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Leveraging the Advantages of Microfinance to Achieve Sustainability

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ABSTRACT

Microfinance plays a pivotal role in promoting economic growth in low-income communities and developing countries. It does so by providing financing for individuals that do not qualify for traditional bank loans. However, microfinance has advantages and disadvantages which require careful consideration. This paper analyzes the success of microcredit programs in Ghana, Romania, and Malaysia, as well as the shortcomings in Nepal. Finally, this paper suggests how the application of a community-centered approach in offering microloans to impoverished communities promotes sustainability in developing countries.

Keywords: Microfinance, Sustainability

1. INTRODUCTION

Microfinance is financial services typically offered for those ineligible or excluded from traditional banking services, and most often consist of offering credit in the form of small working capital loans [1]. While some form of microfinance has existed for centuries, similar financial strategies have rapidly gained popularity over the last 50 years [2]. An early example of microfinance is the utilization of a Rotating Credit and Savings Association (ROSCA). ROSCAs are groups comprised of community members who cannot acquire traditional loans or do not have access to a bank. They collectively pool their savings and loan the sum to one of the members. That member repays the loan at which point it is lent to another member of the ROSCA [3]. In 1960, 15 countries aimed to meet the need for similar microloans and established the International Development Association (IDA), whose primary goal was to reduce poverty by providing financial resources to impoverished communities [4]. This resulted in the establishment of international microfinance programs, which provide small loans to people who may not qualify for traditional bank loans. Such loans help recipients increase productivity, expand their business, get out of poverty, and ultimately achieve self-sufficiency [5].

Research shows that microfinancing promotes entrepreneurship among marginalized communities [6] by increasing their ability to generate income [7], by improving social capital among vulnerable communities, and by providing access to healthcare and education [8]. However, despite the impressive growth of microfinance strategies, its ability to successfully empower low-income communities appears to be relatively limited [9]. This paper analyzes the advantages and disadvantages of microfinance and how developing countries use microfinance to promote the sustainable growth of microcredit in their communities.

2. ADVANTAGES AND DISADVANTAGES OF MICROFINANCE

There are an estimated 1.3 billion people worldwide living in extreme poverty [10]. Many international microfinance institutions (MFIs) aim to significantly reduce this number by serving as a financial building block for small businesses. Most of these institutions have developed a microcredit scheme to address their clients' diverse financial profiles. For example, rather than imposing standardized structures and universal lending strategies like collateral, many microfinance institutions offer microloans with different repayment options. Microfinance lenders today recognize the importance of market research and demonstrations of sustainability before introducing financial services in an effort to meet the evolving needs of the client [11].

One of the chief advantages of microfinance is that it promotes community empowerment by providing credit to those who do not have access to banks or cannot acquire traditional loans. The risks associated with providing traditional loans to communities who have difficulty securing their loans with collateral often deter banking institutions from offering financial support. This is especially felt in rural communities and developing countries that experience riskier economic environments and greater seasonal economic fluctuations. Limited access to these traditional financial services has serious implications on the ability of disadvantaged families to improve their livelihoods. Thus, policymakers regard microfinance as a tool to empower families and to reduce socio-economic vulnerabilities. MFIs seek to support these low-income or marginalized clients by providing microloans and education about a diverse range of money management strategies. Utilizing microfinance as a tool for reducing poverty, MFIs aim to improve economic returns, expand productivity, and promote entrepreneurial activities [12]. Thus, a major advantage of implementing microeconomic programs in developing countries is that such access to credit helps families generate income and improve their standard of living [13].

Beyond offering access to loans, another advantage of microcredit is that it provides a repayment scheme that is better suited for these borrowers. For example, many MFIs offer a group lending scheme, which is an effective system of funneling credit to disadvantaged families that need financial support to expand income-generating activities. Borrowers are required to guarantee loan repayment as a group and are offered short-term loans and weekly payment installments that start immediately after loan disbursement. This repayment scheme helps families that are stuck in a cycle of poverty and struggle to allocate resources.

Many MFIs offer products designed to meet their clients' unique needs. For example, a microfinance business offering its financial services to agricultural communities may find it necessary to adjust the loan repayment terms. Financial liquidity constraints, seasonal fluctuations, and unexpected natural disasters can prevent low-income households in rural areas from achieving efficiency and success in their production. Differentiated financial services are needed to help these communities, and this encouraged MFIs to develop innovative products and services adapted to regional characteristics. Not only does this give low-income agricultural households access to necessary financial resources, but it also provides tools for them to develop financial management strategies and improve their agricultural skills. This external support and guidance help to increase productivity and fosters successful long-term business management practices.

In order to increase repayment assurance, microfinance institutions offer a 'stepped loan' scheme where MFIs initially offer small loans that are repayable for a short period. Borrowers with perfect repayment records have higher chances of obtaining larger loans in the future. Furthermore, MFIs developed a system that offers credit based on the examination of non-traditional factors. For example, they may offer higher loan amounts depending on their assessment of the family's entire income. In recent years, microfinance institutions have diversified their services to include saving innovations and staff deployment for an efficient collection of payments and savings. Microfinance bridges the gap between formal banking institutions and the low-income community by providing effective intermediary mechanisms. Although microfinancing strategies may have had limited success in many developing countries, public perception of MFIs has greatly improved due to their implementation of practical tools and varying payment schemes. While the rise of the popularity of microfinance institutions is attributed to the belief that MFIs help to alleviate poverty, some critics reveal that microcredit systems have failed to deliver what they promised and create more problems than they solve [7].

One of the disadvantages of microfinance is that when poorly administered, it can result in borrowers accumulating more debt rather than relieving it. This claim is validated in the research conducted in Bangladesh by Banerjee and Jackson and identifies three main reasons for the borrowers' failure to pay back their loans [7]. First, a large part of the loan was used for consumption rather than for income generation. According to Banerjee and Jackson, an examination of their sample reveals that only 9% of the loans were invested in business, 35% were used to support agricultural activities, and the rest of the funds were used for other purposes [7].

The second reason for microfinance borrowers' inability to repay their loans is a lack of management skills [14]. Poor financial management skills led to increased debt, which highlights the importance of developing financial management skills before providing financial support. Microfinance institutions that worked with rural communities found that most people live around the poverty line and thus were unable to properly manage their finances after illnesses and other unforeseen circumstances [15]. The additional financial strain on their limited resources during these adverse events caused them to default on their loan, increased their indebtedness, and drove these families further into poverty.

The third factor that contributed to the failure to repay their loans is that borrowers took out multiple loans. The increase of microfinance providers resulted in the establishment of similar institutions within a community. Thus, more institutions work with the same clients in a limited area. Banerjee & Jackson found that the borrowers took out additional loans to repay previous loans [7]. This allowed borrowers to show they were in positive financial standings when, in fact, they were trapped in spiraling levels of debt. This trend had a negative implication on the social and economic standing of the family. For example, Hammil pointed out that low-income families went through the day deprived of nourishment in order to pay back their loans [16]. The entrepreneur likely focused more on the repayment of loans rather than focusing their efforts toward business innovation and expansion.

Another disadvantage of microfinance is the lack of flexibility in the terms of paying the loan. The borrowers are often required to pay on a weekly basis, which is considered favorable as it allows them to repay their loan in smaller amounts stretched over a specific period. However, this can worsen their financial situation when an unexpected turn of events negatively impacts the borrower's already inadequate financial resources. This requires an examination of the requisite structures to address the current problems faced by microfinance institutions and their borrowers.

3. SUCCESS OF MICROFINANCE

3.1 Microfinance in Ghana

In some countries, microfinance providers adopted measures that significantly improved the accessibility of these institutions and their programs in rural communities. According to the United Nations Development Programme (UNDP) Human Development Report, the last decade proved to be a financially transformative period for Ghana [17]. This success is attributed to the political support of microfinance programs in Ghana. In 2006, the government approved a US$50 million Micro-Credit and Small Loans Scheme to give families collateral-free loans ranging from US$100 to US$2,000 [18]. These microcredit programs were developed in partnership with other organizations, such as Freedom from Hunger and the Lower Pra Rural Bank. Several non-government organizations also provided technical assistance and helped subsidize funds provided by external lenders. Furthermore, MFIs established programs that provided women with small loans to support income-generating activities [18]. The accessibility of microcredit among women in Ghana provides increasing autonomy and independence, positively impacting their children and families.

A study of the success factors of MFIs in Ghana also highlights the importance of a high level of core competency in supporting microcredit operations [19]. An example of these core competencies is strong governance, where management is comprised of qualified senior professionals who share their extensive knowledge and experience in financial services. This is exemplified by Advans Ghana, one of the leading microfinance programs in the country, which shares its vision of strengthening businesses in communities by offering financial services to members who lack access to the traditional banking system [20].

Implementing marketing strategies also contributed to the success of microcredit in Ghana. The marketing strategy includes portfolio planning, seeking regular feedback from clients, active trade fair participation, analysis of competitors' activities, and customer categorization [19]. For example, Advans Ghana's marketing strategy focuses on putting clients at the center of its operation. According to the institution's annual report, it believed in responding to its target clients' changing needs to improve their financial integration. The success of microfinance in Ghana is associated with the institution's ability to understand their clients and develop products and services based on their needs. This paved the way for the innovation and diversification of services which improved the client experience at all levels.

3.2 Microfinance in Romania

Microfinance programs were established in Romania in 1992 when the first International Microfinance Institutions programs were launched [21]. Data taken from the 2014 Romanian National Statistics reveals that about 5.5 million people in the country were suffering from poverty [22]. A comparative study from 2016 to 2018 shows that the Romanian microfinance sector saw a 73% growth in its active portfolios and a 22% increase in its active clients [21]. This growth is attributed to the increased availability of financial resources, the improvement of revenue-generating activities due to social investments, and microfinance programs funded by the European Union (EU). An evaluation of the microfinance clientele in Romania during this period shows that over three million small firms, farms, and other small household enterprises are using microfinance services [22].

A critical factor in the success of microfinance programs in Romania is the support provided by the European Investment Fund (EIF). Under the EU's Capacity Building Investments Window, the EIF has helped increase microfinance institutions' financial capacity to deliver microfinance loans to small businesses in Romania. For example, Patria Credit, the largest non-banking microfinance institution in Romania, receives funding to support its growing portfolio. This allows Patria Credit to target vulnerable clients who are otherwise excluded from the traditional financial sector. Another factor that differentiates microfinance in Romania is its partnership with external agencies and institutions. As a prominent name among small business enterprises in rural communities, Patria Credit partnered with other institutions to promote its credit programs and technical assistance projects. The collaboration with other organizations enabled Patria Credit to successfully promote its programs to unbanked clients in rural areas. The establishment of these microfinance programs helps to develop projects which target the unique needs of the client groups within a specific community, especially those excluded from the formal banking sector. As a result, the Romanian microfinance sector recorded an 87% increase in loan disbursements from 2016 to 2018 [21]. This further suggests that microfinance products specifically tailored for the needs of a given region aid microfinance institutions in providing financial sustainability through increased inclusion.

3.3 Microfinance in Malaysia

Since the establishment of microfinance in Malaysia in 1987, microfinance programs have evolved into government-driven programs which facilitate the accessibility of financial services for micro-entrepreneurs [23]. One of these services involve allocating different micro-credit schemes which allow small business owners to access loan programs that fit their needs. Since poverty was more prevalent in rural communities, the Malaysian government focused on implementing poverty alleviating programs in the agricultural sector [24].

In a similar manner as Ghana and Romania, the supportive national policy framework in Malaysia was essential to the management and distribution of microcredit to low-income families. This governmental support helped to foster the success of the microfinance industry in Malaysia. For example, Amana Ikhtiar Malaysia (AIM), one of the most popular microfinance institutions in the country, receives significant government support. This micro-lending institution generates the funds for its operational cost from state and federal governments as well as its borrowers and the private sector.

In addition to government support, client targeting strategies contribute to the efficacy of microfinance programs in Malaysia. For example, AIM adopted a specialized method of testing and identifying eligible borrowers, which ensures that they cater mainly to clients who both need the service and can pay back their loans. Implementing a specialized delivery system also provides members of the low-income community with easier access to credit programs. Some of these factors include analyzing the suitability of loan conditions, making credit accessible to the impoverished, adopting simple procedures, and forming groups among potential members. Furthermore, AIM exemplifies a microfinance institution that has rigorously trained its staff which ensures the quality of its services.

4. COMPARING SUCCESSFUL CASES WITH NEPAL

The success factors common among the case studies in Ghana, Romania, and Malaysia include a supportive national government, careful marketing strategy, and strategic targeting of the clientele.

The additional support from the national government in these countries helped to develop a national framework that strengthened the microfinance institutions and their programs. The marketing strategies helped these institutions achieve their goals of ensuring that low-income families have access to financial services. Client targeting strategies contributed to the effectiveness of microfinance programs by explicitly targeting the impoverished and creating services that cater to their needs as borrowers. The successful practices of microfinance in Ghana, Romania, and Malaysia underscore the importance of these common factors and provides insight into how other developing countries can implement these strategies.

4.1 The Case of Nepal

While microfinance has shown to be an effective means to lessen poverty by advancing loans to low-income communities, an investigative examination of microfinance in Nepal reveals significant obstacles in promoting microcredit and savings programs to the impoverished. These obstacles include unhealthy competition, lack of accessibility, and lack of political awareness of the sustainable role of microfinance in alleviating poverty [1].

In Nepal, microfinance was recognized as a means of poverty alleviation since the Sixth National Plan (1980/81 - 1984/85), and gained momentum during the restoration of democracy in the 1990s and early 2000s [1]. During this period, the government helped the formation of five Regional Development Banks (RDBs) based of Grameen model to make microcredit programs accessible to women and impoverished communities, and these banks became later Microfinance Development Banks (MFDBs). Also, some NGOs which were licensed by Nepal Rastra Bank (NRB) formed Financial Intermediary NGOs (FINGOs). However, microfinance's institutional sustainability in Nepal suffered due to a lack of continued government support and political awareness of MFIs. The government put little effort toward developing basic infrastructure in mountainous rural areas where most marginalized people live and where the improvement of the local economy was urgently needed. Most politicians also did not understand the need for sustainable MFIs and considered them to be a form of charity [1]. Furthermore, microfinance institutions in Nepal did not utilize proper marketing strategies, making it difficult to raise awareness of their services to low-income communities. These inefficient marketing strategies are associated with inadequate business-related knowledge, thereby preventing these institutions from developing sound policies to efficiently deliver their services. This resulted in the exclusion of vulnerable groups from microfinance programs such as those who migrate from rural areas to urban areas for seasonal employment, marginalized castes and refugees from natural disasters.

5. CONCLUSION

Microfinance has been a crucial component for improving low-income communities' economic circumstances in developing countries. Some of the constraints that preclude the success of microfinance are the lack of accessibility, poor implementation of marketing practices, and other inefficiencies of microfinance programs. However, countries that had a supportive national government, properly aligned marketing strategies, and correct targeting of its client base were able to capitalize on the advantages of microfinance and its related programs in the community. A comparative study of successful cases in Ghana, Romania and Malaysia with the unsuccessful practices in Nepal reveals that coordination between microfinance institutions and the respective government is an essential factor for success. The state government also plays a significant role in promoting MFI programs, creating and sourcing funds, and delivering financial products and services to rural communities. Microfinance institutions in developing countries can therefore benefit by examining factors that mediated success in other countries and integrating those elements into their systems.

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