Can Innovations in Micro finance facilitate in eradicating Poverty: Empirical Evidence from Pakistan

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Abstract

Purpose – Microfinance is usually regarded as the most powerful tool to boost the economy of any country by providing access to the basic banking products and services to the poor but it is still inconclusive if microfinance programs can substantially eradicate poverty because researchers have dual opinions about it due to some inefficiencies of Microfinance. The basic purpose of the study is to critically understand the literature review in microfinance at present.
Design /Methodology / Approach – The study reviews the literature related to microfinance institutions (MFI) in general, and microfinance initiatives taken in Pakistan in particular. The evidence related to the role of MFI's in eradicating poverty is generated from these published research studies.
Findings – Our study reveals that the role of government is also pivotal for laying strong foundations of microfinance as well. Government plays a vital role by ensuring the social perspective kept by these MFIs and empowering society with regulatory reforms to create favorable working environment for MFIs. Our paper also explores the role of innovation in microfinance; and according to the literature review covered in this paper it is very vital. However, it also depends on the market conditions.
Practical Implications – Among various challenges faced by MFIs the two main challenges are; High Operational costs and Employee motivation. The success of Microfinance Institutions depends on how effectively they overcome these challenges and achieve their goals in the form of welfare for their clients and financial sustainability as a business.
Originality Value – Several studies have been conducted in this domain that focus on South Asia (India and Bangladesh). This study has been conducted with the Pakistani perspective and the generated evidence only relates to the Pakistani society, as a whole.

Keywords Micro finance, product innovation, process innovation, poverty reduction.

Research type Conceptual Paper

1.0 INTRODUCTION

Poverty is a multidimensional term, therefore it has no universal definition but we can say that Poverty is the "Poor Standard of Living" (Chowdhury, 2009). It includes both economic and social dimensions some of which are non-quantifiable. For instance, indicators like real per capita income, housing condition, health facilities, unemployment rate, literacy level, consumption and saving level are generally regarded as the established measures of Poverty (Lapenu and Zeller, 2001).

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This research study has been conducted to find the products, services and process innovations in microfinance which has led to the success of microfinance institutions in effectively alleviating the poverty while staying financially sustainable. Microfinance institutions (MFIs) offer different products and services to the poor people especially women for the purpose of enabling them to leverage their own revenue generating activities and become socially and economically active (Hans, 2009). The main objective of this research is to explore the innovations which enable the MFIs to provide cheap financing to the poor and still be financially sustainable which is beneficial for both the client (in terms of welfare) and the institution (in terms of financial sustainability). Recent research in this domain (Bhat and Maurya, 2013; Mago, 2013) has argued over the effectiveness of MFIs in reducing poverty and the definite answer still remains unclear. So, this research paper aims at finding out how MFIs strive to strike a balance between society welfare and their own sustainability and success.

Microfinance is generally regarded as the most powerful tool for alleviating poverty but only if the MFIs innovate and introduce new products and services at regular intervals. Micro financing is different from conventional banking as it is specially designed for poor people who are generally deprived of banking services because of their creditworthiness (Brau and Woller, 2004). MFIs try to reach out such to such economically-active people in far-flung rural areas and provide them the necessary capital to kick start their small businesses. However, the general trend is that the interest rates being charged are quite high because the MFIs are overburdened due to their operational costs (Aleumu, 2006). Thus, there is a need to reduce the operational costs for MFIs so that cheap capital can be given to the poor, who can subsequently save more and accumulate wealth and can come out of the “poverty circle”. Thus, it is essential that the governmental polices and legislations must also create a friendly environment where MFIs are easily able to reduce their operational costs, thereby providing more opportunities and benefits for their clients. Government must also keep a check on these institutions to ensure that they are meeting their social objectives and are actually involved in the “development” of the human capital (Berhane and Gardebroek, 2011). Another aspect being discussed in this paper is that the MFI's must also motivate their field staff and train them well so they are motivated to effectively screen out unproductive client and work enthusiastically with their potential clients.

The main argument being reviewed in this paper is that MFIs can help eradicate poverty, provided that they are provided ample incentives which encourage them to launch innovative products and services. The study focuses on the Pakistani environment, where there is a genuine need for sustainable MFIs that can help uplift the overall society. A lot of work has been done in measuring the impact of Microfinance in reducing poverty and boosting the economic development but one question which is still unanswered is whether Microfinance can really do the miracles because researchers have also criticized microfinance as it has 'failed' to provide any viable solution to cope poverty (Mago, 2013). Thus, the role of microfinance in eradicating poverty in developing countries is still debatable, as MFIs have gained some success in few countries like Bangladesh but their success rate is questionable in countries like Pakistan (Al-Mamun, 2012). This paper explores these research questions from Pakistani perspective and aims at gathering empirical evidence as well. This study explores the solutions to those problems that cause inefficiencies in MFIs ability to eradicate poverty in Pakistan and also highlights some of the innovations which have made such institutions successful in other developing countries.

2.0 LITERATURE REVIEW

Microfinance evolved and expanded from the narrow field of microcredit (Helms, 2006; Elahi and Rahman, 2006; Henry et al, 2003). Microcredit is a narrow view of giving small loans to poor people while microfinance is a more comprehensive concept that encompasses a wide range of financial services for poor people. The ideas of microfinance date back to the 15th century when pawn shops were established in Europe as alternatives to usurious money-lending (Mago, 2013). In the 1700s, the Irish Loan Fund System was established in Ireland. The 1800s saw the emergence of financial cooperatives in Germany. These were developed by Friedrich Wilhelm Raiffeisen and his supporters. These cooperatives were developed to improve the welfare of the rural and urban poor people (Mago, 2013). In 1895, Indonesia developed the idea of banks for poor people by establishing the Indonesian People's Credit Banks Savings (Prawiranata, 2013). However, the definition of Microfinance was re-defined by Muhammad Yunus of Bangladesh when he launched the initiative of Grameen Bank in 1970s. Micro finance in its simplest form is the "Banking for the Poor" and this concept was first introduced by Professor Yunus of Bangladesh who discovered that poor could also be creditworthy and if provided with adequate finance, poor can also become economically active and get out of poverty (Rahman, 2015). Grameen bank founder also claims that 5% of its Clients leave poverty circle every year (Hassan and Gurrero, 1997). According to the relevant literature, some of the prominent features of Microfinance Institutions are as follows:

- Small amounts of loans and savings e.g. $100
- Short- terms loan (usually up to the term of one year or less).
- Payment schedules with frequent installments (or frequent deposits).
- Installments are composed of both principal and interest, which amortize with time.

- Higher interest rates on credit (higher than commercial bank rates)
- Easy entrance to the Micro finance program.
- Application procedures are simple.
- Short processing periods (between the acceptance of the application and the disbursement of the loan).
- The clients who pay on time are rewarded with repeat loans with higher amounts.
- The use of Flexible interest rates (decreasing interest rates over several loan cycles) as a motivation to repay on time.
- No collateral is required contrary to formal banking practices. Instead of collateral, Micro finance institutions use other methods, like, the assessments of clients' repayment potential by running cash flow analyses and Group Lending technique with peer monitoring.

In 1972 the practice of lending small loans to poor people was initiated by Mohammad Yunus in Bangladesh (Hassan and Gurrero, 1997) and that concept was called micro-credit. This initiative later on proved to be very successful, as the owner demonstrated that poor people were "credit-worthy" as well (Rhyne, 2012) and have the ability to repay those loans and improve their financial conditions. It was a win-win situation for both the lender and the receiver of the loan. Finally this resulted in creation of market based enterprises, that provide financial services to the poor and micro-credit was replaced by a broader term i.e. micro-financing or "Banking for the Poor" (Hassan and Gurrero, 1997).

There are numerous arguments about the usefulness of micro credit in reducing poverty, for example the former Secretary General of United Nations Kofi Anaan in his speech (*United Nations Press,* 2005) said that *"…. Micro-credit is a critical anti-poverty tool that is an investment in human capital and when a poor woman gets a credit she becomes an economic actor that has the power to improve not only their own life but their family, communities and their nation as a whole"*. Similarly, Brau and Woller (2004) concluded that microcredit has been known as effective tool for reducing poverty because it enables poor people get loans with reasonable interest rate to set-up a small business. Hans (2009) also concluded that Micro finance is an innovative way to alleviate poverty because it help people develop their skills and enables them to earn money through micro enterprises that smooth their consumption patterns and savings so that they can use it to build assets and educate their children.

Alemu (2006) says that countries can win the war against poverty if they use micro finance as a weapon. Micro finance encourages self-employment and business opportunities for those people who do not have investment. Micro finance institutions provide investment to enhance employment opportunities and they can improve their financial conditions. Moll

(2005) concluded that micro finance builds the foundation for poverty reduction and their study illustrated a linkage between micro credit and poverty eradication because when poor gain access to financial resources they become economically productive but the problem arises in program implementation that result in non-inclusion of those people for whom it was designed (the poor). They also suggested that government must regulate these programs to be centered on the basic needs approach because micro credit involves alleviation of poverty not just by lending money but an investment on human capital through health services, education, housing, sanitation, water supply and adequate nutrition etc.(Awojobi, 2011). Hulme and Moore (2006) also indicated that Great Britian supervises its clientele's by field staff that assisted to ensure the repayment of loan.

Since its inception, microfinance has evolved as an economic development approach to benefit low-income people in rural and urban areas. Amongst the developing countries, Bangladesh has one of the longest histories with microfinance (Yuge, 2011). A number of pilot programs and experiments were conducted by Grameen Bank and BRAC in Bangladesh and microfinance has undergone continuous improvement in the country (Rhyne, 2012). Presently, Bangladesh boasts a large number of well-known microfinance institutions (MFIs) including Grameen Bank, BRAC, and the Association of Social Advancement (ASA). As of 2014, over 500 MFIs possess a license from the Microcredit Regulatory Authority (MRA) (Rahman, 2015) many have applied for the license. The success of MFIs in Bangladesh can be understood from the following chart:

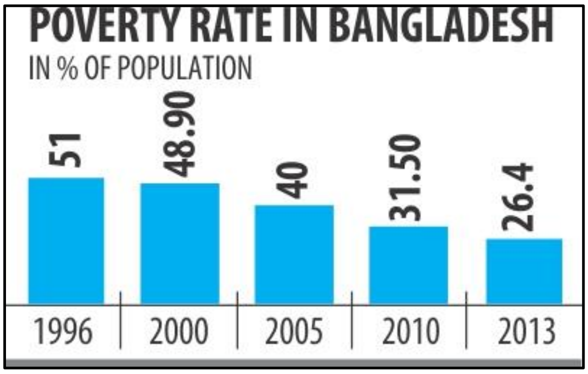

Figure 1 Decrease in Poverty Rates in Bangladesh over the Years

Source: Rahman, S. (2015). The Poverty Rates come down. *The Daily Star*

Traditional financial institutions can operate and control their wide networks easily and can extend it internationally because they have big financial markets to cover and hence cannot give proper attention to poor or small investors. MFIs on the other hand, have been designed to fulfill the needs of small investors and poor people by providing investments and loans at low interest rates and flexible conditions (Karlan and Valdivia, 2011). Islam (2009) argues that micro finance is really important and beneficial to improve employment and reduce poverty but is not sufficient for economic development. Micro finance can have a significantly bigger impact on economy if it is combined with other resources such as human, financial and natural resources.

Karlan and Valdivia (2011) have also argued that in developing countries and particularly in the rural areas many activities that would be classified in the developed world as financial are not monetized. Poor people have very little money but circumstances often arise in their lives where they need money or things that only money can buy. Thus micro finance will be considered as a tool for correcting such problems. Micro finance builds up financial markets for poor people who don't have any access to other financial institutions. The general objective of micro finance is to provide protection against poverty and gives shelter to poor people (Brau and Woller, 2004). Bakhtiari (2006) concluded that micro credit has been known as an effective tool for reducing poverty because it enables poor people to get loans with reasonable interest rate to set-up a small business. Mawa(2008) concluded that Micro finance is an innovative way to alleviate poverty because it help people polish their skills and enables them to acquire wealth. Rena, Ravinder, Tesfy, Ghirmai (2006) concluded that micro finance builds the foundation for poverty reduction and their study illustrated a linkage between micro credit and poverty eradication because when poor gain access to financial resources they become economically productive.

While the literature shows that Micro finance is effective in poverty reduction and economic development, there is also very strong criticism on its effectiveness.

- **Women usually use that Loan for consumption purpose:** Siakwah (2010) said the most women, who are often the targets for Microfinance, use it for consumption purposes and this is why microfinance only immediately impacts their living standard but in long-term it is not so effective because it does only smoothen their daily routines but does not contribute towards long-term poverty reduction or betterment. Women tend to get involved in numerous microfinance programs just to pay their installments for previous loans. This is the reason why newer micro-finance operations continue to get a market in the same areas because several institutions serve the same clients. Repayment rates are very high because women, very smartly, use membership of multiple Microfinance facilities to keep the debt revolving. They are smart enough to know that if they default, the agency will turn off the tap so they won't let it happen. This increases money circulation but does little to lift people out of the poverty trap since very little money is put in entrepreneurial activities (Siraj, 2012).
- **East Asian and Africans countries have progressed faster than Microfinance intensive countries:** This is the fact that countries such as Bangladesh and Bolivia,

which have seen significant expansion of Microfinance, have not witnessed sharp reduction in poverty and insecurity (Al-mamun, 2012). Leaders of poverty reduction instead have been the East Asian economies, which had no or little Micro finance (Lapenu and Ziller, 2001).

- **Charging high interest rates:** MFIs are usually criticized for charging higher interest rates and this is the reason that Micro finance clients have little savings and cannot build assets. On the other hand, MFIs justify their higher interest rates due to their high operational costs (Samson, Olubunmi and Olusegun, 2013).
- **Access to Microfinance Institutions:** Since 1970 microfinance has been proven to be one of the most effective and sustainable tools in poverty fighting. But still are 80 percent of the working poor, more than 400 million families, without reach of financial services (*UN Population Division*, 2012). To be able to serve everyone the microfinance industry must be even more efficient and grow to scale.

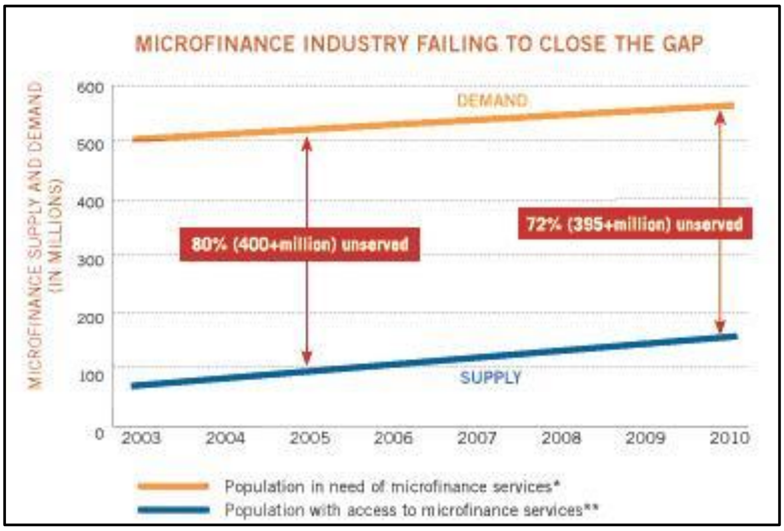

Figure 2 Difference in Supply and Demand of MFIs across the Globe

Source: *Based on CGAP data and population growth rates from UN Population Division (2010)*

- **Societal Development is not the primary agenda:** Researchers also criticized that as Microfinance is the private sector idea hence they do not keep social perspective in mind and charge higher interest rates and their sole purpose is to generate revenue and not the betterment of their clients (Rajendran and Raya, 2011).
- **Lack of Entrepreneurial skills:** As getting loans from Micro finance institutions is relatively easy and hence anyone can get the loan even if they lack entrepreneurial skills, repayment rate tend to decline and the benefit of such programs are wasted (Mayowa and Ota, ; Karlan and Valdivia, 2011; Agboola and Osunde, 2012).
- **Lack of Innovation in MFIs:** Over the years, MFIs across the globe have done little or no innovation to reduce their operational costs. As a result these institutions

continue to charge high interest rates to their clients, making it difficult to alleviate poverty. Strategies are needed to generate innovation in the products and services offered by MFIs and techniques are required to reduce poverty especially in developing countries (Dary and Haruna, 2015).

3.0 RESEARCH METHODOLOGY

The study is based on the review of forty-two (42) research papers related to micro-credit, microfinance, microfinance institutions and the initiatives taken by them to reduce poverty. This review also cover the little work done on this subject in Pakistan and the annual reports published by State Bank of Pakistan and other financial institutions of the country. Therefore, effort has been made to gather empirical evidence for Pakistan Research is focused specially on Pakistan and Bangladesh and generally the rest of the world where microfinance culture is flourishing.

The objective of the study is to investigate various determinants of innovation in microfinance institutions to eradicate poverty. The study is supported by various research papers. This research is helpful for many microfinance institutions that are facing critical challenges to conduct their operations effectively by allocating their operations cost efficiently and trying to achieve their target profits while keeping the social perspective as their first priority. We have explored the strategies and innovations adopted by successful microfinance institutions to reduce their operational costs and reach the best and deserving clients who are motivated to become financially independent and our research will help microfinance institutions to understand the process of innovation in their products and services to reduce their costs so that they could be profitable. Our research is focusing on the following questions:

- Growth of Microfinance institutions is primarily based on repayment of loans.
- Does innovation in microfinance exist?
- What difficulties are being faced by Microfinance institutions?

4.0 RESULTS AND DISCUSSION

In order to find comprehensive answers to the research questions posed in this study, earlier research studies conducted on microfinance and its success rate were studied. As mentioned in the literature review that success of MFIs varies across continents and countries and there are factors which significantly impact this rate. Therefore, in order to present a complete picture, evidence has been gathered from studies conducted in developing countries of Africa i.e. Nigera (Awojobi, 2011; Stewart, Rooyen, Dickson, Majoro, DeWet, 2010; Agboola and Osunde, 2012; Ekpe, Mat and Razak, 2010; Ifelunini and

Wosowei, 2012; Samson, Olubunmi and Olusegun, 2013), Ethiopia (Alemu, 2006; Berhane and Gardebroek, 2011), Ghana (Dary and Haruna, 2013; Issahaku, Dary and Ustarz, 2013; Steel and Andah, 2003; Oteng-Abayie, Amanor and Frimpong, 2013), Zimbabwe (Mutengezanwa, Gombarume, Njanike, Charikinya, 2011; Mago, 2013), Zambia (Copestake, Bhalotra and Johnson, 2001), Kenya and Uganda (Gudz, 1999; Ochanda, 2012) and developing countries of Asia i.e. India (Chakrabarti, 2004; Nasir, 2013; Rajendran and Raya, 2011; Sharma, Himanshu and Hartika, 2014), Pakistan Bashir and Hassan, 2013; Nasim and Khan, 2009), Bangladesh (Hulme and Moore, 2009; Parveen, 2009; Khan and Rahaman, 2007; Yuge, 2011; Rhyne, 2012; Khandker and Samad , 2012) and Vietnam (Nghiem, Coelli and Rao, 2007).

Evidence from the literature suggests that microfinance institutions are successful when they fund microenterprises and economically active individuals. Thus, a major challenge for microfinance institutions is to screen out and reach economically active clients. They should strive to serve as many clients as possible to reduce their operation costs by economy of scales and become sustainable at the same time. With reference to the evidences gathered from developing countries mentioned above, the following categories of challenges have been identified for MFIs:

i. Reducing the cost of operations
ii. Ensuring the Social perspective
iii. Lack of government support
iv. Technology Up gradation e.g. computerized monitoring and automated processing system

Based on the results generated from the above mentioned research studies, the following conclusions can be drawn for the raised questions. In order to combat these challenges and to induce effectiveness of microfinance institutions, 'innovation' must be present in the products and processes. Such innovations can be introduced through:

- **Research and Development:** Micro finance institutions must introduce new products on regular basis and in order to serve diverse need of their clients they should offer services like microcredit, micro savings etc. (Islam, 2009). According to Bashir and Hassan (2013), if MFI's offer micro-saving then clients have the option to mobilize their savings and hence build their assets.
- **Incentive Plans for staff members and provision of proper training sessions for handling clients:** Success of MFI's depends on the motivation of their staff members because the more motivated they are the more effort they will put on field and serve more clients, which will ensure an enhanced repayment rate (Levin, 2012) and hence the sustainability of MFI. So there is a need to develop incentive plans for

staff members to increase their motivation and commitment (Karlan and Valdivia, 2011).

- **Motivation for Borrower:** MFI must motivate their Clients to achieve financial freedom and provide them human development facilities as well such as Health, Education and Food security. Siakwah (2010) says traditional commercial banks do not fulfill the need of poor people so microfinance institutions provide the facility to support and motivate the poor people in order to upgrade their standard of living.
- **Loan product (Flexible, Conditional, funeral, church, fishermen, salaried, education, hajj):** New loan products must be introduced like Flexible interest charges for those who have better repayment history and conditional loans to these clients if they pay on time, and more products like funeral loan, church loan, fishermen loan, salaried loan, hajj loan etc. (Khan and Rahaman, 2007).
- **Saving product (voluntary, mandatory):** Hans (2009) evaluated that for better mobilization of savings, MFIs must offer Voluntary Savings for their clients and mandatory savings as well. It can also be used as collateral for the loan and meet the emergency fund requirements. Savings should be mobilized and encouraged by the establishment of Credit Unions, Village banking and Self-help Groups (Smec and Svobodova, 2009).
- **Marketing Innovation:** MFI's need more clients to become financially sustainable hence they should employ every way to reach more and more people. Programs like Higher loan amount for on-time payment, Radio Advertisement/selling, posters, use of billboards, mobile banking/personal selling, special promotions, TV advertisement/telemarketing, letters/emails/website creation, sponsorship of programs, flyers, visit to institutions like mosque/churches, lower bank charges for on-time payment, Customer appreciation/award/care, general meetings, flexible minimum balance must be implemented (Dary and Haruna, 2013; Brau and Woller, 2004).
- **Micro Insurance:** MFI's must also introduce micro insurance that would guarantee the clients against causalities like accident or any other losses and increase the security (Karlan and Valvidia, 2009).
- **Location Innovation:** Durrani, Usman, Malik and Ahmad (2011) said that MFI's must penetrate into villages and build their centers on locations near to their target customers so that better services must be ensured with lowers cost of operations.

5.0 CONCLUSION

There is no doubt in the potential of Micro finance in reducing poverty if MFI's carefully study their target market and shortlist people who are really capable of utilizing microfinance. MFIs must innovate frequently in their products and processes to provide a diverse set of services. Products such as new saving schemes, loan products and micro insurance should be introduced. MFIs should be able to reach and cater to a wider set of customers and must devise a better mechanism to monitor the loan repayment mechanisms. The objective of overall societal development must always be kept in mind and every effort should be made to reduce or optimize the interest rates for loans. The governmental institutions ought to play a vital role in facilitating MFIs to work smoothly in far flung areas so that operations of these institutions can be capped and MFIs should become financially sustainable. As Rajendran and Raya (2011) and Chowdhury (2009), evaluate that microfinance is the key tool to reduce poverty because MFI's work for the betterment of poor and support them to enhance their living standards and reduced their financial problems.

Microfinance institutions can become profitable with the social perspective only if they innovate well in their products, services and processes. Some recommendations for MFIs are as follows:

- Invest in Research and development to innovate new products
- Train and motivate their field employees as they play a vital role in MFIs' success
- Work with their clients to guide them about business and provide training workshops
- Invest in marketing to reach more people in far flung areas
- Make it easier for the poor to apply and access the loans
- Make offices in villages to reduce operational costs and better understanding of clients

As microfinance is an area which is being discussed frequently by researchers all around the world, there is a need to enhance the literature review to find out more ways to increase the effectiveness of MFIs in poverty eradication. Future work in this domain can start by extracting the exact poverty rates of developing countries for 2014-15, from official sources.

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