that the nature of the loan contract was not fully explained to the borrowers. True cost of the loan facility is not disclosed to the client. Many MFIs explain to the borrower that they charge a mere 15% to 20% flat rate of interest per annum but in reality and common for MFIs to hide actual interest cost by various creative accounting practices (Mitra, 2009: 3). According to Microfinance India: Social Performance Report 2011 (Desai et al, 2011: 7), some MFIs burdened the borrowers with additional charges and compulsory bundled products in order to maximize their own profit at the expense of the poor clients.

In a report on Poverty Reduction by the United Nation Development Programme (2012: 6), it is reported that at times MFIs fail to meet its actual purpose due to the fact that the loans are misused for non-income generating purposes and that the receivers of the loans are not necessarily the users of the loans. It is often that once the loan is obtained by female members, who are responsible to repay the loan, the male members of the household would get their hands on those funds and utilised them on non-generating income activities. This would increase the pressure on these women who constantly being pressured by the MFIs to repay their loan instalments thus increasing the likelihoods of loan defaults leading the families into worst and despair situation.

The most serious issue in microfinance is that most of the time the poverty-stricken people are not qualified for microfinance programme. The reason is that they are considered too risky to be provided with the financing. As a result, the low interest rates scheme then attracts the non-poor borrowers to such credit due to the greater socio-economic and political power. The Special Agriculture Credit Programme in Bangladesh is one of many examples. Under this programme, loans were channelled to the rural elites by the conventional banks. However due to the influence from politicians and influential figures on the selection of beneficiaries, those who are in need most are not chosen. To exacerbate the situation, the chosen poor were requested to provide collateral when requirement for collateral already being specifically waived (United Nation Development Programme, 2012: 8).

The Microfinance India: Social Performance Report 2011 (Desai et al, 2011: 3) states that:

"In order to successfully serve the very poor they need to be explicitly targeted in most cases and assisted with products and services specifically tailored to their needs."

Hence the question now is whether Islamic microfinance is designed to actually reduce poverty and assist the poor with products and services tailored to their needs – responsible financial inclusion? From the examples given below, it appears that Islamic microfinance has been offering products to cater the actual needs of their poor customers. For example in helping the farmers in the Sri Lanka, the Muslim Aid (MA) offers a bai salam and mudharabah provision of finance to the farmers. First under the concept of bai-salam the farmers are provided with funds in advance against a forward sale of their produce at the time of harvest. The funds were used to purchase the necessary inputs for their paddy cultivation. No collateral was required and the farmers just need to obtain a set of recommendations from the local mosque and community leaders who acted as guarantors. The second stage began at harvest where the paddy is ready to be delivered to MA. However due to the mudharabah agreement between MA and local millers, the local millers would take possession of the harvested paddy from the farmers, process it and sell the final product at the market with the profit being shared between MA and the miller(s). It is expected that the profit share of MA would cover the administration cost of the financing. As seen in this model Islamic microfinance encourages economic empowerment of the poor through entrepreneurship (Obaidullah and Saleem, n.d).

Another example where Islamic microfinance encourages poor to participate in economic activities is the case of Sanaduq project in Syria. This project is funded by IFAD's Idled Rural Development Project. In order to improve incomes of the farmers and women living

in the poorest villages, the project created a microfinance programme through “sanadiq” where the credit is channelled through local microfinance institutions. Sanadiq offers murabahah financing whereby instead of disbursing the facility to the customer, Sanadiq pays for the product the customer wishes to purchase and thereafter the customer pays back in instalment the amount of financing including the agreed profit. Profit rates are 12% per year for annual payments and 9% per year for monthly payment. Besides providing financing facility, Sanadiq also provides training so that members have the skills needed to improve their state of income and living (International Fund for Agricultural Development, 2012).

Farz Foundation in Pakistan assists the poor and destitute by providing them with productive zakat (donation) and Qarad- ah Hassan (interest free loan). The institutions assist by providing them with the basic training and necessary market linkages needed to start the business. Once the poor are able to carry out the business independently the institutions then assist by providing murabahah and other Shariah-compliant facilities to keep the business going (Farz Foundation, 2010: 8). Finally the business model “ Ahkuwat” in Lahore Gymkhana, Pakistan is another exemplary case of application of Qarad-al-hassan in helping the extreme poor. The objective of the model is to establish partnership between less privileged people in the society and richer segment of the society. This business model relies on the donation from the better-off in the society. Instead of charging excessive interest in case of default the business, Ahkuwat encourages clients to pay using normative pressure connected with religion where Islamic scholars train the members on the importance of paying debt and being honest to one another. The success of Ahkuwat is due to the four core principles which are interest free loans, use of religious places, spirit of volunteerism and transforming borrowers into donors. It is shown in their website that the first loan of ten thousand rupees was given to a widow who then utilized and repaid within six months. The success of this first loan brought in more donations and instilled confidence on interest-free loan model amongst the local people (Munir: 2012).

Though Islamic microfinance products have their own limitations nonetheless the examples given above testify that their financial products are more responsible in their financial inclusion as compared to their conventional counterpart.

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