IS MICRO FINANCE A PROFIT MAXIMISING INDUSTRY OR A SOCIAL BUSINESS – SOME EVIDENCES FROM RECENT LITERATURE SURVEY

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ABSTRACT

Microfinance (MF) is a considered as a powerful tool for poverty alleviation . It implies provision of financial services to poor and low-income people whose low economic standing excludes them from formal financial systems. From industry point of view also, access to financial services by the poor and the deprived is highly important for the success of market based and poverty alleviation programs. Access to services such as, credit, venture capital, savings, insurance, remittance is provided on a micro-scale enabling participation of those with severely limited financial means. The poor and needy household with no access to financial services, find it extremely difficult to take advantage of economic opportunities, build assets, finance their children's education, and protect themselves against financial requirements and shocks thereby caught into a vicious circle of poverty. Building inclusive financial systems therefore, should be a central goal of policy makers and planners across the globe. In this regard, microfinance has been recognized worldwide as an important policy instrument. This is not the end of the problem. The unorganized and the informal sector is taking due advantage and minting money through high levels of lending rates in the name of poverty elevation, women upliftment and empowerment. In this paper an attempt has been made to study whether microfinance is able to realize the true potential of its clients through social intermediation and ensure in building an inclusive society and eradication of poverty and working with a social cause.

Keywords : Inclusive Financial System, Informal Sector, Poverty Elevation

INTRODUCTION:

The microfinance should not be made as a huge money minting industry at the cost of poor and the help-less. The microfinance business can act as a 'miracle cure' for poverty and ensure smooth of economy.Microfinance is more of a social business rather than a profit maximizing business. It is all about others, all about people, for a social cause, for a social benefit. If this concept is inserted into the economic theory, it becomes social business.The typical microfinance clients are low-income persons who do not have access to formal financial institutions. Microfinance (MF) is a considered as a powerful tool for poverty alleviation . It implies provision of financial services to poor and low-income people whose low economic standing excludes them from formal financial systems.

The availability and access to financial services by the poor and the deprived is highly important for the success of market based and sustainable poverty alleviation programs. Access to services such as, credit, venture capital, savings, insurance, remittance is provided on a micro-scale enabling participation of those with severely limited financial means. This would help the poor to increase household income and economic security, build assets and reduce vulnerability; creates demand for other goods and services (especially nutrition, education, and health care); and stimulates local economies. A large number of studies on poverty reduction reveal that exclusion of the poor from the financial system is a major factor contributing to their inability to participate in the development process. In a typical developing economy the formal financial system serves no more than twenty to thirty percent of the population. The remaining seventy to eighty percent are those who are excluded. This majority are poor living below poverty line. With no access to financial services, these households find it extremely difficult to take advantage of economic opportunities, build assets, finance their children's education, and protect themselves against financial requirements and shocks thereby caught into a vicious circle of poverty. Building inclusive financial systems therefore, is a central goal of policy makers and planners across the globe. In this regard, microfinance has been recognized worldwide as an important policy instrument.

The typical microfinance clients are low-income persons who do not have access to formal financial institutions. Microfinance (MF) is a powerful poverty alleviation tool. It implies provision of financial services to poor and low-income people whose low economic standing excludes them from formal financial systems. Therefore, there is a tendency among development thinkers and practioners to gauge the impact of MFIs purely in monetary terms, i.e. eradication of income poverty.

This is not only a partial view of the potential and purpose of microfinance but also a cause of unbridled growth of MFIs. MFIs have the capacity and responsibility of empower the most vulnerable, such as women, rural artisans etc; to allow the not-yet-economically-active to become so; and to create community-based structures that build mutual support and trust. MFIs have the advantage of combining the good features of both formal and informal credit, even improving productivity and credit-worthiness through the ethics of repayment.

The condition of farmers in India and the scenario of suicides need to be examined in this context. Most conventional microfinance providers charge rates of interest that are found to be high when benchmarked against mainstream banking rates. Several reasons are usually given in defense. First, returns on investment in micro-enterprise are very high, by the standards of banks and other investors – the reason being the miniscule size of investments compared to the earnings numbers. Hence, entrepreneurs can "afford" to pay high interest rates as cost of funds (sometimes as high as sixty-seventy percent) as long as the same are lower than rates of return. And that interest rates are much less important to micro-enterprises than access, timeliness and flexibility. Second, interest rates on microfinance are pegged relatively higher, since they entail higher administrative charges, monitoring costs and are by definition, riskier than a traditional financing portfolio. (Obaidullah Mohammed and Khan Tariqullah, 2008). For microfinance, therefore there is ethical and economic justification for looking beyond income poverty or to move from financial intermediation to social intermediation. So today we not only need to introduce new products or services in the field of microfinance but also explore new frontiers of development towards social and economic cause. This results in human development in terms of infrastructure for health, education, skill and enterprise.

MFIS AND MICROFINANCE MODELS:

Microfinance institutions thus have distinct features that make them specialized components of the formal financial system. The basic point identified for departure of microfinance from mainstream financial systems is its alternative approach to collateral that comes from the concept of joint liability. In this concept individuals together form small groups and apply for financing. Members of these small groups are trained in the basic elements of the financing and the requirements they need to comply with in order to continue to have access to funding. Funds are disbursed to individuals within the group after they are approved by other members in the group. Repayment of the financing is a shared responsibility of all of the group members. In other words they share the risk. If one member is a defaulter, , the entire group members bear the risk. In most cases, microfinance programs are structured to give credit in small amounts and require repayment at weekly intervals and within a short time period– usually a month or a few months. The beneficiary looks forward to repetitive financing in a graduated manner and this also helps them mitigate risk of default.

Grameen Bank model: This model requires careful targeting of the poor through means of tests comprising mostly of women group. The model works on intensive fieldwork by staff to motivate and supervise the borrower groups. Groups normally consist of five members, who guarantee each other's loans. A number of variants of the model exist; but the key feature of the model is group-based and graduated financing that substitutes collateral as a tool to mitigate default and delinquency risk.

Village Bank model: A second model that has been widely replicated mainly in Latin America and Africa, but with substantially less total outreach than the many Grameen Bank replications is the Village Bank model. This model involves an implementing agency that establishes individual village banks with about thirty to fifty members and provides "external" capital for onward financing to individual members. Individual loans are repaid at weekly intervals over four months, at which time the village bank returns the principal with interest/ profits to the implementing agency. A bank repaying in full is eligible for subsequent loans, with loan sizes linked to the performance of village bank members in accumulating savings. Peer pressure operates to maintain full repayment, thus assuring further injections of capital, and also encourages savings. Savings accumulated in a village bank is also be used for financing. As a village bank accumulates sufficient capital internally, it graduates to become an autonomous and self-sustaining institution (typically over a three year time period).

Credit Union (CU): The third type of MF model is a Credit Union (CU). A CU is based on the concept of mutuality. It is in the nature of non-profit financial cooperative owned and controlled by its members. CUs, mobilize savings, provide loans for productive and provident purposes and have memberships which are generally based on some common bond. CUs generally relate to an apex body that promotes primary credit unions and provides training while monitoring their financial performance. CUs are quite popular in Asia, mostly in Sri Lanka.

Self-Help Groups (SHGs): A fourth model originated in India is based on Self-Help Groups (SHGs). Each SHG is formed with about ten-fifteen members who are relatively homogeneous in terms of income. An SHG essentially pools together its members' savings and uses it for lending. SHGs also seek external funding to supplement internal resources. The terms and conditions of loans differ among SHGs, depending on the democratic decisions of members. Typical SHGs are promoted and supported by NGOs, but the objective for them is for to become self-sustaining institutions. Some NGOs act as financial intermediaries for SHGs, while others act solely as 'social' intermediaries seeking to facilitate linkages of

SHGs with either licensed financial institutions or other funding agencies. The SHG model is a good platform for combining microfinance with other developmental activities.

Conventional microfinance over the years has witnessed a paradigm shift – from the traditional donor-based approach to a for-profits approach in building inclusive financial systems. The basic assumption is that the demand for these services is simply too high to be fulfilled by government and donor funds on a sustained basis. The excess demand will, need to be met by commercial capital available at a "fair" market price. The focus therefore, has sharply shifted from charity to profits. Of all the models discussed above, the Grameen model and the village bank model are the more structured than the rest. Indeed the Grameen model has now become the text-book model of microfinance.

KEY PRINCIPLES OF MICROFINANCE:

A major initiative towards achieving the Millennium Development Goals (MDGs) is formation of the Consultative Group to Assist the Poor (CGAP), a multi-donor consortium dedicated to advancing microfinance. It is a consortium of 31 public and private development agencies working together to expand access to financial services for the poor, referred to as microfinance. CGAP forsee a world in which poor people everywhere enjoy permanent access to a range of financial services that are delivered by different financial service providers through a variety of convenient delivery channels. It is a world where poor and low-income people in developing countries are not viewed as marginal but, rather, as central and legitimate clients of their countries' financial systems. In other words, this vision is about inclusive financial systems, which are the only way to reach large numbers of poor and low- income people. To realize this vision, CGAP has come up with eleven key principles of MF based on decade-long consultations with its members and stakeholders. These are as follows:

1. Poor people need a variety of financial services, not just loans. In addition to credit, they want savings, insurance, and money transfer services.
2. Microfinance is a powerful tool to fight poverty. Poor households use financial services to raise income, build their assets, and cushion themselves against external shocks.
3. Microfinance means building financial systems that serve the poor.
4. Microfinance will reach its full potential only if it is integrated into a country's mainstream financial system.
5. Microfinance can pay for itself, and must do so if it is to reach very large numbers of poor people. Unless microfinance providers charge enough to cover their costs, they will always be limited by the scarce and uncertain supply of subsidies from governments and donors.
6. Microfinance is about building permanent local financial institutions that can attract domestic deposits, recycle them into loans, and provide other financial services.
7. Microcredit is not always the answer. Other kinds of support may work better for people who are so destitute that they are without income or means of repayment.
8. Interest rate ceilings hurt poor people by making it harder for them to get credit. Making many small loans costs more than making a few large ones. Interest rate ceilings prevent microfinance institutions from covering their costs, and thereby choke off the supply of credit for poor people.
9. The job of government is to enable financial services, not to provide them directly. Governments can almost never do a good job of lending, but they can set a supporting policy environment.
10. Donor funds should complement private capital, not compete with it. Donor subsides should be temporary start-up support designed to get an institution to the point where it can tap private funding sources, such as deposits. The key bottleneck is the shortage of strong institutions and managers. Donors should focus their support on building capacity.
11. Microfinance works best when it measures—and discloses—its performance. Reporting not only helps stakeholders judge costs and benefits, but it also improves performance.

MFIs need to produce accurate and comparable reporting on financial performance (e.g., loan repayment and cost recovery) as well as social performance (e.g., number and poverty level of clients being served). To sum up, the principles broaden the definition of MF from micro-credit to provision of an array of financial services, such as, savings, insurance and remittance. They emphasize that access to MF and not cost of MF should be under focus in designing and implementing a poverty alleviation strategy. The strategy should aim at sustainability through a shift from a charity-based donor-dependent approach to a market-based for-profits approach emphasizing systemic efficiency and transparency and restricting use of donor funds to capacity building. The principles also underscore inclusiveness and integration of MF with the formal financial system.

INCLUSIVENESS AND MICROFINANCE:

Even while the principles reflect a consensus, they do not imply or advocate a single and uniform approach to microfinance. As CGAP emphasizes, "diverse approaches are needed—a one-size-fits-all solution will not work. Diverse channels are needed to get diverse financial services into the hands of a diverse range of people who are currently excluded. Making this vision a reality entails breaking down the walls—real and imaginary—that currently separate microfinance from the much broader world of financial systems." (Brigit Helms,2006)

Microfinance and Islamic finance have much in common. Islam emphasizes ethical, moral, social, and religious factors to promote equality and fairness for the good of society as a whole. Principles encouraging risk sharing, individual rights and duties, property rights, and the sanctity of contracts are all part of the Islamic code underlying the financial system. In this light, many elements of microfinance are consistent with the broader goals of Islamic finance. Both advocate entrepreneurship and risk sharing and believe that the poor should take part in such activities. Both focus on developmental and social goals. Both advocate financial inclusion, entrepreneurship and risk-sharing through partnership finance. Both involve participation by the poor. (Rahul Dhumale and Amela Sapcanin, 2006)

MDGS, POVERTY ALLEVIATION AND MFIS:

The Millennium Development Goals (MDGs) are eight goals to be achieved by 2015 that respond to the world's main development challenges. The MDGs are drawn from the actions and targets contained in the Millennium Declaration that was adopted by 189 nations-and signed by 147 heads of state and governments during UN Millennium Summit in September 2000.

- Eradicate extreme poverty and hunger: Halve, between 1990 and 2015, the proportion of people whose income is less than one dollar a day; Halve, between 1990 and 2015, the proportion of people who suffer from hunger
- Achieve universal primary education
- Promote gender equality and empower women
- Reduce child mortality
- Improve maternal health
- Combat HIV/AIDS, malaria and other diseases
- Ensure environmental sustainability
- Develop a Global Partnership for Development

For achieving these goals, the United Nations General Assembly adopted 2005 as the International Year of Microcredit to "address the constraints that exclude people from full participation in the financial sector." At the World Summit at the United Nations in September 2005, Heads of State and Government recognized "the need for access to financial services, in particular for the poor, including through microfinance and microcredit."

Microfinance institutions (MFIs) have turned the business of lending tiny amounts to the unbanked poor—from vegetable vendors and tailors in the cities to fishermen and farmers in the villages—into a thriving industry with assets estimated at almost Rs. 12,000 crore in fiscal 2009 according to a study. But MFIs have been targeted by critics for alleged profiteering at the expense of the poor by charging interest rates as high as 24-36%.

Criticism of microlending practices and the high interest rates they charge on loans to the poor has been accompanied by calls for stricter regulation of MFIs. There have been concerns that MFIs could find themselves laden with defaults because of the risk that multiple institutions may have lent to the same borrowers.There were three major allegations against the MFIs that came up during the crisis: (i) MFIs are charging exorbitant rates of interest. Not only that MFIs charge absolutely high interest rate upwards twenty percent; (ii) MFIs are resorting to unethical ways of recovering loans by confiscating title deeds, using intimidation and abusive language, and combining multiple products like savings, insurance and loan to ensure prompt recovery; and (iii) MFIs are aggressively poaching from government and banks to capture their borrowers. They are luring the members of government supported SHGs by liberally financing them, leading to multiple financing (Shylendra, 2006)

It is argued that MFIs are causing a huge burden on the poor, leading to a vicious cycle of debt, poverty and even deaths [Kumar 2006]. Though there is no clear evidence to prove these allegations against the MFIs in AP; there is however some evidence from studies carried out at other places, which indicate that these allegations are to some extent true about MFIs in general [Hulme 2000; Mitra 2005; Rhyne 2001; Sinha and Matin1998].

The profitability of microfinance is driving a new wave of investment into the sector. Three deals alone in the past year would cause the size of the microfinance capital markets to increase substantially. Deutsche Bank announced the formation of its Global Commercial Microfinance Consortium, a $75 million fund that brings together over 25 institutional investors with an interest in microfinance.(Deutsche Bank, 2005).

The global recession which started in 2008 after the sub-prime crisis and the unprecedented default or rescue of many financial institutions has strongly affected the credibility of the international banking system, damaging also the real economy. Due to this joint crisis, the credit crunch is severely affecting the economy in Western globalized countries. Developing countries, not fully integrated with international markets, seem less affected and local microfinance institutions might also allow for a further shelter against recession, even if foreign support to donor driven NGOs or not fully independent microfinance banks is slowing down and collection of international capital is harder and more expensive. (Moro Visconti, Roberto,2008) .

Many failed MF programs owe their failure to inadequate evaluation of the client's financial condition. Provision of micro finance does not stand to reason for a person in need of social safety nets resulting in the funds being consumed away instead of being invested. The poor come in disparate categories with varying needs of consumption and productive investment and risk of delinquency and default (Obaidullah Mohammad, 2008)

CRITICAL ISSUES IN MICRO FINANCE:

What are the basic impacts of credit?
What are the Savings?
Who benefits from microfinance?
What are the returns on capital employment?
How do different products affect different people in different ways (heterogeneous effects)?
Whether are loans used for consumption or business purpose? What is the crux of the problem?
How can the poor mitigate risk?

How do the poor think of fees and high interest rates?

ALTERNATE MODE OF MICROFINANCE:

The interest rates prevailing in the microfinance sector are very high and are certainly much higher than the rates of formal agencies. Even SHGs which are linked to formal banks normally charge 2 per cent per month to their ultimate borrowers. With regard to MFIs, though the rates are much lower than the informal sector, they have ended up creating an interest rate structure which is only second best for the poor. At times it becomes difficult to estimate the effective rate of interest charged by the MFIs. Not many MFIs make it clear to their borrowers what the effective rate would be. So, there is a need for an alternate system which from interest towards the upliftment of the deprived and needful at a very low cost to fulfill the expired expenses attached to such activity. It is a social business.

But there is a need to examine Islamic microfinance at three levels – micro level (microfinance institutions, contracts/products and resources), meso level (financial infrastructures) and macro level (policy and regulatory framework). At a micro level, the major challenges to microfinance providers arise from their diverse organizational structures, lack of product diversification and poor linkages with banks and capital markets. Some strategic initiatives are suggested as solutions, such as, a move towards collective resolution of Shariah issues, enhancement of product range through research and financial engineering and increased participation of banks in microfinance through provision of credit guarantees and safety nets. Meso level initiatives constitute provision of education and training, better coordination and networking, technical assistance through Awqaf and Zakah Funds, provision of rating services specific to Islamic microfinance institutions in view of their unique risks through creation of a rating fund. Macro level initiatives constitute development of an enabling regulatory and policy environment (Obaidullah, Mohammed and Khan Tariqullah, 2008)

Social performance measures are not nearly so well developed. That may seem ironic for an industry which was founded because of the social benefits that it can achieve. Yet the lack of well-developed social standards may be the product of that heritage. It may simply be presumed that a microfinance institution in Bolivia, Bangladesh, Bosnia or Botswana is providing significant social and economic benefits to the poor.

These are exciting days to be involved in microfinance, but they are not easy. The managers of most microfinance institutions will continue to find difficulty as they try to meet the strong demand for their services by raising more capital. They will need to have a strong business model, a growing market and the ability to clearly communicate those successes in terms that are understood by both commercial and social investors. Like any emerging industry, the rewards will come to those with the discipline and perseverance to recognize its social responsibility, manage risk and understand the ethical aspects attached to the industry.

There are some ethical aspects of lending and borrowing loans in the larger interest of the society. In the current scenario and global economic conditions, where the interest-based system is towards its decline. An alternate model is needed to be developed which is free from interest and several other elements which are unethical and unsocial. Islamic concept of micro-finance is the best alternative. Islamic MF products must be free from interest and several other elements forbidden under Islamic law. (Obaidullah Mohammad,2008)

Even if poverty decreases through micro-finance, albeit at a slow rate, poverty is rampant in a country that has the largest presence of micro-finance programs in the world. Micro-finance is not to blame for this high incidence of poverty. We must admit that micro-finance is only an instrument among a large number of poverty reduction strategies that policymakers must pursue to reduce poverty. Certainly growth is a significant factor in reducing poverty. Investment in human capital and other means to empower the poor are also important tools for reducing poverty. Similarly, micro-finance intervention reduces poverty for a small percentage of the poor, and certainly provides an institutional credit and savings facility to a large percentage of the poor, especially women. The role of micro-finance must be evaluated from such perspectives.(Shahid Khandker, 2001).

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