

1-1-2016

## The Pitfalls of the Microfinance Promise

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### Recommended Citation

Mull, Kelleen R. (2016) "The Pitfalls of the Microfinance Promise," *Global Tides*: Vol. 10, Article 9.

Available at: <http://digitalcommons.pepperdine.edu/globaltides/vol10/iss1/9>

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## **INTRODUCTION**

The modern world suffers from a poverty epidemic. One proposed solution to this problem is microcredit, or microfinance, the concept of giving small loans to those who do not have access to the traditional banking institutions because they lack collateral, a steady job, or a credit history. The idea is that the loan will be repaid through profits gained from entrepreneurial endeavors of the debtor. Modern microfinance institutions (MFIs) come in many forms: NGOs, commercial banks, private banks, and financial institutions. Generally, these institutions choose to offer loans to groups within a community in order to create social collateral and hold all loan holders in a group responsible for one another (Fishman, 2012).

Microfinance is often advocated as the tool that will eradicate poverty in the twenty-first century, and its elevated portrayal may lead some to the conclusion that microcredit is the one-stop shop in the future of volunteerism and aid. However, upon serious consideration, it is apparent that the industry has many weaknesses that are not indicative of moral or effective practices. The validity of microfinance institutions as poverty alleviation instruments is drawn into question by the structure and practices of the industry, which hinder the efficiency and depth of aid. This paper aims to outline the history and popularity of microfinance, followed by the difficulties of its implementation. Then, it will explain the scope of research in the field, microcredit's role in the empowerment of women, and the perception of microfinance in the West. Finally, it will discuss the monumental ideological shifts within the industry and their consequential negative effects on the field.

## **HISTORY AND POPULARITY**

According to the United Nations estimates of world poverty, in 2012, 896 million people lived on less than \$1.90 a day. At higher poverty lines, 2.2 billion people lived on less than \$3.10 a day in 2011 (United Nations, 2004). Microfinance is often championed as the means to eliminate global poverty and has gained immense attention and popularity in recent decades as a cure-all poverty reduction tool. The United Nations even projected 2005 to be the international year of microcredit (United Nations, 2004). Additionally, in 2006, Muhammad Yunis and the Grameen Bank were awarded the Nobel Peace Prize for "their efforts to create economic and social development from below" (The Nobel Peace Prize 2006, 2014). Subsequently, nations and organizations poured funding into the establishment of microfinance. For instance, in Bangladesh, microfinance exploded as a poverty reduction tactic, yet, despite this dramatic increase in funding, there has been little change in the poverty levels of the region

(Ali, 2014). Thus, after more than two decades, questions of the effectiveness of microfinance begin to arise.

Historically, the roots of microfinance were in informal banking. However, in the 1970's, the establishment of the Grameen bank pushed microfinance into the global eye (Fishman, 2012). In India, microfinance began in as a public initiative called the Initiated Rural Development Program (IRDP) to reach rural households and provide reasonable aid with hopes that it could prove sustainable, although the IRDP was eventually deemed incredibly corrupt. It was reformed in the 1990's with the onset of neoliberal shifts through which microfinance was presented as a tool to facilitate capitalism (Taylor, 2011). The establishment of modern microfinance can be traced to Dr. Muhammad Yunus who drew attention to the idea that a lack of access to credit was a main cause of poverty. He consequently established the Grameen Bank in India, which quickly received international praise as a revolutionary means of poverty alleviation (Ali, 2014) and the expansion of microfinance has been substantial in the past two decades. With this enlargement, and a shift in the Indian political sphere toward liberalization, microfinance produced a private sector strain of institutions (MFI's) which function as for-profit establishments financed by commercial banks and investors (Taylor, 2011). These institutions often operate in self-interest and have changed the nature of the field significantly. MFIs are separate institutions from standard banks because of high transaction costs, difficulty of obtaining collateral, and short loan duration (Ambrish, 2014). The substantial investment in the field reflects the unusual consensus of confidence regarding the microfinance system.

### **THE REALITY OF THE FIELD**

However, there are multiple fundamental issues with the institution of microfinance and the effectiveness of its implementation because of lack of consideration for the market. For instance, Megan Moodie, a professor at UC Santa Cruz, suggests that microfinance operations may amplify the existing vulnerabilities of the clients they aim to help (Moodie, 2013). An institution that ignores the glaring limits of the markets in the rural communities it attempts to reach is engaging in unproductive and wishful thinking, and ironically, the dialogue surrounding microfinance is in terms of the risk and benefit of the lender instead of the borrower (Moodie, 2013). The fact remains that just because a man has the means and tools to start a business, he will not necessarily be met with sufficient demand for his products. Similarly, while there is potential that the increase in vendors of certain markets through microfinance may aid some sellers, it may also displace other individuals already in the market. As a result, it would merely redistribute poverty rather than make any concrete improvements. In such

a case, there is risk that microfinance is a solution which creates a fixed pie resolution to poverty (Khan 2009). A zero sum approach however, requires a market for funded goods. Equally as concerning is the fact that most microcredit funding goes toward entrepreneurial endeavors when the glaring reality is that not every person is, or has the skills to be, an entrepreneur.

Another main concern of the practice of microfinance it is essentially impossible to ensure that microloans are allocated toward so called “sustainable expenditures.” Many individuals choose to use their loans simply for consumption spending which is neither productive nor sustainable (Khan, 2009). In fact, many use the microloan as provisions for non-income producing items and income shocks such as repaying debts, planning weddings, or rebuilding a home (Roodman, 2012). Similarly, there are challenges to holding the assets, such as livestock or farming materials, which microloans could traditionally fund. For instance, livestock may require veterinary care or a farmer may not be prepared for a year of drought. Essentially, due to a lack of savings, the borrower has no capacity to handle income shocks (Fishman, 2012). In total, the reality of assuming that each loan contributes to establishing a successful small business venture is unrealistic and misguided.

Partially because of an increased focus on sustainability figures, there is a concerning lack of research on the effects of microfinance. Currently, there is simply insufficient evidence to claim that microfinance is an effective tool to those truly in poverty (Khan, 2009). As of 2009, research shows mixed results, which do little to justify the incredible amount of funding poured into the microfinance industry annually (Khan, 2009). Although there are millions of dollars donated toward fighting poverty every year, very little energy is allocated toward evaluating what kind of aid is most necessary and effective (Roodman, 2012). The fact is that the effects of microcredit can be as varied as the clients who take out loans (Roodman, 2012). Thus, it is invalid to claim microfinance as the catch-all poverty reduction tactic as it is often presented.

This ambiguity is exemplified in the divide which exists in the debate regarding microfinance subsidization. The proponents of subsidization argue that on one hand, were microfinance truly the ultimate tool to fight poverty, then even the poorest should have access to it. If interest rates do not cover the increased costs of reaching that demographic then donors should make up the difference (Roodman, 2012). However, opponents argue for the importance of the industry’s self-sustainability. A second disconnect lies in defining the source of poverty and how it will be cured. Dr. Yunus originally attributed poverty to institutional flaws, maintaining that the poor have skills which are undiscovered and unutilized. The fault that some may find in this theory is that it does not recognize or account for the range of capabilities of the impoverished. Simply providing someone the tools to create a product does little to guarantee that there will be a market for the

merchandise, and this assumption may even displace individuals already present as sellers in a specific market with finite demands (Khan, 2009).

## **WOMEN AND MICROFINANCE**

One of the greatest accolades of microfinance is its potential to empower women in rural communities who are traditionally underprivileged in the household or society. Again, the results are overwhelmingly mixed. At its best, microfinance has the potential to provide women the tools to be self-sufficient actors in communities where they could not have been before (Moodie 2013). However, it would seem that this hope is often unrealistic. Initially, in addition to the social benefits, women were the target group of MFIs because of their perceived reliability as clients. As MFIs grew, they used intermediaries such as NGOs to lower transaction costs. These loans primarily went to groups of women which, in the minds of NGOs, were being empowered and represented through the process of becoming financially literate. However, in the perspective of policy makers, these processes served as self-selection to reduce costs and probability of default. It was a tool in moving toward the goal of self-sustaining microfinance institutions and a process geared toward effectiveness, not merit of aid (Taylor, 2011).

Unfortunately, this process often gives primarily male loan officers power over the primarily female borrowing population (Roodman, 2012). Additionally, microfinance has not been demonstrated to alleviate the strain of basic human needs such as food or shelter. Specifically, for women, this peril holds serious weight as microfinance has been presented as a means for women's empowerment. In the most cynical view, there is even evidence to suggest that there is an increased likelihood that these women become victims of household violence as amplified stress and anxiety surrounding debt magnify tensions and create new forms of social dominance (Moodie, 2013). In addition, although women take out loans, it is often men who actually go on to use the money. This peril arises for women because of the borrowing as well as the requirements which they submit to when agreeing to a loan which places them in a position of weakness (Moodie, 2013). Unfortunately, the industry is not the safe-haven it is often perceived to be for women.

## **THE PERCEPTIVE OF THE WEST**

One of the greatest testaments of the Western world's misunderstanding of microfinance is the popularity and processes of Kiva.org. Kiva, a website dedicated to collecting donations and giving it to MFIs, has become enormously popular through its peer-to-peer approach. By providing potential lenders with

photos and descriptions of “entrepreneurs,” Kiva creates a sentiment of personal connection to the borrowers (Moodie, 2013). Much of the draw of microfinance, specifically in the personal method presented by Kiva, is that the lender would be “helping a person help themselves.” In reality, however, Kiva has no follow up process for what happens once a lender’s money is delivered to an MFI. Kiva’s simple portrayal of microfinance is not an accurate representation of the complicated process through which money is filtered. The money goes through Kiva and a microfinance institution before being delivered to a lender similar to the one pictured. The money then may or may not be used for an entrepreneurial enterprise because often, borrowers tell lenders what they want to hear out of simple self-interest. A study of a group of women receiving microloans in Bangladesh revealed that a marginal minority of the women were using the loans for their intended purposes (Roodman, 2012). Kiva’s intention, however, is only to provide funding to the MFIs, who they deem to be the true experts, and hold that their MFI partners in the field should not be micromanaged or supervised by Kiva (Moodie, 2013). The result, however, is that after the funding, Kiva holds no accountability for the people served by the MFIs (Moodie, 2013). The focus is on the loan and the risk of the lender rather than that of the borrower, and the borrowers’ needs are rarely discussed as part of this risk (Moodie, 2013). Kiva plays to the West’s lingering paternalistic approach to aid and intentionally ignores the weaknesses of the industry.

### **CHANGES IN THE INDUSTRY AND THE QUEST FOR SUSTAINABILITY**

A neoliberal perspective of poverty states that the poor are capable of achieving financial independence if they are part of the free market. Currently, most microfinance institutions work from a neoliberal premise. This neoliberal idea of poverty thus suggests that when the poor fail to lift themselves from poverty, the blame is placed on the victims, which then legitimizes the coercive tactics of recovery used by lenders (Ali, 2014). The vast majority of microfinance institutions work within neoliberal terms, which essentially frees them from the concern of poverty reduction.

Additionally, the microfinance industry’s affiliation with Wall Street is a new wave of microfinance that focuses on its financial sustainability rather than the decline of poverty. The result is an increased pairing of banks with microfinance institutions (Moodie, 2013). The reality is that with this change, the institution becomes a business rather than an institution whose goal is to lift people from poverty. While ideally, both models may be possible simultaneously, under these practices, the microfinance industry shows the damaging effects of profit concerns in the field of aid.

The criticisms of microfinance are often credited to the shift of the institution from service to profit. In recent years, organizations have made the effort to minimize reliance on grants and adhere to a policy of loan repayment which requires interest (Khan, 2009). Many institutions have a “double bottom line” referring to their goal for financial sustainability paired with maintaining some level of service. However, in order to provide small loans to rural areas and feasibly still cover costs, interest rates usually must be high (Khan, 2009). Additionally, this change often affects the mindset of fieldworkers. They may be more inclined to provide loans to an individual who cannot pay them off in the name of financial gain (Khan, 2009). This shift was deemed necessary by the idea that a profit driven model of microfinance allows for greater penetration of the market of poor individuals (Taylor, 2011). The divide lies in the fact that microfinance analysis follows two approaches: the “welfarist” and the “institutionalist.” The welfarists’ focus lies in providing fiscal services rather than financial sustainability (Adhikary & Papachristou, 2014). Contrastingly, institutionalists value sound financial organization and tend to provide services to more clients, but at a decreased depth of the services. Generally, this focus on quantity usually serves better-off clients, overlooking small recipients with small loans and undermining the commonly argued strengths of these policies that “the commercial viability of MFIs increases with the number of borrowers” (Adhikary & Papachristou, 2014). Furthermore, this pressure of sustainability may take away from monitoring of client impact in favor of lender impact (Khan 2009).

The consequences of the shift to a for-profit model in microfinance are substantial as the focus, goals, and results of the industry shift as well. One of the biggest and most widely criticized changes is the increase in interest rates. As institutions move toward a goal of sustainability, and even profit, the natural result is an increase in interest rates. In order to cover the costs of providing financial services in rural areas, these interest rates are considerably higher than what Western borrowers would find reasonable. This increase is not inherently unfair; however, many institutions have increased their interest rates further with the intention of maximizing profits. With interest rates ranging from 30 to 60 percent and being implemented in multiple forms, it is difficult for rural borrowers to protect themselves from falling into an inescapable cycle of debt.

Furthermore, loan providers are aware that many of the borrowers are financially illiterate. Often, borrowers demand no explanation of the terms of a loan before agreeing. This opens a door to exploitation in an industry in which the original intention was aid. For example, implemented widely, a deceptive flat interest rate effectively doubles the interest on the loan by requiring interest in the full loan amount even as the owed amount declines after payments (Roodman, 2012). Thus, without transparent prices, borrowers are deprived of the opportunity to compare policies. In some cases, interest rates even increase as loan amount

decreases in order to maintain profits (Ambrish, 2014). Such practices are an obvious departure from an attitude which had upheld microfinance as an arm of international aid similar to donation. Mahammad Yunus (2011), one of the pioneers of microfinance himself, openly condemned this change in a New York Times article:

In the 1970s, when I began working here on what would eventually be called “microcredit,” one of my goals was to eliminate the presence of loan sharks who grow rich by preying on the poor. In 1983, I founded Grameen Bank to provide small loans that people, especially poor women, could use to bring themselves out of poverty. At that time, I never imagined that one day microcredit would give rise to its own breed of loan sharks. 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.

Such explicit criticism from one of the founders of modern microfinance speaks as a testament to the problems within the industry. Critics argue, however, that Grameen bank is in the unique position of being an attraction to donors because of its history and name recognition, which other institutions simply do not have (Roodman, 2012).

Another weakness of microfinance’s shift to profit is the widespread use of loan recovery rates as indicators of success. The microfinance industry often measures success in the ability of borrowers to repay loans on time, yet there seems to be little correlation between actual economic empowerment and higher loan repayment (Ali, 2014). Nonetheless, microfinance institutions tout their high recovery rates (Ali, 2014). Thus, the measure of repayment which is used so often as a testament to the strength of the microfinance practice is not concretely connected to escape from poverty. Essentially, the financial practices of MFI’s range from reasonable to unjust and accurate to delusional.

As institutions look to maximize profits and please investors, a main criticism is that they intentionally forgo providing loans to the poorest members of the population because they are typically less profitable. By attempting to reduce costs by “clustering,” institutions leave some parts of the market oversaturated and others in need. The initial costs of going to remote locations discourage MFIs from establishing there (Ambrish, 2014). Many institutions’ hesitance to provide loans to individuals without an existing source of income excludes the poorest sector of the population. There is also evidence that some of the poorer clients who are offered loans choose not to take them out of fear that they will not be able to repay them (Khan, 2009). This clear limit of the industry

is born out of focus on profit. The purpose of microfinance institutions is bypassed by measuring success through earnings.

## **LENDING PRACTICES**

With the shift toward sustainable microfinance practices, a great increase in breadth of provided loans increases profits of MFIs. However, it is not necessarily accompanied by assurance that a borrower has the capacity to repay a loan. Thus, there is accusation of aggressive lending practices being implemented on the part of microfinance institutions. A main concern is the willingness to lend to the financially illiterate, and the lack of accountability to create fair practices in such a case. Many individuals take out loans knowing only how to sign their names and having no real idea what the parameters and possible repercussions of the agreement are (Ambrish, 2014). Microfinance NGO's earn profit from hidden fees, service charges, unregulated interest rates, and obligatory savings (Ali, 2014). For example, in Bangladesh, it is a known practice to give intentionally vague or complicated parameters to a loan, or even provide unwritten contracts (Roodman, 2012). Often, repayment begins almost immediately after a loan is given, which is not a realistic time frame to build business or reap profits (Khan, 2009). An explanation of the continued compliance of the impoverished is financial illiteracy: essentially, a debt trap (Taylor, 2011). This phenomenon also often results in multiple institutions lending to the same borrowers (Fishman, 2012). Cross borrowing, or multiple borrowing, demonstrates the ineffectiveness of such practices. It is clear however, that the practice is common and widespread in regions with multiple MFIs. As a result, such practices create the idea of debt as a social norm, which perpetuates uninformed and ill-advised borrowing (Roodman, 2012).

After these loans have been outlined and implemented, the debate then turns to the means by which loans are recovered. Loans are often issued according to the concept of group lending. Members of a community must choose to be tied to one another in their loans and, if one member defaults, the other members will be held responsible. The result is immense social pressure. In some cases, this practice increases effectiveness and accountability. However, it also provides opportunity for the exploitation of these groups by MFIs or for the group members to act out against one another if a member defaults. This problem of exploitation is compounded by the fact that currently, there is little regulation across the MFI field (Ambrish, 2014). As such, the recovery process can become entrenched in violence and exploitation. For example, NGO's in Bangladesh perpetuate violence through the creation of imbalanced power structures, institutional practices, and unequal opportunities, and can come in the form of direct as well as structural violence. Examples of this aggression include creating

unequal power relations in the community, manipulation of groups of women to oppress their peers, and shaming (Ali, 2014). In addition, within groups and at the hands of microfinance institutions, the poorest clients are often bypassed in loan consideration because they are not believed to be able to repay (Ali, 2014).

In the most extreme cases, there have been serious accusations of the immoral and aggressive acts of microfinance institutions leading individuals to commit suicide. In 2010, in the Indian state Andhra Pradesh, the suicides of multiple impoverished borrowers, who faced incredible debt and underwent hostile tactics of collection, drew negative attention to the MFI's and resulted in widespread loan defaults (Taylor, 2011). The concentration of MFIs in Andhra Pradesh was caused by the neoliberal reforms pursued by the state government and the promotion of microfinance as a means of aiding the community (Taylor, 2011). MFI's soon began to seek external shareholders, which consequently marginalized the borrowers' role in the system as institutions looked to build their base and expand monetary gain (Taylor, 2011). In many cases, the groups began lending to individuals who already had financing from another institution (Taylor, 2011). This market oversaturation resulted in a bubble in Indian microfinance. Many households took out multiple loans, paying off one with another and numerous suicides were then linked to the questionable tactics of collection agents (Taylor, 2011). As a result, more than 80 people committed suicide in the region after defaulting on microloans. The shame facilitated by group lending in many of these cultures for loan defaults suggests that suicide is not at all of unheard of or uncommon. There is even fear that the collapse of repayment in Andhra Pradesh could spread to similarly glutted regions of the microfinance industry if recovery practices remain the same (Fishman, 2012). This crisis brought skepticism of microfinance to the forefront of governmental and public attention. The financial commitments of large world governments and upswing in private investment to microfinance were subsequently questioned (Taylor, 2011).

## CONCLUSION

As a practice, microcredit is meant to harness the resources of capitalism and allocate them among the poor and impoverished. Founded primarily in South Asia, it's an inspiring idea that a person could be lifted from poverty with only a small loan. Upon closer inspection, however, research reveals flaws with the practicality of microfinance as an industry and even just as a practice. The primary assumption of the field that every person can be an entrepreneur regardless of background, market limitations, or intelligence has been demonstrated to be problematic. Similarly, the reality of these loans is that they are often used for purposes other than the entrepreneurial pitch for which they were attained. Statistical and social evidence gives at best mixed results in favor

of the microfinance as an all-purpose poverty reduction method. The infatuation of Western cultures with the solution of microfinance is understandable given the incredible ambiguity with which most institutions discuss the practice. People become enamored with the idea of helping the women whose photo they've connected to via screen. In reality, their money is being filtered through a bureaucracy to a person who may or may not bear resemblance to the woman pictured. Essentially, recognizing the industry for what it is, rather than what people hope it to be, can be a daunting task.

Another realization made apparent in the research was the real effect of the liberalization of microfinance and the subsequent shift toward a goal of sustainability and profitability. This shift changes the very foundation of the industry, the effects of microcredit services foundationally, and has not been properly recognized as a destructive influence in the industry. Microfinance's potential for good has resulted in unquestioned positivity toward it as an idea, regardless of the uncertainty of its benefits in the target communities. In approaching the subject of microfinance, it is important to evaluate its actual role in the service industry. Historically founded from criticism of the practices of loan sharks, microfinance has nonetheless succumbed to similar deviations in its mission.

The microfinance industry has great potential as a means for providing financial services to those who are traditionally excluded by the market. However, the impression most of the world has on the current effects of such practices is misled. On an individual basis, there is much potential for microloans to create a solution to poverty via self-help. However, as an actual practice and field of poverty reduction, there are glaring problems in the implementation of microfinance in a safe, effective, and realistic way. These problems are compounded by the industry's current focus on profit and sustainability, which further distract from the original focus of poverty alleviation. Further, the industry, and its research, is often self-serving and focused on loan recovery. Microfinance, although born out of honorable intentions, often creates a culture of exploitation between the lender borrower relationships. It appears that there will have to be widespread reform of the industry before the practice could ever be condoned as a whole. There is indeed potential for microfinance to be an effective tool in the world of poverty reduction as are clearly cases of people being aided in a positive way through microloans. However, the existing flaws lead to the belief that microfinance should be removed from rhetoric of perfect poverty eradication tool and demoted to one tactic of poverty alleviation among many.

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