

**ANALYSING SHARIAH-COMPLIANT MICROFINANCE:
A CASE STUDY OF UGANDA**

by

Abdullah Al Saleh

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London South Bank University

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Supervisor: Prof. John Taylor

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To my Lord Allah the All Mighty

وقل رب زدني علما

My Lord! Increase me in knowledge.

(Noble Qur'an, 20: 114)

To my beloved parents

وقل رب ارحمهما كما ربياني صغيرا

My Lord! Bestow your mercy on them, even as they did bring me up when I was young.

(Noble Qur'an, 17: 24)

To my Supervisor Prof. John Taylor

من لا يشكر الناس لا يشكر الله

He who does not thank people does not thank Allah.

Prophet Muhammad (Peace be upon him)

To the poor people in the World: without you I would not have the honour to help people.

ABSTRACT

This study focuses on the impact of microfinance on the income and vulnerability of poor rural households. In order to clarify this question, the study examines household participation and access to credit through Joint Liability Lending (JLL) programmes, the allocation of household credit, and subsequent loan repayment. The study, the first of its kind conducted through extensive fieldwork in Uganda, concentrates on Joint Liability Lending programmes, instead of looking at other models of microfinance, because the Joint Liability Lending model targets the poorest segments of the population. Although the objective of poverty reduction is clearly included in most microfinance models, not all microfinance institutions have poverty reduction as a primary mission. Today's microfinance industry consists of a wide range of institutions serving different market niches with the aim of providing small-scale financial services to businesses and households that have been traditionally kept outside the formal financial system. But these institutions do not necessarily have as their mission reducing poverty.

The models described in this thesis provide clear evidence that Shariah-compliant financial principles can be compatible with microfinance and technical standards can be put in place, for example, through standard Shariah-compliant microfinance arrangements such as a *murabaha* agreement, or possibly even a *mudaraba* agreement. As shown too, the leasing or purchase of property or other goods can be accomplished via an *ijara* agreement. Elsewhere in microfinance, we have seen that bank accounts can be offered by banks under an *amanah* or *wadia* contract, while the community-based solution found in a *takaful* contract is ideal for providing microinsurance.

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PREFACE

The question of how to help the world's poorest people lift themselves out of poverty – instead of relying on foreign aid or hand-outs – remains one of the developing world's most pressing problems.

Around the world, the threats to societies that grapple with deep and intractable poverty among their citizens continue to proliferate. Civil unrest, corruption, illiteracy, disease and poor health devastate societies and countries where poverty is not tackled effectively (Valadez & Buskirk, 2011). Poverty and the lack of education breed civil unrest and political volatility, thus making prosperity even more difficult for those societies and trapping them in a vicious circle of deprivation and social exclusion.

One possible solution appeared in 1976, when Grameen Bank was founded in Bangladesh. The founder of the concept of microfinance, Muhammad Yunus, started the entire movement by giving a 27-dollar loan to 42 women in Bangladesh. This new method of giving poor people access to credit was soon called microfinance. Since Muhammad is a Muslim (The Arab American News, 2013), it was based on Shariah-compliant principles. This is a crucial concept in the current thesis. Yunus was awarded the Nobel Peace Prize in 2006 for his efforts to foster economic and social development in poor communities.

Since then, microcredit has spread around the world, with a gross loan portfolio of 43 billion dollars in 2009 and over half a billion borrowers (Goldsworthy, 2010). It has not remained purely Shariah-compliant as more and more traditional financing organisations have taken a hold of the concept of microfinance. Nevertheless, there is no doubt that microcredit or microfinance has been an empowering tool for millions of people. As noted by Bayulgen (2008), microfinance links individuals' self-efficacy (their ability to help themselves) with social capital, the 'glue' that connects people, communities and groups within a society in meaningful and productive ways. He suggested that this link between "self-efficacy and social capital, which can be generated from a particular form of micro-credit lending where clients apply for loans as a group and share responsibility for repayment" results in stronger societies (Bayulgen, 2008, abstract). According to Bandura (1997: 11), an expert in the field of self-efficacy, "perceived self-efficacy is concerned with judgments of personal capability, whereas self-esteem is concerned with judgments of self-worth". The poor feel a sense of being capable when they are able to convert natural resources or their services into the production of goods or delivery of services. Having the funding to do this will give them

more confidence and lead to a feeling of self-worth once they meet their expectations through their work.

Access to some form of microcredit or microfinance appears to be one of the most viable ways for the poor to gain access to credit to start a business from which they can, over time, extract a livelihood and a sustainable income. The legal infrastructure, technical implementation and issues related to information-sharing, education and access to help are also crucial factors for the success of such schemes.

Microcredit works by spreading the risks of lending to the world's poorest across communities and self-help groups that monitor and support each other. It also works through a number of secondary tools and systems: accommodating education, public-private partnerships, high interest rates, and so on. Some of these mechanisms have won praise from analysts; others have generated great controversy and criticism. According to Ramadugu (2009), corporate-MFI partnerships are enabling companies to understand the needs and requirements of rural consumers in better ways and accordingly customise their products. While this is the case with companies, MFIs are also showing equal inclination towards these partnerships, as they are creating social impact.

At the heart of microfinance is a set of founding principles. The most famous of these principles is promoted by the Grameen Bank and reads: "we are disciplined, united, courageous and workers" (Grameen Bank, 2010). Magnoni (2010: 13) asks a key question: 'Is the value of microfinance its ability to alleviate poverty, promote financial inclusion or some combination of the two? If the answer is the former, are profits appropriate?').

Financial services are one of the key resources that poor people are generally unable to access. It would be reasonable to argue that if they did have greater access to credit, they might be able to escape from poverty and improve their living standards. Even the poorest households could thus improve the prospects of their small businesses and, in the long run, break the vicious circle of poverty.

It is not surprising, therefore, that there should be a strong demand for credit among poor people. When they attempt to obtain it, however, they are often turned down because they lack sufficient collateral. Hence, the formal financial sector does not normally supply the credit demanded by the poor. Financial institutions believe that the small and frequent loans solicited by poor people are too risky and have a low profit potential. Another crucial problem is that formal moneylenders often lack any personal knowledge of their clientele's

activities and characteristics. Thus, they are not able to monitor how the loans are actually employed. Too often, then, poor people can only access the informal financial market, which has better information about their clientele but provides credit at much higher interest rates. This situation contributes to the difficulties that poor people have in breaking away from the poverty trap.

Because microfinance avoids the problem of the individuals' lack of collateral, it has become an efficient way of supplying credit to the poor. Loans are given to small cooperatives that use peer pressure to ensure that the money is returned in time. If one of the members of the cooperative failed to repay, no one else would have access to any more loans. Hence, the group as a whole works to guarantee that there are no defaults. As mentioned, this concept gives access to small loans and other financial services to people living in a vulnerable situation. They would otherwise be left outside the financial sector.

Microcredit gives such people the possibility of investing in small-scale businesses or other forms of self-employment, which allows them, in turn, to increase their income and improve their living standards.

Since it was first put into practice, microfinance has been quite successful and there has been a constant increase in the number of microfinance institutions (MFIs), especially in the developing world. Often, somewhat regrettably, labelled as loan sharks, MFIs operate with very high administrative costs per dollar lent relative to formal financial institutions so, in order to achieve financial sustainability, MFIs have to charge relatively high interest rates. However, they have social as well as financial goals that attract investors and donors whose capital contributions help make MFIs sustainable where they might otherwise fail. Of course, this success begs the question: what makes microfinance work?

Microfinance is not a universal solution to the eradication of poverty because the existing models primarily offer loan packages rather than tailored lending services for the poor. For example, Schreiner (1999) found that microfinance was able to take people from welfare to self-employment only 1 per cent of the time. In other countries, micro-lending works because it accepts social collateral in which there is joint liability wherein each group member is made responsible for the loans of other group members. If one member defaults, the other group members are required to cover the loan from their own resources, and if they do not, they lose access to future loans.

In terms of context, this study focuses on the impact of microfinance on the income and vulnerability of poor rural households in Uganda. The study specifically examines household participation and access to credit through Joint Liability Lending (JLL) programmes, the allocation of household credit, and subsequent loan repayment. The study concentrates on JLL programmes, instead of looking at other models of microfinance, because this model targets the poorest segments of the population.

In the past decade, the impact of so-called “social capital”¹ has appeared as a popular, albeit not wholly accepted, explanation. The reason for the growing interest in social capital is that it is a way, not only of only explaining different political and socioeconomic problems, but also of addressing them. Social capital refers to the institutions, relationships, and norms that shape the quantity as well as the quality of the social interactions in a society. Social capital is a multidimensional concept, and two of its most important dimensions are trust and networks. Social capital facilitates cooperation among individuals and helps them to achieve socially optimal goals. It could therefore explain why microfinance works.

¹‘Social capital is defined by its function. It is not a single entity, but a variety of different entities, having two characteristics in common: they all consist of some aspect of a social structure, and they facilitate certain actions of individuals who are within the structure’ (Coleman, 1994: 302).

CHAPTER 1: INTRODUCTION

1.1 GENERAL INTRODUCTION TO THE STUDY

The World Bank report (Honohan & Beck, 2007) shows that African economies are seriously under-banked. Uganda is one such country in Sub-Saharan Africa. This has a crippling impact on economic growth as people, especially the economically active rural poor who generally do not have access to financial services. A way of ameliorating this problem is to provide access to microfinance which could open up the financial system so that the poor can also have access to financial resources. Poverty is rife in Uganda which has seen the greater majority of the population marginalised from the financial mainstream. The objective of rural microfinance is to implement an inclusive financial system so that the economically active rural poor have access to a full package for financial services that will enable them to escape poverty. Micro-finance is a proven but under-utilised development and poverty reduction tool as has been shown in many studies, but the provision of Islamic micro-financing in Uganda has enjoyed little attention. This is the main reason for carrying out this study.

This is essentially an ontological question which asks: What can we know about the form and nature of reality? The fundamental ontological question is “why does anything exist”? In this thesis, the more specific ontological question I seek to answer is “what is the nature of Shariah micro-finance in Uganda?” The questions arising from this is: “does micro-finance exist independently of the observer or is such knowledge socially constructed”? Ultimately, these basic questions lead to more general enquiry: “what evidence is there of Shariah micro-finance provision in Uganda?” and “why are there problems in this regard?”

Furthermore, the societal context of Uganda, which is a predominantly Christian country, and a country of which I am a non-citizen, demands that provision be made to accommodate Shariah principles in providing microfinance to Ugandans. While several studies on microfinance in particular societal and cultural contexts have been undertaken in countries such as Pakistan (Hussein, 2009), Indonesia (Johnston & Morduch, 2011) China (The World Microfinance Forum, 2010), and India (Vadra, 2012), few appear to have focussed on Shariah-compliant microfinance. Some estimates have found that 72 per cent of the populations of predominantly Muslim countries do not avail themselves of financial services such as loans or insurance, because they do not follow the precepts of Islam as embodied in Shariah law. Those Muslims that do use conventional financial products have indicated in

various surveys that if they had the choice, they would use Shariah-compliant financial products (El-Zoghbi & Tarazi, 2013). The market is therefore ripe for analysis of the microfinance sector in the Islamic world and the potential for the expansion of its impact if it is made Shariah-compliant.

This thesis will investigate this particularly in relation to Shariah financial law by focusing on the question of whether microfinance can proliferate successfully in Shariah-compliant societies, with the main focus being on Uganda, which may then provide a foundation for further contextually-based research.

Many questions and issues have been posed about microfinance. Key among these relate to the way(s) in which microfinance is organised, comparisons between the Grameen Bank system and other kinds of self-help groups (SHG), the role of microfinance in alleviating poverty, the empowerment of rural groups and marginalised groups, especially women, and so on and so forth. There is also a large, unexplored area of potential research into how microfinance operates outside the Indian subcontinent, and particularly outside Bangladesh, where the system was originally introduced and where it remains widely used and studied (Wright, 2000).

1.2 DEFINITIONS OF MICRO-FINANCE

1.2.1 General Definition

Known collectively as microfinance, these services include “micro-credit, micro-savings, micro-insurance, and money transfers, and have been attributed with enabling micro-entrepreneurs to build businesses and increase their income, as well as improving the general economic wellbeing of the poor” (van Rooyen, Stewart & De Wet, 2012: 2249).

1.2.2 Definition of Shariah Microfinance

Islamic, more correctly termed ‘Shariah-compliant’, microfinance is the provision of financial services for low-income populations in which the services provided conform to Islamic financing principles. In many respects, Islamic finance is simply ethical finance.

These definitions form the conceptual framework for the study, and each of the key terms in this definition is discussed in greater detail in the sections that follow.

1.3 RESEARCH OBJECTIVES

All these research gaps (namely, the organisation of members, the use of loans and the impact of microfinance credit) are particularly acute in the area of Shariah-compliant microfinance and its more common counterpart, conventional microfinance. The general objective of this study, therefore, is to compare and analyse the differences in impact on the socioeconomic level of Ugandan poor households between conventional microfinance and the Shariah-compliant microfinance. In order to achieve this, five specific objectives have been identified:

- To understand the provision of microfinance in Uganda;
- To understand the principles of Shariah-compliant microfinance;
- To investigate the main problems with microfinance;
- To compare conventional finance with Shariah-compliant microfinance; and
- To determine the extent of Shariah-compliant microfinance provision in Uganda.

The thesis will thus undertake a qualitative examination of Shariah-compliant microfinance clients in Uganda, in order to discover the strengths, weaknesses, opportunities, and threats faced by both conventional and Shariah-compliant microfinance under the economic and financial circumstances of the country.

1.4 THEORETICAL FRAMEWORK

The theoretical basis of this thesis is social ethics (Bunge, 2012) which can be seen as a central part of political philosophy, itself that domain of philosophical thinking looking for a theory of social arrangement. If we want to see a link with more familiar subjects of economic theory, we can say that this area of philosophical research belongs to the foundations of the theory of social choice. Social ethics is also deeply rooted in the more global subject of moral philosophy.

The theory of justice (Rawls, 1971) is the most appropriate domain on which to rely for the development of the concept of poverty. This is supported by the work of Sen (1992) on the theory of equity.

1.4.1 The Theory of Social Choice

According to Sen (2014), the study of social choice as a formal discipline first came into its own in the late eighteenth century, when the subject was pioneered by French

mathematicians, particularly J. C. Borda and Marquis de Condorcet. Social choice theory in its modern and systematic form owes its foundation to the work of Kenneth J. Arrow in his 1950 Columbia University PhD dissertation. It is the study of collective decision processes and procedures. It is not a single theory, but a cluster of models and results concerning the aggregation of individual inputs (e.g., votes, preferences, judgments, welfare) into collective outputs (e.g., collective decisions, preferences, judgments, welfare). The concern of this thesis focuses on the welfare output of this theory, namely to what extent Shariah-compliant microfinance impacts the welfare and well-being of people. Linked to this is a secondary question about why people should choose Shariah-compliant microfinance over conventional financing methods.

1.4.2 The Theory of Justice

Rawls's (1971) theory of justice revolves around the adaptation of two fundamental principles of justice which would, in turn, guarantee a just and morally acceptable society. The first principle guarantees the right of each person to have the most extensive basic liberty compatible with the liberty of others. The second principle states that social and economic positions are to be (a) to everyone's advantage and (b) open to all. He introduced a theoretical "veil of ignorance" in which all the "players" in the social game would be placed in a situation which is called the "original position". Having only a general knowledge about the facts of "life and society", each player would then need to make a "rationally prudential choice" concerning the kind of social institution they would enter into contract with (for example a bank or microfinance institution). In essence this comes down to fairness (in Rawl's view); a framework that explains the significance, in a society assumed to consist of "free and equal persons, of political and personal liberties, of equal opportunity, and cooperative arrangements that benefit the more and the less advantaged members of society" (Garret, 2005, n. p.). The "cooperative arrangements that benefit the more and the less advantaged members of society" are the essence of microfinance, which substantiate the inclusion of the theory of justice in this thesis.

1.4.3 Defining Poverty

Since the foremost problem that microfinance aims to solve is poverty and put poor communities on a path to social dignity and economic growth, it is crucial to know from the outset what that concept means. Poverty can be defined in several ways and the selected

definition will have an impact on the approaches and measures implemented to estimate the number of poor people (Gauci, 2005).

For the purpose of this study, “poverty” is defined as a state or condition whereby a person’s income and empowerment is insufficient to meet basic needs such as food, clothing, and shelter (UNESCO, 2015). Overall poverty takes various forms, including:

"lack of income and productive resources to ensure sustainable livelihoods; hunger and malnutrition; ill health; limited or lack of access to education and other basic services; increased morbidity and mortality from illness; homelessness and inadequate housing; unsafe environments and social discrimination and exclusion. It is also characterised by lack of participation in decision-making and in civil, social and cultural life. It occurs in all countries: as mass poverty in many developing countries, pockets of poverty amid wealth in developed countries, loss of livelihoods as a result of economic recession, sudden poverty as a result of disaster or conflict, the poverty of low-wage workers, and the utter destitution of people who fall outside family support systems, social institutions and safety nets” (Gordon, 2005)

At its most fundamental level:

“poverty is a denial of choices and opportunities, a violation of human dignity. It means lack of basic capacity to participate effectively in society. It means not having enough to feed and clothe a family, not having a school or clinic to go to, not having the land on which to grow one’s food or a job to earn one’s living, not having access to credit. It means insecurity, powerlessness and exclusion of individuals, households and communities. It means susceptibility to violence, and it often implies living on marginal or fragile environments, without access to clean water or sanitation” (ECOSOC, 1998).

The element of poverty on which this thesis focuses is “not having access to credit”.

The concept of poverty has been lately expanded to include the scarcity of basic capabilities, such as education, environment, health, and the inability to participate in development. Thus, poverty is not only defined by unsatisfactory income, but also a lack of basic capabilities (Gauci, 2005). One of the main proponents of this view is Sen (1999 cited in Lister, 2004: 15), who questioned the use of just income and living standards as measures of poverty and argued that these components did not matter in their own right. What really matters, according to Sen, are the choices and opportunities that persons have available to lead their lives. He suggests that functionalities and capabilities should be the focus of poverty-

alleviation. Functionalities refer to the different states and activities that a person is in or does, while capabilities constitute the combinations of functionalities that persons are actually able to achieve. Sen makes it clear, however, that the lack of income can be one of the main causes for a person's lack of capabilities.

1.5.3.1 Kinds of Poverty

Definitions of poverty are usually defined in either relative or absolute terms and are largely based on income and consumption. Poverty has other dimensions as defined by UNESCO (2015) – economic (the right to work and have an adequate income), social (access to health care and education), political (freedom of thought, expression and association) and cultural (the right to maintain one's cultural identity and be involved in a community's cultural life). The focus in this thesis is on the financial or economic aspects of poverty, while it is not denied that this is a fairly narrow and possibly simplistic view.

- Consumption-based poverty

One of the most common methods of defining poverty is to consider that a person, a household, or even a society as a whole is poor when it has to live below a certain minimum standard of living. In this situation, the individuals or groups are unable to obtain the resources and assets required to fulfil their most basic needs. This type of consumption-based poverty fundamentally refers, therefore, to “physical measures of well-being” (Gauci, 2005: 2).

- Extreme poverty

In another definition of poverty, Robinson (2009) makes a distinction between the extremely poor and the economically-active poor. Extreme poverty includes, not only those who are unemployed, but also those who are underemployed. People in this situation cannot achieve a minimum standard of living and often suffer from malnutrition. According Robinson (*ibid.*), even those who are actually working but do not earn enough wages to reach a minimum standard of living should be classified as extremely poor.

- Economically-active poverty

The economically-active poor group, in turn, consists of those who have some form of employment and are able at least to buy food. It is mostly the economically-active poor who can take advantage of microfinance.

- Asset poverty

We define households or persons as being “asset poor” if their access to wealth-type resources is insufficient to enable them to meet their basic needs for some limited period of time. This statement leaves open a number of issues on which judgments are required in order to develop a measure of asset poverty as Oliver and Shapiro (1997) noted. This is specifically relevant in Shariah-finance because lending is dependent on the materiality of assets as noted earlier.

1.4.4 Poverty Indices

1.4.4.1 Human Poverty Index (HPI)

This index views poverty as reflecting the lack of choices and opportunities in the key areas of education, health, and command over resources, as well as the lack of a voice related to democratic processes. The first HDR in 1990 introduced the Human Development Index (HDI).

The Human Poverty Index may be defined as follows: "A composite index measuring deprivations in the four basic dimensions captured in the human development index — a long and healthy life, knowledge and a decent standard of living — and also capturing social exclusion."

1.4.4.2 Multidimensional Poverty Index

Most measures see poverty through a one-dimensional lens, for example using the dollars/day income measure. Instead, the multidimensional measure argues that no single metric can be sufficiently broad to capture all relevant aspects of poverty and adopts a multifactorial approach composed of health, education, living standards, inadequate income, social disempowerment, poor working conditions and living under the threat of violence.

The multidimensional approach attempts to comprehend poverty from various angles, paying due respect to the complexity of the phenomenon.

1.4.4.3 Approach in this thesis

The approach adopted in this research is based upon the definition within the human poverty index (HPI). The reasons for doing so are that it enables a quantifiable measure, albeit an approximation, of some of the dimensions of poverty. It is submitted that, through this measure, more efficient comparability may be achieved in comparison to the qualitative measures in place under the multidimensional index.

1.4.5 The Issue of Empowerment

Empowerment and poverty are inextricably linked. If we refer back to the theory of social choice as briefly mentioned above, “empowerment” is defined as having decision-making power and using it to assert legal, economic and social control over one’s situation in life (Web.worldbank.org, 2015). There cannot be empowerment of a group if it does not have the possibility to participate in public life and decision-making processes. However, when the most basic needs of survival such as food, housing and clothing are lacking, the question arises as to how people living under those conditions, can think of anything else. Poverty can be reduced or eliminated through the empowerment of those most affected, for example by granting them access to credit finance so that they can begin to uplift themselves from their dire condition and begin to fend for themselves and their families (International Fund for Agricultural Development (IFAD), 2014). Lack of empowerment results in maintaining the status quo for those in poverty, which comes down to injustice and inequality because they are denied equal opportunities in almost every sphere of life. Of course, the issue of empowerment goes far beyond the confines of access to finance, but for the purposes of this thesis, this is the focus, and it is not intended that considerations of other basic elements of empowerment such access to land or water, health facilities or employment should form part of this discussion, despite their interrelatedness.

1.5 PRINCIPLES OF ISLAMIC FINANCE

It is important at the outset to establish the principles of Islamic (or shariah) finance in order to distinguish it from conventional financing principles. The following figure provides a high-level overview of the differences in terms of banking principles.

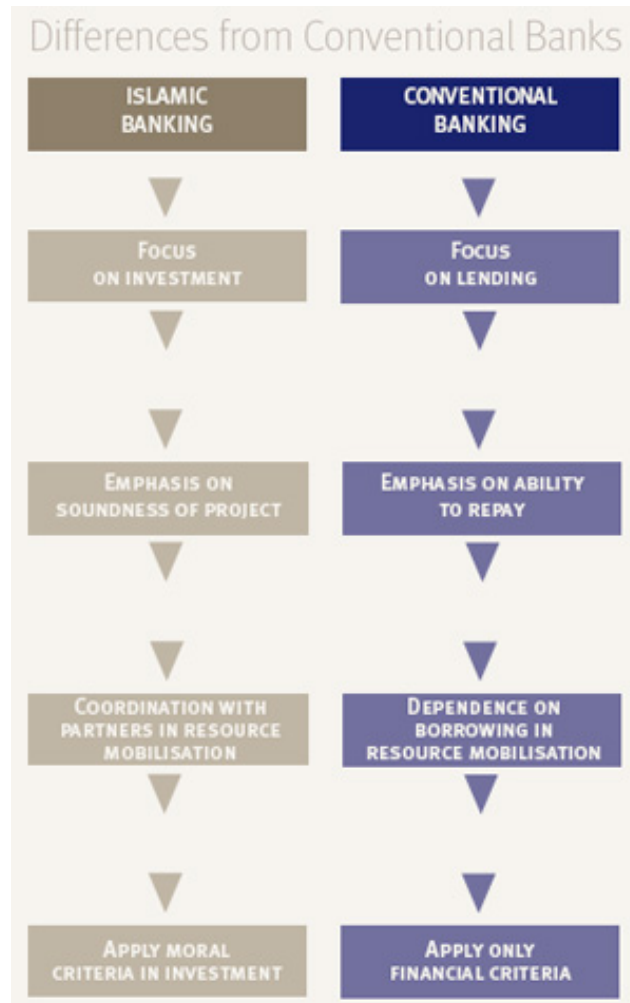


Figure 1.1: A high-level overview of Islamic and conventional banking principles
 Source: Al Baraka Banking Group (2015)

These practices are based on the four principles of Islamic finance as established in the Qur'an, which Muslims believe are the exact Words of God as revealed to the Prophet Mohammed. The Shariah-compliant financial model is based on four basic principles as outlined by the Al Baraka Banking Group (2015):

- Risk sharing: Financial transactions should involve a proportional share of the risks and returns amongst each participant. This principle concerns the overarching concept of fairness, the idea that all parties concerned should both share in the risk and profit of any endeavour. To be entitled to a return, a provider of finance must either accept business risk or provide some service such as supplying an asset, otherwise the financier is, from a Shariah point of view, not only an economic parasite but also a sinner. This principle is derived from a saying of the Prophet Mohammed (May Peace be upon Him) "Profit comes with liability". What this means is that one becomes entitled to profit only when

one bears the liability, or risk of loss. By linking profit with the possibility of loss, Islamic law distinguishes lawful profit from all other forms of gain.

- **Materiality:** Financial transactions should have a “material finality”, i.e. they should be connected to real economic transactions. This links financing directly with the underlying asset so that the financing activity is clearly and closely identified with the real-sector activity. There is a strong link between the performance of the asset and the return on the capital used to finance it (Yousuf, 2014).
- **Ethical standards:** Financial transactions should not involve the mistreatment of any of the parties involved in the transaction. When Muslims invest their money in something, it is their religious duty to ensure that what they invest in is good and wholesome. Islamic investing therefore includes serious consideration of the business to be invested in, its policies, the products it produces, the services it provides, and the impact that these have on society and the environment. In other words, Muslims must take a close look at the business they are about to become involved in.
- **Morality:** Financial transactions should not involve the financing of sinful or evil activities and products, such as the production of food from pork or alcoholic beverages (El-Hawary & Grais, 2005). The Qur'an also calls on all its adherents to care for and support the poor and destitute. Islamic financial institutions are expected to provide special services to those in need. This is not confined to mere charitable donations but has also been institutionalised in the industry in the form of profit-free loans or *Al Quard Al Hasan*.

If we contrast this with conventional banking principles, with regard to the granting of credit, a number of limitations can be highlighted by Ascent Capital (2013) as follows:

- It requires the debtor to make regular monthly payments of principal and interest. Because of shortage of cashflow experience by such debtors, it is usually difficult to make regular payment of to creditors.
- Most lenders provide severe penalties for late or missed payments, which may include charging late fees, taking possession of collateral, or calling the loan due early.
- Failure to make payments on a loan, even temporarily, can adversely affect a small business's credit rating and its ability to obtain future financing.

- Debt financing availability is often limited to established businesses. Since lenders primarily seek security for their funds, it can be difficult for unproven businesses to obtain loans.
- The amount of money small businesses may be able to obtain via debt is likely to be limited, so they may need to use other sources of financing as well, creating greater indebtedness

These limitations are clearly fundamentally different from Islamic financing principles. Perhaps the most well-recognised distinction between conventional and Islamic finance is the way in which the financial institutions receive a return on their investment. Conventional financial institutions charge interest at a fixed rate above the prime lending rate prevailing in any one country. According to Neiman (2010), the prime lending rate is the interest rate that banks charge their preferred customers, or those with the highest credit ratings. It is used to determine borrowing costs on many short-term loan products. For example, in the United States, the prime rate is calculated daily by a number of different sources, most notably The Wall Street Journal. The Wall Street Journal's prime rate index is generally considered to be the "official" source. It establishes the prime rate after determining the daily base rate of corporate loans from 75 percent of the 30 largest banks in the United States. The prime rate index can be volatile or remain constant for months on end, depending on the economic climate. The interest rate payable on loans is fixed at 3% above the prime rate. Other countries use a similar system.

Islamic microfinance on the other hand prohibits the paying or receiving any fixed interest (*riba*). Therefore, Islamic microfinance institutions should operate on the basis of profit or mark-up. In the vein of Islamic banks, these institutions can earn profits in three areas: trading, leasing and by direct financing in Profit Loss Sharing (PLS) contracts. Islamic Finance.com. (2013) provides the following example:

Imagine, for example, that an individual approaches an Islamic bank having identified a house that he wishes to purchase from a builder. The banker agrees to buy the house from the builder on behalf of the individual at the market price of say £100,000, and then sells it to the individual for a price of £150,000 to be paid in instalments of £7,500 per year over twenty years. The 'mark-up' of £50,000 represents the banker's profit, not an interest charge, argue the Islamic bankers who practise this technique. The bank acts as a trader, they say, buying the house for £100,000 and selling it for

£150,000. In this manner, a contract of exchange is used to provide the required finance to the house buyer.

Based on all the above, therefore, this thesis aims to build on extant literature by examining in detail how Shariah-compliant microfinance works in Uganda, both on a macro- as well as micro-level. Other studies have focused on Somalia (Hurlbert, 2012), Algeria and Pakistan (El-Zoghbi & Alvarez, 2015a) or have merely examined the principles of shariah finance as they are applied to microfinance (Moisseron, Moschetto & Teulon, 2013). The current investigation will point to new issues faced by individuals and groups who take out microfinance loans.

1.6 THE CONCEPT OF THE MICROFINANCE INSTITUTION (MFI)

Microfinance is also a subject that divides opinion. As explained by Bruck (2006), microfinance attracts investment from the private sector that can end up generating large profits for shareholders. On the other hand, however, micro-lenders or micro-finance institutions (MFIs) can charge very high rates of interest that end up punishing the poor, the very people such schemes are designed to help. Thus, “the role of fully commercial, profit-seeking institutions in providing such microfinance loans is controversial” (Cull, Demirgüç-Kunt & Morduch, 2007: 168).

MFIs represent, to most observers, something of a success story, although important caveats should, of course, be noted. Firstly, these institutions enjoy high repayment rates. This has been attributed, rightly or wrongly, to the lending practices associated with ‘group lending’ (Cull, *et al.*, 2007). As noted by Cull, *et al.* (2007: 170): ‘In the original models, customers were typically formed into small groups and required to guarantee each other’s loan repayments, aligning their incentives with those of the bank.’

At the same time, there is still work to be done to understand how rural groups organise themselves to participate in microfinance initiatives. The operations, strategies, strengths, weaknesses and efficacy of MFIs and their impact on borrowers constitute an under-explored area within studies on microfinance, especially in countries outside the Indian sub-continent. One of the main interests of the present research, therefore, is to understand how members are able to organise themselves into borrowing groups and how these groups operate as institutions, facilitating household access to credit. Moreover, our research attempts to understand how households use credit and to measure the impact of this credit on household income.

Microfinance institutions (MFIs) provide small-scale financial services to vulnerable people who are otherwise excluded from the formal banking sector (Morduch, 2002). Operating mainly in emerging and developing countries, they offer minor-scale loans that allow individuals to initiate small productive businesses and enhance their entrepreneurship capabilities. Financial systems are particularly weak in the rural areas of developing countries, and sometimes they have not emerged at all. For this reason, MFIs are often the first and only opportunity that local populations have to access financial capital and pursue their business options.

1.6.1 The Grameen System

The dominant model today is the Grameen system. Most microfinance providers are not interested in helping the borrowers to become part of the “banked” population, whereas Grameen specifically created a bank for this purpose with a range of standard deposit accounts and mutual-fund accounts available to borrowers (Mainseh, Heuer, Kalra & Zhang, 2004). “Grameen goes beyond providing the loans to help their clients achieve a life free from begging. It supports its members by making arrangements with local shops to provide items for them to sell such as bread, candy, and toys and will guarantee payments to these shops in case of defaults” (Magner, 2007). The system has been copied and modified by other MFIs, where it has been widely imitated by a number of large and small MFIs. The scheme is fairly well-developed in Yunus’ ‘home territory’ of Bangladesh and this deserves some mention at this point. In addition to the first example of an institution that offers microfinance (the Grameen Bank – currently with over 2.2 million members on its books), two other major users of the system, BRAC and Proshika, each have over a million clients. Further, there are many other MFIs across the developing world with over 10,000 members, and many hundreds of other smaller such organisations. Although official estimates vary, it has been estimated that some ten million people in Bangladesh receive financial services through this system. It has also been widely replicated by MFIs elsewhere, including by a small number of organisations in India and in more than twenty other countries in Asia, in Africa, Latin America. It has also been replicated in disadvantaged rural and urban areas in North America and Europe. The Grameen Trust supports ‘replicators’ with funding and technical assistance.

While other organisations had focused on offering loans and saving opportunities to destitute people before Grameen Bank (Counts, 2008), Yunus’ innovation consisted of the successful implementation of a system of group-lending, which effectively replaced the need for

collateral as a means to guarantee repayment of outstanding loans. In his academic work, Yunus has specifically mentioned a number of indicators that can help to measure the impact of poverty elimination methods (Counts, 2008, p. viii). These indicators are mainly concerned with the basic needs of persons, as defined by the International Labour Organisation in 1976 (Schubert, 2007). However, the financial situation of the most vulnerable individuals is also taken into account through indicators such as the weekly loan repayment rates and the average annual balance of saving deposits.

Yunus argues that global poverty does not emerge from market breakdowns, but rather from the theoretical framework of capitalism, which does not accurately model real economic structures in general or individual economic behaviours in particular (Yunus, 2007). He goes on to claim that access to capital is crucial for social development and that free markets have indeed the capacity to contribute to poverty reduction. However, the social component is still missing from economic systems and needs to be incorporated in order to understand observed behaviour.

Although Yunus' criticisms of conventional microfinance (i.e. a term associated with high rates of interest based on collateral requirements that poor people may not meet) are certainly valid, it is difficult to ascertain if his vision of a socially responsible microfinance model would be wholly successful. This uncertainty is due not only to the profit motive that dominates credit institutions today but also because 'access to capital,' as he puts it, necessarily carries a price and this price relates to risk. Unless risks are identified and managed, socially responsible forms of microfinance are not likely to flourish.

At this point in time, MFIs are able to respond to both the financial and the social requirements of modern economies, such as poverty alleviation by providing access to capital on a small scale, acting as social businesses with the understanding that economic behaviour is also regulated by social preferences. They enable vulnerable people to participate in productive activities and thereby contribute to the economic development of low income populations. According to Masanjala (2002: 97), the mechanisms implemented by MFIs constitute the link that had been lost between the "arbitrariness of informal lenders" and conventional banking institutions.

1.6.2 Microfinance: An Overview and Critical Perspectives

Today, the word microfinance is widely used in the vocabulary of development. Although it is made of two words, *micro* and *finance*, which literally mean "small credit", the concept of

microfinance goes beyond the provision of small credit to the poor. According to one definition, microfinance is “the means of providing a variety of financial services to the poor based on market-driven and commercial approaches” (Christen, 2013). This definition encompasses the provision of a wide array of financial services, such as savings, money transfers, payments, remittances, and insurance. Yet, most microfinance practices today are focused on microcredit. This entails providing the poor with small credit in the hope of improving their productivity and thereby their income. Although the social mission of poverty alleviation and community empowerment of the world’s poorest initially won acclaim from observers, journalists, politicians, NGOs and others, criticisms of some of its aspects have emerged.

Microfinance as a practice began in the 1960s and 1970s “when organisations such as ACCION International, Opportunity International, and Grameen Bank started to grant small loans (less than US\$100) to micro-entrepreneurs, mostly women” (Argandoña, 2010: 419). These loans were backed by a group guarantee, thus overcoming the lack of collateral which was the main reason why commercial banks neglected the low-income segments of the population. Since then, microfinance has experienced considerable growth.

The simplest definition of microfinance is the provision of financing (in the form of loans and other forms of credit) to very poor people who would otherwise find it difficult or impossible to get loans through conventional channels for a number of reasons (the term *unbankables* was coined as a descriptor of these people). These reasons included the fact that they lived in remote locations, and had no financial track record, reliable source of income or even a livelihood. In a sense, microfinance was a means of providing financial services (initially in terms of loans) to the *unbankables*, although not exclusively to them alone.

Many institutions provide microfinance services. These include commercial as well as public and development banks, credit unions, both non-profit and for-profit. The institutional landscape is composed of

- the providers of funds, which may be the clients themselves (through deposits) or other financial institutions, such as unit trusts, private equity, and public or private donors,
- partner financial institutions that render services to foundations or NGOs and
- supranational organisations that create micro-lending networks, such as ACCION International, Women’s World Banking (WWB), Kreditanstalt für Wiederaufbau (KfW), and the Small Enterprise Education and Promotion (SEEP) Network.

At the heart of microfinance is faith in the entrepreneurialism of the poor and the ability of self-help groups to improve the lives of millions of the poorest in the world only if some kind of access to credit can be provided. Therefore, it is based, as noted by Argandoña (2010: 420), on two assumptions. Firstly, it assumes that “the lack of access to financial services is a major (although not the only) cause of poverty” and secondly, that “access to credit is key for the development of entrepreneurial projects that will provide borrowers with a stable income, assets, and the knowledge and skills that will enable them to lift themselves from poverty, thereby extending the impact to the local community (through the creation of jobs and income, the generation of new ideas) and to the country as a whole”.

At the same time, microfinance, as a concept and in practice, suffers from several challenges. At this point, two can be highlighted, namely joint liability and high interest rates. Both of these features will be discussed in considerable detail later on in the thesis.

The key features of microfinance have been helpfully and concisely summarized by Armendáriz de Aghion and Murdoch (2005). Based on the practices of the Grameen Bank, microcredits are usually identified as having the following 12 features:

- They are for small amounts;
- The borrowers are poor or very poor families and, within them, particularly women;
- Their goal is to help the borrowers put an end to a state of poverty by generating self-employment activities or entrepreneurial projects and, sometimes, enabling the construction or purchase of a dwelling. Importantly, however, the microcredits do not cover day-to-day expenses;
- They are not backed by physical collateral or a contract whose performance can be enforced by law but are founded instead on trust;
- In order to obtain the credit, the borrower must belong to a group (group lending). Considerable importance is given to the creation of social capital among the participants;
- The guarantee is collective with joint responsibility by the entire group.
- The microcredit programme develops a distinctive credit selection and management methodology and a personalized system for relations between the MFI’s staff and its clients. It is the bank that goes to the client and not the client who goes to the bank.
- Interest and capital are paid in regular instalments at frequent periods (every week or fortnight) and in public.

- The credits are granted in a continuous sequence. The quantity offered in each new credit increases and is conditional upon prior repayment of the previous loans by all of the group's members.
- The lending programme is complemented by compulsory or voluntary savings programmes.
- The interest rates stipulated do not seek to provide an attractive return for investors but to guarantee the programme's sustainability. However, the sustainability goal is subordinated to that of providing a service to the poor.
- The loans are usually granted through non-profit organisations or institutions owned by the users themselves (cooperatives), although participation is also open to for-profit institutions.

A number of these features bear closer scrutiny. For instance, the loan amounts are kept very small (as low as \$22) in order to allow the very poor to access and repay them without undue difficulty (Kota, 2007). This is a key feature of Shariah finance, in that it supports the principle of morality. This is crucial as the borrowers range from the poor (those living on more than \$2 a day) and the very poor (those living on less than \$2 per day) to the destitute (those living on less than a dollar a day). Women, too, are singled out for attention and are given preferential treatment under microfinance schemes based on three assumptions. These are that women are better at managing money, are more careful with it, are more responsible for the family's wellbeing and, therefore, less likely to take risks with the loan. Finally, the schemes argue that women are discriminated against in many countries and therefore deserve more of a helping hand with getting access to loans.

A key feature of microfinance is the Joint Liability scheme, whereby the group, rather than individuals, are responsible for paying back the loan. These schemes involve groups of people who usually live in close proximity to one another voluntarily joining a system and who rely on trust to manage, use and repay the loan. As used in this research, Joint Liability Lending (JLL) is the sort of microfinance model that targets the poorest segments in society, i.e. those that are not able to borrow individually and must therefore do so as part of a group. Participants in Joint Liability Lending organise themselves into borrowing groups and secure each other's loans. In reality, it is the group, not the individual that is responsible for the repayment of the loan to the microfinance institution. Borrowing groups use peer pressure and peer monitoring to ensure that loans acquired are repaid by all members.

There are, however, a number of serious problems that can arise with JLL (Simtowe, Preller & Phiri, 2006). For one, it can give rise to ‘free riding’, whereby one or more members of the group do very little to help or support the group, taking advantage of the benefits of belonging to it whilst giving very little back. Second, it can attract borrowers of a higher risk profile. It therefore becomes difficult to account for, or calibrate, the overall level of risk that the group takes on, or has taken on, by the time the loan has been offered. In addition, one member of the group may default, causing the others to suffer a reduction in credit worthiness (Schreiner, 2003). This has been termed “moral hazard” by Simtowe, *et al.* (2006) which is a consideration in Shariah-finance and could be a potential inhibitor for Islamic MFIs.

To complicate the picture further, many in lending to groups, MFIs do not report when individual clients within the group default. From the institution’s perspective, this makes sense: There is no default if the rest of the group repays the loan. But from the clients’ perspective, one person’s default means more suffering for everyone. Lending to individuals may, therefore make better sense. For administrative reasons, it is obviously easier to lend to an individual, and it has also been argued that lending to individuals promotes self-responsibility and direct empowerment, which appear to be important characteristics of solving problems of poverty.

The key differences between conventional and Islamic microfinance provide a high-level overview are shown in the following table:

Table 1.1: Differences between conventional and Shariah-compliant MFIs

	<i>Conventional MFI</i>	<i>Shariah-compliant MFI</i>
Liabilities (sources of funds)	External funds and savings of clients	External funds, savings of clients, Islamic charitable sources
Assets (mode of financing)	Interest-based	Shariah-compliant financial instruments
Financing the poorest	The conventional doesn’t target the poor adequately	Poorest are included when integrating <i>zakah</i> with microfinance It can meet the needs of the poorest of the

		poor.
Funds transfer	Cash given	Goods transferred
Deductions at inception of contract	Part of the funds deducted at inception	No deductions at inception
Main target group	Primarily targeting women	Targeting the household members either the husband or the wife or both.
Reason for targeting women	Empowerment of women	Ease of availability
Liability of the loan (when given to women)	Recipient	Recipient and spouse
Work incentive of employees	Monetary	Monetary and religious
Dealing with default	Group/community pressure and threats	Religious values/family kinship
Social development programme	Secular (non-Islamic) behavioural, ethical and social development	Religious (includes behaviour, ethics and social)

Source: Ahmed (2002: 25)

These aspects of microfinance are discussed in detail in subsequent chapters.

1.7 JUDEO-CHRISTIAN FINANCING PRINCIPLES

Note: All scripture references in this section are to the Holy Bible, NIV, 1984.

This section provides a brief overview of Judeo-Christian financing principles. It does not, however, debate the merits or demerits of these principles nor does it provide a critique of Islamic finance in contrast. This debate is outside the scope of this thesis. The fact that this section focuses mainly on Judeo-Christian finance is not to deny that there are other religious ethical financial systems such as Confucianism and Hinduism. Islamic scholars tend to call

alternative systems “conventional financing” (Jawadi, Jawadi & Louhichi, 2014: 3) because these systems use interest as the way of earning returns on loans.

Judeo-Christian finance is essentially based on the principle of stewardship (Newell, 2012). The first principle is to tithe (Collins, 2012). "Bring the whole tithe into the storehouse, that there may be food in my house. Test me in this," says the LORD Almighty, “and see if I will not throw open the floodgates of heaven and pour out so much blessing that there will not be room enough to store it” (Malachi 3:10). Christians are expected to tithe to their local church, and the Scripture promises them blessings as a result. They may also give freewill offerings as an act of worship to God or a sacrifice for a specific purpose. Moreover, they are expected to give alms. Almsgiving is the Christian habit of giving things to fill the needs of perfect strangers. Philippians 4: 14-19) sets out that almsgiving is based on the principle of mutuality, giving and receiving, which bestows a blessing on both the giver and the receiver (Hutton, 2010).

The second Biblical principle that guarantees freedom from anxiety in money matters is avoiding borrowing (Newell, 2012). Although borrowing is not forbidden, there are warnings about it. "The rich rule over the poor, and the borrower is slave to the lender," says Proverbs 22:7 (Holy Bible, NIV, 1984). Money-lending is, in many situations, a means by which the rich become richer and the poor become poorer. According to McIllroy (2011, n.p.), “Christians need to practise self-control in their use of money, learning to save and to live simple lifestyles. Christians need to demonstrate generosity and to be prepared to offer interest-free loans to another. Christians need to practise fellowship in financial matters, sharing with one another and offering those in need alternatives to the money-lenders. Christians should be committed to mutual growth, supporting micro-credit initiatives which provide start-up capital to small businesses”. Bradshaw and Ellison (2010) posit that debt is a spiritual issue and state that, in the modern era, excessive debt leads to societal problems such as family breakdown, mental health problems and even suicide.

Essential to the Bible’s teaching about economic matters is the practice of fellowship, mutuality and trust. To give a loan is to grant credit (Latin root: credere, to trust), trusting that the borrower will repay the loan. However, there is always an element of risk that the loan might not be repaid due to dishonesty, fecklessness or misfortune of the borrower, which is why interest is charged. McIllroy (2011) states that Christians are expected to reflect their trust in God by displaying an appropriate level of trust in one another. In situations of close

fellowship, this means lending money without charging interest, or, if a borrower cannot repay because they have suffered a misfortune, forgiving all or part of the debt, a principle reflected in the parable of the unmerciful servant (Matthew 18:21-35, Holy Bible, NIV, 1984) which indicates that all of us have been forgiven an unpayable debt by God Himself. These principles are reflected in credit unions established by faith-based institutions; these are small scale financial associations united by a common bond (Emmons & Schmid, 1999) and operating on the principle of mutuality. These credit unions operate on a not-for profit basis (Fried, Lovell & Eeckaut, 1993), and encourage their members to learn self-control through the discipline of saving. They then lend the money saved to other members of the credit union at low interest rates (usually limited by legislation). Therefore, they provide low cost credit to those in need. Because there is mutuality between the borrowers and the lenders, the risk of non-repayment is lower which means that the credit union can charge a lower rate of interest than would a commercial lender (McGraw, 2013). Such loans cannot, however, be interest-free, because credit unions have to pay the costs of being regulated, may have to pay staff members, and have to pay interest on the deposits made by savers. Conversely, where there is no fellowship between borrower and lender (such as in a banking/customer relationship which is to all intents and purposes, strictly a business transaction), the risks of default are much greater.

There may, of course, be times when a loan cannot be repaid. In such instances, God's overarching directives are love and justice, even in finance. This means lenders should be willing to forebear, restructure and forgive debts, while at the same time, borrowers should do whatever they can to repay their debts. Chewing (2000) argues, based on Proverbs 6:15, that if someone cannot pay his debts, he should humble himself and plead with his lenders for mercy, rather than seek bankruptcy court protection from the lender.

The key difference between Islamic finance and Judeo-Christian finance is the matter of charging interest. Van Drunen (2012) states that people who want to borrow money do so by entering into a mutually beneficial voluntary arrangement with an investor who has more resources than he currently needs. For example, a farmer can borrow money from a bank to buy seed, grow grain, sell some of the crop and repay the borrowed money with some interest. The farmer earns his living and the bank earns interest on the loan.

According to Ritenbaugh (n. d.), although a Christian's attitude should be one of giving, sharing, and helping in meeting the needs of the less fortunate, there are instances when it is

permissible to charge and accept interest. For example, if money is loaned to another individual purely as a business deal so he can make money, then it is not wrong to collect interest, because both parties are sharing in the profits. It is also proper to accept interest from money placed in savings, since the money is earning the increase. The interest is not harming anyone else. From a Judeo-Christian perspective, interest rates facilitate and stimulate a just re-allocation of resources and provide a way for those people without resources to gain access to resources simply by agreeing to fairly compensate the saver for the temporary use of the resources (Van Drunen, 2012).

However, the Bible does encourage people to not hoard grain and to give grain away to the poor, the widow and fatherless (Leviticus 19: 9-10, Luke 12:16-21). In this way, people honour God and show love and justice to fellow humans. The Bible teaches the same about financial resources (van Drunen, 2012). The Bible's directive to not charge interest to family and the underprivileged is similar to giving away grain. In this way, there is no dissonance between allocating some financial resources via markets with a price (interest rates), and sharing other financial resources freely (zero interest rates) with family or the poor.

This Biblical teaching is mostly from the lender's perspective, with much of the teaching telling lenders not to take collateral (Exodus 22:26-27, Deuteronomy 24:6,12-13,17, Ezekiel 18:7, Job 24:3) which erodes the asset base of the borrowers. Biblical examples include injunctions against loans secured with a widow's ox (Job 24:3), widow's garment (Deuteronomy 24:17), sleeping cloak (Deuteronomy 24:13) and millstone (Deuteronomy 24:6). The prohibitions in the Bible are quite specific and are centred on showing love and justice for one's fellow humans. The Bible prohibits seizing collateral if the borrower is poor (Deuteronomy 24:12) or a widow, or if the collateral is a cloak that gives warmth at night, or is a tool that provides someone's livelihood, or if doing so would be oppressive (Ezekiel 18:7). Importantly the Bible does not prohibit (or is silent on) collateralised loans in any other case. This is in contrast to Islamic finance which is based on a collateralised system. "Islamic banks use collateral to secure finance, because *al-rahn* (an asset as a security in a deferred obligation) is allowed in the sharia" (Ahmed & Khan, 2007: 155).

1.8 THE LIMITATIONS OF ISLAMIC FINANCE

The limitations of Islamic financing are discussed below:

- Risk taking. The key difference between a *murabaha* and a conventional interest-bearing loan is that, in a *murabaha*, the financier takes ownership of the goods that are the subject of the *murabaha* transaction, whereas in a conventional loan the banks merely extend financing and are not exposed to any potential liability arising from the goods purchased with that money (Ghoddusi & Khoshroo, 2015). This ownership may result in potential liabilities for the Islamic banks, because there may be residual risks for the Islamic bank from the time they purchase the goods from the supplier to the time they sell and deliver them. These residual risks arise out of the risk of credit default and potential asset devaluation. Risk sharing, the key *shariah* requirement, is yet to take root, some thirty years into the establishment of Islamic banking (Bacha, Mirakhor & Askari, 2015)
- Infancy of the industry. Islamic financing instruments are new and diverse. The lack of adequate experience in the market impedes the interest and trust of the market (Ghoddusi & Khoshroo, 2015).
- Liquidity. A major problem with some Islamic instruments is the low level of market liquidity. Non-existent or shallow secondary markets for the majority of Islamic finance instruments are the main reason for the low liquidity of Islamic instruments (Ahmed, 2015), despite the banks themselves being highly liquid and, in a sense, having too much money with nowhere to invest it (Sobol, 2013). Problems regarding liquidity are also a major obstacle to the growth of Islamic banking. In Islamic banking, liquidity risk can be divided into two types, namely the lack of liquidity in the market and lack of access to funds (Mohamed & Samsudin, 2013). For the first type, illiquid assets of Islamic banking make it difficult for banks to meet their liabilities and financial obligations, while for the second type, it exists because the Islamic banking institutions are not able to get loans or raise funds at a reasonable cost when necessary. Illiquidity can contribute to the problem of cancellation risk in *murabahah* instruments or the inability to trade contracts and also *bay 'salam* contracts that can only be traded at par value.
- Additional premium. Islamic finance contracts tend to be more expensive compared to similar conventional products (Weill & Godlewski, 2014), accompanied by lower cost efficiency for Islamic banks relative to that of conventional banks because Islamic banking is more complex and entails higher legal costs. It can increase the cost of capital for large capital projects and make it an unfeasible option for projects with small profit margins.

- Market incompleteness. Islamic finance markets have not yet introduced liquid and efficient contingent claim contracts. The lack of those products limits opportunities to manage financial and market risks (Ghoddusi & Khoshroo, 2015). Conventional banking facilities have a well-developed interbank market which provides various financial instruments to meet short and medium term liquidity needs, provides flexible consideration to the banks in adjusting short-term cash flows that they own, while there are limited Shariah-compliant interbank money market instruments (Mohamed & Samsudin, 2013).
- Credit risk of underlying assets. Islamic finance structures are generally asset-based, which means the transaction is backed by a physical asset. Islamic banks may face greater credit risk due a variety of factors such as: the complexity of Islamic loan contracts, limited default penalties and moral hazard incentives caused by profit-and-loss contracts. For long-term contracts, there is a risk of damage or loss of the asset, environmental liabilities or even expropriation or nationalisation by the government of the host country (Ghoddusi & Khoshroo, 2015). However, Abedifar, Molyneux and Tarazi (2013) noted that Islamic banks were less affected by the 2008 crisis because they are not allowed for ethical reasons to invest in excessively risky instruments such as credit default swaps, leading to better credit and asset growth performance compared to conventional banks.
- Risk management. As Islamic finance is still in its infancy, there are certain types of functions that are not yet deliverable using Islamic finance instruments. A major limitation is the lack of risk-management instruments. There is no popular instrument yet for option type pay-off structures. Thus, the chance of separating and packaging a large capital project's risks to sell to other investors is not easily available (Ghoddusi & Khoshroo, 2015).
- In terms of insolvency risk, the special relationship with depositors could provide Islamic banks with greater capacity to bear losses yet at the same time, operational limitations on investment and risk management activities could make them less stable than their conventional counterparts (Abedifar, et al., 2013). Nevertheless, Abedifar et al. (2013) found that, regarding insolvency risk, small Islamic banks seemed to be more stable, and their loan quality less sensitive to the domestic interest rates compared to conventional banks.
- In addition to lending, conventional banks also allocate a part of their funds to investments. Such investments normally include purchase of bonds (as well as

instruments with shorter maturities) of different types that have risk/return features that help manage portfolio risk. However, Islamic banks have limited options for such investments since they are not authorized to invest in interest-bearing instruments. Alternatively, they can invest in Islamic bonds, known as *Sukuk*. Although (like in short-term Islamic money markets) this asset class still remains relatively underdeveloped, these limitations have been partially offset due to the expansion of alternative Islamic financing instruments (Abedifar, Molyneux & Tarazi, 2013).

It could be said that Islamic micro-finance might offset some of these limitations in that exposure to risks is lower for the financing institution, although the risks for the borrower may be higher because they might have supported their loan applications by offering collateral of everything they have (their assets) and stand to lose more by comparison than a large corporate which may have a diversified financing structure whereby losses can be offset by other assets if necessary.

1.9 CURRENT PERCEPTIONS OF MICROFINANCE

That microfinance is successful in reducing poverty is generally recognised in research (Chowdhury, 2009; Leikem, 2012; Neumann, 2012). Many policy makers are thus working to ensure that microfinance is sustainable and available to most poor households in the future. For their part, stakeholders in the microfinance industry, especially donors and investors, argue that “microfinance can pay for itself, and must do so if it is to reach very large numbers of poor households” (CGAP, 2002a: 10). The central message is that, unless they cover their own costs of operation, microfinance providers will always be limited by a scarce and uncertain supply of subsidies from governments and donors. This argument assumes that microfinance is good for its clients and should be made available to as many poor people as possible. Morduch (2002) correctly points out that such enthusiasm for microfinance rests on an enticing win-win proposition: those microfinance institutions that follow the principles of good banking will also be the ones that make the largest contribution to poverty alleviation. It is thus assumed that good banking practices, by operating in a sustainable manner, allow institutions to serve their clients and thereby alleviate poverty on a permanent basis (Morduch, 2002).

This “win-win” situation, it is argued by Ali (2012), applies both for investors and poor borrowers and is a particular feature of Shariah-finance. If investors in microfinance programmes follow good banking practices, they will likely make some profits from their

venture. At the same time, the welfare of the poor will benefit from their continued access to reliable credit and other financial services. Supporters of the “win-win” proposition, such as Sullivan (2006), Kiiru (2007) and Moser (2013), stress that the ability of poor borrowers to repay their loans is a good indicator that they are able to make profits from whatever investments they make with the borrowed funds. Given the assumption that microfinance is already beneficial to the poor, the “win-win” proposition further emphasises that the reduction in household poverty is directly proportional to the number of households that benefit from access to microfinance. This “win-win” vision has given rise to a set of best practices adopted by a number of key donors, including the Consultative Group to Assist the Poorest (CGAP), a consortium of NGOs hosted by the World Bank. Other donor organisations that embrace microfinance’s best practices include the United States Agency for International Development (USAID) and the United Nations Development Program (UNDP). It should be noted, however, that the idea of a commercial approach to microfinance lending for the poor has been questioned by socially oriented services providers (Abelkader & Salem, 2013). These organisations have particularly criticised the assumptions underlying the “win-win” proposition, questioning their validity in the real world.

1.9.1 The Microfinance Vogue

In 1997, the Microfinance Summit called for the mobilisation of \$20 billion over a ten year period to support microfinance. 2005 was declared the “Year of Microcredit” by the United Nations. The publicity accorded to microfinance risks creates the image of exceedingly successful institutions which would pre-empt needed criticism. In order to justify the enthusiasm for microfinance as opposed to alternative models of poverty reduction, the claim that “microfinance reaches and helps the poor most” (Kiiru, 2007: 16) should be proven and not just taken for granted or assumed.

This excitement mostly relies on the stories about the benefits and successes of microfinance in many parts of the world. These stories have contributed to transforming microfinance, from its humble beginnings into a global industry. For example, there are many stories about women and their families struggling on the verge of poverty and desperation whose lives are dramatically improved thanks to their access to financial credit (First Women Bank, Ltd., 2012). These women do not usually go into very sophisticated enterprises varying widely from sewing to packaging to fashion design to small retail outlets or similar small-scale

business ventures; however, this is enough to set them on a route out of poverty, allowing them to provide better nutrition, health and education to their households.

Armendáriz de Aghion and Morduch (2005) point out that these kinds of anecdotes should not be substitutes for careful statistical investigations. It is important to understand that these stories are generally meant to illustrate the potential of microfinance, while statistical investigations and analyses should show the impacts across a wider array of cases. There is the risk that policy makers and donors take anecdotes like the ones described above, together with the fact that microfinance clients are able to borrow and repay their loans, to imply that poor clients can benefit from whatever investments they make.

1.9.2 What do the Poor Need Money For?

The financial needs of poor households are not unlike the financial needs of most other households around the world. The poor need funds to cover medical expenses, to purchase, renovate, or make an addition to a house, to educate their children, to celebrate birthdays, festivals, and rituals, to arrange weddings, to provide old age security, and to arrange funerals or cremations. For them, however, predictable financial needs such as expenditures on life cycle events and education often become sources of financial stress.

Most working poor households face a high level of risk for a number of reasons (Eurostat, 2014). In the first place, those who work in the informal economy have a high exposure to risks derived from the conditions under which they live and work. Secondly, they tend to have low levels of income, and are therefore less likely to be able to save for contingencies. Thirdly, they tend to have little or no access to formal means of handling risks (e.g., insurance, pensions, and social assistance) or paying for housing and education (e.g., mortgages, scholarships, and loans).

According to Savitha and Kiran (2013), poor working households cope with risks through some combination of saving, borrowing, and insuring. Not only their sources of income, but also their sources of savings, loans, and insurance are mainly informal. They save at home or through rotating savings, credit associations, and increasingly microfinance institutions. They borrow from family and friends, from moneylenders, employers, and traders, and increasingly from MFIs (Karlan & Morduch, 2010). They usually insure through informal reciprocal schemes, notably to cover costs associated with death ceremonies and marriages. Thus, their current risk management instruments are often inadequate. No amount of borrowing on unfavourable terms or insuring under reciprocal systems can compensate for

the lack of access to formal sources of insurance, mortgages, education loans, pensions, and other financial services.

In times of hardship, social capital is a form of non-monetary currency that can help sustain a poor family's viability (Zephyr, 2004). This is the basis for group lending offered by MFIs. An individual's reputation in the community is an asset to be cultivated in better times because it determines what networks will be available or not to help them leverage whatever assets they may have left to help cover their expenses until they can regain more financial stability. MFIs cannot only help poor people manage risk but also help build existing social networks (Perdana, 2005).

1.9.3 What do the Poor Need Beyond Credit?

The discussion below correlates with the theory of social choice as well as the theory of justice. The findings of our study will illustrate how and why financial needs, even anticipated needs, become financial risks for the poor. They will also show why the poor need to save even when they have little surplus with which to do so. The common understanding is that the poor save and borrow because they periodically need to obtain sums of money much larger than the amounts normally available in their households (Rutherford, 2000). For some types of expenditures, such as weddings and rituals, this might be true. For other types of expenditures, such as illness, death, old age, housing, or education, it would be more accurate to say that the poor periodically need lump sums of money to cover expenses that less disadvantaged households, especially in more developed countries, would cover through insurance, pensions, mortgages, scholarships, or education loans.

What distinguishes households from one another is not their financial needs but their financial resources, namely how much money they have and how easily (and on what terms) they can get the additional funds they need (Zeller & Johannsen, 2006). Less disadvantaged households can draw the funds they need from a wide range of mechanisms and sources. For instance, according to Churchill (2012), they can resort to credit, savings, mortgages, or insurance products (health, property, life, and maternity) provided by formal financial institutions. They can also resort to insurance, pensions, social security, education scholarships, or safety nets provided by statutory schemes and private institutions. However, the tides change and advantaged households can experience shocks and poor households can overcome their adversity. MFIs can serve the whole spectrum of households, in good times and bad.

In developing countries, poor households typically do not have maternity benefits, education loans and scholarships, health, life and property insurance, sick leave, or old age pensions, whereas in industrialised countries most households have access to some of these schemes or benefits (Bertulfo, 2011). Thus, it is commonly understood in industrialised countries that there are significant risks associated with not being covered by such instruments, an understanding that should also be extended to developing countries, where few poor households are indeed covered. The increased emphasis, for example in the field of microfinance, on the role that financial services can play in helping poor households to cope with risk, albeit welcome, should not distract our attention from the wider development failures that contribute to or exacerbate their exposure to risk. This is because no amount of credit, or perhaps only a very large amount of credit, can make up for the lack of insurance, worker benefits, pensions, mortgages, and other such provisions.

The types of instruments and policies needed to prevent and mitigate the risks faced by those in the informal economy can be usefully classified into four groups (Hoogeveen, Tesliuc, Vakis & Dercon, 2004). First, there are pensions, insurance, and safety nets to cover the common risks of illness, maternity, disability, old age, death, unemployment, loss of assets, and loss of income. Second, there are special savings and loan products to cover social expenditures on life-cycle events such as birth, marriage, death ceremonies, festivals and rituals, and education. Third, there are business development services to increase skills, improve products, and access markets. Finally, there are regulatory and institutional policies that address demand and supply fluctuations, transaction failures, price changes, and market access. In terms of Shariah-finance, supplying credit for these needs meets the principle of morality – caring for the poor and the destitute by means of profit-free loans.

1.10 BACKGROUND TO MICROFINANCE IN UGANDA

The evolution of microfinance in Uganda dates back to the time before European colonialism. In a way, the traditional financial methods of the country were already an informal type of microfinance. It was common to find people giving seeds for planting to their neighbours. After the harvest, the recipients would return the seeds in a basket larger than the one they had received. The cattle keepers had a similar system, whereby some people would give animals to their neighbours, who would then return the loans by giving back calves. Other traditional methods were barter and the so-called “merry go-rounds” (Zeija, 2009).

In the 1980s, the government of Uganda recognised microfinance as a positive poverty eradication tool and a potentially powerful engine of growth for the economy. At that time, it also began investing heavily in direct and subsidised credit through the cooperative movement and through banks. This was achieved through schemes such as the Uganda Commercial Bank's Rural Farmers Scheme and, later, the Entandikwa Credit Scheme. Due to poor repayment rates, however, the expected results did not materialise (Zeija, 2009).

During the economic liberalisation of the 1990s, there was a paradigm shift from a "beneficiary" to a "client" mentality, prompted by the donors and by the growing investment in the industry. At that time, donors convinced the government to stop acting as a direct player in the industry. Thus, in its Mid Term Strategy and Poverty Eradication Action Plan (PEAP, 1997; updated in 2000 and 2005), the government of Uganda began to conceive of microfinance as its major tool for development, an idea that was again stressed in the 2002, 2003 and 2004 National Budget Speeches (Zeija, 2009).

Thanks to the involvement of the government, donors and other private sector actors, the industry was so large, diverse and dynamic by the end of the 1990s that a regulatory policy had to be developed. In 2000, the government initiated the Rural Microfinance Support Project (RMSP), which was managed by the Microfinance Support Centre Limited (MSCL), a new fund whose purpose was to invest in the MFIs. From 2000 to 2003, microfinance services in Uganda were regulated by a cabinet directive that established the following guidelines for the industry:

- the government would withdraw from the direct delivery of credit;
- the government would play the role of facilitator in the microfinance industry, limited to the provision of a favourable policy and regulatory environment;
- the government would, in addition to the above, provide capacity building to the microfinance industry; and
- microfinance service delivery would henceforth be undertaken by private sector providers.

This environment is the one that prevails in Uganda today.

It is important to mention at this stage that Islamic banking in Uganda was approved in 2014 which is evidence of the regulatory role of the government (Tetana, 2014), although the Finance Minister noted the challenge of a lack of trained and skilled personnel to support

banking according to Islamic principles. This development could, in the main, be attributed to the growing demand for Islamic finance across East Africa (where Uganda is situated) as a result of the Muslim population of the region becoming aware that there is a viable *Riba*-free way to interact with the financial sector, as well as a result of a conscious effort by the governments of East Africa to create a regulatory framework that is attractive to foreign Islamic banks (The Islamic Globe, n. d.).

1.11 PROJECT AREA: KAMPALA DISTRICT

1.11.1 Geography

The district of Kampala is located in southern Uganda, about 45 km north of the equator on the shores of Lake Victoria. It has a tropical rainforest climate, with temperatures ranging from 10 to 32°C and an annual rainfall of 120-150 cm. Its capital city, Kampala, is entirely surrounded by a rich hinterland that enjoys reliable rainfall throughout the year, with two wet seasons from August through December and from February through June.

1.11.2 Demography

The district's population has been increasing at a fast rate. Rural-urban migration is cited as the key contributory factor to this population growth. As a consequence, Kampala has become a cosmopolitan city, where all the ethnic groups in Uganda are represented together with the region's indigenous people, the Buganda. The main language spoken is Luganda. According to the latest Population Census (2011), the whole district has approximately 2.5 million inhabitants and its capital, with 1.7 million, is by far the largest city in Uganda.

1.11.3 Economy

Kampala District is Uganda's main commercial centre and serves as a crucial processing, marketing, and distribution hub for agricultural commodities. The rural-urban connection between the city of Kampala and the surrounding areas is critical for its economic prosperity, in terms of both the formal and informal trading sectors. Kampala's economy is largely cash based.

Over the last three decades, numerous political and economic disruptions in Uganda have led to the collapse of formal sector employment. As a consequence, many residents of Kampala have faced difficulties in meeting their subsistence needs. Redundant government staff members, as well as those individuals who are employed (but not earning a living salary) are

compelled to engage in numerous other income-generating activities in order to sustain their households. The diversification of the city's business sectors has resulted in a dramatic expansion of women's participation in income-generating activities. This is particularly noticeable in those households that are headed by women.

In the whole district, people predominantly live from subsistence agriculture, with 90 per cent of crops being rain-fed while about 10 per cent are irrigated. Livestock rearing and apiculture (bee-keeping) are also quite common. Other income-generating activities are hired labour (mainly in small towns), irrigation schemes, selling of firewood and charcoal, petty trading, brick making, selling of vegetables (by those who have irrigation), and food aid (when available).

Informal sector activities take place both in commercial centres and in trading/residential areas. The substantial growth of the informal economy is often mentioned as a key challenge for the district's planning and administration. Informal sector activities are projected to generate around 80 per cent of Kampala's industrial output. These business activities take place outside the formal market areas for several reasons such as the scarcity of room in formal markets, the unaffordability of market stalls by vulnerable entrepreneurs, the need to locate services close to the customers and women uniting reproductive and productive roles by working in close proximity to or within their homes. One of the main constraints faced by informal sector activities is the fact that they are often undervalued by the authorities at the city council. This leads to insufficient provision of infrastructure and utility services in most of the areas where informal sector activities occur.

A majority of the urban poor engaged in the informal sector do not have access to the commercial banks operating through branches in Kampala, since they are usually under-qualified to meet their requirements. They often lack the needed collateral or even a financial history that would enable them to obtain credit. The amounts they are able to save through their economic activities are too small to even open savings accounts. The few other properties they might have, such as a house built and owned on an untitled piece of land (a common practice amongst the urban poor), are likely to be declined as collateral for a commercial bank loan.

1.11.4 Religion

Uganda is religiously diverse nation with Christianity (85.1%) and Islam (12.1% or 4.3 million people) being the most widely professed religions (Index Mundi, 2014). Without

Shariah-compliant banking in Uganda, this means that a considerable percentage of the population is excluded from taking advantage of financial services, as discussed in the next section, because Islamic teachings are against *riba* which means excess, increase or addition, which according to Shariah terminology, implies any excess compensation without due consideration.

1.12 THE FINANCIAL SECTOR IN UGANDA

Uganda has a relatively diverse financial sector, considering its low overall level of development.

- The formal financial institutions are controlled by the Bank of Uganda. They are commercial banks (Tier I), credit institutions (Tier II), and microfinance deposit-taking institutions (Tier III).
- Semiformal financial institutions are licensed or registered under an Act of Parliament (Tier IV), but are not monitored by the Bank of Uganda. In this category, we find savings and credit cooperatives (SACCOs) and credit-only MFIs (companies limited by shares, companies limited by guarantee, or NGOs), which are allowed to make loans but not to collect deposits for intermediation. SACCOs are regulated by the Ministry of Trade, Tourism and Industry.
- Finally, informal financial institutions include those that are not monitored by the Bank of Uganda and are not registered under Acts or Statutes enacted by the Parliament of Uganda. They fall into numerous categories. Almost all of these are voluntary groups of members from the same location who meet on a regular and frequent basis. Examples of informal financial institutions are rotating savings and credit associations (ROSCAs), accumulating savings and credit associations (ASCAs), and savings clubs.

Table 1.1 below shows the different types of financial institutions and informal sources of credit available in Uganda.

Table 1.2: Financial institutions and informal sources of credit in Uganda

Formal institutions	Semiformal institutions	Informal institutions
Tier I, Tier II, Tier III	Tier IV	No ranking
Commercial banks	Credit-only MFIs, not supervised by BOU	Groups, such as ROSCAs, ASCAs and savings clubs

Credit institutions	Savings and credit cooperatives (SACCOs)	Friends, employers, shops and others as a source of credit
Microfinance deposit-taking institutions (MDIs)		Private money-lenders

Source: FinScope Uganda (2006)

Whilst this list of lenders is quite comprehensive, there are other forms of support available to poor people and needy organisations provided through AMFIU by its associate members. In its 2015 Directory (AMFIU, 2015), AMFIU Associate Members offered such ancillary services as: financial management and consultancy, conventional and Islamic Finance Project Development, training and capacity building, as well as a variety of other services that can be tailored to fit the client's unique needs.

According to Beck and Hesse (2006), the Ugandan financial sector is not as developed as that of neighbouring Tanzania and Kenya in terms of the private credit ratio to GDP. Moreover, the Ugandan market is more concentrated. In the early 2000s, there was a major influx of foreign investment into the financial sector, which had a far greater impact on the savings than on the credit side of the business. Nevertheless, as Beck and Hesse (2006) point out, in spite of the diversity of small microfinance providers, when measured by overall volumes, the formal sector clearly dominates the market.

Recently, the Ugandan government has started to promote the creation of savings and credit cooperatives (SACCOs), as a way to enlarge Ugandan citizens' access to financial services (Nuwagaba, 2012). It should be pointed out that this initiative had not yet been launched at the time when FinScope² data was being collected. Another important development in Ugandan public policy towards the financial sector was the ratification in 2003 of the Microfinance Deposit-taking Institutions Act. This was the first legislative act allowing big microfinance NGOs to take deposits from the public. This put them under the supervision of the Bank of Uganda. Thus, a significant feature of the Ugandan financial market is that the

² FinScope, a FinMark Trust initiative, is a nationally representative study of consumers' perceptions on financial services and issues, which creates insight to how consumers source their income and manage their financial lives.

largest MFIs have in effect become formal financial services providers at the Tier III level in the form of microfinance deposit-taking institutions (MDIs).

1.13 RESEARCH PURPOSE

According to Yunus (2007: 924), “We can create a poverty-free world if we collectively believe and participate in it, rethinking our institutions and policies while building practices that expressly service the needs of the poor.”

Part of the solution, as can be seen from the discussion above is to enable people to save money for productive investment. However, the poor are generally not able to save and therefore cannot invest to grow their businesses or improve their income-generating activities. Since they have no savings, they are also not eligible to use the financial services of banks or other formal financial institutions. Even if poor individuals or households were able to provide collateral worth up to \$10,000, banks or financial institutions would still avoid serving these clients because doing so would generate them more costs than profits (Haupt & Hamann, 2004). For that reason, financial services provided by traditional banks exclude more than half of the world’s population (Yunus, 2007). Hence, the poor are often forced to rely on abusive moneylenders who prey on their needs and lend them money at a usurious interest rates. This leaves the poor locked in the poverty cycle (Haupt & Hamann, 2004).

According to Yunus (2007: 24), “everyone should have equal access to financial resources in order to reduce poverty”. By providing them with savings, low-interest credits, as well as insurance products and payment services (Ledgerwood, 2014), microfinance allows the poor to escape from poverty.

The first Microcredit Summit was held in Washington D.C in 1997 where microfinance was highlighted as a universal poverty alleviation tool (Elahi & Danopoulos, 2004). The idea was raised again at the 2004 Microcredit Summit, when one of the contributors stated: “The time has come to recognise microcredit as a powerful tool in the struggle to end poverty and dependence” (*ibid.*: 643). This same concept was included in the UN Millennium Development Goal of reducing absolute worldwide poverty by half by the year 2015 (Elahi & Danopoulos, 2004). The importance of microfinance was further recognised when the United Nations declared 2005 the “UN Year of Microcredit” (Haupt & Hamann, 2004) and when the Nobel Peace Prize Committee honoured Professor Muhammed Yunus and the Grameen Bank in 2006 (Hamilton, *et al.*, 2008).

Microloan products are available to individuals and groups. Due diligence on individuals takes more time than for groups and is more expensive to offer. Group loans (e.g. villages or communities) are often structured in such a way that the receiving group can determine what interest it will charge members of the group, depending on the project and other circumstances. For example, FINCA Uganda (2015) offers no collateral small group loans in amounts as low as Shs. 50,000 (\$16 USD) to 1 million Shs. (\$330 USD) with flexible payment terms over a 4-8-month period. They offer a variety of loans and services for agriculture loans, business loans, school fee loans, loans for the purchase of solar power units and more. Field, Pande, Papp and Rigol (2013) found that by varying loan terms, borrower behaviour could be affected in terms of loan use and willingness to assume risk. In their study involving Village Financial Services (VFS) in Kolkata, India, in loans to 169 five-member loan groups (ranging from \$90 USD to \$225 USD), loans with an eight-week grace period, the researchers showed that there was no influence on the frequency of repayment after the grace period and, relative to clients on a regular contract, grace period clients increased business spending and reduced spending on house repairs. Moreover, the likelihood of starting a new business was almost three times higher among the grace period clients. The evidence suggests that greater liquidity affects entrepreneurial behaviour and that grace periods, loan size and interest rates can be adjusted to encourage more profitable, though riskier, investment while promoting entrepreneurial behaviour.

From these precedents, there is a growing recognition that microfinance is an important tool for poverty alleviation, hence, the current research aims at analysing Shariah-compliant MFIs and assessing their ability to overcome the limitations of conventional microfinance approaches (identified above as debt financing, with the emphasis on the word “debt”) in Uganda.

As we shall go on to examine, there are real cleavages between those who regard microfinance as a force for social good (rather than profit-generating) and those who believe that the financial sustainability of MFIs must first be secured before microfinance can be effective. Shariah-compliant financing thus becomes a further intriguing factor in the mix. Can Shariah-compliant financing help to bridge the gap between microfinance models and if so, how? In the following section, the objectives of this study with regards to these key questions are outlined in greater detail.

1.14 RESEARCH DESIGN

1.14.1 Qualitative Research

The thesis follows a qualitative research approach. Qualitative research is used to examine Shariah-compliant microfinance clients in Uganda, in order to discover the strengths, weaknesses, opportunities, and threats faced by both conventional and Shariah-compliant microfinance under the economic and financial circumstances of the country. In addition, it provides a comparative analysis between the Shariah-compliant and conventional microfinance institutions of Uganda. In the specific context of Uganda, the study focuses on the reasons behind the emergence of Shariah-compliant microfinance as well as on the role these institutions have played in the socioeconomic life of the country. The study then examines the different impacts of Shariah-compliant and conventional microfinance institutions.

The study also reviews the empirical research done by Muslim and non-Muslim scholars on the socioeconomic impact, sustainability, and the success and failure of both conventional and Shariah-compliant microfinance practices. Although Shariah-compliant and conventional MFIs are present in most parts of the world, our constraints of time, length and topic force us to focus only on the comparison between the Shariah-compliant and conventional MFIs in the case of Uganda. One reason why it was decided to focus on Uganda is because limited research on microfinance has been done in this country, and there is also limited research into the potential growth of Shariah-compliant MFIs in the region.

In order to carry out this comparison at the qualitative level, the case study approach was used to compare Shariah-compliant and conventional microfinance institutions. The study was conducted in Uganda in 2013. It included semi-structured interviews, with three different groups of people, namely MFI directors, government representatives, and representatives of the microfinance beneficiary programmes in both Shariah-compliant and conventional MFIs in Uganda. The goal of the interviews was to discover the sources of both client satisfaction and dissatisfaction.

In addition to many other Uganda-based MFIs, the Shariah-compliant microfinance programmes organised by three charity organisations, namely the Kuwaiti Direct Aid, the Kuwaiti IICO, and the Saudi WAMY, and other Ugandan MFIs were investigated. These three charity organisations were targeted because they have been present and accumulated expertise in development work in Africa since 1984. In addition, the researcher had good

relationships with all these organisations and could easily communicate with them and access the necessary information to conduct the research.

In addition, an interview schedule was used to examine the client's views about microfinance. A random sample of 150 borrowers was selected to participate in this study. Due to the limited time spent in the field, the researcher tried to gather most of the beneficiaries of the microfinance projects in one place to question them at the same time. If there were any additional comments or clarifications to be obtained from the respondents' answers, further interviews were arranged on an individual basis. In addition, interviews were conducted with 100 MFI employees and five government officials. The analysis is limited to descriptive rather than inferential statistics.

1.14.2 Primary and Secondary Data

Primary data was collected in Kampala, the capital city of Uganda. Semi-structured interviews held with MFI clients and employees over a period of three months provided a rich pool of primary data for analysis. The interviews conducted focused on households' access to microfinance, uses of credit, and fluctuations of income over the period. In order to obtain more accurate information about household incomes and expenditure, and also to capture marginal changes over this relatively short period, relative measures of income and poverty were used. These measures mainly focused on access and ownership of assets by households, as well as on the fluctuations within the period of observation.

In addition to the primary data collected in the field, secondary sources were carefully assessed and analysed. Most of the literature used in the study was produced by reputed worldwide organisations and institutions, such as the World Bank, the International Monetary Fund, the Islamic Development Bank, the Microfinance Information Exchange (MIX), and the Consultative Group to Assist the Poor (CGAP).

The research aimed to examine the extent to which participation in a Shariah-compliant microfinance programme leads to:

- improvements in the economic welfare of households;
- enterprise growth or stability;
- increases in empowerment, especially among women; and
- stronger social and rural networks.

Each of these concepts includes specific types of measurable impacts which were identified during the work leading up to the final design of the baseline questionnaire (Appendix A) which formed the basis of the analysis. The range of anticipated impacts reflects differences in the socioeconomic context of Kampala and in the clientele of the MFIs covered by the assessment.

The interview schedules were designed around the measures used in other studies, for example

- Social Performance Indicators initiative (SPI) – Questionnaire for MicroFinance Institutions (MFIs) v2.1 (socioeco.org, 2005);
- Microfinance satisfaction questionnaire (Grameen Credit-Agricole.Org, 2013); and
- Microfinance impact assessment survey (Royal Bank of Scotland India Foundation, 2008).

The analysis of household economic welfare focused on the following measurable impacts:

- improvement in living conditions through increases in the number of rooms used by households and improved infrastructure;
- increased proportion of educated young males and females;
- improvement in household diet;
- improvement in the household's effectiveness to cope with financial crises;
- increase in the amount of land used, the number and types of crops sold, and the number of livestock owned by households engaged in agriculture;
- increases in numbers of clients on programmes providing health and nutrition information that try new practices; and
- increases in household assets.

To determine if participation leads to enterprise growth or stability, attention was given to the following measurable impacts:

- investments in enterprise fixed assets;
- increases in paid and unpaid employment; and
- rates of continuation, expansion, and diversification of microenterprise activities.

In order to measure empowerment, the study focused on the greater control of resources by households. It was hypothesised that this would occur through the following measurable impacts:

- increases in controlling decisions about the use of money earned;
- increases in assets owned and controlled; and
- changes in savings patterns.

To determine if microfinance programmes were likely to strengthen social and rural networks, benefiting individuals beyond the clients and their immediate households, the study looked at the increase in the flow of resources to rural areas, for example through growing remittances and transfers.

1.15 ORGANISATION OF THE THESIS

The thesis is divided into seven chapters.

Chapter 1 has introduced the study and presented the aims and objectives of the research.

Chapter 2 reviews the literature on conventional microfinance, particularly the contributions that are most relevant for understanding its impact. The chapter begins by highlighting the history of microfinance, along with the main aspects of conventional microfinance. Moreover, the chapter discusses how conventional microfinance operates and how it differs from Shariah-compliant microfinance.

Chapter 3 goes on to discuss Shariah-compliant microfinance, reviewing the literature from both Islamic and modern resources. The chapter argues that Shariah-compliant microfinance is a new model capable of providing effective financial services to the vulnerable and that it has a relevant role to play in poverty reduction. From this analysis, the following chapters discuss the practical issues that MFI directors and policy makers have to deal with in trying to provide financial services to the vulnerable.

Chapter 4 discusses the problems of microfinance which have been debated in the microfinance literature. More specifically, the chapter analyses the major shortcomings of microfinance as an instrument for poverty alleviation in an attempt to reach an objective conclusion on this issue.

Chapter 5 deals with the conceptual and methodological issues of the study. In particular, the chapter describes the field work conducted in Uganda. Also in this chapter, the general

methodologies that have been used to measure the impact of microfinance in earlier research are discussed. The chapter points out that future empirical research would be useful to reach conclusive results.

Chapter 6 is where the research results are presented and discussed. The chapter begins with a rich qualitative analysis, which focuses on the field work research conducted in Kampala. The practical issues of loan acquisition, usage and repayment, are discussed here. Group formation and activities are also discussed in some detail. One of the conclusions of this chapter is that the provision of affordable financial services to the rural population remains an important component of the development strategy. On the other hand, the chapter points out the need to come up with innovative microfinance institutions that support asset accumulation and wealth creation for their clients. This would involve targeting new clients, as well as streamlined microfinance conditions to protect them.

Chapter 7 presents the final recommendations of the researcher. The chapter attempts to spark future research in the area by proposing a theoretical paradigm of how microfinance can fit into the larger picture of rural development and poverty reduction.

1.16 CHAPTER SUMMARY

Chapter 1 provided a general introduction to the study which was followed by an explanation of the theories underpinning the study, namely the theory of social choice and the theory of justice. The issues of poverty and empowerment were discussed as key themes of the thesis. Shariah-finance principles were introduced. The focus then shifted to the concept of microfinance and the establishment of microfinance in Uganda. Finally the research design was briefly described. The next chapter provides a literature review of the development of microfinance globally and in Uganda.

CHAPTER 2: LITERATURE REVIEW

2.1 INTRODUCTION TO MICROFINANCE

This chapter reviews what microfinance is, its history, its challenges, successes and failures, and what researchers have said regarding the import and intent of microfinance institutions, with a threefold focus: MFIs have to be financially sustainable, they have to reach a greater number of poor, and they have to reach a greater proportion of the poorest members of society.

2.2 WHAT IS MICROFINANCE?

At the beginning of Chapter 1, microfinance was defined as a range of services including “micro-credit, micro-savings, micro-insurance, and money transfers, ... enabling micro-entrepreneurs to build businesses and increase their income, as well as improving the general economic wellbeing of the poor” (van Rooyen, Stewart & De Wet, 2012).

Other definitions add nuances such as “the provision of financial services to low-income poor and very poor self-employed people” (Otero, 1999: 8), while Schreiner and Colombet (2001: 339) defined microfinance as “the attempt to improve access to small deposits and small loans for poor households neglected by banks.” The emphasis in these definitions is on poor, small and banks. Therefore, microfinance involves the provision of financial services like savings, loans and insurance to poor people living in both urban and rural settings who are unable to obtain such services from the formal financial sector. An interesting nuance in the mix is the idea of self-employment. According to Ledgerwood (1999), microfinance is a crucial economic development tool that focuses on offering financial services that benefit low-income men and women, including those who are self-employed.

For the purpose of this study, microfinance is interpreted to be a medium for providing financial resources to poor people who would not normally have access to acceptable collateral for credit or financial arrangements, providing them with opportunities to improve their financial status using financial products and services designed specifically for them. There is little or no evidence in the literature to indicate that people in other less disadvantaged socioeconomic categories need access to microfinance, since they are able to take advantage of a full range of financial services from the formal financial sector. It is in only in recent years, since the 2008 global financial crisis, that unemployed people have also been considered as a target market for microfinance services, despite financial support for the

unemployed tending to be highly restricted and unemployed people often facing barriers in accessing commercial loans (Chong, 2009). My assumption in this regard is that this situation refers to the previously employed, generally in Westernised first-world communities, as opposed to the never-employed who live in African or Asian third-world or developing countries. The conclusion, then, is that recipients of microfinance are generally excluded from mainstream financial services and work in the informal sector (Leone & Poretta, 2014).

The primary goal of microfinance services is to alleviate poverty amongst poor individuals around the world (Hulme & Maitrot, 2014). Nevertheless, microfinance institutions have extended their microfinance activity to provide insurance and payment services, as well as social intermediation services. These services help to develop self-confidence, group formation, and management and marketing capabilities among financial and health literacy groups (Ledgerwood, 1999).

The microcredit movement operates under the assumption that the poor lack access to formal financial services and that their only alternative is to obtain credit from informal lenders charging usurious rates. Two potential strategies through which MFIs alleviate poverty are financial inclusion and the development of income-generating activities (Banerjee, Duflo, Goldberg, Karlan, Osei, Parienté, Shapiro, Thuysbaert & Udry, 2015). The first strategy emphasises the benefit to poor people of having an alternative to the abusive moneylenders who charge exorbitant interest rates. The second strategy emphasises the generation of additional sources of income that allow individuals to permanently escape the trap of poverty.

2.2.1 The Emergence of Microfinance

Microfinance as it is known today, is usually attributed to the creation of the Grameen Bank. However, its historical precedents have much earlier origins.

More than 3,000 years ago, pawn shops first emerged in Ancient China as a method of granting short-term credit to peasants (Liming, 2000). Some pawnbrokers operated independently, but over time most of these businesses were run through pawn shops. Pawnbroking thrived in ancient Greece and Rome, giving merchants a way to get small shops off the ground (Graeber, 2012). Institutionalised pawnbroking first made its appearance in Europe during the Middle Ages, where charitable groups or governments opened non-profit pawn shops as a service to the poor (Caskey & Zikmund, 1990). Microfinance through informal savings and credit groups has therefore occurred at least since the 2nd Century BCE.

Thereafter, the lending system developed into formal credit and savings institutions that helped vulnerable populations neglected by commercial banks. In the 1700s, the Irish Loan Fund system was established, offering financial services to poor people (Mwangi, Shisia, Mwai & Okibo, 2014). By the 1840s, there were already 300 of these funds all over Ireland. In the 1800s, the failure of credit institutions focused primarily on rural and urban poor led to the development of the financial cooperative model in Germany (Guinnane, 2011). Its aim was to help the rural poor to achieve self-dependence and to improve their welfare, freeing them from their dependence on moneylenders. This movement subsequently reached other parts of Europe and was then replicated elsewhere. In fact, many of the current financial cooperatives in the world have European roots. For example, the Indonesian People's Credit Banks were established in 1895 following the European model (Ikasari & Hadzic, 2012). In the early 1900s, the credit and savings system developed further to suit the needs of a larger population of poor people and to modernise the agricultural sector.

Microcredit and microfinance are relatively new terms in the field of development, first coming to prominence in the 1970s, according to Charles (2007), and have since been rebranded as financial inclusion (Allen, Demirgüç-Kunt, Klapper & Peria, 2012). Although often used interchangeably, they are technically different. Microfinance is an umbrella term that includes an array of financial services, including loans, savings and insurance, available to poor people, entrepreneurs and small business owners, primarily in developing countries who have no collateral and wouldn't otherwise qualify for a standard bank loan (Brooks, 2013). Microfinance may or may not require collateral for loans to be made to very low income borrowers. Typical microcredit loans are a small amount of money loaned to a client by a bank or other institution and can be offered, often without collateral, to an individual or through group lending (Yearofmicrocredit.org, 2005). Ledgerwood and Earne (2013) defines financial inclusion as referring to people and businesses having access to appropriate and affordable financial services.

From the 1950s through the 1970s, the provision of financial services by donors or governments was mainly in the form of subsidised rural credit programmes. These often resulted in high loan defaults, high losses, and the inability to reach poor rural households (Robinson, 2001). Between the 1950s and the 1970s, most governments focused on increasing the productivity and income of farmers by providing agricultural credit. All these efforts of the state-owned financial institutions were intended to give loans at below-market

interest rates for the expansion of the agricultural sector. That was when microcredit emerged (Helms, 2006).

Robinson (2001) points out that the 1980s represented a turning point in the history of microfinance, as new MFIs like the Grameen Bank and BRI2 began to show that they could provide small loans and savings services profitably on a large scale. They received no continuing subsidies, were commercially funded and fully sustainable, and could attain wide outreach to clients (Robinson, 2001). It was also at this time that the term “microcredit” came to prominence in the development discourse (Gatimu & Kalui, 2014). The difference between microcredit and the subsidised rural credit programmes of the 1950s and 1960s was that microcredit insisted on repayment, on charging interest rates that covered the cost of credit delivery, and focused on clients who were dependent on the informal sector for credit (*ibid.*). It was now clear for the first time that microcredit could provide large-scale outreach in a profitable manner.

The 1990s “saw accelerated growth in the number of microfinance institutions created and an increased emphasis on reaching scale” (Robinson, 2001: 54). Dichter (1999: 12) refers to the 1990s as “the microfinance decade”. According to Robinson (2001), microfinance had now turned into an industry. Along with the growth in microcredit institutions, attention changed from the mere provision of credit to the poor (microcredit) to the provision of other financial services such as savings and pensions (microfinance), as it became clear that the poor had a demand for these other services (Gatimu & Kalui, 2014).

The adoption of microcredit as a major tool in development and poverty reduction by governmental and non-governmental organisations is a highly debated issue. Current research has generally underestimated the benefits of microcredit as an essential tool for poverty reduction and rural development (Islam, 2012). Moreover, if one looks at the end results, even when microcredit does reach the very poorest and may not increase incomes as much as it does smooth consumption and diversify income, it often reaches many of the poorest whose net gains accrue to the benefit of those near the poverty line (Johnston & Morduch, 2011). While the Grameen plan may not fit every situation, its success inspired innovation in other microfinance applications that has changed the global landscape for serving the poor.

The positive effects of microcredit come through the creation of opportunities for entrepreneurship, as it helps the vulnerable to eliminate poverty and unemployment by funding their creative potential (Yunus, 2001). Successful microcredit programmes include

the Grameen Bank in Bangladesh, BRI in Indonesia, and ACCION in the United States, all of which are involved in “the supply of loans, savings, and other financial services to the poor” (Littlefield, Morduch & Syed, 2003). Despite the spectacular success of these and other microcredit initiatives around the world, some of the current literature contradicts the most optimistic views of microfinance. In particular, researchers have criticised outstanding problems in the provision of microfinance, such as the exploitation of women borrowers, high loan repayment default rates, high interest rates, the unchanging status of poverty levels, and the failure to effectively reach target groups (Islam, 2012).

The importance of microfinance in the field of development was reinforced with the launch of the Microcredit Summit in 1997. By the end of 2015, the Summit aimed to reach 175 million of the world’s poorest families, especially women, by providing credit for the self-employed and other financial and business services (Simanowitz & Walter, 2002). More recently, the UN declared 2005 as the International Year of Microcredit, giving a further boost to this expanding industry.

2.2.2 Microfinance and Microcredit

Although in the literature the terms ‘microcredit’ and ‘microfinance’ are often used interchangeably, it is important to highlight the differences between them in order to avoid confusion. Sinha and Matin (1998: 2) point out that “microcredit refers to small loans, whereas microfinance is appropriate where NGOs and MFIs supplement the loans with other financial services (savings, insurance, etc.)”. Therefore, microcredit is a component of microfinance as it involves providing credit to the poor. But microfinance also includes other non-credit financial services such as savings, insurance, pensions and payment services (Okiocredit, 2005). As explained earlier (section 2.1.1), the terms are used interchangeably here and among those in the industry.

With this caveat taken into account, it should be noted that this researcher has sometimes used these two terms interchangeably because distinguishing between the two in a substantial piece of work such as this thesis would not be overtly helpful.

2.2.3 Recent Studies and the Current Research Problem

Rigorous empirical analysis of the statistical impact of microfinance began in the 1990s. The many studies conducted so far have reached highly controversial conclusions. One school of thought questions the relevance of microfinance as a poverty reducing instrument. Adam and

Von Pische (1992: 468) argued that “debt is not an effective tool for helping most poor people to enhance their economic condition, be they operators of small farms or micro entrepreneurs”. Their main argument was that small agricultural households face more important constraints than just access to credit, such as product prices, land tenure, technology, market access and risk. In support of the same view, Gulli (1998) argued that credit is not always the main factor constraining the growth and development of microenterprises and that poor people demand a wide range of financial, business, and social services for different professional and household purposes. Similarly, Mayoux (2002) argued that the logical assumption of a virtuous spiral of economic empowerment due to microfinance does not correspond with reality. She points out that the existence of gender imbalances in society, particularly regarding loan uses, more often than not leaves poor female borrowers highly indebted at the end of the process.

Other in-depth studies have shown that micro-entrepreneurs below the poverty line do not experience the same percentage increases in their income after borrowing as those above the poverty line. As these studies have pointed out, one reason is that households below the poverty line tend to use loans for consumption purposes to a greater extent than households above the poverty line (Fenton 2010). It is rather intriguing, however, that the microfinance institutions serving these same poor households, which are more likely to use loans for consumption purposes, are able to achieve better loan repayment rates than formal financial institutions, which are generally used by the well-off in society (Ghatak, *et al.*, 1999).

Against these pessimistic arguments, other studies have found that microfinance is indeed conducive to poverty reduction and has positive effects, not just for beneficiaries, but also for the rest of the community (Khandker, 2006). In a study using a panel survey of households from Bangladesh, Khandker observed that access to microfinance contributed to reduced poverty, especially in the case of female participants, as well as to improvements in the overall economic situation of villages. Although another study by Pitt and Khandker (1998), using data from three programmes in rural Bangladesh, found that borrowing from group-lending schemes increased consumption in poor households, Warby (2014) has argued that these results reflect programme selection effects rather than the impact of borrowing *per se*.

There are other studies that seem to support to some extent the relevance of microfinance as a tool for poverty reduction. For instance, Warby (2014) argued that microfinance generally has a positive impact on poverty reduction. However, Morduch (1999) adds that “even in the

best of circumstances, credit from microfinance programmes helps fund self-employment activities that most often supplement income for borrowers rather than drive fundamental shifts in employment patterns. It [microfinance] rarely generates new jobs for others and success has been especially limited in regions with highly seasonal income patterns and low population densities”.

Other studies have shown that, while microfinance may be relevant for poverty reduction, it does not reach the poorest to the extent that is often claimed. The results from these studies have identified beneficial impacts for the “active poor,” but have also shown that microfinance does not assist the poorest in society to the same degree (Sharma, 2000; Kiiru & Mburu, 2007). These studies often report mixed results, suggesting the existence of both positive and negative impacts for different types of households. Coleman (2006) found that microfinance programmes have a positive impact on relatively richer households but have insignificant impacts on poorer households. In Coleman’s study, richer households were able to obtain larger loans for themselves because they had influential positions in the village banks, often acting as committee members. Coleman argued that the size of the loans that households were able to acquire had a significant impact on their incomes. This same study showed that many poor female borrowers dropped out of the credit programmes because the size of the loans was too small to make any significant investments that would improve their incomes. In another study focused on the impact of microfinance on household assets, Kiriti (2005) showed that microfinance tends to increase the debt of the poorest women, leaving them more vulnerable and exposed than before. It seems that poor households tend to deplete livelihood assets in the course of loan repayment, as income generating activities fail to produce enough profits to repay the loans on time. Warby (2014) states that the beneficial effects of microfinance might be washed out by the harm MFIs do to some households.

Armendáriz de Aghion and Morduch (2005) observed that, while microfinance can make a real difference in the lives of borrowers, it is neither a panacea nor a magic bullet against poverty. It cannot be expected to work everywhere and for everyone. While the statistical impacts of microfinance have received mixed reviews, suggesting at least the possibility of a positive welfare effect, no robust study has been conducted so far that would allow us to conclude that microfinance has a strong impact on poverty levels (Armendáriz de Aghion & Morduch, 2005). Future research should therefore be directed towards, not just obtaining specific results, but also examining the context within which particular results are expected. What worked in a particular sociocultural and economic context may not necessarily work

when sociocultural and economic conditions are altered. This focus of future research on the contexts of microfinance programmes should contribute to increase our knowledge and improve the effectiveness of policy.

In terms of context, this study focuses on the impact of microfinance on the income and vulnerability of poor rural households in Uganda. In order to clarify this question, the study examines household participation and access to credit through Joint Liability Lending (JLL) programmes, the allocation of household credit, and subsequent loan repayment. The study concentrates on Joint Liability Lending programmes, instead of looking at other models of microfinance, because the Joint Liability Lending model targets the poorest segments of the population.

2.3 POSITIVE IMPACTS OF MICROFINANCE

The above critique may be true for MFIs who do not specifically target the extreme poor. However, an argument can be made that most MFIs do develop such target strategies and design their loan products accordingly making microfinance an effective instrument to reach people at all levels of poverty (Morduch & Haley, 2002). As pointed out by Hulme (2000), there is no moral requirement that MFIs should assist the extreme poor, but to reduce poverty, targeting programmes at people in different levels of poverty is essential for success.

Morduch (2002) mentioned that while the quality of many studies could be improved, there is an overwhelming amount of evidence substantiating a beneficial effect of microfinance on increases in income (Kiiru, 2007; Duvendack, Palmer-Jones, Copestake, Hooper, Loke & Rao, 2011; Liheta & Mosha, 2014) and reductions in vulnerability to poverty (Swain & Floro, 2010).

Studies have shown evidence of a positive impact as it relates to the first six out of seven Millennium Goals (Adamu, 2007; Irobi, 2008). These studies all subscribed to the belief that microfinance is an effective and powerful tool for poverty reduction. For example, Amin, Rai and Topai (2003) focus on the ability of microfinance to reach the poor and affirmed that microfinance has served people below and above the poverty line. Also, Hossain (1988) found that Grameen members who are poor and landless have average household income of 43 per cent higher than marginal landowners. Rosintan and Cloud (1999) conducted empirical research on a local microfinance program in Indonesia. They found that the average income increased drastically by 112 per cent (the research does not specify the time period of this increase) and that 90 per cent of the program's participants were able to earn an income

above the poverty line, thereby taking them out of extreme poverty. Dunn (1999) studied the effects of MFIs in Peru and found that the average income of participants in microfinance programmes was 50 per cent higher than the income of non- participants; also 41 per cent of the non-participants were living in extreme poverty compared to only 28 per cent of the programme's participants.

The results of empirical evidence indicate that the poorest can benefit from microfinance from both an economic and social well-being point-of-view, and that this can be done without jeopardizing the financial sustainability of the micro-financial institutions (Robinson, 2001; Dahiru & Zubair, 2008).

Mosley and Rock (2004: 467) observed, in a study of six African MFIs, that “many benefits to the poor from microfinance programmes, in Africa at least, are likely to come via an indirect route, via ‘wider impacts’ or ‘spin-offs’, rather than through direct impacts on borrowers”. They argued that microfinance can reduce poverty through job creation and by the improvement of household risk management through MFI training and the building up of social networks. This improvement is said to stabilize village income, reducing the vulnerability of the poorest (*ibid.*). They also argued that microcredit enhances human capital regardless of poverty level because expenditures on education and health care are increased, “which may then extend to poor individuals through intra-household and inter-generational effects”.

Mawa (2008) concluded that microfinance is an innovative step towards alleviating poverty. The author mentioned that microfinance facilities provided to the people help them to use and develop their skills and enable them to earn money through micro enterprises. Moreover, the provision of microfinance helps them to manage both their consumption levels and unexpected risks. Microfinance helps the poor to build assets, educate their children and have a better quality of life. Banerjee, *et al.* (2010) used a non-traditional approach in studying the effects on poverty reduction. They tested the impact of introducing a new microfinance programme by randomly selecting 104 slums in a large city in India, and evaluating the differences in household expenditure 18 months after the start of the programme. Their findings show that there was no increase in household's monthly expenditure overall, but that participants did spend more money on durable goods than non-participants and that business start-ups had increased in frequency.

Gurses (2009) conducted a study in Turkey and concluded that microfinance and microcredit in particular are powerful tools to reduce poverty. The author mentioned that one fifth of the population of Turkey was at risk due to the poverty even though it is not a poor country according to global standards. This was due to the introduction of microcredit by two NGOs – KEDV and the Turkish Foundation for Waste Reduction (TISVA).

Ravinder and Ghirmai (2006) concluded that microfinance is a cornerstone for poverty reduction. Their study showed that there is a fundamental linkage between microfinance and poverty eradication, in that the latter depends on the poor gaining access to, and control over, economically productive resources, which includes financial resources. However, previously implemented programmes have not produced good results due to the non-involvement of people for whom the programmes was designed (the poor).

Jalililan and Kirkpatrick (2002), among others, have found empirical proof that development of the financial sector has a significant impact on poverty reduction in developing countries. Moreover, Chavan and Ramakumar's (2002) study on several developing countries found that microcredit programmes did result in a marginal improvement in the borrower's income. Zaman (2000) focused on Bangladesh by studying households that participate in the microfinance programmes offered by BRAC (one of Bangladesh's largest MFIs). The author finds that microfinance indeed reduces poverty and a moderately poor borrower who receives a loan of approximately \$200 is the one who is profiting the most from the programme by showing the largest effect in a reduction of poverty.

Khandker (2005) examined 1,638 households in Bangladesh. These were made up both of participants of microfinance programmes of the Grameen Bank and non-participants of any microfinance program. The author found that microfinance is effective in reducing poverty for individuals as well as for the village as a whole by showing an increase in per capita household consumption for both participants and nonparticipants. Chemin (2008) followed this study by also studying participants of Grameen Bank microfinance programmes, but adding some more detail in the external effects that microfinance programmes can have. He found that participants did have significantly higher expenditures than individuals in villages without microfinance programmes, but there was no difference between participants and non-participants in villages with microfinance programmes.

2.3.1 Non-Financial Impacts at a Household Level

Health and education are two key areas where microfinance has a non-financial impact at household level. According to Wright (2000: 31), research conducted on the impact of microfinance intervention on health and education shows that the nutritional indicators tend to improve where MFIs have been at work. Research on the basis of Grameen Bank data has shown that members are statistically more likely to use contraceptives than non-members with direct implications for family size. Littlefield, Morduch and Syed (2003: 3) also acknowledge that there is limited specific evidence on the impact of microfinance on health. But where studies have been conducted, they conclude that “households of microfinance clients appear to have better nutrition, health practices and health education than comparable non-client households”. Among the examples they give is FOCCAS, a Ugandan MFI whose clients were given health care instructions on breastfeeding and family planning. These clients appeared to have much better health care practices than non-clients, with 95 per cent of them engaged in improved health and nutrition practices for their children, as opposed to 72 per cent for non-clients (Littlefield, Morduch & Syed, 2003).

Microfinance interventions also appear to have a positive impact on the education of children. Littlefield, Morduch and Syed (2003) point out that one of the first things that poor people do with the new income gained from microenterprise activities is to invest it in their children’s education. Studies show that children of microfinance clients are more likely to go to school and to stay in school longer than children of non-clients. Again, in their study of FOCCAS, Littlefield, Morduch and Syed found that client households were investing more in education than non-client households. Similar observations were made in projects in Zimbabwe, India, Honduras, and Bangladesh.

In a study of 16 different MFIs globally, Robinson (2001) showed that having access to microfinance services led to an enhancement in the quality of life of clients and to an increase in their self-confidence, while helping them to diversify their livelihood security strategies and to increase their income.

Following a three-year study of 906 clients, ASA17, an MFI working with 60,000 rural women in Tamil Nadu (India), found that the programme had a “positive impact on livelihoods, social status, treatment in the home and community, living conditions and consumption standards” of their clients (Nojonen, 2005: 202). Compared with new members, long-term members were more likely to live in tile-roofed and concrete houses, to have a

higher percentage of their children in school, to have a lower incidence of child labour, to be the largest income provider or joint provider in the home, and to make decisions on their own regarding major purchases (Noponen, 2005). Clients also reflected significant increases in ownership of livelihood assets such as livestock, equipment and land.

In 2002, FINRURAL, a microfinance networking organisation in Bolivia, carried out impact assessments on eight of its partner MFIs, focusing on economic and social impacts at an individual, household and community level, on both clients and non-clients (Marconi & Mosley, 2004). Many of the impacts on income appeared to be positive for the less poor and negative for the poorer clients, a trend on which we have already remarked. As Marconi and Mosley point out, this should not be surprising, as poorer clients are more risk-averse and less likely to invest in fixed capital. Thus, they are more vulnerable to having to sell productive assets in the event of a shock. However, it was found that social networks played an important part in helping clients escape from poverty. Access to social networks provided clients' households with a defence against having to sell physical and human assets.

Chowdhury and Bhuiya (2004: 377) assessed the impact of BRAC's poverty alleviation programme from a "human well-being" perspective. In particular, they examined seven dimensions of human well-being in a project in Bangladesh. The project included the provision of microfinance and training on human and legal rights for clients. The researchers noted that the project led to better child survival rates, higher nutritional status, improvement in the basic level of education, and increased networking in the community. Children of BRAC clients suffered from far less protein-energy malnutrition than children of non-members, and the educational performance of BRAC members' children was also higher than that of children in non-BRAC households. BRAC member households spent significantly more on food items than poor non-members, and per capita calorie intake was also significantly higher.

As these studies and findings indicate, it seems that microfinance is indeed having positive and diverse impacts at the level of households.

2.3.3 Impacts beyond the Household

In this section, we review various studies that show the positive impacts that microfinance interventions can have beyond client households. Imp-Act (2004) gives several examples of microfinance projects having effects beyond the immediate clients. They refer to studies on CERUDEB, an MFI in Uganda, which show that loans given to small farmers have resulted

in substantial increases in part-time and permanent wage labour for non-clients. Even though the clients themselves were usually above the poverty line, the people they employed were not. This illustrates the positive knock-on effects of such an intervention, even when the poorest segment of the population was not being targeted. In a study of six African MFIs, Mosley and Rock (2004: 467) found similar results, which led them to conclude that MFI services provided to relatively well-off clients can reduce poverty by “sucking very poor people into the labour market as employees of microfinance clients”. They also pointed out that microfinance services often enhance human capital through increased spending on education and health, which may have an impact on poor households through intra-household and inter-generational effects.

Zohir and Matin (2004) observe that many MFI loans are used for agricultural production, trading, processing and transport, resulting in an increase in the use of agricultural inputs and in agricultural production. Consequently, employment opportunities in these sectors are improved for the wider community and prices of agricultural products are reduced due to increased supply. Zohir and Matin also point out that trading activities financed by MFIs can help to establish new marketing links and increase the income of traders. This leads in turn to a reduction of migration due to the improvement in employment opportunities and increase in income. From a social perspective, the reduction in migration enhances family cohesion and greatly contributes towards improving child-upbringing.

Kabeer (2003) refers to a study conducted by the Grameen Bank that showed that non-members in a Grameen village were significantly more likely to use contraception than non-members in a non-Grameen village. This seemed to result from the diffusion of the “small family norm” (*ibid.*: 110) by Grameen women through social networks within the village. It is well known that the Grameen Bank emphasises women’s productive roles, as opposed to their reproductive role, and non-members seemed to pick this norm up from members. Studies have also shown that Grameen-style projects, based on collective activism, can lead to a greater level of legal and political awareness among clients. People are more likely to engage in political campaigns the longer they have been members of the Grameen Bank (Kabeer, 2003).

Zohir and Matin (2004) point out that the interaction within MFI groups can create co-operation and trust. More than just facilitating the microfinance activities, this also contributes to a greater sense of community and the establishment of bonds of trust and

mutual reliance in times of crisis. These networks can lay the foundations for other social capital developments in the community. As Zohir and Matin suggest, examples of the wider cultural impact of social intermediation are the change in attitude of society towards the acceptable age of women's marriage, domestic violence, and dowry.

In order to provide an accurate representation and measure of impact, therefore, the assessment of microfinance projects should not just focus on the individual and household levels. As shown in Figure 2.1, microfinance can have impacts far beyond the household.

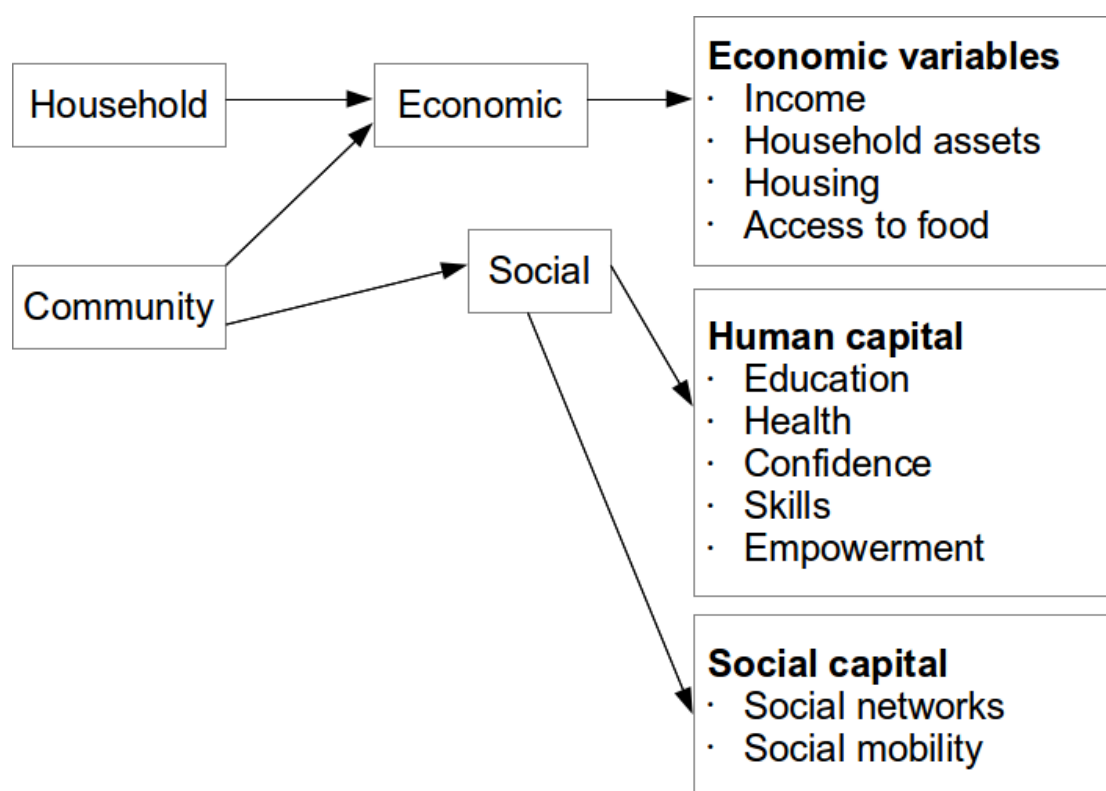


Figure 2.1: Potential impact of microfinance at a household and community level
Source: Wrenn (2005)

From all the evidence surveyed above, it appears that microfinance reaches both the moderate poor and the extreme poor. Khandker (2005) comes to the same conclusion by stating that access to microfinance programmes contributed to the reduction of both moderate and extreme poverty of individuals, and that these programmes are especially successful in reaching women at different levels of poverty. Although, this is only achieved by MFIs that specifically focus on the extreme poor, it is proven that when MFIs do this the extreme poor are indeed benefitting from microfinance without harming the financial sustainability of the MFI (Morduch & Haley, 2002). This last result confirms Khandker's (2005) outcome on the positive externalities that microfinance programmes can have on a village as a whole. Two

cross-country studies on the effectiveness of microfinance also show results that indicate the positive effects of microfinance activities on poverty reduction. Lucarelli (2005) discusses several case studies in Asia and the Pacific to test the effectiveness of microcredit. This paper shows that families who have access to credit have a higher income than families who do not have access to credit. In Indonesia for example, the average annual income of participants in a local microfinance project increased by 12.9 per cent in contrast to a 3 per cent increase in average annual income of non-participants.

Coleman (2005) recommends that MFIs' strategies should be specific in targeting the extreme poor and they should be very clear in communicating their eligibility criteria and program rules. These results prove that microfinance is, in most cases, effective at reaching people at different levels of poverty and not solely in the group of the poor living just above the poverty line, as stated by critics of microfinance. Kai and Hamori (2010) found proof that microfinance has an equalizing effect on people's income and Imai, Gaiha, Thapa and Annim (2010) show that microfinance is effective at reducing the poverty gap and the poverty head count ratio.

Yet, there are also numerous studies that question the conventional wisdom of the poverty-alleviating effects of microfinance. The reliance on donor subsidies can greatly blunt its poverty alleviation effects because MFIs rely on these loans instead of focusing on increasing efficiencies and trying to give the poorest of the poor access to finance.

Hulme and Mosley (1996, cited in Wrenn, 2005) whilst acknowledging the role of microfinance can have in helping to reduce poverty, concluded from their research on microfinance that "most contemporary schemes are less effective than they might be." They stated that microfinance is not a panacea for poverty-alleviation and that in some cases the poorest people have been made worse-off by microfinance.

Knight and Farhad (2008) stated that microfinance directly improves the quality of life of its users and promotes poverty reduction. Seibel (2003) proved through the survey that microfinance is the instrument by which the burden of poverty can be lifted. Matovu (2006) mentioned that microfinance undoubtedly plays an important role in poverty alleviation but the part of microfinance in poverty alleviation is like a drop in the ocean. Imai, *et al.* (2010), concluded that there is no doubt that microfinance is a powerful tool against poverty but some evidence creates a black spot on its performance.

Shastri (2009) argues that there is no better way to fight poverty than through microfinance. Creating self-employment opportunities is one way of attacking poverty and solving the problems of unemployment. Microfinance has been found as an effective instrument for lifting the poor above the level of poverty by providing them self-employment opportunities and making them credit worthy. The study conducted by Shirazi and Khan (2009) took into consideration the poor and the extreme poor categories. The authors examined the impact of microcredit on poverty alleviation. Microcredit had reduced the overall poverty level in India by 3.07 percentage points (from 6.61 per cent to 3.54 per cent) and the borrowers had shifted to higher income groups during the reported period. The poverty status of the extremely poor borrowers was marginally increased (by 0.63 percentage point), showing obviously no effect of microcredit on poverty status of these households. The reason behind no effect of microcredit on the extremely poor was that, the extreme poor get the loan for protective purposes and not for further income or self-employment. In the case of the 'ultra-poor', the net impact of microcredit shows a reduction by 1.45 percentage points which is a positive impact.

2.4 NEGATIVE IMPACTS

Critics have outlined several negative effects of microfinance provision, as discussed below.

The most commonly-raised criticism about microfinance is that it does not reach the poorest of the poor, identified under the Millennium Declaration and in the first MDG as the extreme poor. Critics acknowledge that microfinance can be effective in reaching the poor in general, but that often the group that is in most need of access to finance is left out. Hulme (2000) states that MFIs almost never work together with refugees, the physically- or mentally-ill or street children, even though the general claim states that microfinance is there to assist the poorest. Wright and Dondo (2001) argue that MFIs are not reaching the poorest percentage of the population and that they do not expect this trend to improve in the future since it is becoming more and more accepted by broader society. Scully (2004) provides the same evidence by concluding that the extreme poor are not reached by microcredit programmes. Coleman (2005) has found that wealthier villagers are more likely to participate in microfinance programmes than less wealthy villagers. The literature finds two main causes for this trend. First, the extreme poor are very risk averse and therefore they mostly determine the loans provided by MFIs to be too risky for them. Secondly, a lack of confidence excludes them from participating in these programmes (Ciravegna, 2005).

In addition, Simanowitz (2002), among others, contends that microfinance programmes exclude the extreme poor from their programmes. This is at first caused by the structure of most microfinance programmes, among them the joint liability contract. Other group members see the extreme poor as a risky group and they are therefore not willing to participate together in a microfinance programme (Marr, 2004). The joint liability contract that most MFIs use is disadvantaging the extreme poor since they cannot participate without belonging to a group. Besides exclusion by potential group members, staff members of MFIs also appear to not prefer the extreme poor. In their risk assessment test conducted before providing loans, they favour the moderate poor since they are more likely to meet their repayments and this will positively influence their own performance (Datta, 2004). Second, administrative requirements set by MFIs lead the extreme poor to be excluded from the programmes. Examples are MFIs requesting borrowers to have a registered company before they grant a loan, to make some savings themselves before granting a loan and to only grant minimum amounts of loans that are too high for the extreme poor since they in most cases will not be able to meet the repayments set on these loans by the MFIs (Kirkpatrick & Maimbo, 2002).

Shaw (2004) studied households participating in microfinance programmes in Sri Lanka, and found no clear evidence for microfinance to be a broad solution to poverty in this country. Only participants who lived very close to the minimum poverty line showed some improvement in their situation. Kah, Olds and Kah (2005) studied the evolution, sustainability, and management of ten microcredit institutions in Senegal. The results indicate that microcredit institutions had helped to create some positive change, but that there was no clear and marked evidence of poverty reduction that was attributable to the microfinance programmes studied.

Bateman (2011) points out that most of these evaluations were undertaken by MFIs, microfinance advocacy groups, or international development agencies promoting and funding microfinance. Naturally, this raised concerns about potential bias, especially under-research on the downsides. As a result, a growing number of impact evaluations were commissioned from independent researchers, mainly university-based academics to question the rigour and validity of earlier evaluations, highlighting data and methodological problems.

Sinha and Matin (1998) argue that it is notoriously difficult to measure the impact of microfinance programmes on poverty. The reason is that money is fungible, making it more

difficult to isolate the impact of credit. Other reasons have to do with the definition of poverty, how it is measured, and who constitute the poor. These “are fiercely contested issues” (Sinha & Matin, 1998: 3).

It is interesting to note that various researchers, using a variety of measurement tools came to similar negative conclusions:

- Using the difference-in-difference approach, Morduch (2002) found that microcredit has little or no effect on poverty, although it reduces the consumption volatility of the poor.
- Using household-level panel data, a subsequent study by Khandker (2005) found the impact of microcredit on poverty much weaker compared to his earlier study with Pitt (Pitt & Khandker, 1998). He concluded that, although microcredit has had a positive effect on the very poor (it raised their consumption and non-land assets), it has had little effect on aggregate poverty.
- Banerjee, *et al.* (2009) investigated the impact of microcredit in 104 slums in urban Hyderabad, India. They found that access to microcredit had no impact on the poverty of the treatment group (measured by average monthly expenditure per capita); however, it led to an increase in expenditure on durable investments and higher profits in existing businesses, despite higher competition from new businesses. As the study was conducted 15-18 months after the opening of the microcredit programme, the results did not capture the longer run impacts of the programme (that would emerge after the conclusion of the study). This is particularly important as graduation from poverty is a slow and arduous process.

Bateman (2011) concluded the following regarding the findings of several studies:

- There are many ambiguous conclusions about the impact of microfinance, ranging from negative to insignificant to extremely positive, which means that a more comprehensive and a better goal-oriented assessment is needed.
- Unsustainable microcredit indebtedness is commonplace across developing countries such as India, Bangladesh, Peru and South Africa, and also in transition countries, notably the Balkans, Bosnia and Herzegovina.
- Poor households do not benefit from microfinance; it is only non-poor borrowers (with incomes above poverty lines) who can do well with microfinance and enjoy sizable positive impacts.

- Indebtedness often leads to greater indebtedness with the exploitation of the poor by local loan sharks who lend money to borrowers to pay off microloans they obtained all too easily from their local MFIs, thus starting a vicious cycle of poverty.

Other studies indicate much more mixed impacts, such as benefits for the poor but not for the poorest (Hulme & Mosley, 1996; Morduch, 2002; Mosley & Hulme, 1998; Zaman, 2000); or helping the poor to better manage the money they have (Rutherford, 2000) but not directly or sufficiently increasing income; empowering women (Mayoux, 1999; Husain, Mukherjee & Dutta, 2010); that money spent on microfinances could be better used more effectively for other interventions (Karnani, 2007); or that a single intervention (such as microfinance) is much less effective as an anti-poverty resource than simultaneous efforts that combine microfinance with health, education and other social issues (Lipton, 1996). The World Bank (2015: n. p.) states that “The benefits of microcredit have been modest in field experiments, and commercial microfinance is unlikely to reach the poorest of the poor”.

Van Rooyen, Stewart and De Wet (2012) allude to negative impacts (i.e. that microfinance actually does harm), such as the exploitation of women, increased or at best unchanged poverty levels, increased income inequality, increased workloads and child labour, the creation of dependencies and barriers to sustainable local economic and social development. They state that microfinance is increasingly questioned, not only for its lack of proven poverty reduction and development outcomes, but also on ideological terms.

Wright (2000: 6) claims that much of the scepticism about MFIs stems from the arguments that microfinance projects “fail to reach the poorest, generally have a limited effect on income [...] drive women into greater dependence on their husbands and fail to provide additional services desperately needed by the poor” In addition, Wright points out that many development practitioners, more than just finding microfinance inadequate, claim that it actually diverts funding from “more pressing or important interventions” such as health and education. Navajas, Schreiner, Meyer, Gonzalez-Vega and Rodriguez-Meza (2000) agree that there is a danger that microfinance may siphon funds from other projects that might be more helpful for the poor. In their view, governments and donors should know whether the poor gain more from microfinance than from other interventions, such as improved health care or food aid, for example. Therefore, there seems to be a need for everyone involved in microfinance and development to ascertain with more precision the impact of microfinance in combating poverty.

Nonetheless, as Simanowitz (2001) points out, there is some debate about whether the impact assessment of microfinance projects is actually necessary. According to some, if the market can provide adequate proxies for impact, by showing for example that clients are happy to pay for a service, assessments might be a waste of resources. But this seems too simplistic a rationale, as market proxies tend to mask the range of client responses and benefits to the MFI. Therefore, impact assessment of microfinance interventions is necessary, not just to demonstrate to donors that their interventions are having a positive impact, but also to improve through learning the services and the impact of the projects carried out by MFIs (Simanowitz, 2001).

Perhaps the most damning indictment of microfinance yet are the findings of members of the Global Development Professionals Network. Sinclair (2014) states that the microfinance sectors of entire countries have collapsed, raising uncomfortable ethical questions, and yet the hype continues. Over-indebtedness is a chronic problem in some countries, particularly India, Mexico and Peru, where the problem is not a shortage of credit, but an excess. Bateman (2013) adds that microcredit has been a disaster for the poorest in South Africa. For far too many now "financially included" individuals in South Africa, using microcredit to support current spending has been a disastrous and irreversible pathway into chronic poverty.

The principal source of revenue for the sector is interest on loans, which is rarely publicised on websites. Rates exceeding 100% per year, even over 200%, are disturbingly common, particularly in Zambia and Mexico (Sinclair, 2014), with the sector refusing to define what constitutes extortionate rates, or encourage basic requirements for sensible loan use. Finally, the sector glosses over the fact that much credit is spent on consumption rather than investment or income-producing activities.

It is precisely this background that motivates and justifies the present study. It is clear that studies have either praised or criticised the provision of microfinance and “the jury is still out” on the issue, to put it colloquially. Is there a place for both conclusions or a spectrum of opinions? It would seem so. It seems that what works in some scenarios does not work in others. The evidence suggests that the truth lies in the in-between. Stern (2011: n. p.) states that “microfinance works really well sometimes – but not always. It works for some people the way we thought it might, and for others in ways we didn’t anticipate. For some people, microfinance doesn’t seem to have any measurable effect”.

2.5 LIMITATIONS OF MICRO-FINANCE

Probably the most common criticism of microfinance directly concerns the reality that microfinance programmes have to strike a balance between two competing incentives i.e. the inherent risk and the interest rate. Dusuki (2007) focused on the potential for market failure in microfinance. It should be noted that these problems do not specifically relate to Shariah finance alone, but to all kinds of micro-finance. Dusuki (2007) highlighted that one of the main problems was accessing information regarding clients. Information problems relating to searching, monitoring and enforcement costs are directly related to the information problems inherent in the rural financial markets. In addition, there is uncertainty regarding the ability of borrowers to meet future loan obligations, an inability to monitor the use of funds and demand for small loans by rural households which further leads to higher transaction costs, which are characterised by fixed costs. Likewise, physical and socio-economic barriers may also contribute to the market failure. These include poor infrastructure, remote, difficult terrain, illiteracy, poor healthcare, malnutrition, caste or ethnicity and gender. These barriers are more apparent in developing countries, such as Uganda, whereby over 90% of households living in the rural areas are without access to institutional sources of finance. Thus, matching access to or supply of financial services with demand has been a consistent challenge for financial institutions attempting to serve clients who fall outside the formal finance arena. These findings are depicted in Figure 2.2 below.

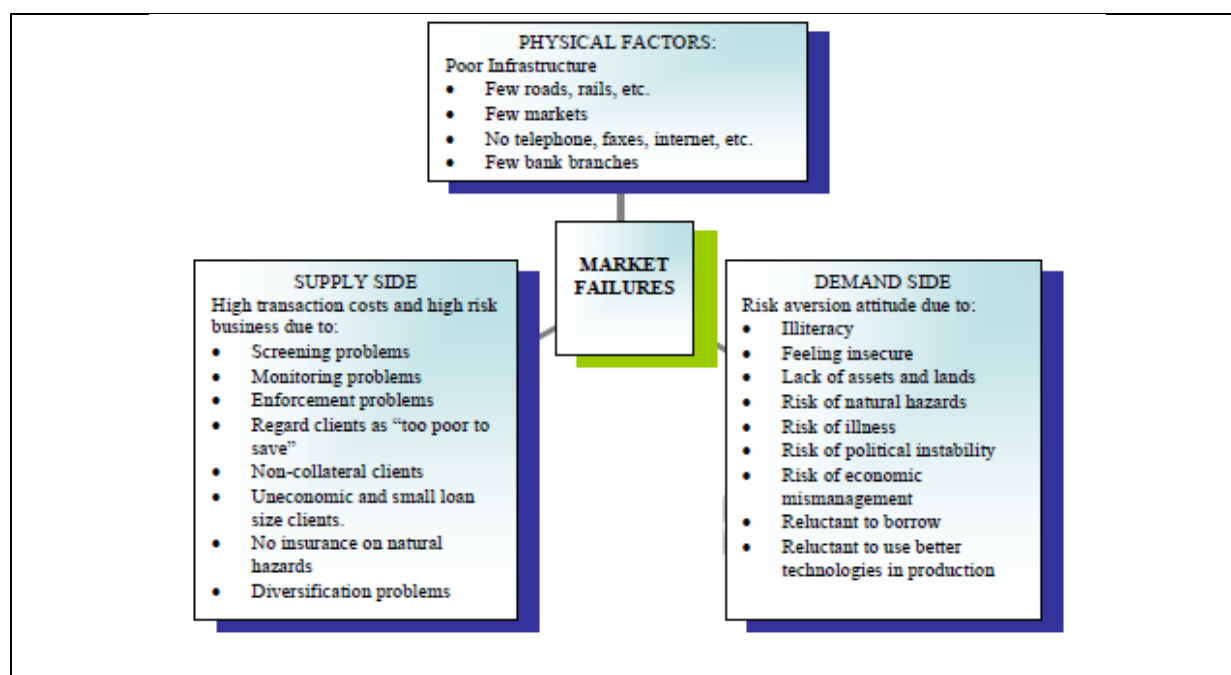


Figure 2.2: Causes of market failure

Source: Dusku (2007: 6)

A problem, according to Samad (2014), is that, despite the growth of Islamic banks over the last 30 years, many people in the Muslim and non-Muslim world do not understand what Islamic banking actually is. The basic principle is that it is contrary to Islamic law to make money out of money and that wealth should accumulate from trade and ownership of real assets. However, there does not appear to be a single definition of what an Islamic-banking product is or is not; nor is there a single definition of Islamic banking. A major issue here is that it is the Shariah Councils or Boards at individual Islamic banks that actually define what Islamic banking is and determined the acceptable way to do business, which in turn can complicate assessment of risk for both the bank and its customer. A question is to what extent such control can be exercised over the multiplicity of MFIs, most of which are independent of banks? Nothing in the literature has pointed to Shariah Councils operating in the MFI industry to provide such direction. Mughal (2014) stated that a need to introduce a legal and regulatory regime of Islamic microfinance institutions so that Islamic microfinance can be introduced globally. More generally, the uncertainty over an Islamic product is, has so far prevented standardisation. This makes it difficult for regulators to have any certainty about what it is they are authorising. It is also an added burden on the banks that have to educate customers in new markets. The problems are compounded when it comes to micro-financing where the MFIs are so disparate, with product offerings that are extremely diverse and changeable, accompanied by little customer education. Moreover, the long term impact of Shariah microfinance has not yet been determined due to the industry being in its infancy.

In the case of Uganda, the main limitations of conventional microfinance are:

- The lack of appropriate infrastructure in the country to allow MFIs to grow rapidly at low cost: In Uganda, the growth of any type of organisation takes time. There is a need to confront problems such as the lack of electricity, poor or inadequate roads, poor sanitation, business and healthcare facilities and unstable communication links further complicate the process of managing growth in the microfinance industry. In general, growth and increased profitability depend on the capacity of MFIs to mobilise savings and to find ways of managing long-standing issues such as those described.
- The increasing need for equity capital to finance long-term growth. Any major investment in opening or enhancing operations, equipment, and training requires capital. This capital may come from private or public investors (international donors and the government). Mobilising this capital involves institutional capacity and resources. Moreover, in a

country like Uganda, political and macroeconomic risks are still very much a limiting factor.

The question that begs asking, therefore, is why another study on microfinance might produce different results. The rationale of this study therefore bears scrutiny. Until now, it has focused on microfinance in general with its underlying motivation of profit, and for the time being continues to do so as it now examines the role of the microfinance institutions themselves as opposed to the concept of microfinance *per se*. However, the thesis is building to its central focus on the impact of Shariah microfinance where ethics and morality and an emphasis on helping and not burdening people is paramount.

2.6 BEST PRACTICES

Best practices are principles of microfinance that reflect the wisdom and the lessons learnt after decades of real-life microfinance experience. These practices are well-experimented and well-documented, and they are made widely available throughout the global microfinance community. A significant contributor to the promotion of these practices has been the Consultative Group to Assist the Poor (CGAP), a multi-donor consortium dedicated to the advancement of microfinance. CGAP envisions a world in which poor people everywhere enjoy permanent access to a wide range of financial services delivered by different providers through the most convenient channels. As a way to realise this vision, CGAP has come up with a set of key principles which constitute the essence of microfinance's best practices:

- Poor people need to have access to a variety of financial services, not just loans. In addition to credit, they want savings, insurance, and money transfer services. For example, BRAC provide additional services to their clients, such as safe custody of valuable items (land titles, wills, etc.) or the secure transfer of money from one point to another, particularly in rural areas. BRAC entered Uganda in 2006 and currently serves approximately four million people, with programmes in microfinance, small enterprises development, agriculture, poultry and livestock, empowerment and livelihood for adolescents, including a MasterCard Foundation Scholars Programme. It has been recognised for many of its innovations (Karmakar, 2014).
- Microfinance is a powerful tool to fight poverty. Poor households use financial services to raise income, build up their assets, and cushion themselves against external shocks.
- Microfinance involves building financial systems that serve the poor. Microfinance will reach its full potential only if it is integrated into a country's mainstream financial system.

- Microfinance can pay for itself, and should do so if it is to reach large numbers of 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.
- Microfinance is about building permanent local financial institutions that can attract domestic deposits, recycle them into loans, and provide other financial services.
- Microcredit may not always be the answer to development problems. Other kinds of support facilities may work better for people who are so destitute as to be without income or means of repayment.
- Interest rate ceilings hurt poor people by making it harder for them to obtain credit. Providing many small loans costs more than providing a few large ones. Interest rate ceilings prevent microfinance institutions from covering their costs, and thereby choke off the supply of credit to poor people.
- The task of government is to enable the provision of financial services, not to provide them directly. Governments can almost never do a good job in lending, but they can set up a supportive environment through adequate policies.
- Donor funds should complement private capital, not compete with it. Subsidies should temporarily support start-ups, as a way of getting the institution up to the point where it can tap private funding sources, such as deposits, on its own.
- The key bottleneck in microfinance is the shortage of strong institutions and managers. Donors should focus their support on building capacity.
- Microfinance works best when it measures (and discloses) its performance. Reporting not only helps stakeholders evaluate costs and benefits, but it also improves performance. MFIs need to produce accurate and comparable reporting on their financial performance (e.g., loan repayment and cost recovery), as well as on their social performance (e.g., number and poverty level of their clients).

These principles broaden the definition of microfinance from mere microcredit to the provision of an array of financial services, such as savings, insurance, and remittances. They emphasise that *access*, rather than *cost*, should be the main focus in designing and implementing an effective microfinance programme for poverty alleviation.

Very few researchers or analysts would seriously argue with the point that finance-based programmes are not the answer to the problems of truly destitute households. Nevertheless, microfinance could be an important aid for households that are not yet destitute but remain considerably below the poverty line. Of course, the scale of lending to this group is not likely

to permit the kind of scale economies that are usually available to programmes that focus on households above poverty lines.

Still, by forging ahead in the face of scepticism, microfinance programmes now offer hope to millions of households. Even its critics have been inspired, in one way or another, by this success.

2.7 PROVIDERS AND MODELS OF MICROFINANCE INTERVENTION IN UGANDA

A microfinance institution can be defined as “an organisation that offers financial services to the very poor” (MIX, 2005). According to the UNCDF (2004), there are approximately 10,000 MFIs in the world, but they only reach four per cent of potential clients, or roughly 30 million people. On the other hand, according to the Microcredit Summit Campaign Report, as of 31 December 2003, the 2,931 microcredit institutions on which there is data available, report that they have reached almost 90 million clients, of whom 55 million were the poorest when they took their first loan. Although referring to microcredit institutions, this survey includes “programmes that provide credit for self-employment and other financial and business services to very poor persons” (Wrenn, 2005).

These sources allow us to highlight a number of points. First, they show how the two terms, microcredit and microfinance, are often confused with each other and used interchangeably. Adding a new level of meaning to the mix is the recent emphasis on “financial inclusion” (Sinclair, 2014) because of the world’s emphasis on equity, equality and human rights. Strictly speaking, microfinance refers to the provision of a range of services (on fixed terms) to the poor while microcredit refers only to the provision of credit to the poor. Second, the difference between the statistics cited above shows how difficult it is to obtain a true picture of the size of the microfinance industry and of the size of its current client base. Similarly, the IMF points out that “no systematic and comprehensive data on MFIs is collected and there are no authoritative figures on key characteristics of the microfinance industry, such as the number and size of MFIs, their financial situation, or the population served” (IMF, 2005: 6).

Despite this lack of data on the sector, it is clear that a wide variety of models of implementation are employed by different MFIs to reach clients. This study focuses on only three of the fourteen different microfinance models identified by the Grameen Bank (2000), namely the Rotating Savings and Credit Association (ROSCA), the Grameen Solidarity

Group Model, and the village banking models. These are the microfinance models that were encountered when conducting field research in Uganda.

2.7.1 Rotating Savings and Credit Association Model

ROSCAs are formed when a group of people come together to make regular and cyclical contributions to a common fund, which is then lent as a lump sum to one member of the group in each cycle (Wrenn, 2005). This model is a very common form of savings and credit. The members of these associations are usually neighbours and friends. The group provides an opportunity for social interaction and tends to be very popular with women. Sometimes they are also called merry-go-rounds or self-help groups.

2.7.2 Grameen Solidarity Group Model

This model is based on group peer pressure. Loans are given to individuals within groups of four to seven members (Christen, 2013). Group members collectively guarantee the repayment of outstanding loans, as the access to subsequent loans depends on successful repayment by all group members. Payments are usually made weekly (Rahman, Luo, Ahmed & Xiaolin, 2012). According to Rahman, *et al.* (2012), solidarity groups have proved quite effective in deterring defaults, as evidenced by loan repayment rates attained by organisations such as the Grameen Bank. This model has also brought broader social benefits due to the mutual trust arrangement at the heart of the group guarantee system. The group itself often becomes the building block for a wider social network.

It is clear that the solidarity group mechanism lowers transaction costs for the MFIs in any country (Orrick, Herrington & Sutcliffe, 2012). In contrast, however, it creates certain social costs, such as an undesirable restraint of borrowing, coercive peer pressure, loss of faith, and rejection or additional stigmatisation of the most vulnerable and poorest in the community. These social costs are higher in some societies than in others, depending for instance on the existing social relations (e.g. which influence the ease/difficulty of group formation) and on the distances that people must travel to participate in group activities. In general, these costs tend to be higher in rural areas.

2.7.3 Village Banking Model

Village banks are community-managed credit and savings associations, often established by NGOs to provide access to financial services, to build community self-help groups, and to facilitate the accumulation of savings (Allen, 2006). They have been in existence since the

mid-1980s and typically have 25 to 50 members who are low-income individuals seeking to improve their lives through self-employment activities. These members run the bank, elect their own officers, establish their own by-laws, distribute loans to individuals and collect payments and services (Grameen Bank, 2000). The loans are backed by moral collateral in the form of the promise that the group stands behind each loan (MIX, 2005).

The sponsoring MFI lends loan capital to the village bank, which in turn lends it to the members. All members sign a loan agreement with the village bank to offer a collective guarantee. Members are usually requested to save twenty per cent of the loan amount per cycle (Ledgerwood, 2014). These savings are tied to loan amounts and are used to finance new loans or collective income-generating activities, and so they stay within the village bank. No interest is paid on savings, but members receive a share of the profits from the village bank's re-lending activities. Many village banks predominantly target women (McLean, 2012).

2.7.4 Limitations of Microfinance in Uganda

We have seen that conventional microfinance holds much potential for encouraging entrepreneurship and development in the developing world, at least on paper. It can provide a vital means of financial assistance and other business support to fledging enterprises in these countries, harnessing local expertise and business interest and nurturing the desire of women as well as men and their families for an economically sustainable means of livelihood. However, the limitations of conventional microfinance should not be underestimated.

In the case of Uganda, the main limitations of conventional microfinance are:

- The lack of appropriate infrastructure in the country to allow MFIs to grow rapidly at low cost: In Uganda, the growth of any type of organisation takes time. There is a need to confront problems such as the lack of electricity, poor or inadequate roads, poor sanitation, business and healthcare facilities and unstable communication links further complicate the process of managing growth in the microfinance industry. In general, growth and increased profitability depend on the capacity of MFIs to mobilise savings and to find ways of managing long-standing issues such as those described.
- The increasing need for equity capital to finance long-term growth. Any major investment in opening or enhancing operations, equipment, and training requires capital. This capital may come from private or public investors (international donors and the government).

Mobilising this capital involves institutional capacity and resources. Moreover, in a country like Uganda, political and macroeconomic risks are still very much a limiting factor.

2.8 MEASURING THE IMPACT OF MICROFINANCE

2.8.1 Livelihood Security and Microfinance

According to Carney (1998: 4), a livelihood comprises “the capabilities, assets (including both material and social resources) and activities required for a means of living”. Similarly, Chambers (2004: 10) points out that livelihood security is basic to well-being and that security refers to secure rights, physical safety and reliable access to resources, food, income and basic services. It includes tangible and intangible assets to offset risk, ease shocks and meet contingencies” Lindenberg (2002: 304) defined livelihood security as “a family’s or community’s ability to maintain and improve its income, assets and social well-being from year to year”. Concern argues that livelihood security is more than just economic well-being, insofar as livelihood security is defined as “the adequate and sustainable access to and control over resources, both material and social, to enable households to achieve their rights without undermining the natural resource base” (*ibid.*). Therefore, livelihood security, like poverty, is not just about income, but it includes tangible and intangible assets, as well as social well-being.

Johnson and Rogaly (1997: 122) point out that “NGOs aiming for poverty reduction need to assess the impact of their services on user’s livelihoods”. They argue that, in addressing the question of the impact of microfinance, NGOs must go beyond the analysis of quantitative data detailing the numbers of users and volumes and sizes of loans disbursed, in order to understand how their projects are impacting on clients’ livelihoods. From their point of view, the provision of microfinance can give poor people “the means to protect their livelihoods against shocks as well as to build up and diversify their livelihood activities” (*ibid.*: 118). Therefore, when analysing the impacts of microfinance, the overall effects of the microfinance services on the livelihoods of the poor need to be taken into consideration. This is also the focus of our study.

According to Concern Worldwide (2003), a livelihood security approach aims to achieve a holistic analysis and understanding of the root causes of poverty and the ways through which people cope with it. Livelihood shocks, such as natural disasters or drought, are thus identified with the social, political and economic context, while people’s livelihood

resources, such as education and local infrastructure, are described as factors that affect people's livelihood security. Therefore, when analysing the impact of microfinance on livelihood security, which is one of the main objectives of this dissertation, a holistic analysis of people's livelihood security must be conducted, instead of just focusing on the material/economic impact that microfinance has on the livelihoods of the poor.

2.8.2 The Use of the Sustainable Livelihoods Framework in Impact Measurement

We have seen that microfinance can have a wide range of impacts on the households involved in the project, as well as wider social impacts. There are different ways of measuring impact. These include Social Performance Assessments (SPAs) (Copestake, 2004), the AIMS20 toolkit (Simanowitz, 2002), or Internal Learning Systems (Noponen, 2005). Most assessments use a combination of quantitative (surveys, financial ratios) and qualitative (focus group discussions, participant observation) research tools (Simanowitz, 2002).

As has already been mentioned, the present research focuses on the impact of microfinance on livelihood security. In order to carry out a livelihoods impact assessment, as Ashley and Hussein (2000: 5) point out, it is necessary to understand the significance of a project for the livelihoods of its beneficiaries and other people in the local community. Similarly, Simanowitz (2002: 17) argues that impact assessment should be based on a "sound conceptual framework that can be used for developing hypotheses about possible impact channels, and as a framework for analysis and understanding. Particularly useful is a livelihoods analysis that helps contextualise specific interventions in a broader understanding of poverty".

One way of approaching such livelihood analysis is through a livelihoods framework.

According to Neefjes (2000: 82), a livelihoods framework is "people-centred and aims to explain the relationships between people, their livelihoods, (macro) policies and all kinds of institutions". Brocklesby and Fisher (2003: 187) describe the four main components of the livelihoods framework used by DFID21, which has been widely adopted in the development field. These components include:

- people live within a vulnerability context, i.e. they are exposed to risks such as sudden shocks, trends over time and seasonal change;
- people have a number of capital assets which they draw upon to make their livelihoods;

- these assets are drawn upon within people’s livelihood strategies; and
- policies, institutions and processes help to shape people’s assets, livelihood activities and the vulnerability context within which they live.

Carney (1998) suggests that an examination of the five capital assets offers a holistic analysis of people’s livelihoods. These capital assets form the centrepiece of people’s livelihoods, as they influence the level of vulnerability of beneficiaries to shocks and trends. Policies and institutions also have an impact on these assets. These policies and institutions, together with the vulnerability context of beneficiaries, influence their livelihood strategies, which in turn influence their livelihood outcomes. Devereux and Sabates-Wheeler (2004) also point out that such a framework makes it possible to investigate the ways in which a project directly and indirectly affects people’s livelihoods. It is this framework, therefore, that will be used in the present study to assess the impact of microfinance on the livelihoods of borrowers, by focusing on its impact on their five capital assets.

2.9 OTHER CURRENT DEBATES ABOUT MFIS AND THEIR ROLE IN DEVELOPMENT

When examining the impact of microfinance on livelihood security and poverty, it is important to be aware of current debates in the field of microfinance. One of these debates, as we have seen, focuses on the measurement of impact. However, there are two other major issues that will be examined in this section: reaching the poor and financial sustainability.

2.9.1 Reaching the Poor

One of the key roles that microfinance has to play in development is the provision of access to financial services for the poor, particularly for those who are neglected by the formal banking sector. Mainstream banks target clients who have collateral. The poor generally lack assets that can be used as collateral and are therefore ignored by the formal financial sector. These banks tend to be located in urban centres, while the majority of poor people in the developing world live in rural areas, where there is no provision of financial services. It is clear, therefore, that MFIs need to reach the rural poor in order to fill this void. According to most studies, however, microfinance is only reaching a small fraction of the estimated demand for financial services from the poor (Littlefield & Rosenberg, 2004; Wrenn, 2005). The World Bank (2009: 1) using the term “financial inclusion” rather than microfinance,

estimates that less than 10 percent of the 2.5 billion people living on less than \$2 per day have access to financial services of any kind.

In general, MFIs do not have the depth of outreach needed to meet the demands of the rural poor. Serving the rural poor in the developing world involves a major financial commitment, given that rural microfinance projects are expensive to run. Claessens (2005) points out that high transaction costs, small volumes, and the high costs of expanding outreach make it unprofitable to serve the rural poor. It is for this reason that commercial banks are located in areas of high population density. However, if MFIs are to meet their social mission of serving the poor, financial services need to reach rural areas.

Current operational procedures of MFIs, such as peer group self-selection and the drive for self-sustainability, are also criticised because they often end up working with the moderately poor, while marginalising the poorest of the poor. Simanowitz (2002) highlights a number of factors that lead to the marginalisation of the poorest and lessen the impact of microfinance on poverty. These factors include self-exclusion, exclusion by other members, exclusion by MFI staff, and exclusion by design. Similarly, Markowski (2002) and World Bank (2009) argue that MFIs are failing to meet the needs of the very poor and destitute, who often have an unsatisfied demand for microfinance services, especially for savings products (Dichter, 1999; Littlefield & Rosenberg, 2004; Guérin, Morvant-Roux & Servet, 2011). Rai and Rai (2012: 1) also indicate that “millions of potential clients still remain unserved and the demand for financial services far exceeds the currently available supply” although this finding does contradict various studies, mentioned earlier, where microcredit is said to be in over-supply. As long as these potential clients continue to be ignored, the objective of the Microcredit Summit of 1997 to reach 175 million poor people by 2015 does not seem to be on target.

Organisations like BRAC, with its IGVD²⁷ and CFPR²⁸ programmes, have shown that the poorest people can be targeted in a sustainable manner (Halder & Mosley, 2004). Moreover, Mersland and Strøm (2012) argue that some features of savings and credit schemes are able to meet the needs of the very poor. Littlefield, Morduch and Syed (2003: 5) refer to a study of 62 fully self-sufficient MFIs to point out that the 18 that targeted “the poorest clients” had on average better profitability than the rest. This shows that programmes that target the very poor, when properly managed, can become financially sustainable.

If the social mission of microfinance is to be achieved, MFIs need to improve their depth and breadth of outreach. They must design appropriate products based on the needs of the poorest

and they must ensure that these products are delivered in a cost-effective manner (Quayes, 2012).

2.9.2 Financial Sustainability versus Serving the Poor

As argued previously, there is a debate between ‘institutionalists’ and ‘welfarists’ (de Haan & Lakwo, 2010: 533). Institutionalists argue that MFIs need to be financially sustainable (Roberts, 2013). This means that they need access to funds in order to continue to service their users. The ‘welfarists’ argue, on the contrary, that MFIs have a social mission and should focus on client sustainability. NGOs argue, in particular, that a commercial imperative skews the social mission badly enough that the poorest of the poor cannot be reached. These views are considered in depth below.

The mission of MFIs is not simply social. Markowski (2002: 117) argues that they have both a social mission “to provide financial services to large numbers of low-income persons to improve their welfare”, and a commercial mission “to provide those financial services in a financially viable manner”. While the MFIs generally have a social mission, as yet they are not fully meeting the demands of the poor for financial services. According to Simanowitz and Walter (2002), microfinance is a compromise between this social mission and its commercial mission. Due to the emphasis on financial and institutional performance, the opportunities for maximising poverty impact and depth of outreach have not been adequately pursued. These researchers call for a balancing of social and financial/commercial objectives, and criticise the current focus on financial objectives as it means that fewer of those that mostly need microfinance services are being targeted. As they state, “it is now time to innovate and design services that maintain high standards of financial performance, but which set new standards in poverty impact” (*ibid.*: 3).

Markowski (2002) refers to the CGAP29 estimates that only about 5 per cent of MFIs worldwide are financially sustainable, while the IMF (2005) puts the figure at only 1 per cent. This is clearly an important issue for the microfinance sector. To achieve financial sustainability, according to Quayes (2012), an MFI must cover the cost of funds, operating costs, loan write-offs, and inflation with the income it receives from fees and interest. However, because providing credit to the poor in many cases is a very costly activity, MFIs are often loss making, i.e. they are not financially sustainable. In fact, the only way that many MFIs succeed in lending to domestic small companies and poor agents, is because Western donors and NGOs provide financial support by offering them loans against below-market

interest rates (Hermes, Lensink & Meesters, 2011). According to the IMF (2005), the MFIs that have become self-sustainable tend to be larger and more efficient. They also tend not to target the very poor, as targeting the less poor leads to an increase in loan size and improved efficiency indicators, while MFIs that focus on the poorest tend to remain dependent on donor funds (IMF, 2005). In order to achieve sustainability and at the same time reach those that are most in need, microfinance programmes must be managed in a rigorous and professional manner, subsidies must be removed, and tight credit control procedures and follow-up on defaulters must be in place (Hartarska & Mersland, 2012). There is no doubt that sustainability is also very important from the perspective of clients, as they place a high value on continued access to credit and might have less incentives to repay loans if they feel that the MFI will not survive (Hartarska, Nadolnyak, Armendáriz & Labie, 2011).

Sustainability hinges on four factors, namely: financial viability, economic viability, institutional viability and borrower viability (Rai & Rai, 2012). Financial viability relates to loan sizes that match clients' needs, realistic interest rates, prerequisite savings, regular, short and immediate repayment periods, and the achievement of scale. If these measures to achieve sustainability are put in place, while focusing on the needs of the poorest, then both the social and financial objectives could be achieved. In simple terms, the trade-off between the financial and the social mission can be balanced if the MFI is well managed (institutional viability) and understands the market and its clients (Armendáriz de Aghion & Morduch, 2005). In fact, by combining both objectives, financial returns can potentially be increased in the long run (Pawlak & Matul, 2004). According to Imp-Act (2004), when assessing the performance of an MFI, both the financial and the social performance must be assessed, as both of them are needed for the successful running of an MFI. Hermes, *et al.* (2011: 4) refer to this as the MFI's "double bottom line." As Morduch (2004: 1) says, "achieving profitability and strong social performance is the ultimate promise of microfinance. It is not impossible but neither is it easy and few microlenders are there yet".

2.10 WOMEN AND MICROFINANCE

According to the State of the Microcredit Summit Campaign 2001 Report, 14.2 million of the world's poorest women now have access to financial services through specialized microfinance institutions (MFIs), banks, NGOs, and other nonbank financial institutions. These women account for nearly 74 per cent of the 19.3 million of the world's poorest people now being served by microfinance institutions. In some cases, access to credit may be the

only input needed to start women on the road to empowerment and some of the most valued benefits include expanded business and social networks, improved self-esteem, increased household decision-making power, and increased respect and prestige from both male and female relatives and community members (Cheston & Kuhn, 2002).

2.10.1 Empowering women

In Chapter 1, a definition of empowerment was provided. This section now expands on that definition with a specific focus on the empowerment of women. A key objective of many microfinance interventions is to empower women. According to Krishna (2003) empowerment means increasing the capacity of individuals or groups to make effective development and life choices and to transform these choices into desired actions and outcomes, while Sarumathi and Mohan (2011) suggest that women's empowerment needs to occur along multiple dimensions including the following: economic, socio-cultural, familial/interpersonal, legal, political, and psychological. If empowerment addresses only the economic and financial dimensions it fails to acknowledge the multidimensionality of the construct of empowerment. Tuuli and Rowlinson (2007: 4) assert that “[attaching] only one understanding to the empowerment construct will ultimately hinder research and practice”. Nevertheless, the entire scope of the construct is too broad for this thesis, and so it necessarily focuses on and is limited to a consideration of the economic and financial dimensions of empowerment, touching only here and there on the other aspects as they impinge on economics and finance.

Mosedale (2003: 1) reminds us that wanting to empower people implies that we currently see them as being disempowered or disadvantaged by the way power relations shape their choices, opportunities, and well-being. She also points out that empowerment cannot be bestowed by a third party, but must be claimed by those who seek empowerment through an on-going process of reflection, analysis and action.

Kabeer (1999, cited in Mosedale, 2003: 2) states that women need empowerment as they are constrained by “the norms, beliefs, customs and values through which societies differentiate between women and men”. She also points out that empowerment refers to the “process by which those who have been denied the ability to make strategic life choices acquire such an ability”, where strategic choices are “critical for people to live the lives they want (such as choice of livelihood, whether and who to marry, whether to have children, etc.)”. It should be noted that studies have shown that an increase in women's resources results in increased

well-being of the family, especially children (Hulme & Mosley, 1996; Kabeer, 2003). A more feminist point of view stresses that an increased access to financial services represents an opening/opportunity for greater empowerment. So, while MFIs may not be able to empower women directly, they can help them through training and awareness-raising to challenge the existing norms, cultures and values which place them at a disadvantage in relation to men, as well as to help them gain greater control over resources and their lives. At the very least, empowerment corresponds to the right of a woman to take hold of and control her own preferences in choosing between different alternatives, to enhance the level of independence or self-dependence and to develop the ability of controlling financial and economic resources and economic assets.

Littlefield, Murdugh and Syed (2003) point out that access to MFIs can empower women to become more confident, more assertive, more likely to take part in family and community decisions, and better able to confront gender inequalities. However, they also state that this does not mean that this is not an inevitable result. Hulme and Mosley (1996) also make this point, when they refer to the “naivety of the belief that every loan made to a woman contributes to the strengthening of the economic and social position of women”. Indeed, Leach and Sitaram (2002) problematize this assumption, calling it simplistic to assume that women who have increased their income are automatically empowered. However, with careful planning and design, the position of women in the household and community can indeed be improved. According to Littlefield, Morduch and Syed (2003), the Women’s Empowerment Programme in Nepal found that 68 per cent of its members were making decisions on buying and selling property, sending their daughters to school, and planning their family. All of these decisions were previously made by husbands. The researchers refer to studies in Ghana and Bolivia, which indicate that women involved in microfinance projects had increased self-confidence and an improved status in the community.

Malhotra and Malhotra (2015) point out that microfinance projects can reduce the isolation of women, for example by allowing them to come together in groups where they can share information, discuss ideas, and develop new bonds. Based on their studies of the MFIs, Islam, Siddiqui, Hossain and Islam (2014) showed that clients of microfinance programmes suffered from significantly fewer beatings at the hands of their husbands after they had joined the MFI. However, in a separate study of a BRAC project, Chowdhury and Bhuiya (2004) found that violence against women actually increased when women joined the programme, as not all men were ready to accept the change in power relations and resorted to violence to express

their anger. Nonetheless, this violence decreased over time and the study found that, when faced with violence, MFI members were more likely to report on their marital life and get support from the lending group.

Sachs (2005), on a visit to a BRAC project, was amazed to find out that the women he spoke to had only one or two children, when he was expecting them to have five or six, the usual number for Bangladeshi women. When he asked those with less than one child how many children they would like to have, the majority replied two. According to him, this is the “demonstration of a change of outlook” (Sachs, 2005: 14). It appears that that reproductive choices are influenced markedly by participation in microfinance because of a new spirit of women’s rights, independence and empowerment among female clients, where they have more say over what happens in the home than they previously did.

Osmani (1998) analysed the impact of credit on the well-being of Grameen Bank female clients. He found that the project had increased their autonomy, allowing them to spend family income more freely and to have greater control over family planning than non-clients. While the project did not seem to have an impact on clients’ control over other decisions, female clients did appear to have greater access to household resources than non-clients did.

However, Johnson (2004: 5) warns that having women as key participants in microfinance projects does not always lead to empowerment. Sometimes there are negative impacts, such as increased workloads (Dyar, Harduar, Koenig & Reyes, 2006), or increased domestic violence and abuse (Islam, 2013). This leads us to ponder on the reason behind women’s participation in microfinance. Is targeting women just an efficient way of getting credit into the household, given that women are more likely than men to be able to attend meetings, to be manageable by field staff, and to take repayment more seriously, even if they do not invest or control the loan themselves? Or is such targeting fully justified on the grounds of enhancing gender equity? According to Johnson (2004), the answer probably lies somewhere between these two alternatives. She goes on to argue that MFIs must analyse both the positive and negative impacts of their interventions on women, and that MFIs need to work with men to help pave the way for a change in attitudes towards women’s enhanced contribution to the household.

Mayoux and Hartl (2009) highlight the fact that women comprise at least half the population in rural areas of developing countries like India and Uganda, especially with high levels of male outmigration as men seek to work in the cities, leaving women to head the rural

households. Any development strategy that fails to include and directly benefit such large numbers of people is clearly deficient. Aspects relating to gender empowerment are highlighted by several authors, including Mayoux and Hartl (2009), as follows:

- Poverty reduction. Women the overwhelming majority of poor people, but research has shown that women are also more likely to invest additional earnings in the health and nutritional status of the household and in children's schooling. This means that the targeting of women has a greater positive impact on child and household poverty reduction, measured in terms of nutrition, consumption and well-being. Aggarwal, Goodell and Selleck (2015: abstract) also found that women borrowers are more trustworthy and have greater social impact, which they described as "social trust".
- Economic growth. Gender equality is an essential component of economic growth, enabling women to become more effective economic actors. While the number of women entrepreneurs is growing at a faster rate than that of men in many countries, serious constraints hamper the growth of women's incomes (Mayoux & Hartl, 2009).
- Financial sustainability of microfinance providers. Women have not only often proved to be better repayers of loans (Appui au Developpement Autonome, 2007), but also better savers than men (Matus & Matus, 2010), and more willing to form effective groups to collect savings and decrease the delivery costs of many small loans. This latter point is emphasised by Holvoet (2006) whose study focused on collective action by women's groups, which is also supported by Gobezie (2013: 13) who found that "group lending modality provided a forum for strengthening mutual support networks and social security structure, as well as a potential platform for delivering multiple services demanded by the poor cost effectively". Gobezie also found that there are real positive changes on key local empowerment issues, such as joint land ownership, or sharing of household responsibilities when microfinance is provided to women. She cautions however, that these findings need to be contextualised, making specific reference to rural Uganda where serious gender inequality has been part of the rural cultural system for generations. The current study examines household participation and access to credit through Joint Liability Lending (JLL) programmes, the allocation of household credit, and subsequent loan repayment. The study concentrates on JLL programmes, instead of looking at other models of microfinance, because the Joint Liability Lending model targets the poorest segments of the population.

Mayoux and Hartl (2009: 8) refer to ‘virtuous spirals’ of economic empowerment, increased well-being and social and political empowerment for women themselves, thereby addressing goals of gender equality and empowerment, as well as potential vicious circles in which women are also almost universally disadvantaged in access to and control of incomes (from their own or household economic activities) and assets (particularly land). These differences and inequalities affect the types of financial services they need and also the ways in which they are able to use and benefit from them. It seems right and proper therefore to make the full spectrum of microfinance services available to women, and this should be a primary consideration for MFIs.

2.10.2 Case Studies: How Microfinance Benefits Women

The following case study examples illustrate how women, in particular, have benefited from access to credit and microfinance products and services perhaps more than any other poverty class.

2.10.2.1 The Philippines

In the Philippines, data showed that the number of physical assets of the sample beneficiaries increased after they joined the microfinance program. Participants reported that they were able to acquire more productive assets (e.g., sewing machines, tricycles, motorcycles) and more household appliances (e.g., coloured televisions, DVD players, karaoke machines).

In terms of financial assets, the respondents reported that microfinance helped them invest more capital in their businesses and savings increased. The women in the focus groups also said that they gained more self-confidence in managing their business and felt an increase in their sense of fulfilment as they were now able to help provide for the needs of their children. Others said that they could now make decisions on their own as they had their own business and were less dependent on their husbands for income. The women also said that they had learned how to deal with other people, improved their public relations, and established a support group that they could rely on when they had problems. Most of them said that their husbands had become partners in their business and this resulted in a better and closer relationship (Asian Development Bank, 2007).

2.10.2.2 Bangladesh

In Bangladesh, the Grameen Bank mostly targets women (98 per cent of their clients) based on the perception that women tend to repay their loans in a more timely and responsible

fashion than men, owing, in part to the fact that they are also more vulnerable, due to situations of inequality and oppression (Murray & Boros, 2002). Loans extended to women are supposed to benefit all household members, bringing an improved level of health, food intake, and education. Average loans range from US\$100 to US\$200 with a maturity period of 3 to 12 months. While average loan amounts differ from country to country, they tend to be higher (\$500 or more) in countries that are in the process of adopting this system.

The female microfinance clients of the Participatory Livestock Development Project said that, after participating in the Project, the number of their assets increased. Ownership of these assets (e.g., household furniture and appliances, cows, and rickshaws) also changed, either into joint ownership or ownership by single women. Houses were improved from bamboo material to corrugated iron, which indicates improved living conditions. Similar responses were made for the Rural Livelihood Project in terms of housing. However, participants in that project did not report much of a change in the acquisition of productive assets. There were, however, significant changes in purchases of household furniture, TVs, electric fans, and clothing. Prior to gaining access to microcredit, women borrowed rice, flour, and wheat from neighbours and did not have any savings. After participation in the microfinance program, these women were able to save either in group savings schemes, pension schemes, or in their homes. With their improved technical knowledge and skills, they were able to contribute to family income (Asian Development Bank, 2007).

2.10.2.3 Uzbekistan

In Uzbekistan, the asset acquisition (the acquirer buys some or all of the target's assets/liabilities directly from the seller) indicated an increase in physical asset ownership after the women joined the microfinance program. They were able to purchase appliances, livestock, improve their business premises, and repair their houses. Prior to participation, these women relied on their husband's salary. After receiving microcredit, they were able to augment household income through their businesses. However, this business income was reported to be unstable. Increased knowledge and self-confidence in doing business, and increased experience in dealing with people were among the benefits reported by these women (Asian Development Bank, 2007).

2.10.2.4 Tanzania

Kato and Kratzer (2013) challenge the assumption that providing credit to women necessarily increases their status within the household; the mode of loan instalment repayment is seen as

an important gauge in this respect. Traditionally the position of women in Tanzania has been low compared to men. Women are poorer, have low education and suffer from traditions and customary laws. However, the results of the study show a significant difference between the women members of MFIs and non-members in the dependant variables related to women empowerment. Women members of MFIs have more control over savings and income generated from the business, greater role in decision-making, greater self-efficacy and self-esteem, and greater freedom of mobility and increased activities outside home.

2.10.3 Negative Impacts on Women

Many authors have suggested a positive relationship between microcredit and the empowerment of women as a result of their findings. However, some of the authors and researchers have observed and reported the negative impact of microcredit on the empowerment of women (Jahanian, Nawazz, Hassan & Nawaz, 2012). These researchers suggest that microcredit is not an efficient tool to change the traditional practices and norms of patriarchal society. Here are some of the findings in this regard.

One impact of microfinance on a household is that the woman starts to experience an increased work load, as a result of her inclusion in microcredit arrangements. The traditional household chores and tasks remain there to be performed by the woman who takes on extra tasks in terms of her responsibility after acquiring microcredit. This makes women overloaded with work. In the absence of availability and access to proper resources such as school or nursery for childcare, the women become the sole bearers of responsibility and care for the family.

Jahanian, *et al.* (2012) also noted that 17.8 per cent of the women had full control over loans, 19.4 per cent of the women had significant control, 24.1 per cent had partial control on the loans, 17 per cent of the women had very limited control over loans and 21 per cent of the women had no control on the loans. This lack of control over loans by the women can be a source of tension and may create unique form of dependence on men. A study on microcredit and empowerment revealed that in many instances husbands use their wives to access loans and they feel no shame in abusing or engaging in domestic violence if they face resistance from their wives. Some of them perceive the loan taken in the name of their wives as another form of dowry.

Hunt and Kasynathan (2002) found on changes in gender relations with microcredit that only a minority of 30 per cent of women receiving credit from poverty-oriented microfinance

programmes were controlling their loans. According to them, many women act as “post-boxes” for these loans. That is, they pass on the full amount of their loans directly to their husbands, sons or sons-in-law, with little or no access to the income generated receiving in return only enough money to make weekly loan repayments. In other cases, loan management and control within the family is more complex, with some women keeping part of their loans for their own enterprises and passing on the remainder to men (*ibid.*).

Rahman’s (1999) research is a study of Grameen Bank lending to women in Bangladesh as well. Based on findings similar to Goetz and SenGupta’s study, Rahman questions the degree to which microfinance benefits women and explains that women in Bangladesh are often unable to use loans by themselves in the structure of patriarchy and the rural market economy. The absence of investment opportunities for rural women and the lack of control by the lending institutions as to how loans are used and by whom lead women to pass on their loans to others (generally men) and lose control of their loans altogether. He further points out that the empowering influence of microfinance is not always associated with improvements in women’s lives, and credit as a debt for the household constitutes a risky strategy due to many factors such as income control by the husband which compromises the rights of women to decide how to use the money. Other threats to positive empowering effects include the possibility of increased intra-household tensions as a result of a desperate need for a cash to make weekly loan repayments, or the possibility of men withdrawing their own incomes and/or women struggling to retain control of their own earnings.

These studies are reminders of the importance of the sociocultural setting, to not extrapolate findings between different contexts, and that the cultural context can limit the empowerment benefits of microfinance programmes for women. Changes in the power structure are not seamless. Development and transformation are often associated with upheaval and in some cases might be faced with resistance at the household and community level. In addition, ‘empowering’ effects might be linked or even dependent upon success. If a woman ‘fails’ in her business or if group dynamics are highly fractious, it seems likely that a spiral of disempowerment might be set into motion. So, while the potential for many positive expressions of empowerment exist, they cannot be assumed to be automatic or complete (MkNelly & McCord, 2002).

The available evidence highlights that a significant number of women, who may have access to finance, may not have control over the loans contracted (Norell, Lawson-Lartego, White,

Bante & Conn, 2015) and that men try to control income from women's enterprises, loans are often invested by male relatives, used for men's productive activities and that women were passing on all or most of their loans to male family members under circumstances that gave them little control over the use of this capital.

Other critics highlight the negative impacts of microfinance on women. Kerr (2002), for instance, has argued that on its own, microcredit can sometimes increase women's disempowerment through higher debt and work burdens since credit by definition is a liability. The mechanism of disempowerment is actuated by overworking women for long hours to repay the loan that might lead to physical abuse by the husband for perceived household remissness.

2.10.3.1 Bangladesh

One of the most cited articles from the 'sceptics' camp is one that focuses on the aforementioned issue of women's control over their loans, an indicator used as a proxy for female empowerment. Goetz and SenGupta (1996) used a sample of 253 female borrowers covering four rural credit providers in Bangladesh and classified the extent of control by the borrower into five categories: full, significant, partial, very limited and no involvement. Their qualitative investigation of loan histories led the authors to conclude that 'about 63 per cent of the cases fall into the three categories of partial, very limited or no control indicating a fairly significant pattern of loss of direct control over credit' (*ibid.*: 49). Moreover, in their study, it appeared that women's ability to control their loans varied significantly according to their age and marital status; younger brides are less likely to be able to retain control in view of their subordination to their husband, mother in law and possibly even older wives.

The authors disaggregated their data in terms of loan activity and concluded that investing in traditional women's work increased their chances of being able to control the loan. Moreover, the paper suggests that an inverse relationship between loan amount and control exists as well as diminishing control beyond a threshold level of membership age. This is explained by the gendered divisions of cash control within the household. Women may be permitted to handle small amounts but men take control beyond a certain amount (Khan, 1998).

If, for instance, the loan is invested by a male member of the household and he provides the loan instalments regularly on a 'quasi contractual' basis, Goetz and SenGupta. (1996: 54) believe the woman can potentially become more 'empowered' in the process as she is seen as a source of household resources. On the other hand, if the male member controls the loan but

fails to provide instalment payments, then the female is left to her own devices in terms of searching for a means to meet her weekly obligations. As is evident, in this case borrowing from a MFI could prove to be a ‘disempowering’ experience. The authors also report that a number of borrowers felt that violence had risen due to instalment-related tensions within the household. The article also implies that field officials prefer to lend to women in order to internalize the high transaction costs of lending to men and that ‘women in effect offset these costs by using intra-household gender relations of obligation and persuasion to recover weekly loan instalments’ (Khan, 1998: 55.)

2.10.3.2 India

Evidence from India and some other countries show that even in financially successful microfinance programmes, women are not necessarily the actual users of loans accessed in their names (Mayoux, 2003). Even where women use loans for their own economic activities, most women remain confined to a narrow range of female low-income activities. Increasing access to loans cannot therefore be taken as an automatic indication of benefit to women. This depends upon what the services are used for and by whom. The appearance of a woman in the loan register as beneficiary does not imply that she actually uses the loan for the purpose for which it was sanctioned. Even in SEWA (Self Employed Women’s Association - basically a trade union of self-employed women), where there was found to be some high level of control by women over loan use (37 per cent), most said their husbands made the decision without consulting them (Jameela, 2009).

In a survey by Garikipati (2010), the 397 SHG-women surveyed used their loans in broadly four different ways: as working capital for family farms or businesses (57 per cent), in enterprises that they manage or help manage 21 per cent; towards household maintenance (12 per cent) and to purchase or improve family land (10 per cent). This suggests that nearly 80 per cent had their loans diverted into family farm or household requirements. This, in turn, implies that the demand for credit within the household, both for production and consumption is high. It is also the case that the loans received by women are mainly used to enhance or procure assets controlled primarily by their husbands, indicating that lending to women may actually amplify the existing resource divide between men and women. The problem with diverting the loan to household requirements is that it contradicts the conditions of loan use, and since the percentage of diversion is high there will be lack of cash to establish the business. In this case women are disempowered by struggling to repay the loan.

A later study conducted in 2013 by Community Based Health Project (2013) found that there was insufficient enforcement by lenders, that men were more entrepreneurial than women, that banks and panchayat (village councils) alike frustrated women who applied for loans as a group, and that bribes had been demanded by bank and panchayat officials.

Roodman (2012) reports that MIT economists, in a 2009 study, found that “in the slums of the megalopolis of Hyderabad, India, small loans caused more families to start micro-businesses such as sewing saris. Existing businesses saw higher profits. But over the 12 to 18 months the researchers tracked, the data revealed no change in bottom-line indicators of poverty, such as household spending and whether children were attending school”.

2.10.3.3 Uganda

In Uganda, Mayoux (1999) noted that among the Langi people of Pakwach district, the larger the amount of the loan, the more likely it was to be appropriated by the husband or other male members of the family and invested in activities over which women had no control (Wakoko, 2003). It will not be surprising to find similar social behavior in Arua as opposed to Mukono since the Arua and the Pakwach have many values in common (Wakoko, 2003).

2.10.3.4 Bangladesh

In the Grameen Bank microfinance program, women borrowers who were widowed, separated, and divorced were more likely to retain control over loan-use, compared to the young, unmarried women or new brides (Goetz & SenGupta, 1996). The Grameen Bank study notes that characteristics such as loan amount, one’s membership in a supportive group, and the nature of the investment activity also affected how much a woman was able to keep under her control,

Additional criticism by Karim (2008) has reported on the growing extent of social violence and public humiliation deployed to enforce high rates in Bangladesh’s main MFIs, especially by Grameen Bank. Each of these MFIs worked with micro-credit, had millions of dollars in donor support, and millions of rural subscribers. They reached 80 per cent of the rural people. Karim concluded that Grameen Bank and other MFIs have essentially been constructed upon the routine use and abuse of Bangladeshi women’s honour and shame. High repayment rates are therefore not surprising under such pressure. Karim describes ‘a local economy of shame’, and she shows how local norms of gender cohesion and community are undermined

by the juggernaut that is microfinance. Such widespread practice mainly leads to the subjugation of women, rather than to their emancipation or empowerment.

Importantly, the research shows that the ongoing commercialization of the microfinance sector has markedly intensified these aggressive tactics, including routine pressure on the male partner and his wider kinfolk to repay a microloan. At least one of the major MFIs in Bangladesh, ASA, quite freely admits to using pressure on borrowers' husbands and male relatives to enforce its high repayment levels on microloans taken out by women (Bateman, 2010).

2.10.3.5 Bangladesh

Montgomery, Bhattacharya and Hulme (1996) also have reservations about the 'empowering effect' of BRAC's approach to micro-credit. Their argument is based largely on secondary sources and a small field survey of sixty-seven BRAC borrowers focusing on the issue of control over household cash. The authors admit that their sample is too small to draw any major conclusions on the 'cash-control' issue although there was some tentative evidence to suggest that '...control over the loan-assisted activity seems to be higher for successive female borrowers than for first-timers...' (*ibid.*: 170). Anecdotal evidence in their fieldwork is used to suggest that certain forms of 'collective action' undertaken by VO members would have taken place regardless of whether they had been members of BRAC (Khan, 1998).

2.10.4 Summary of Benefits and Drawbacks

Table 2.1 below summarises and draws out the key points of these case studies with a focus on the positive and negative impacts that have been highlighted in the discussion this far.

Table 2.1: Comparing the positive and negative impact of microfinance on women

Positive impact	Negative impact
<p>Economic empowerment through enabling an increase in women's involvement in decisions about savings and credit use (Chowdhury & Bhuiya, 2004).</p> <ul style="list-style-type: none"> • Bangladesh • Tanzania 	<p>Women are subjected to domestic abuse and gender conflict (tensions over household decisions between husband and wife) and are simply intermediaries for loans to their spouses (Kim, Watts, Hargreaves, Ndhlovu, Phetla & Morison, 2008).</p> <ul style="list-style-type: none"> • Bangladesh

	<ul style="list-style-type: none"> • Bangladesh
<p>Women's ownership of assets increased</p> <ul style="list-style-type: none"> • Philippines • Bangladesh • Uzbekistan 	<p>Loans are diverted to purposes other than what they were granted for, such as household necessities rather than productive activities. Men often take control of the loans and do not use them for the purposes that the women applied for.</p> <ul style="list-style-type: none"> • Bangladesh • India • Uganda
<p>Combination of women's increased economic activity and increased decision-making in the household can enable wider social and political empowerment (Simanowitz & Walter, 2002).</p> <ul style="list-style-type: none"> • Philippines • Uzbekistan 	<p>Women that have set up enterprises benefit only from small increases in income at the cost of heavier workloads and repayment pressures (Kabeer, 2007).</p> <ul style="list-style-type: none"> • Bangladesh • India
<p>Women's economic empowerment at the individual level has potentially significant contributions at the macro-level through increasing women's visibility as agents of economic growth and their voice as economic actors in policy decisions (Mayoux, 1998).</p> <ul style="list-style-type: none"> • Ghana • Bolivia 	<p>Many MFIs operate only under the cover of gender empowerment because this is the coded language needed to ensure 'respectability' of unlocking some additional government and international donor financial and technical support.</p> <ul style="list-style-type: none"> • Bangladesh
<p>Drawing women out of their homes was in itself a big stride for poor women because it helped them to overcome some of the restrictive socio-cultural barriers and also widened their opportunities to get</p>	<p>MFIs mainly benefit the women who are already better off, whereas the poor women are either neglected by the MFIs or are least able to benefit because of their low resource</p>

information and possibilities to develop other social roles (Hunt & Kasynathan, 2001). <ul style="list-style-type: none"> • Philippines • Uzbekistan 	base, lack of skills and market contacts. <ul style="list-style-type: none"> • Bangladesh
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One thing that is quite evident from the table above is the issues of microfinance need to be contextualised and that different results are evident in different countries and even at different times within the same countries. There is little evidence in any of these studies that Islamic financing principles were applied. It therefore seems to be an opportune time to conduct another study in Uganda, but looking at Shariah-compliant microfinance provision rather than conducting another general study on microfinance per se.

2.11 CONCLUSION

This chapter has reviewed the evolution of microfinance over the past thirty years and briefly examined three of the MFI models that exist today. The role of MFIs in development, specifically in relation to the alleviation of poverty and empowerment of women has also been considered. As discussed above, the key challenges faced by MFIs today are the emphasis on the objective of financial sustainability over social objectives and a failure to reach the poorest segments in society. There seems to be a greater need for MFIs to carefully design services that meet the needs of the poor. And this can only be done when MFIs understand these needs and the context within which the poor are working.

As we have seen, the impact of microfinance on poverty alleviation is a keenly debated issue. It is generally accepted that microfinance is not a panacea for all the financial woes of the poor and that, in fact, it has not always lived up to expectations. Studies have shown both successes and failures. When carefully designed, implemented and managed, microfinance services have had positive impacts, not just on clients, but also on their families and on the wider community. If the true value of microfinance for development is to be understood, the assessment of these wider impacts should be improved (Zohir & Matin, 2004). One tool for measuring these impacts, as this thesis will illustrate, is livelihood security analysis, based on a livelihoods framework that tries to understand how a project affects the livelihoods of beneficiaries.

De Haan and Lakwo (2010: 533) point out, with insight, that there is ‘a third position’: “...in our view, the debate should not be about which comes first, poverty reduction or sustainable profitability, but rather how these gains promote social emancipation”. Women, in particular, are the focus of related debates on how microfinance can promote social freedom and choice.

Until now, the focus has been on microfinance in general terms and as most people understand it. The next chapter moves to a discussion of Shariah-compliant microfinance which differs in many ways from microfinance as it is generally understood.

2.12 CHAPTER SUMMARY

Chapter 2 provided an in-depth review of the concept of microfinance, its history, the positive and negative impacts and how these tend to be measured. There was a specific focus on the provision of microfinance services to women, followed by a brief summary of the benefits and drawbacks of microfinance.

CHAPTER 3: SHARIAH-COMPLIANT MICROFINANCE

3.1 ISLAMIC FINANCE – TRANSITIONING TO THE MODERN WORLD

From the beginning of Islamic civilization, Islamic scholars served the Islamic society as the interpreters who inquired into the Quran and the tradition of the prophet to find the solutions for the growing complexities of the everyday life. Each query reflected the times in which they lived. The transformation from an agrarian society to today's modern society creates the need to view financial transactions differently. Islamic jurists have made those determinations for their era. A person can be wealthy today without owning any kind of physical assets like a house, for example, in terms of stocks and shares, and borrowers and lenders exist in competitive, controlled environments. To adapt to the socioeconomic phenomena of the modern world, modern scholars have combined the Quran (cited revelation), the tradition of the Prophet (*hadith*, or non-cited revelation) and *ijtihad*, the process of independent reasoning on which the Islamic legal system is based.

As Islam began to expand throughout the world, the diversity of opinions among Muslim jurists as to the methodology of law led to the evolution of different schools of thought, each of which uses different rational methods to codify the legal system of Islam. The schools range from pure traditionalists who consider Quran and *hadith* as the only basis of law, to the rationalists who believe that the primary sources need to be complemented with rational principles to develop laws. Each agree that contracts are permissible between consenting parties, provided that their contracts do not involve anything prohibited in the Shariah (e.g. usury or similar prohibitions).

Saleh (1989: 102) states that “from the outset numerous exceptions and qualifications were dictated by business exigencies and found accommodation with an evolving legal system.” Moreover, it can be argued that every age and nation has its own practical wisdom in dealing with contracts and transactions and the following section helps explain how modern Islamic Law is interpreted and applied, given the rapidity with which financial transactions are evolving and need to be considered valid from the onset.

3.2 INTRODUCTION TO THE SHARIAH-COMPLIANT FINANCIAL SYSTEM

Islam is not simply a religion. According to Kabbani (n. d.), for Muslims, it provides a comprehensive code that covers all aspects of human existence at every level: the individual and the social, the material and the moral, the economic and the political, the legal and the

cultural, the national and the international. It is a comprehensive way of life, at the same time secular and religious. It includes a set of beliefs and a specific form of worship, a massive and integrated system of laws, a particular culture and civilisation, a set of commercial norms and economic practices, a form of polity and peculiar approaches to governance, rules for family and social conduct. In sum, Islam attempts to embrace the totality of the human experience, both in this world and the spiritual realm.

The Shariah is the skeleton of Islamic Law. It is not a codified legal system, but an abstract form of law that can be adapted, developed and interpreted. The Shariah does not provide overall principles of law. Rather, it sets out the rules that govern certain areas of social and individual behaviour. It is derived from two primary sources: the Quran (the transcript of God's message to the Prophet Muhammad) and the Sunna (the words and deeds of the Prophet Muhammad). In addition, there are two dependent sources, *qiyas* and *ijma`*, which are required to provide interpretation of the primary sources, and therefore facilitate the development and implementation of the Islamic judicial system. *Qiyas* is a form of deductive analogy, whereby a jurist applies to a new case a ruling previously made in a similar case. *Ijma`* is the consensus of Islamic legal scholars. It is through this consensus, for example, that consultation becomes incorporated in Islamic policy. While it allows the law to be responsive to popular opinion, *ijma`* tends to act as a conservative force, given that it requires the consensus of a large number of scholars.

Islamic microfinance is a sector with great potential for further expansion. It is estimated that 72 per cent of the population living in predominantly Muslim countries do not use financial services, because the services provided do not comply with the precepts of Islam. Muslims use conventional financial products, but at least one survey shows that if they had the choice they would use Shariah-compliant financial products (El-Zoghbi & Tarazi, 2013). Abeldaker and Salem (2013: 220) state that "there is still a gap in empirical studies analyzing the performance of Islamic MFIs". El-Zoghbi and Alvarez (2015b) found that Islamic microfinance is still in its infancy and that only a miniscule number of potential clients (they put the number at 650 million poor Islamic people in the world) have accessed shariah-compliant microfinance services. El-Zoghbi and Badawi (2015) call it a "nascent industry".

3.3 SHARIAH-COMPLIANT BANKING AND MICROFINANCE

Access to credit and other financial services by the most vulnerable people is also a concern for Shariah-compliant banks (Islamic Financial Services Board (IFSB), 2007). The awareness

of the benefits of a Shariah-compliant approach is encouraged by social welfare responsibilities and religious commitments to achieve, not just Shariah-compliant financial objectives, but also social justice, equitable distribution of income and wealth, and economic development (Yaqub & Bello, 2007; Aris, Azli & Othman, 2013). For many years, researchers have noted that Shariah-compliant banking has the potential to become involved in microfinance programmes catering to the needs of those segments of the population that usually fall outside the formal banking sector (Dusuki, 2008), but it is apparent that for all the recommendations that have been made, little implementation has occurred in terms of Islamic microfinance.

In the 1970s Shariah-compliant microfinance experiments already existed in India and Egypt, consisting of small rural cooperatives inspired by European mutual, but later spread to other Gulf States. For instance, in 1963, an institution such as Mit Ghamr in Egypt focused on poverty alleviation, economic development, and the promotion of a thrift culture amongst vulnerable Muslims (Dusuki, 2008). Despite this, with the passage of time, Shariah-compliant banking and financial institutions have been largely dominated by a profit-maximisation doctrine, “vying for countless billions of Arab Gulf petrodollars” (Dusuki, 2008: 7). As a consequence, most of the financial instruments they offer are designed for the needs of privileged clients, while the most vulnerable are left out of the banking system.

As the name suggests, Shariah-compliant banking is first and foremost about maintaining religious identity and duty, because there are essential differences between Shariah-compliant banks and their conventional counterparts, not only in the ways they carry out their business, but above all in the values that guide the operations and general outlook of Shariah-compliant banks, as indicated in Chapter 1, Section 1.3, namely risk-sharing, materiality, ethical standards and morality, as opposed to “economic rationality” (Dusuki, 2008: 7). (The prevalent values in Shariah-compliant banking are expressed, not only in the details of their transactions, but also in their wider involvement in society.

Overall, Shariah-compliant banking is concerned with much more than just refraining from the charging of interest, being equity-based and emphasising risk-sharing rather than “risk-shifting” which Cheng (2013: 1) identifies as a characteristic of traditional banking where “the banker-customer relationship is that of a creditor-debtor”. It is a system that strives to make a positive contribution to the fulfilment of the socioeconomic objectives of an Islamic society as formalised in *maqasid al-Shariah* (the objectives of Shariah). Constituted as

business entities within the domain of Shariah, Shariah-compliant banks are expected to be guided by Shariah economic objectives. One of these objectives is to make sure that wealth is circulated fairly among as many hands as possible without causing any harm to those who acquire it lawfully (Ibn Ashur 2006). Thus, the issue of financing vulnerable people through microfinance is not alien to Shariah-compliant banks, according to Obaidullah (2005), who investigated Islamic microfinance programs across the globe in the Middle East North Africa (MENA), South Asia, South East Asia, Sub-Saharan Africa, and Central Asia, and found that various microfinancing products were available in all these regions. On the contrary, it is an attitude that should inspire the operations of all Shariah-compliant institutions, particularly those that adhere more explicitly to the principles of Shariah.

While Shariah-compliant banks may emulate existing models of microfinance, their activities must nevertheless be carried out in a way that does not conflict with the principles of Shariah. In other words, Shariah-compliant microfinance initiatives must not become involved in activities prohibited by Islam, such as usury (*riba*), gambling (*maysir*), the use of harmful substances (*darar*), or excessive ambiguity (*gharar*). As long as they abide by these rules, however, Shariah-compliant banks can always benefit from the various approaches used by microfinance institutions to ensure an effective provision of financial services to marginalized segments of society.

In addition to the innovative approaches used by many microfinance institutions, Islamic banking can incorporate in its practice other instruments and mechanisms such as *zakah*³, (charity), and *waqf*⁴, which can be integrated into microfinance programmes to promote entrepreneurship amongst the poor and alleviate poverty (Hassan & Alamgir, 2002; Obaidullah, 2005).

3.3.1 Zakah

Zakah is the third pillar of Islam. It is a prescribed share of one's wealth that should be distributed among those entitled to it. As stated in the Quranic verses, "the offerings (*zakah*) given for the sake of Allah are (meant) only for the *fuqara* (poor) and the *masakeen* (needy),

³ *Zakah* is one of the fundamental pillars of Islam. *Zakah* literally means 'to purify, to develop, and, to cause to grow'. *Zakah* is the prescribed share of one's wealth to be distributed among the categories of those entitled to receive it. An individual entitled to pay *zakah* is called *muzakki* and the individual entitled to receive *zakah* is called *mustahiq*. Islamic microfinance programs aim at transformation of *mustahiq* into *muzakki* within a definite time frame.

⁴ *Waqf*, or 'endowment', is a long-standing Islamic tradition. It refers to the dedication of some valuable goods – land, a building, or even money – such that it no longer belongs to anybody, and cannot be bought or sold. The profits which are then generated from this endowment are given away as charity.

and *ameleen-a-alaiha* (those who are in charge thereof), and *muallafat-ul-quloob* (those whose hearts are to be won over), and for *fir-riqaab* (the freeing of human beings from bondage), and for *al-gharimun* (those who are overburdened with debts), and *fi-sabeelillah* (for every struggle) in Allah's cause, and *ibn as-sabil* (for the wayfarer): (this is) an ordinance from Allah, and Allah is all knowing, wise" (9:60).

According to Chapra, the renowned Islamic economist, *zakah* is the financial duty of a Muslim "to pay out of his net worth or agricultural output, if these are higher than the threshold of *zakah*, a specified portion as an indispensable part of his religious duties" (Khan). A primary objective of the *zakah* is economic empowerment, which can be interpreted from the Quranic verse as a way of providing for the basic needs of Muslims, especially those who are most needy.

3.3.2 Waqf

In Islam, *waqf* is an inalienable endowment. It involves the seizure of a specific physical asset and its maintenance so that the benefits constantly flow to a precise group of beneficiaries and are used for a specified purpose. The different forms of *waqf* include devoting land, buildings, books, shares, agricultural machinery, and even cash, to religious or philanthropic purposes (Obaidullah, 2005).

Waqf-based MFIs are able to generate a considerable amount of funds through cash *waqf*. This enables them to provide *qard hassan* loans (see description below) on a regular basis. *Qard hassan* loans can be instrumental in setting up communities and businesses. Cash *waqf* also enables Shariah-compliant MFIs to expand in scale and reach out to more customers by gaining geographical coverage. As many potential clients refuse conventional microfinance loans due to their non-compliance with Shariah guidelines, *waqf*-based MFIs can meet the needs of borrowers who have previously been avoiding conventional loans.

As with any novel endeavour, there are a few drawbacks in the implementation of this model. First of all, *waqf* is not a sustainable source of funds. Although it can generate a considerable influx of cash, there is no guarantee that all of these funds will be dedicated to microfinance or placed with a particular MFI. There is no legal framework currently in place to redirect the funds collected by the provincial *waqf* boards to Shariah-compliant MFIs. At the moment, *waqf* boards use the money to maintain the properties under their jurisdiction. A fully functioning Shariah-compliant MFI, as described by Ahmed (2002), would require considerable cash reserves, which may not be readily available for most MFIs.

At the same time, however, there are many opportunities in the *waqf* model. If properly implemented, it can help address existing concerns about Shariah-compliant microfinance. In particular, this model can be a great tool in eradicating poverty, since the purpose of the *waqf* funds is precisely to help the poor. Providing *qard hassan* loans would, in other cases, not be financially viable for MFIs. Moreover, *waqf* can allow Islamic MFIs to expand their operations, which are often being held back by a lack of funds. To some extent, some MFIs such as Akhuwat are already running on *waqf*, with members of the community making donations and becoming part of the organisation. There are also those MFIs, like CWCD, that have a strong and profitable product lines which could be enhanced and developed with the *waqf* model.

3.3.3 *Qard hassan* or Benevolent Loan

Under Shariah law, lending money is permissible. Only *riba* is actually forbidden. *Qard hassan* are benevolent loans with “no interest” that attempt to support the vulnerable and alleviate their hardships. Although the cash paid by the lender is considered an interest-free loan, Lewis and Algaoud (2001) point out that the borrower can repay any amount over the loan as long as the lender has not asked for it. Obaidullah (2005) adds that it is allowed for the lender to ask for collateral and charge administrative expenses on the loan.

3.3.4 Freedom from Riba

Riba means to grow, to increase, to exact, to exceed by more than is due, but also to practice usury. Metwally (2006: 17) links the concept more closely to usury: “Usury is translated to mean *riba* which literally means an excess or addition above the principle lent. Interest, however small, is an excess over the capital lent”. The Quran states that Allah has permitted trade and forbidden *riba* (2:275). There are two types of *riba*: *riba al-nasiah* and *riba al-fadl*. *Riba al-nasiah* refers to the fixing in advance of a mandatory payback on a loan as compensation for waiting, while *Riba al-fadl* refers to the trading of goods that are of the same type but of dissimilar quality in exchange for cash (Mavarakis, 2009).

3.3.5 Freedom from gharar

Gharar refers to the consequences of uncertainty and deceit. The definition of *gharar* may also include “settlement risk, inadequacy of information, misspecification, and inaccuracy of information shared between parties in a transaction” (Obaidullah, 2005: 20). More simply, El-Gamal (2001: 7) defines *gharar* as “the sale of probable items whose existence or

characteristics are not certain, due to the risky nature which makes the trade similar to gambling”.

3.3.6 Freedom from *maysir*

Under Shariah law, it is not permitted to earn a profit from speculation. Therefore, gambling and any arrangements or contracts that involve speculation are not allowed. Of course, there is an element of speculation in most commercial arrangements. Unlike the absolute prohibition of interest, Shariah law accepts that it is a question of the degree of speculation involved in a transaction and whether the intention behind the transaction is to realise a gain from some productive effort or purely from speculation (Allen & Overy, 2009:4). Iqbal and Molyneux (2005: 15) provide the following evidence from the Quran: “O, you who believe! Intoxicants (all kinds of alcoholic drinks), and gambling, and *al-ansab* (animals that are sacrificed in the name of idols on their altars) and *al-azlam* (arrows thrown for seeking luck or decision) are an abomination of Satan’s handiwork. So avoid that (abomination) in order that you may be successful” (5:90).

The following sections delineate the various instruments that Shariah-compliant microfinance institutions can use to mobilise funds and provide credit and other financial services to the poor.

3.4 INSTRUMENTS OF SHARIAH-COMPLIANT MICROFINANCE

In recent years there have been many studies on Islamic microfinance. In one of the most thorough studies on the topic, Dhumale and Sapcanin (1999) tried to analyse how to combine Islamic banking with microfinance. In particular, they took the three main instruments of Islamic finance (*mudarabah*⁵, *musharakah*⁶, and *murabaha*⁷) and tried to integrate them into a successful microfinance programme. To put this into more commonly understood terminology, these three basic instruments of Islamic finance are essentially

- trustee financing (*mudaraba*), most commonly used in trade and commerce that are capable of achieving full operational status in a short period.

⁵ The term refers to a form of business contract in which one party brings capital and the other personal effort. The proportionate share in profit is determined by mutual agreement.

⁶ A joint enterprise or partnership structure with profit/loss sharing implications that is used in Islamic finance instead of interest-bearing loans. Musharakah allows each party involved in a business to share in the profits and risks.

⁷ **Murabaha** is an acceptable form of credit sale under Sharia (Islamic religious law). Similar in structure to a rent to own arrangement, the intermediary retains ownership of the property until the loan is paid in full

- equity participation (*musharaka*), similar to a joint venture. It allows equity participation by the parties, who finance a project in agreed proportions in either cash or kind, They each agree to accept a percentage of the returns and risk, sharing the profit and loss of a project in proportion to their investment; and
- cost plus markup (*murabaha*), for example, a commodity is sold for cost plus profit, and both the buyer and seller know the cost and the profit involved.

These instruments are explained in more detail later in the chapter.

3.4.1 The Provision of Shariah-Compliant Microfinance

Microfinance has been identified as an important tool in increasing the productivity of the poor and in fostering economic development. However, there are, as stated previously, about 650 million poor Islamic people in the world (El-Zoghbi & Alvarez, 2015b) and they are unable to take advantage of conventional microfinance contracts, which generally involve the payment of interest which infringes the norms of their faith (Karim, Tarzani & Reille, 2008). It is estimated that over one third of the world's poor are Muslims (CIA World Factbook, 2010; Economist, 2008). In 2007, a global survey conducted in nineteen Muslim countries by the Consultative Group to Assist the Poor (CGAP) found that 20-40 per cent of respondents had religious reasons for not using conventional microfinance. It is clear, therefore, that the design and provision of Shariah-compliant microfinance products would extend the reach of microfinance in countries with large Islamic populations and contribute to the economic progress of poor Muslims. It should be remembered, also that Islamic financing does not exclude non-Muslims as it is open to everyone. This may be an aspect that is not well-known, but it might be a way of reaching other poor people who may also not be able to take advantage of microfinance because they are excluded for one reason or another, such as the ability to repay capital with interest which is a hallmark of traditional banking practices.

Shariah-compliant principles of economics and finance aim to provide clarity, fairness, care, and the just treatment of others. The ethics underlying the principles of Shariah-compliant economics and finance are values that aim to target the extreme poor. According to Said and Elangkovan (2014: 101), the reasons why Shariah finance forbids the charging of interest is that “interest is unjust to one of the parties, sometimes to the lender and sometime to the borrower” and “interest corrupts society”. The argument is that there is an association between charging interest with *fasad*, loosely translated as the corruption of society (QS. 30: 37- 41).

They are fundamentally based on the idea of socioeconomic and distributive justice (which in turn are derived from Rawls's (1971) theory of justice discussed earlier) and have moral values at their very essence (Ayub, 2007). The proponents of Islamic economic and finance believe it has “the power to reduce the environmental crisis, global financial crisis, poverty alleviation and inequality problem” (Said & Elangkovan, 2014: 100) or what Islam terms “economics’ evils” (*ibid.*). It strictly prohibits all form of the exploitation, and implements concrete measures to ensure the “flow of resources from the rich to the poor members of society with *zakat* [charity]” (Allawi, 2009: 318) which underpins the concept of social justice.

Shariah-compliant financial institutions have grown from one in 1975 to about 255 in over 75 countries today (El Zoghbi & Tarazi, 2013), but the number of MFIs remains very small. Most of these institutions are large banks found in the Middle East and South-east Asia, with Bahrain and Malaysia having the highest concentrations. In order to take advantage of the market demand, they have added Islamic banking products to their mix of product offerings, and are not purely Shariah-compliant. Recently, the model has also appeared in the United Kingdom, continental Europe, and the United States. Nevertheless, according to The Economist (2014), Islamic banking assets grew at an annual rate of 17.6% between 2009 and 2013, and will grow by an average of 19.7% a year to 2018, with total assets of around \$2 trillion. According to Khan (2013) there are only 14 purely Islamic financial institutions in the world, which then begs the question of how many genuinely Islamic MFIs there are. According to a survey by Karim, *et al.* (2008), Islamic MFIs serve 300,000 clients through 126 institutions operating in 14 countries. Table 3.1 provides the details.

Table 3.1: Outreach of Shariah-compliant microfinance by country

Region	Number of institutions	per cent female clients (avg.)	Total number of clients	Total outstanding loan portfolio (US\$)	Avg. loan balance (US\$)
Afghanistan	4	22	53,011	10,347,29	162
Bahrain	1	n/a	323	96,565	299
Bangladesh	2	90	111,837	34,490,490	280
Indonesia*	105	60	74,698	122,480,000	1,640
Jordan	1	80	1,481	1,619,909	1,094
Lebanon	1	50	26,000	22,500,000	865
Mali	1	12	2,812	273,298	97
Pakistan	1	40	6,069	746,904	123
West Bank and Gaza**	1	100	132	145,485	1,102

Saudi Arabia	1	86	7,000	586,667	84
Somalia	1	n/a	50	35,200	704
Sudan	3	65	9,561	1,891,819	171
Syria	1	45	2,298	1,838,047	800
Yemen	3	58	7,031	840,240	146
Total	126	59	302,303	197,891,882	541

* Micro and rural banks only.

** With training and funding facilities provided by the Islamic Development Bank, seven MFIs in the West Bank and Gaza offered a total of 578 Shariah-compliant loans between 2005 and 2006. Only the data from one of the 7 MFIs is displayed in the table because the remaining institutions were disbursing Shariah-compliant loans with average loan sizes larger than 250 per cent of the region's gross domestic product per capita.

Source: Karim, *et al.* (2008: 8).

Moreover, while there is much literature on Shariah-compliant finance in general, little has been published regarding Shariah-compliant microfinance. This scarcity is even more pronounced in relation to African case studies, making this research both important and timely. In fact, Table 3.1 only makes mention of Somalia and makes no mention of Uganda or any other African countries for that matter. The field work undertaken by the author, therefore, makes an important contribution to further knowledge about the subject.

3.4.2 Economic Empowerment

Ibn al-Qayyim emphasises the role of economic activity in fulfilling man's needs and requirements. He writes:

When it is preordained that grains will be obtained only after performing a certain chain of activities, it means that the produce cannot be obtained without the sowing of the seeds and the cultivation of the land. Likewise, quenching the thirst or satisfying the appetite depends on drinking water or taking food. Neither of these objectives can be achieved without the specific action it demands. The same is true of all affairs in this life and affairs pertaining to the life hereafter.

Although Islam encourages charity in all forms, it also condemns those who are strong enough to earn money and yet are requesting charity. Charity should be provided for the

poorest of the poor. The following incident with the Prophet, narrated by Anas ibn Malik⁸, shows the importance of economic dependency: A man of the Ansar came to the Prophet (peace be upon him) and begged from him. He (the Prophet) asked: “Have you nothing in your house?” He replied: “Yes, a piece of cloth, a part of which we wear and a part of which we spread (on the ground), and a wooden bowl from which we drink water.” He said: “Bring them to me.” He then brought these articles to him and he (the Prophet) took them in his hands and asked: “Who will buy these?” A man said: “I shall buy them for one dirham.” He said twice or thrice: “Who will offer more than one dirham?” A man said: “I shall buy them for two dirhams.” He gave these to him and took the two dirhams and, giving them to the Ansari, he said: “Buy food with one of them and hand it to your family, and buy an axe and bring it to me.” He then brought it to him. The Apostle of Allah (peace be upon him) fixed a handle on it with his own hands and said: “Go, gather firewood and sell it, and do not let me see you for a fortnight.” The man went away and gathered firewood and sold it. When he had earned ten dirhams, he came to him and bought a garment with some of them and food with the others. The Apostle of Allah (peace be upon him) then said: “This is better for you than that begging should come as a spot on your face on the Day of Judgement. Begging is right only for three people: one who is in grinding poverty, one who is seriously in debt, or one who is responsible for compensation and finds it difficult to pay” (IFSB, 2007: 25).

This incident clearly highlights the focus of Shariah-compliant microfinance: assessment of the financial health of the poor, access to the transformation of unproductive assets, meeting of basic needs, technical assistance, transparent accounting, and reaching the poorest of the poor. In short, the Shariah-compliant approach to microfinance consists of providing basic needs to the poor while maintaining their dignity and enhancing their capacity to earn their living on their own (IFSB, 2007).

3.4.3 Debt avoidance

In Islam, debt is permissible if it is required to cover basic needs, but not for financing lifestyle needs. Even when there are basic needs, debt should be the last resort, after all Shariah-compliant financial tools are exhausted. In the Quran, Allah warns against extravagance by saying: “Eat and drink, but waste not by excess, for God loveth not the

⁸ Anas ibn Malik was born 10 years before the Hijrah of Prophet Muhammad to the Bani Khazraj tribe of Yathrib. He was present in Madinah during Muhammad's time there and afterwards. He was the longest lived of the Companions of the Prophet, having died 93 years after the Hijrah (approximately 711 CE)

prodigals” (7:31). “Squander not wastefully, surely the squanderers are the devil’s brethren” (17:26-27). The wisdom behind the Shariah-compliant microfinance approach is that a loan is given under serious need and under the condition that the recipient will repay it on time and in full. Furthermore, it also aims to prevent the recipient’s entrapment in the loan cycle. Recognising the inevitable role of debt in financial transactions, Islam does not prohibit its use. Even if it is permitted, however, debt is also discouraged. That belief can affect how Muslims finance a house, a car or an education, how they start a business, how they pay bills and how they use credit cards. This is illustrated in the following Hadith, narrated by Muhammad’s wife Aisha:

Allah’s Apostle used to invoke Allah in the prayer saying, “O Allah, I seek refuge with you from all sins, and from being in debt.” Someone said, O Allah's Apostle! (I see you) very often seeking refuge with Allah from being in debt. He replied, “If a person is in debt, he tells lies when he speaks, and breaks his promises when he promises.”

However, if a Muslim does choose to be in debt, he/she is fully expected to repay the debt incurred. This is a serious responsibility and observant Muslims do not take the matter lightly. The following Hadith, narrated by Abu Huraira, emphasises the importance of the intention to pay one’s debt:

The Prophet said, “Whoever takes the money of the people with the intention of repaying it, Allah will repay it on his behalf, and whoever takes it in order to spoil it, then Allah will spoil him.”

While this strict language is used concerning individuals in debt, the Quran and Hadith also praise creditors who show lenience and understanding to individuals in debt. Such an attitude is purely dependent upon the creditor’s goodwill, and the debtor has no right to request forgiveness from a loan. If the creditor does choose to be lenient and forgive a loan, the forgiveness is reciprocated with God’s forgiveness, as expressed in the following Hadith, narrated by Abu Huraira:

The Prophet said, “There was a merchant who used to lend the people, and whenever his debtor was in straitened circumstances, he would say to his employees, ‘Forgive him so that Allah may forgive us.’ So, Allah forgave him.”

The following verse from the Quran prohibits any form of late payment and encourages leniency for people who are in debt:

If the debtor is in a difficulty, grant him time till it is easy for him to repay. But if ye remit it by way of charity, that is best for you if ye only knew. [2:280]

Finally, since debt is an inevitable occurrence, the Quran provides guidelines to ensure that it is incurred in a responsible and just manner:

O ye who believe! When ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing. Let a scribe write down faithfully as between the parties... Let him who incurs the liability dictate, but let him fear His Lord Allah, and not diminish aught of what he owes... [2:282]

The Shariah has a comprehensive set of rules on contracting, in order to ensure that transactions are carried out with honesty and justice. Its emphasis on how to record such transactions further supports the acceptance of debt in Islam. Despite the great differences between the economic systems of 8th century Arabia and those of today, the need for additional funds and financing to undertake economic activity persists. However, the way these funds are supplied has considerably changed. In the 8th century, the lending system had a grassroots nature which necessarily affected interpersonal relationships. Today, banks play the role of financial intermediaries and the interpersonal dynamics that previously resulted from issuing debt no longer prevail.

3.4.4 Cooperation and Solidarity

An important norm related to social behaviour in Islam is mutual cooperation, solidarity, and assistance. Within the Muslim community, there is a spirit of brotherhood that stands for group-based financing and helps to support needy individuals. This is one of the elements that underpin Shariah-compliant microfinance: it is based not only on collateral guarantee but also on a religious obligation to help and support the poor (Obaidullah, 2008: 18).

To deal with arrears and defaults, conventional MFIs use group and centre pressure as a form of “substitute collateral” (Ledgerwood & Earne, 2013: 217), whereby many providers facilitate the formation of groups whose members jointly guarantee each other’s loans. When this fails, threats are sometimes made and, in extreme cases, assets are sold. The Shariah-compliant approach has certain advantages when dealing with arrears and defaults. The spirit of brotherhood and mutual help encouraged by Islamic teachings induces members of a group, or the centre, to assist in paying the arrears. Other than the group/centre members, the spouse of a member can also be approached. Furthermore, the Islamic doctrine, by describing

non-payment of debts as a sin, also motivates members to repay their dues because their religious convictions are so strong that they do not wish to fall foul of these precepts.

3.4.5 Targeting Women

Most clients of conventional MFIs are women. The rationale is that women can use the funds productively to increase their income levels (Momaya, 2015). As a result, they become more independent and their self-respect improves. As pointed out above, however, recent studies show that this is not necessarily always the case (Gobezie, 2013). The male members of the household often persuade the women to obtain credit for their own use. Ramesh (2014) cites instances of violence against women where “the husbands had compelled their spouses to take loans. This money, in many cases was in the control of the men who used it up in drinking liquor. Then under the influence of, the men would resort to violence against their wives”. In addressing this problem, Gobezie, (2013: 9) states:

to the extent that group lending in microfinance entails peer monitoring by other borrowers in the same group, microfinance is likely to provide protection to women within their households, and violent acts and abuse by men against women can now be subject to third party scrutiny.

However, women are still responsible for repaying the instalments. Guérin, Morvant-Roux and Villarreal (2013) found, in their study of Latin American microfinance arrangements, that this can create tensions in the family. The question is whether this applies in Muslim societies as well. However, it seems that this situation does exist, because Kessey (2005: 31) in his study of Muslim women in Ghana states that “economic empowerment of women is a source of concern to men in respect of them maintaining a position of pre-eminence or final arbiter status within the family power structure”, and (ibid.: that the economic empowerment of women “heightens men’s frustration and thereby fuelling local resistance in diverse forms and shapes for the maintenance of men’s control”. Bobaid (2002) refers to financial abuse of Muslim women in Canada. This seems to deny or at least temper the statement that one of the potential benefit of microfinance in Muslim societies is the empowerment of Muslim women.

While the ability of microfinance institutions to deliver financial services to rural women in gender-segregated societies is commendable, working with Muslim women is a sensitive issue that often raises accusations of meddling with social codes, For example, “while women have fewer financial obligations than men, some of their financial rights are limited.

Women's share of inheritance, as outlined in the Qur'an, is typically less than that of men. Women's right to work is also disputed” (Bhai, 2008).

Although most beneficiaries of Shariah-compliant MFIs are also women, the underlying rationale for choosing them is very different from the conventional approach which is outlined in chapter 2. Shariah-compliant MFIs target the family group. This is evident in the contract between the Shariah-compliant MFI and the beneficiary. Both the woman and the man sign the contract and are liable for the repayment of the funds. According to Ahmed (2002), this arrangement, along with other religious aspects of the Social Development Programme (discussed below), tends to create less tensions in the family (mentioned above).

3.4.6 Shariah-Compliant Contracts

There is nothing to prevent the development of Shariah-compliant microfinance instruments based on the prohibition of *riba*, *gharar*, *maysir*, and other religious norms. In fact, the need for Shariah-compliant microfinance has led to considerable research into product development. In the same way that conventional microfinance provides interest-based deposits, loans, and donations, Shariah-compliant microfinance programmes are able to provide an array of instruments for the mobilisation of funds, risk management, and financing (IFSB, 2007: 27).

3.4.7 A Non-Profit Model of Shariah-Compliant Microfinance

The major aim of Shariah-compliant finance is to encourage people to invest their wealth effectively and efficiently without any injustice for those who are either lenders or borrowers. For these reasons, lenders must equally share with borrowers the profits or losses from the funded enterprise. In general, they should share both the risks of the business and the capital contributed to the enterprise. Kahf and Khan (1993 cited in Gait & Worthington, 2007: 12) refer to this as the profit-sharing principle and the profit/loss sharing principle.

3.4.8 Profit-Based Modes

3.4.8.1 Microsavings

- *Wadia*

Wadia is a “deposit under the regulation of Shariah law that is used by the financial institution or microfinance programme at its own risk” (Obaidullah, 2005: 44).. It is a guaranteed deposit where the depositor is not accountable for any losses incurred by the

microfinance programme. Also, the depositor has the full right to withdraw the deposit at any time.

- *Qard hassan*

Qard hassan is a benevolent loan. It has already been explained in the previous section.

- *Mudarabah*

Mudarabah (or capital trust) is a profit or loss (equity-based) Shariah instrument. According to jurisprudence, it is “a mode of financing through which the bank (the owner of the capital or *rabb-al-mal*) provides capital finance for a specific venture indicated by the customer (the entrepreneur or *mudarib*)” (Obaidullah, 2005: 57). *Mudarabah* consists of an agreement between two parties: an investor (individual or bank) who provides the entrepreneur with resources to finance a particular enterprise. Profits are then distributed between the two parties according to a pre-agreed ratio. If there are losses, the investor assumes all of financial losses and the entrepreneur, all operating losses. Each one bears the opportunity cost of his/her own efforts. Most Islamic jurists and scholars hold the view that “*mudarabah* agreements are only appropriate for commercial activities” (Gait & Worthington, 2007: 15).

3.4.8.2 Microcredit

- *Murabaha*

Murabaha (cost-plus-profit or mark-up sale) refers to the purchase and resale of capital goods and other commodities by institutions. *Murabaha* transactions take place between three parties: the seller of the product, the buyer of the product, and the Shariah-compliant financial institution. The seller works out the cost and the two parties negotiate a profit margin to add to the cost as a compensation for the trader’s work (Mavarakis, 2009: 23). A *murabaha* agreement is simply a two-party buying and selling agreement between the financial institution and the customer, with no financial intermediation or financing. In brief, the financial institution offers this service to its customers, who pay the cost of the goods plus the profit margin. The customer can pay in cash, deferred instalments, or a deferred lump sum, without any additional charge over the original value. This form of agreement is referred to as *bai muajjal murabaha* or *bai bithaman ajjal* (Obaidullah, 2005).

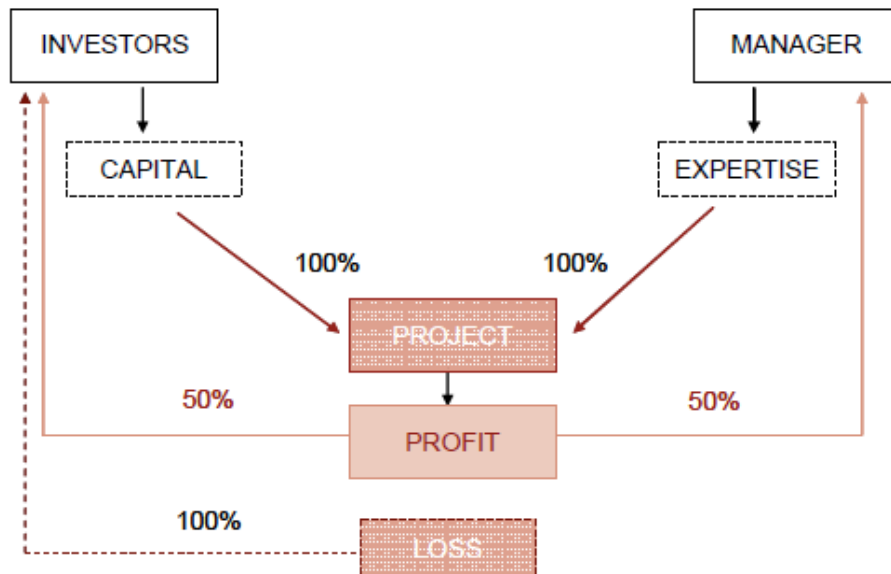


Figure 3.1: *Bai muajjal murabaha* agreement

Source: Allen & Overy (2009: 17)

- *Musharakah*

Musharakah (or full partnership) is “an arrangement where two or more parties establish a joint commercial enterprise and all contribute capital as well as labour and management as a general rule” (Iqbal & Molyneux, 2005: 20). Profits/losses from *musharakah* are distributed between the parties in a pre-agreed ratio. The advantages of *musharakah* are that it provides equal benefits for all parties. There is a general agreement among Islamic jurists and scholars that it is a valid instrument under Shariah law. However, the parties in *musharakah* agreements, according to El-Gamal (2000), often require the assistance of legal experts to ensure that any potential *riba* or *gharar* is carefully avoided.

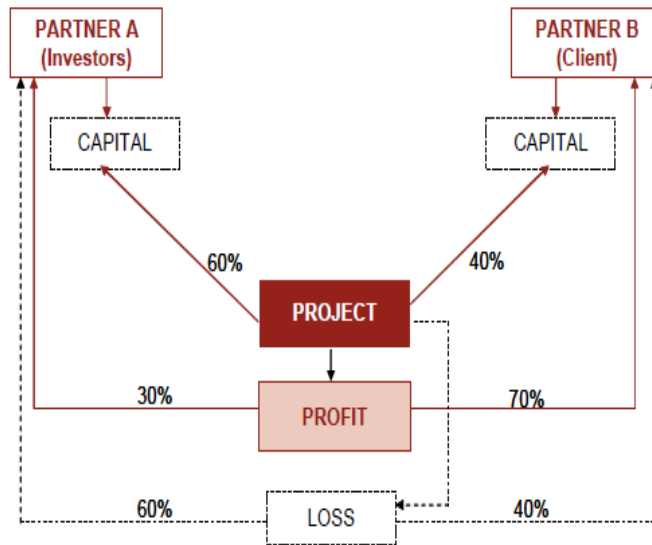


Figure 3.2: *Musharakah* agreement

Source: Allen & Overy (2009: 19)

- *Bai muajjall*

Bai muajjall refers to a sale with deferred payment or payment on a lump sum basis, allowing individuals or firms to receive products immediately and pay for them on a later date at today's market value (Gait & Worthington, 2007). Islamic jurists and scholars agree on the permissibility of *bai muajjall* as a form of finance without *riba*. El-Gamal (2000) points out that Islamic jurists have mainly allowed deferred sales with an increased price, while forbidding deferred sales that increase the amount of debt.

- *Ijarah*

Ijarah or micro-leasing literally means "to give something on rent" (Lewis & Algaoud, 2001). It refers to the compensation from a rental agreement where "the lessor (the holder of the asset) leases a capital asset to the lessee (the customer of the asset) for a specified period that is shorter than the useful life of the asset" (Mavarakis, 2009: 30). The following diagram demonstrates the method of *ijarah*:

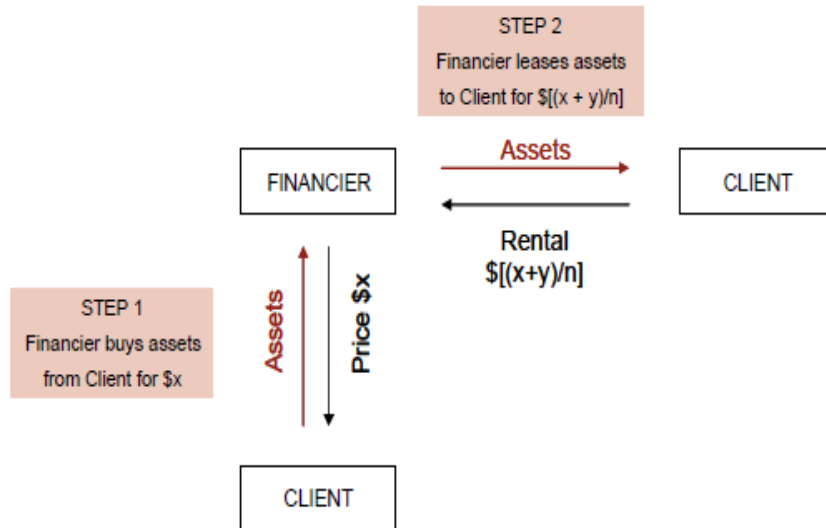


Figure 3.3: *Ijarah* agreement
 Source: Allen & Overy (2009:18)

- *Bai salam*

Bai salam or “prepaid purchase” is defined by Iqbal and Molyneux (2005: 25). as “a sale contract in which the price is paid in advance at the time of contracting against delivery of the purchased goods/services at a specified future date” The benefit of *bai salam* is that “the seller gains the cash needed to invest in production of the asset and the buyer eliminates the uncertainty of price fluctuations in the future” (Gait & Worthington, 2007: 19).

- *Bai istisna*

Bai istisna or “commission to manufacture” is defined as a manufacturing agreement which permits one party to acquire industrial goods to be delivered at a later date, either through prepaid payment or deferred payment in instalments. The product or building thus acquired has a lower price than if it had been bought already finished. According to El-Gamal (2000), Muslim jurists generally accept that *bai istisna* is equivalent to *bai salam*, even if both instruments differ in some ways. The diagram below shows the method of *bai istisna*.

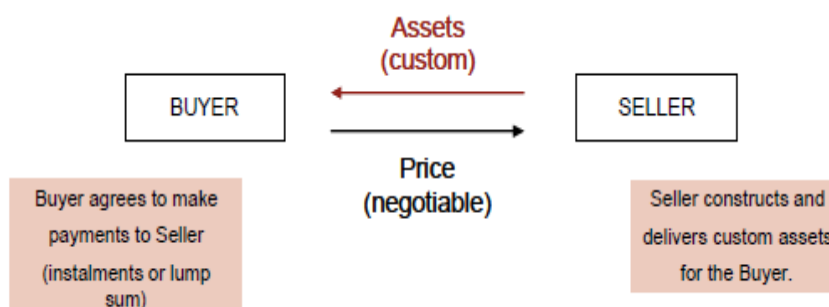
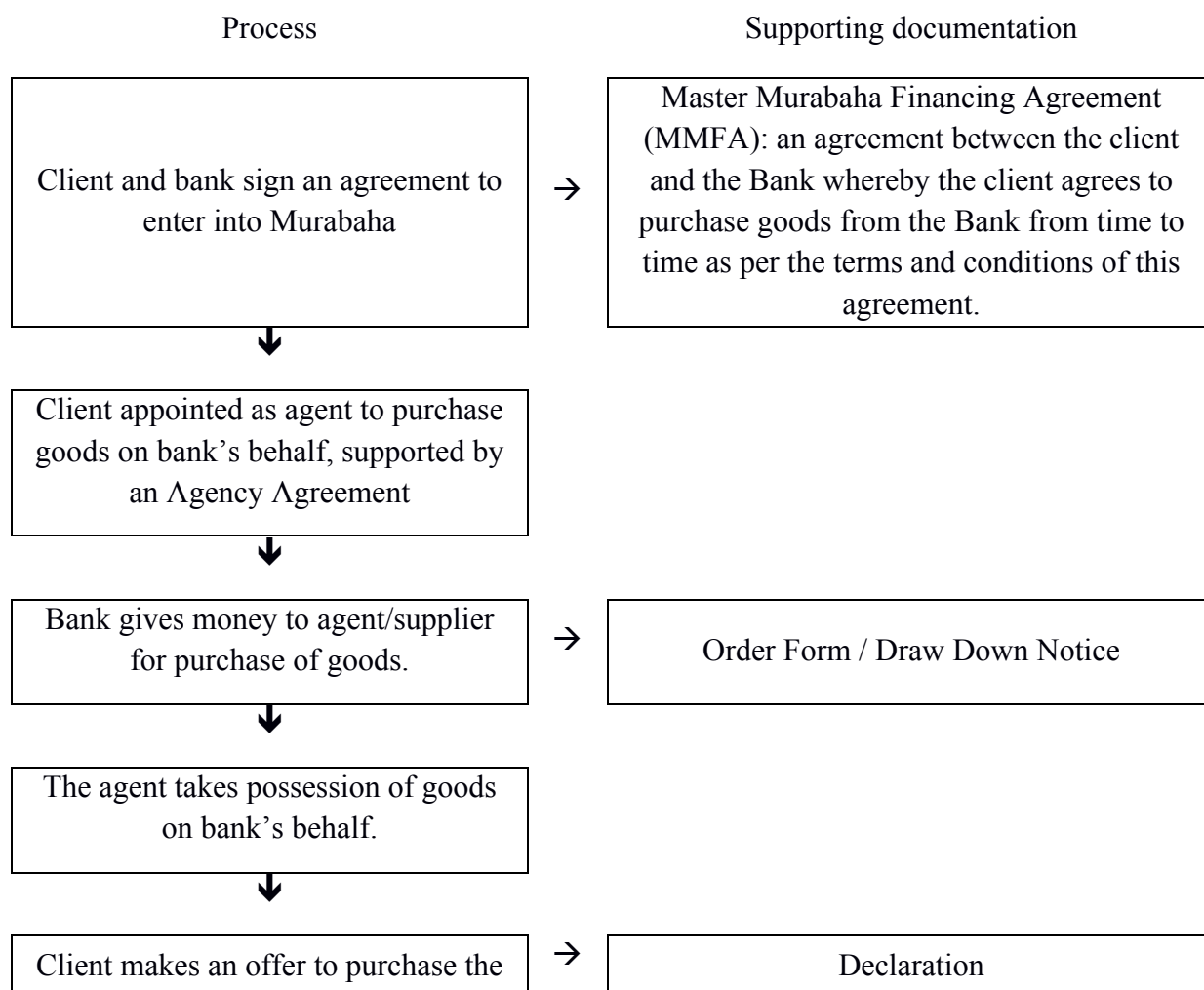


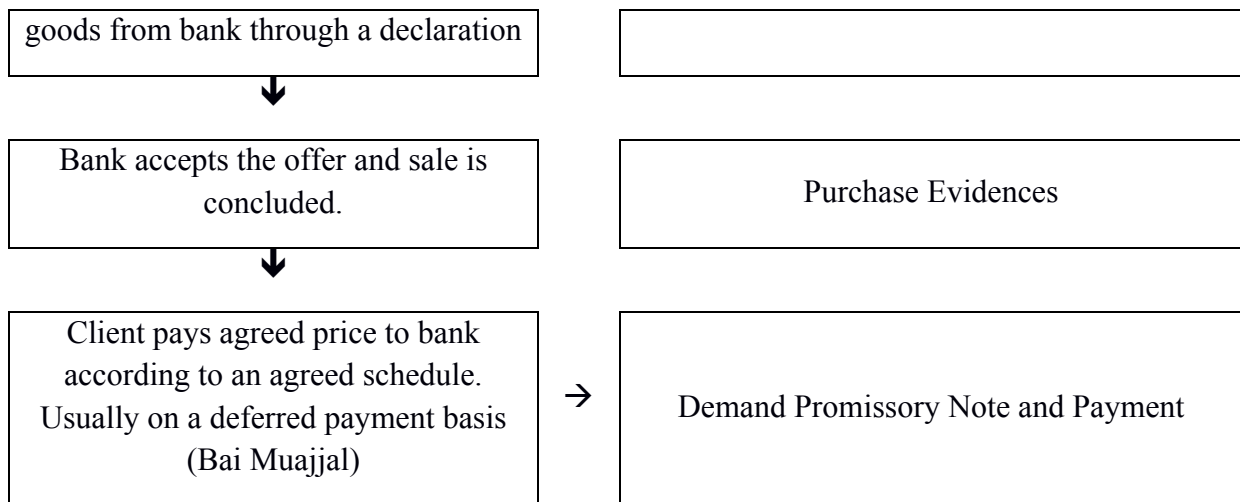
Figure 3.4: *Bai istisna* agreement
(Allen & Overy, 2009:19)

3.4.9 Steps involved in obtaining Shariah Approval

It is important to bear in mind that the steps for obtaining Shariah approval will vary from institution to institution and quite possibly from transaction to transaction. For example, an Islamic bank or a conventional bank with an Islamic division or “window” will most likely have a Shariah board (Song & Oosthuizen, 2014). Other institutions may not have a Shariah board but may approach Shariah scholars on a transaction-by-transaction basis or in relation to a particular product. If the institution has a permanent Shariah board, the process for obtaining Shariah approval (which will culminate in the issuance of a *fatwa*). Shariah-compliant micro-loans typically use the *murabahah* concept, in which the financing party purchases assets for the client and sells them at a predetermined profit margin. The basic steps in the transaction are shown in Table 3.2 below:

Table 3.2: Steps in an Islamic microfinance transaction





Source: Adapted from: Siddiqui (n. d.)

3.5 SHARIAH-COMPLIANT MICROFINANCE PROVIDERS ACROSS THE GLOBE

In the following sections, the main Shariah-compliant microfinance institutions in each of the regions where they are prevalent are described. These examples are important because they can serve as proto-type models for application in other contexts where new initiatives are needed to serve the poor in those regions.

3.5.1 Middle East and North Africa

A microfinance initiative in Egypt, the Mit Ghamr project, laid the foundations of modern Shariah-compliant banking, notwithstanding the short lifespan of the project. In the Middle East North Africa (MENA) region, several successful experiments have been recently undertaken:

- the Sanadiq project at Jabal al-Hoss, in Syria;
- the Mu’assasat Bayt Al-Mal, in Lebanon and
- the Hodeidah Microfinance Programme, in Yemen.

3.5.1.1 Sanadiq project at Jabal al-Hoss (Syria)

The Jabal al-Hoss “Sanadiq” (village bank) in Syria is an excellent model that could be worth replicating elsewhere (Hassan & Mahlknecht, 2011). Some of the unique features of this model are:

- a *musharakah*-type structure, owned and managed by the poor;

- financing based on the concept of *murabaha*: high profit rates with net profits shared among members;
- good governance through committees with sound election and voting procedures;
- project management teams responsible for creating awareness of microfinance practices and providing training for committee members;
- financial management of funds based on standardised by-laws and statutes for each of the village funds, resulting in fair credit decisions and low transaction costs;
- financially viable operations with repayment rates close to 100 per cent;
- equal access to both men and women as owners and users;
- Sanadiq apex fund for liquidity exchange and refinancing; and
- support from UNDP in the form of matching grants equal to the minimum share capital of the village fund.

3.5.1.2 Mu'assasat Bayt Al-Mal (Lebanon)

The Mu'assasat Bayt Al-Mal in Lebanon is an affiliate of a political party, Hezbollah, and comprises the Hassan Loan Institution (*al-Qard al-Hassan*) and its sister organisation called Al-Yusor for Finance and Investment (*Yusor lil-Istismar wal Tamweel*). The former provides *qard hassan* financing while the latter provides financing on a profit-loss sharing model. The uniqueness of the Mu'assasat Bayt Al-Mal lies on its emphasis on voluntarism. It has maintained a very close relationship with the people and is seen as a very trustworthy organisation, with volunteers entirely taking care of collection and disbursement of funds. It relies on a network of donors that have complete confidence in the activities of the institution and also enjoys high repayment rates. Financing is backed by collateral in the form of capital assets, land, gold, guarantor and bank guarantee (Hassan & Mahlknecht, 2011).

3.5.1.3 Hodeidah Microfinance Programme (Yemen)

The Hodeidah Microfinance Programme in Yemen predominantly uses the group lending methodology that was successfully pioneered by the Grameen Bank. Unlike Grameen, however, it uses a *murabaha* mode of financing (El-Hawary & Grais, 2005).

3.5.2 South Asia

Among South Asian countries, Bangladesh has the largest presence of Shariah-compliant MFIs, with organisations like Islamic Bank Bangladesh, Social and Investment Bank Bangladesh, Al-Fallah and Rescue (Karim, *et al.*, 2008). Akhuwat in Pakistan is notable for

its unique mosque-based model. In India, a country with the second largest Muslim population in the world, there have been some experiments, mostly outside the formal financial system, like AICMEU and Bait-un-Nasr.

3.5.2.1 Bangladesh

Shariah-compliant microfinance institutions in Bangladesh have primarily been using deferred-payment sales (*Bai muajjall*) as a mode of financing. However, they have had to face tough competition from conventional microfinance giants like Grameen Bank and BRAC. Shariah-compliant microfinance institutions have displayed better financial performance than their conventional counterparts, but the latter have a far greater outreach. Indeed, institutions like Grameen and BRAC have pioneered models of microfinance that are now replicated across the globe.

3.5.2.2 Pakistan

In Pakistan, the Akhuwat model of microfinance has generated considerable interest among observers (Obaidullah, 2005). Credit consists of small interest-free loans (*qard hassan*) provided in the spirit of Islamic brotherhood. There is no funding from international donors or financial institutions. All activities are carried out by volunteers around mosques and involve close interaction with the community. There are no independent offices; loans are disbursed and recovered in the local mosque and therefore imply low overheads. The institution uses collateral-free group and individual financing based on mutual guarantees. Moreover, the fact that the loan is disbursed in a mosque attaches a religious sanctity to the oath of returning it on time.

3.5.3 South-East Asia

In South-east Asia, Malaysia was the earliest adopter of Shariah-compliant microfinance, with the Tabung Haji, which was aimed at financing the Hajj related expenditure of poor Malaysian farmers who used to sell their only source of livelihood (agricultural land) for that purpose (Wong, 2003). Although initially Tabung Haji was primarily a savings-and-investments institution, it has grown into a large specialised finance house. Indonesia has largely followed Malaysia in the development of the Islamic financial sector, including the microfinance activities. Cases of Islamic microfinance projects have also been documented in Thailand, Brunei and the Philippines.

3.5.3.1 Malaysia

With its relatively developed Islamic banking system and capital markets, Malaysia has established several organisations under the aegis of government agencies, in order to finance small and medium scale enterprises using a wide range of Islamic financial instruments (Wilson, 2009). Some of these instruments are based on microfinance models.

3.5.3.2 Indonesia

Shariah-compliant microfinance institutions in Indonesia may be placed in three categories; the microfinance divisions of Islamic banks, the Islamic rural banks (BPRS and BPR), and the Islamic financial cooperatives that are not part of the formal financial sector. They are generally referred to as Baitul Maal wal Tamwil (BMT) (Juwaini, Rambe, Mintarti & Febrianto, 2010).

Shariah-compliant microfinance institutions in Indonesia have shown remarkable resilience and robustness in the face of the 1997-8 and 2008-9 global financial crises, even when the mainstream banks have had to depend on governmental assistance to tide over their financial problems. It should be noted that Indonesian grassroots BMTs largely fall outside the financial regulatory mechanism, since they operate as member-based cooperative organisations (similar to the *musharakah* structure) without governmental assistance or intervention. These organisations have been found to be less vulnerable to systemic risks that arise due to interdependence, as each BMT is an independently operating entity. As such, the system poses a serious challenge to the regulator who is faced with the problem of how to strike a balance between the need to strengthen the linkages between the formal financial system and the BMTs while retaining the benefits of flexibility and independence.

3.5.4 Conclusions regarding the Positive and Negative Impacts of Microfinance

3.5.4.1 Positive impacts of microfinance

As we have noted from our earlier analysis, the main positive outcomes are:

- “Microcredit has contributed positively to the well-being of the poor in general” (Datta, 2004:57);
- The access to microfinance services helps to improve the security of poor people and reduces their vulnerability to extraordinary threats;

- Microcredit plays a role in lowering birth rates and child mortality, provides better housing and improved nutrition, gives the opportunity to utilise survival skills, creates self-employment, and increases income (Yunus, 2007).

3.5.4.2 Negative impacts of microfinance

Negatively, authors have stressed the following:

- “providing effective microfinance services to poor people is part of a poverty reduction strategy, but only a part” (Hulme, 2000);
- the problem of microfinance institutions is that they lack quality management (Hamilton, *et al.*, 2008);
- a shift in microcredit programmes from being donor-driven institutions to becoming more profitable operations based on the capital markets (Kiviat, 2008).

3.6 WHERE SHARIAH FINANCE CAN MAKE A DIFFERENCE

This chapter has shown that conventional microfinance relies heavily on simple interest-based deposits, government subsidies, donations, and loans. Shariah-compliant microfinance institutions, on the other hand, can offer a wider array of instruments⁹ for their source of funds. Shariah-compliant microfinance instruments can basically tap either internal resources or external resources. The former relate to financial resources that can be mobilised internally to ensure self-sustainability and self-sufficiency, while the latter reflect the common practice of microfinance institutions worldwide, which rely on external parties to provide financial resources such as government grants, subsidies and donations.

- Internal resources for Shariah-compliant MFIs include: Deposits: Shariah-compliant microfinance can mobilise various forms of deposits such as *wadiah* (safekeeping), *qard hassan* (benevolence loan), and *mudarabah* (profit-sharing). Under the *wadiah* mechanism, deposits are held as *amanah* (trust) and utilised by the bank at its own risk. The depositors are not entitled to any return since the profit or loss resulting from the investment of these funds is entirely due to the bank. However, banks can offer unilateral and discretionary gifts that are sometimes commensurate to the rates of return given by their conventional counterparts on their interest-bearing deposits. Another model is using

⁹ All of the Shariah-Compliant instruments are mentioned earlier, such as: Zakah, Waqf, benevolent loan etc.

the *qard hassan* mechanism, where funds deposited in the bank are treated as a loan from the depositor. Under this scheme, the bank has to guarantee the principal amount but is not allowed to offer any return to depositors. *Mudarabah* deposits, on the other hand, are based on profit-sharing between the bank acting as the entrepreneur (*mudarib*) and the depositors as the capital owners (*rabb-ul maal*). The amount deposited is not supposed to be guaranteed and depositors are not entitled to any return derived from the invested funds.

- *Equity*: Shariah-compliant microfinance initiatives may also mobilise funds through participatory models such as *musharakah* and *mudarabah*. There is great potential to attract depositors amongst the rich who intend to do charity via Islamic participatory approach of risk and profit-sharing. In the *musharakah* model of fund-raising, investors can buy shares and participate in the ownership of the whole microfinance programmes initiated by Islamic banks or choose specific financing projects. Any profits realised from the project are distributed annually to shareholders, while losses incurred are shared in proportion to the amount of capital contributed by each participant. In this regard, Islamic banks guarantee that every segment of society can participate in the financial system. As opposed to the emerging financial exclusion that is a common phenomenon in most developed countries, the adoption of an Islamic participatory approach in fund mobilisation and financing promotes justice, brotherhood, social equality, and financial inclusion.

3.7 CHAPTER SUMMARY

This chapter set out the situation with regard to what Shariah finance is. Shariah terminology and kinds of financial arrangements that would meet Shariah principles were discussed. Examples were provided from a number of countries where Shariah finance has been implemented, and the chapter concluded with a consideration of positive and negative impacts of microfinance. The next chapter discusses the key problems with micro-finance, namely interest rates and loan diversion/

CHAPTER 4: KEY PROBLEMS WITH MICROFINANCE: INTEREST RATES AND LOAN DIVERSION

4.1 INTRODUCTION

Attention now turns to some of the key problems with microfinance that are problematic in terms of Shariah principles. Addae-Korankye (2014) cites several studies that indicate a litany of problems that have been experienced with microfinancing since it was implemented in the 1970s. The litany includes:

- lack of willingness to pay loans coupled with diversion of funds by borrowers, wilful negligence and improper appraisal by credit officers;
- loan shortages, delay in time of loan delivery, small farm size, high interest rate, age of farmers, poor supervision, non-profitability of farm enterprises and undue government intervention with the operations of government sponsored credit programmes;
- farm size, family size, scale of operation, family living expenses and exposure to sound management techniques;
- loan disbursement lag and high interest rates that increase borrowing transaction costs and can also adversely affect repayment performance;
- improper selection of an entrepreneur, deficient analysis of project viability, inadequacy of collateral security/equitable mortgage against loans, unrealistic terms and schedule of repayment, lack of follow up measures and default due to natural calamities;
- the nature, time of disbursement, supervision and profitability of enterprises, contributed to the repayment ability and consequently high default rates;
- type of the loan; term of the loan; interest rate on the loan; poor credit history; borrowers' income and transaction cost of the loans;
- high interest charged by the microfinance banks;
- wrong economic decisions by individuals and plain bad luck (bad weather, unexpected price changes for certain products, etc.);
- non-performing or bad loan problems from poor management procedures, loan diversion and unwillingness to repay loans;
- Interest rate ceilings usually imposed by the government, monopoly power in credit markets often exercised by informal lenders, large transaction costs incurred by borrowers in applying for loans and moral hazard problems.

In terms of Shariah-compliant finance, the key issues in this list that are important are interest rates and diversion of loans, which are discussed in detail below:

4.2 INTEREST RATES

In order to better understand Shariah microfinance views about *riba*, (meaning excess or addition), it is important to understand its mainstream definition which was expressed by the Federal Shariah Court Pakistan (1999) as being any amount, big or small, over the principal, in a contract of loan or debt, or a transaction of money for money of the same denomination where the quantity on both sides is not equal, either in a spot transaction or in a transaction based on deferred payment (Nadri, 2007). Although new definitions of *riba* are being explored by modern jurists, Shariah-compliant finance methods continue to co-exist and compete with conventional microfinance practices which are described below.

MFIs that claim to be helping poor people nevertheless “charge them interest rates that are considerably above the rates richer borrowers pay at banks” (Rosenberg, Gonzalez & Narain, 2009: 1). MFIs generally argue that they can usually serve their poor customers best by operating sustainably, rather than by generating losses that require constant replenishment of subsidies that are, at best, intermittent and available at the will of the suppliers of the finance, be it donor organisations or governments.

Nevertheless, high microloan interest rates have been criticized since the beginning of the modern microfinance movement in the late 1970s (Rosenberg, *et al.* 2009; Wariuru, 2012). The criticism has, indeed, intensified in the past few years, and legislation on capping interest rates is being discussed in a growing number of countries. Part of the reason for the increased concern about rates is simply that microfinance is drawing ever more public attention, including political attention. Another factor is that quite a few MFIs are now being transformed into private commercial corporations (CGAP, 2009).

4.2.1 The Components of Microfinance Interest Rates

While the necessity of charging interest on microfinance has been widely accepted, there seems to be plenty of disagreement over the level of interest rate charged by microfinance providers because the factors that go into these calculations are not well known. We often hear about high transaction costs and cost of funds in microfinance as justifications of high interest rates, but there is more to it than that.

Four main components are reflected in an MFI's interest rate: cost of funds, loan loss expenses, operating expenses, and profits. MFIs use their interest income to cover costs, and the difference between income and costs is profit (or loss) (Wariuru, 2012). A simplified version of the relevant formula is:

$$\text{Income from loans} = \text{Cost of funds} + \text{Loan loss expense} + \text{Operating expense} + \text{Profit}$$

Lowering interest rates would require lowering one of the four components on the right side of the equation. If we want to judge whether interest rates are reasonable, the most direct approach is to look at whether each of these components that are funded from interest income is at a reasonable level.

4.2.2 Literature

Empirical data suggests that high operating cost of delivering small loans is one of the main drivers of high interest rates in microcredit (Gonzalez, 2011). Accordingly, the solutions to reducing the interest rate are not only cutting the dividend to investors or interest rates to creditors, but also improving management efficiency – involving cooperation between managers and employees. For example, after stakeholders put pressure on managers to improve efficiencies, Compartamos was able to pass the saving to its customer, which resulted in cutting interest rate by 30 per cent over the subsequent five years (Sun, Zhao, & Im, 2013)

For example, MFIs that are driven by profit for investors are likely to charge high interest rates to clients and, therefore, may damage other stakeholders' interests (Cull, *et al.*, 2007). Furthermore, when the high interest rates burden is too heavy for the poor to carry, the poor may default on their loans, which in turn affects the rate of returns given to investors, the very group who are supposed to benefit from the high interest loans (cited in Sun, *et al.*, 2013).

According to Dehejia, Montgomery and Morduch (2011) and Moll (2005), the interest rates in microfinance are often higher than those within the commercial bank system, as a result of the perceived high risk of lending to the poor, thus interest rates are adjusted to cover the perceived risk. In other words, MFIs have to charge rates that are higher than normal banking rates to cover their costs and keep the service available. These interest rates are also necessary to cover the high transaction costs within MFIs. However, our recent research found borrowers are comfortable with the present interest rates, particularly if the

microfinance institution is member-owned (Knight, 2007). However, even these rates are far below what poor people routinely pay to village moneylenders and other informal sources, whose percentage interest rates often rise into the hundreds and even the thousands (CGAP, 2002). Practical evidence shows that clients are willing to pay the higher interest rates necessary to assure long term access to credit. They recognize that their alternatives – even higher interest rates in the informal sector (moneylenders, etc.) or simply no access to credit – are much less attractive for them.

Waterfield (2011) explains what is referred to as the ‘price curve’ in microfinance: meaning that higher prices necessarily have to be charged on issuing smaller loans, because the operating cost ratio for loans increases (dramatically) as loan size decreases. Hence, MFIs with the lowest prices in datasets also tend to have the largest average loan balances. Those MFIs with the highest prices have the smallest loan balances. In this way, the author argues, not all microfinance organisations are the same and assessing the ‘fairness’ of interest rates by looking at averages across MFIs with different loan balances is misleading. To illustrate this point, Waterfield (*ibid.*) provides examples of cross-country comparisons of efficiency that show that Bolivian MFIs are efficient, but this is because they give very large loans. MFIs in the Philippines vary widely in efficiency because they cover a broad span of loan sizes, and Bangladeshi MFIs have fairly consistent efficiency figures because they deliver very similar loan products (*ibid.*). Waterfield (*ibid.*) argues that instead of asking what is a fair ‘price’, the industry should be asking what is a fair profit.

Dehejia, *et al.* (2011: 1) observe that ‘high repayment rates are insufficient to drive the microfinance revolution’. Consequently, they identify high interest rates as necessary for generation of profitability, in order to ensure reduced reliance of microfinance institutions (MFIs) on external funding. This is confirmed by Mallick (2002, cited in Hossain & Knight, 2008) who observes that the interest rate on income-generating loans is 20 per cent, which is notably higher than the 8 to 10 per cent rates offered by Bangladeshi commercial banks.

In addition, studies by Dehejia, *et al.* (2011) emphasize that the poor are extremely sensitive to increases in interest rates which results in a reduced demand for financial services among this group. However, it is also acknowledged that, despite the detrimental effects of changes in the interest rate, the actual rates themselves are substantially lower than those of the rural traditional money lender, which, as confirmed by Hossain (2002), may range from 100 to 150 per cent. This latter point is supported by Moll (2005) who expounds that the high rates are

due to transaction costs incurred as a result of the risk of lending to the poor, as well as information costs incurred in establishing the ability and the willingness of the borrower to repay. He concurs that despite the necessary additional cost, the rates are still competitive and therefore attractive to clients of MFIs. It is worth noting that in recent years many of the Bangladeshi MFIs (former NGOs) have been able to ensure their financial and operational sustainability and reduce their foreign-aid dependency with the relatively high interest rates they charge their clients (Hossain & Knight, 2008).

In a recent study by Knight (2007), it was observed that the interest rate is often dependent on the purpose of the loan. Interest rates have been lowered for particular initiatives such as education, agriculture and housing or mortgages, as well as those which encourage productivity and help the poor to obtain access to the basic necessities of life.

While a few studies have examined the relationship between interest rate and MFIs performance (Cull, *et al.*, 2007; Dehejia, *et al.*, 2011), most research has paid undue attention to the interests of a single stakeholder (either borrower or lender), widely ignoring the joint forces of other stakeholders in this social venture such as the government, managers, employees, and communities.

While institutionalists (i.e. who advocate concentrating loans through MFIs who are integrated into the formal financial system) and welfarists (i.e. who advocate committing loans to people who live below the poverty level in their community) agree that the ultimate goal in helping as many poor people as possible in a sustainable way, the former emphasise the importance of financial sustainability of the social venture (Woller, 2000). They argue that setting high interest rate is necessary to achieve financial self-sufficiency and operational sustainability (Cull, *et al.*, 2007). Some empirical data also indicates that the poor can afford high interest rates (Hermes, Lensink & Meesters, 2011). This argument is further corroborated by the successful commercialization of microfinance, which stimulated its global expansion (Biepke & Kiweu, 2009). The following cases or examples illustrate how microfinance have worked effectively in some locales, despite high interest rates.

4.2.3 Uzbekistan and Mexico

In Uzbekistan and Mexico, interest rates are generally above 60 per cent (Kneiding & Rosenberg, 2008). In Uzbekistan, mean operating costs in relation to loan portfolios add up to 39 per cent, which could be because it is a relatively young sector, while in Mexico, the average is 45 per cent. Gonzalez (2008) shows that for MFIs younger than six years old, one

additional year in the market is expected to reduce the operating expense ratio by between two and eight percentage points.

4.2.4 Bangladesh

Using evidence from a microfinance initiative in Dhaka, Dehejia, *et al.* (2011) question the assertion that poor customers are insensitive to an unexpected increase in interest rates and they suggest that the banks make profits from larger-scale customers whilst smaller-scale customers and new borrowers are left out. Therefore, the welfarists challenge so called “win-win logic” in which MFIs can improve financial performance without compromising outreach (Morduch, 2002). They argue that high interest rates may create a debt trap for the poor and hamper the poor’s ability to pay back the loans (Taylor, 2011).

4.2.5 Bangladesh

A recent study in Bangladesh found that although the accumulation of high interest on loans may exacerbate the financial burden of microcredit users, they are not the main contributing factor to users being unable to make repayments on time (McLoughlin, 2013). Jahiruddin, Short, Dressler and Khan (2011) used survey data and in-depth interviews with women whose circumstances had worsened following their taking out microcredit loans, and revealed four key sets of circumstances in which poverty was exacerbated among the most vulnerable female borrowers:

- long periods between start-up and revenue generation from the investment;
- financial setbacks or losses incurred during the initial stages of business;
- use of the loan money to meet unforeseen contingencies/emergencies; and
- use of loan money for day-to-day consumption or one-off, ‘luxury’ expenditure.

4.2.6 Mexico

Based on the best data available, the median interest rate for sustainable (i.e., profitable) MFIs was about 26 per cent in 2006 (CGAP, 2009). The 85 per cent interest rates that drew so much attention to the Mexican MFI Compartamos are truly exceptional, rather than representative of the industry. Fewer than 1 per cent of borrowers pay rates that high. MFI interest rates declined by 2.3 percentage points a year between 2003 and 2006, much faster than bank rates.

In each of the four previous illustrations, it can be seen that high interest rates may not necessarily inhibit success, but rather show how access to credit with mutually acceptable terms between the borrower and the lender is instrumental in providing a mechanism for economic relief to those who have a viable plan for overcoming their poverty status.

4.3 SHOULD MICROFINANCE INSTITUTIONS CHARGE HIGH INTEREST RATES?

The preceding section showed that many poor people can pay, and therefore that MFIs can charge rates of interest that are much higher than the rates that commercial banks charge to their usual customers. This result is not particularly surprising, but given that MFIs can charge such rates, the question remains whether they should. While many poor people, specifically micro-entrepreneurs, may be able pay high interest rates, it is also clear that some cannot, and are thus excluded from programmes that insist on charging interest high enough to cover all costs. This is an ethical and moral question which relates directly to the principles of Shariah-compliant finance. Most MFIs funded non-governmental organisations (NGOs) whose overarching objective is helping the poor, not maximizing profits which is line with the Shariah approach. In essence it comes down to a value judgment: which do you care more about – poor people or profits? If we assume that the only objective we care about is maximizing benefit to poor people, from this perspective, the argument for high interest rates is straightforward. In most countries, donor funding is finite and will never be able to reach more than a minute fraction of those poor households who could benefit from quality financial services. However, if MFIs could mobilize relatively large amounts of commercial finance at market rates reach in order to reach those households only, they have to charge interest rates that cover their costs.

4.3.1 Can Micro-Borrowers Pay High Interest Rates?

There is overwhelming empirical evidence that huge numbers of poor borrowers can indeed pay interest rates at a level high enough to support MFI sustainability, cited in CGAP (2002).

- Informal credit markets already exist in most poor communities. One typically finds lower-income borrowers taking and repaying repeated informal loans at interest rates much higher than any formal MFI would charge.
- Some MFIs make loans to women grouped into “village banks.” The women’s obligatory savings often remain within their group as an “internal account” that they can lend out to

each other on whatever terms they wish. When such an arrangement prevails, the women commonly charge each other an interest rate that is substantially higher than what the MFI charges on its loan to the village bank.

- MFIs charging very high interest rates almost always find that demand for their products and services far outstrips their ability to supply them. Most of their customers repay their loans and return repeatedly for new loans: this pattern demonstrates the customers' conviction that the loans allow them to earn more than the interest that they have to pay. This phenomenon does not appear to be restricted to particular regions or countries.
- For the past ten years, the author of this thesis has been asking in conferences, courses, and (more recently) Internet newsgroups whether anyone present has ever heard of a microfinance programme that ran into trouble by driving clients away by charging interest rates that were too high. No one has yet pointed to a single example. This piece of evidence alone does not indicate that there is no limit to the interest rates that the microcredit market can bear, but it does suggest that the limit is probably considerably higher than what even the more aggressive MFIs are charging. Thus, there is abundant proof that poor people's tiny businesses can often pay interest rates that would strangle a larger business. Still, this proposition strikes many as confusingly counterintuitive. The following examples serve to illustrate the principle.

Rosenberg (2002) cites the case of a Bolivian woman who sells merchandise from a blanket that she spreads every day on a pavement in La Paz.

Her sales, and thus her income, are directly proportional to the time she spends sitting on the street, offering her goods. Because of her shortage of working capital, she spends two hours of each ten-hour workday traveling to purchase supplies from her wholesaler, whose warehouse is outside the city. These two hours produce no sales or income for her. If a working capital loan allows her to buy inventory for three days at a time instead of one, she can save eight hours in travel time each six-day week. This translates into a 17 per cent increase in selling time, and thus in her sales, every week. If the amount of the working capital loan is double her daily sales, and her gross profit is 25 per cent of sales, then she could afford to pay 40 per cent a month on the loan and still come out slightly ahead. A loan from an MFI at, say, 5 per cent per month would be immensely advantageous to her.

He further cites examples of MFI borrowers in Chile, Colombia, and the Dominican Republic who were paying relatively high effective interest rates, averaging 6.3 per cent

per month. However, these interest payments made up a small fraction of their overall costs, ranging from 0.4 per cent to 3.4 per cent.

This kind of analysis makes it easier to understand the oft-repeated assertion that for poor entrepreneurs, access to finance tends to be a much more important issue than the cost of that finance.

In a widely-cited study, Karlan and Zinman (2008: 1) argue there has been an assumption of ‘price inelastic demand’ (meaning the poor are largely insensitive to interest rates) amongst policymakers. This has provided a foundation for encouraging MFIs to charge profitable (high) interest rates on the basis that it is unlikely to reduce poor people’s demand for, or access to microcredit. To test this assumption, the authors used an experimental research design to measure the effects of rate fluctuations (of between 50-200 per cent) on the uptake of loans by new and existing customers in the case of a South African MFI. The study found demand curves were gently downward sloping throughout a wide range of rates below the lender’s standard ones, but that demand sensitivity rose sharply at prices above the lender’s standard rates. Lower rates produced more borrowing by poor females in the sample. Higher rates also reduced repayment. They also found that ‘loan price is not the only contracting parameter that might affect demand, and hence MFI profits and targeting. Liquidity constrained individuals may respond to maturity as well, since longer maturities reduce monthly payments and thereby improve cash flows’ (*ibid.*: 2). In fact, the study found that maturity ‘may actually be more influential than price in determining demand for credit if individuals are more concerned with monthly cash flows than interest expenses’ (*ibid.*: 2). In reviewing this study, Roodman (2011) points out that the subjects of the study lived well above standard poverty lines of \$1 and \$2 a day, and their successes revolved around employment, not entrepreneurship.

4.3.2 Opposing Arguments

For some time, policymakers have been concerned about the effects of the seemingly high interest rates typically charged by microfinance institutions (MFI) lending money to poor people. Available data indicates that microfinance interest rates typically fall between 20 per cent and 50 per cent per year (in places where inflation runs no higher than 10 per cent per year). McLoughlin (2013) argues that such interest rates may diminish surpluses generated by borrowers, leaving them with little net gain. There is also concern that high rates reduce the demand for and uptake of financial services. As Dehejia, *et al.* (2011) point out, high interest

rates can undermine ‘the original intention of the push for microfinance’ where these effects are seen. However, whilst experts agree that high interest rates seemingly should make it more difficult for poor people to repay micro loans, in practice there is little evidence of these effects, and little research has been done in this area. In the same way that there is ongoing debate about the impact of microcredit on poor people’s well-being in general, there is also lack of clarity about whether and in what ways high interest rates might be harmful to the poor. As Stewart, *et al.* (2010, cited in McLoughlin, 2013) point out, whilst some studies ‘allude’ to negative impacts of high interest rates, there are very few rigorous impact studies on this topic.

The literature concerned with the ‘fairness’ of interest rates has largely adopted a supply-side perspective with little emphasis on the borrower perspective. Supply side studies on the pricing of loans typically use large-scale comparative data to assess what is and is not an acceptable level of profit for MFIs in order to establish whether or not the poor are being exploited by rates charged. High interest rates in the sector are generally seen as related to the high operational (and transaction) costs involved in providing high numbers of relatively small loans. Another driver of interest rates is seen to be the need for MFIs to achieve financial sustainability (Roberts, 2013). Some have suggested that high interest rates might only justifiably be criticized where they produce excessive profits for MFIs, or where they result from operating inefficiencies that could be avoided (Rosenberg, Gonzalez & Narain, 2009). The limited available literature on the impact of interest rates from the borrower perspective tends to focus on two main issues: the effects of high interest rates on demand for microcredit (or credit elasticity), and the effects on over-indebtedness. In both instances, research mainly takes the form of country-specific case studies. Recent systematic reviews which have looked at the impact of microcredit on users reveal little about the role of interest rates, and this has not been a key research question for these studies (Stewart, *et al.*, 2010, cited in McLoughlin, 2013; Duvendack, *et al.*, 2011; Vaessen, Rivas, Duvendack, *et al.*, 2014).

This does not mean that all high interest charges by MFIs are justifiable (Rosenberg, *et al.* 2009). Sometimes MFIs do not do enough to contain transaction costs. The result is that they pass on unnecessarily high transaction costs to their borrowers Sustainability should be pursued by cutting costs as much as possible, not just by raising interest rates to whatever the market will bear (Shardul & Carraro, 2010).

According to Kimando, Kihoro and Njogu (2012), if the demand for credit by the poor changes little when interest rates increase, lenders can raise fees to cost-covering levels without losing customers. This claim is at the core of sustainable microfinance strategies that aim to provide banking services to the poor whilst eschewing long-term subsidies, but, so far, there is little direct evidence of this.

Mitra (2009) mentions that MFIs are charging exorbitant rates of interest. Not only do MFIs charge a high absolute interest rate (upwards of 20 per cent), but their practices like forced savings, applying a flat rate method and adding service and other charges, over and above the annual interest rate, further exacerbate the cost. These practices lead to an overall high cost of borrowing for the poor, making MFIs' rates look almost usurious. Further, MFIs lack transparency with regard to their interest rate practices (Sridharan, 2013), which is helping them to transfer various costs on to gullible borrowers. This can happen in the following ways

- MFIs resort to unethical ways of recovering loans by confiscating title deeds, using intimidation and abusive language, and combining multiple products like savings, insurance and loans to ensure prompt recovery; and
- MFIs aggressively poach from government and banks to capture their borrowers. They lure the members of government supported self-help groups by liberally financing them, leading to multiple financing.
- It is difficult to isolate the role of high interest rates in over-indebtedness, and studies tend to point to a range of factors related to the circumstances of the borrower and unforeseen shocks, as well as the role of MFI policies and how loans are priced (including interest rates).
- Whilst one or two qualitative studies have illustrated that high interest on loans is disliked by borrowers and may increase their financial burden, interest rates are not the only element of pricing that affect users' capacity to make repayments on time.
- The capacity to keep up interest payments may be dependent on how the loan is used. High interest rates may be particularly harmful in instances where investments yield low financial returns. One study in South-Asia suggested that the types of activities that poor people use microcredit for typically generate moderate returns which reduce their capacity to service high interest loans (Fernando, 2006). Likewise, where microcredit is used to increase consumption, as opposed to making productive business investments, it

may not be feasible to expect high interest loans to have a positive effect on the finances of poor households in the short term (Stewart, *et al.*, 2010).

- Where high interest rates ensure the profitability and sustainability of the sector, and therefore the capacity of lenders to reach out to poor and remote users, some have argued that the impact of high rates, therefore, needs to be judged against the relative harm of poor people not having access to microcredit at all (Roodman, 2011).

Because of such practices, it is argued that MFIs are causing a huge burden on the poor, leading to a vicious cycle of debt, poverty and even suicides (Kumar, 2006). There is evidence from various studies that these allegations are to some extent true about MFIs in general (Sinha & Matin, 1998; Rhyne, 2001; Mitra, 2005; Shylendra, 2006).

4.3.2.1 India

The cost of microfinance loans to poor borrowers in India varies anything between 12 per cent per annum to more than 120 per cent per annum depending on nature of MFIs that provide service to the poor. MFI should disclose effective interest rate to the borrowers. Hiding effective interest rates from poor and illiterate borrowers by using “creative” accounting practices is highly unethical. Many MFIs simply state that they only charge a 15 per cent flat rate of interest. However, the effective interest rate including the processing fee, compulsory savings, etc. goes well over 100 per cent per annum. As a result, some of these micro-lending organisations break even very quickly, after which their motives are only to earn profits. According to Mitra (2009), microfinance should not deviate from its original objective of extending a helping hand to the poor and should not be viewed as an opportunity to make money from poor borrowers

High interest rates charged by MFIs have attracted criticism from government and opposition leaders. In March 2006, district authorities closed down about 50 branches of two major MFIs in the Krishna district of Andhra Pradesh (India). Some borrowers complained to the district authorities that these MFIs were charging “usurious interest rates” from the poor borrowers and also using “forced loan recovery” practices. The crisis attracted the attention of both local and national media. The local media, especially, carried many stories which were highly critical of the role played by MFIs. The issue also came up before the State Level Bankers’ Committee (SLBC) meet held on March 17, 2006. The chief minister (CM) of AP who chaired the meet took a tough stance against the MFIs by alleging that they were exploiting the poor by charging exorbitant rates of interest and adopting unethical means of

loan recovery. He expressed the view, “MFIs were turning out to be worse than moneylenders by charging interest rates in excess of 20 per cent” (Kumar, 2006). Further to the development, there was even an allegation that ten borrowers of MFIs in the Krishna district committed suicide because they were unable to repay the loans taken from MFIs. There were three major allegations against the MFIs that came up during the crisis (Mitra, 2009).

Though the rates may seem unduly high, around 26 per cent in India due to the cap and ranging from 26-35 per cent in most other regions of operation, according to Nagarsekar (2012) the rates are in fact justified. Bad debt is considered one of the most important factors that cause the high interest rates in microfinance. By reducing the risk of lending to non-payers the other people who need the loan will be able to avail it at a much lower rate. Interest rates across India today vary from 26-30 per cent. Although this is substantially lower than the rates village money lenders charge (around 150 per cent) it is quite high compared to the usual interest rates and there is definitely scope for improvement.

There is substantial evidence to suggest, however, that high interest rates remain a serious problem for the poor. First, one cannot get away from the basic fact that clients will inevitably end up worse off than otherwise would be the case under a subsidized interest-rate regime. High interest rates always eat into the typically minimal margins realized in a microenterprise, and this is painful for the poor. This is why, whenever asked, the poor overwhelmingly argue that they are not be able to generate a decent surplus. In India, the National Sample Survey Organisation reported that its latest 2005 mass survey showed exactly that. Moreover, studies of the interest-rate elasticity of micro-credit show that the poor react very proactively to lower-priced microfinance. We cannot, therefore, simply ignore their petitions on this issue, because there is so much evidence to back them up.

4.3.2.2 Sub-Saharan Africa

Sub-Saharan Africa has come under the spotlight since March 1995, when the World Summit for Social Development was held in Copenhagen (de Haan & Lakwo, 2010). At that meeting and subsequent ones, the focus has been on progress that has been made or not on goals and objectives that were intended to address needs of poverty stricken people in the region. A more pragmatic approach was on the agenda, based on a stronger focus on financial performance, client services and stronger governance mechanisms overall. This business change has been described as the ‘microfinance paradigm shift’. According to Mayoux

(2002), this has seen the MFIs turned into more formal banking institutions, the advent of greater outreach to rural areas through the establishment of village banks, a decrease in the presence of commercial banks and a greater presence of NGOs (de Haan & Lakwo, 2010).

The main reason given by the critics of high microfinance interest rates is that the modest rates of return achieved in most small-scale businesses in general, and in agriculture in particular, are insufficient to cover debt service at such rates. Academic research on the matter has been inconclusive.

A recent systematic review which looked at evidence of the impact of microfinance on poor people in sub-Saharan Africa (Stewart, *et al.*, 2010) concluded that high interest rates were one among a number of reasons why microcredit can sometimes fail to increase the well-being of poor people. The report stated that: ‘some people are made poorer, and not richer, by microfinance, particularly micro-credit clients. This seems to be because: they consume more instead of investing in their futures; their businesses fail to produce enough profit to pay high interest rates; their investment in other longer-term aspects of their futures is not sufficient to give a return on their investment; and because the context in which microfinance clients live is by definition fragile’ (*ibid.*: 5). Overall, the review did find some evidence that microcredit can help poor people cope with economic shocks, but acknowledged that the implications of failure (to repay) high interest loans are high. This is because in order to repay high interest loans, borrowers effectively rely on an increase in their income (*ibid.*: 49): ‘if clients are unable to increase their incomes, they will not only default on their loans, falling into a debt trap, but also be unable to invest in their savings accounts’. Returns on investment depend on how loan money is spent, which may fall into two broad categories: i) investing in the future (business or productive assets, education), and ii) increasing consumption (health, nutrition or housing). Overall, the report argues that investments in long-term outcomes such as increased primary school enrolment do not increase micro-credit clients’ ability to repay their loans in the short-term, and may even lead to increased poverty. This leads the authors to conclude ‘it seems short-sighted to expect that small loans with interest rates of between 25 per cent and 37 per cent might make very poor people richer’ (McLoughlin, 2013).

Mayoux (cited in Bateman, 2010) reports that, in Uganda, women associated with FINCA rejected the high-interest rate model once they had enough cash to go on their own.

Using data from a randomized trial in South Africa, Karlan and Zinman (2008) demonstrated that the poor’s demand for microcredit is quite responsive to interest-rate changes. In fact,

there are many instances where the poor feel they have to ‘shop around’ for much cheaper microcredit as soon as they think they might be able to obtain it elsewhere. Karlan and Zinman’s (2008) study suggests that there may be some interest inelasticity in microfinance consumer loans, contrary to conventional wisdom which assumes that low-income clients are willing to bear high interest rates if transaction costs are low and repayment schedules convenient.

Another recent study (Bidwell, 2009) found that returns on agricultural investment are quite high in Ghana but that farmers seem to be risk-constrained, fearing a loss of collateral because of the high variability in rainfall. Defenders of commercial microcredit claim that access to credit is more important than the cost of credit, and that the mere fact of steady growth in the number of clients willing to pay the high interest rates is proof that microfinance provides a valuable service (Campion, Ekka & Wenner, 2010).

On the other hand, World Bank research in Sri Lanka and Mexico (De Mel, McKenzie & Woodruff, 2007) found that monthly rates of return on capital are very high in a wide range of non-farm micro-entrepreneurial activities, ranging from 4 to 7 per cent per month, well above the typical interest rates charged by microfinance lenders of 2 to 3 per cent per month.

4.3.2.3 Asia

A review by the Asian Development Bank (ADB) (Fernando, 2006) argues the high cost of loans means the majority of the poorest people have not been reached. High interest rates also prevent the use of loans for activities that produce low returns, for instance farming activities. This is because ‘only those who can generate a sufficiently high surplus of funds can afford high interest rates on microcredit. More specifically, a borrower's realized rate of return on investment needs to be greater than the interest rate to service the loan’ (*ibid.*:7). The report explains that although some enterprises with very high margins do exist in the region (petty trading, small-scale restaurants, bakeries, and micro-livestock activities) most investment opportunities typically involve more moderate returns. Households using loans in these ways do not have the same capacity to service high-interest loans because they are not making high enough returns on their investment. Indeed, poorer households are more likely to invest in low-return activities, including health, education and basic needs. The report concludes that it is, therefore, important to lower microcredit interest rates to enable the poorest households to benefit (McLoughlin, 2013).

World Bank research in Sri Lanka (De Mel, McKenzie & Woodruff, 2007) found that monthly rates of return on capital are very high in a wide range of non-farm micro-entrepreneurial activities, ranging from 4 to 7 per cent per month, well above the typical interest rates charged by microfinance lenders of 2 to 3 per cent per month.

4.3.3 High Repayment Rates ‘Prove’ that Borrowers are succeeding with their Expensive Microloans

The success of the Grameen Bank model was very much based on the simple fact that there was an almost complete separation of repayment from the ultimate success of any micro-project. Of course, it was generally not feasible to find out whether individual clients were making a success of their microenterprises or not, and still less whether they were helping out in the event of any difficulties. Instead, high levels of repayment were secured thanks to various forms of social collateral such as solidarity circles and personal guarantors.

In fact, it was precisely because most income-generating projects actually failed, or at least failed to generate sufficient cash to repay the microloan, that the early MFIs were considered very astute in deciding to develop social collateral-based lending methodologies. We recall, too, from the discussion above the fact that most microfinance schemes are now mostly advanced for consumption purposes, and not for income-generating projects. Precisely because the microloan was not advanced in order to be used for any business project, high repayment rates therefore prove very little in terms of sustainable development and poverty reduction successes. In fact, one of the most glaring features to arise in microfinance in recent years is the huge divide that separates the success of microenterprises and high repayment rates, and the associated fact that repayment in the event of an unsuccessful microenterprise venture further reduces the income and assets of the poor. To explain the disconnect between repayment and development, the fact must be recognized that the poor generally have fallback strategies that they deploy to repay a microloan when the original microenterprises fails (Bateman, 2010).

4.3.4 The Moral and Ethical Dilemma in terms of Shariah-Compliant Finance

Throughout this thesis, it has been emphasised that *riba* is forbidden in terms of Islamic financial principles. This is fundamentally a religious tenet, but for Islam it goes beyond mere religious practice into the practical realities of everyday life. Islamic relief is dedicated to alleviating the poverty and suffering of the world’s poorest people (Kahn, 2008), and it is regarded by Islam that interest rates irrespective of the level, place a burden on the borrower,

and more particularly the poor borrower. We must therefore deal with a major moral and ethical dilemma here. High interest rates are routinely justified by the microfinance industry not just as a way to attain financial self-sustainability. Profits are needed, so the argument goes, in order to expand the MFI (disburse more microloans or open new branches) (Roberts, 2013), despite the questions about whether MFIs with stronger profit orientations are better able to sustainably address the needs of poor borrowers, especially if the anti-poverty orientation of MFIs is “to reach more clients in the poorer strata of the population” (*ibid.*: 120). Roberts (2013: 121) goes on to say that “supporters of commercial microfinance argue that business models generating profits and returns to shareholders can overcome the reliance on scarce donor money”, with the implication that this increases the volume of microfinance available to other equally poor individuals.

This justification effectively rests on a very shaky moral imperative, however: it is effectively asking one set of very poor individuals to (generously) agree to help out another set of poor individuals. That is, the poor in one place and time are effectively being asked to turn away possible subsidies and pay high (market-based) interest rates not just to facilitate their own possible way out of poverty, but that of other poor people too. This is hardly the most equitable scenario. It should come as no surprise, then, to find that the poor generally resent such unorthodox forms of wealth redistribution; indeed many poor individuals collectively reported to the World Bank that ‘there is a limit to how much one hungry man can feed another’ (Narayan, Pritchett & Kapoor, 2009). Finally, an even more disconcerting question is that if high interest rates are indeed ‘no problem,’ then how do we explain the routine unwillingness on the part of MFIs everywhere to lower them? There are also many instances of outright deception: when asked to clearly present their interest rates, fees and the total changes imposed in their poor clients, for example, MFIs have proven to be either recalcitrant or neglectful altogether (Bateman, 2010).

4.4 LOAN DIVERSION

Diversion of loans means the diversion of a part of the loan from the purpose for which it has been taken. It is considered a major problem in the microfinance industry (Addae-Korankye, 2014) and even more so in terms of Shariah-principles where “honesty and moral responsibility in Islamic finance contracts are indispensable ingredients of Islamic behaviour” (Khan, 2008: 10) There may be several socio-personal and economic reasons responsible for this. An attempt is made hereunder to identify the factors affecting diversion of loans.

The household mentions an income generating activity as a purpose of taking of loan from microfinance institution as the microfinance institutions seldom supply credit for anything beyond income-generating activity (Khaleque, 2010). Although there is considerable regulation by governments in terms of how an MFI should operate (Levy, 2011), it seems that MFIs have no monitoring system of evaluating the usages of received loans, being focused almost exclusively on ensuring that loans are repaid within the terms of a contract, but not how the money loaned is actually used. It appears that households have an inherent tendency to divert their resources from their proposed activity to their actual activity (Addae-Korankye, 2014; Dampsey, Oppong, Agyeiwaa & Abruquah, 2015).

4.4.1 Reasons for Funds Diversion

Clients may decide to use the loan funds for an income generating activity other than that for which the loan was intended, in the hopes that they will earn additional revenue. Although this may not be a problem for the client who could be better off at the end of the day, this may point to an inherent dishonesty in the application for the loan. In terms of Shariah-finance, this would be an unacceptable practice because the loan is tied to the project or purpose for which it was lent. This is in contravention of the principle of “material finality” as discussed in Chapter 1, Section 1.3.

The majority of GBL program borrowers borrowed for the purpose of investing in their businesses for income generation. Although the proportion of borrowers who borrowed with the intention of non-income generation purposes was relatively small, a higher proportion of borrowers ended up using at least some proportion of their loans for unplanned, non-income generating purposes for example they borrow money to assist them to start a small business, but then use some of the money for household needs or to pay school fees (Burki, 2010),

Burki (2010) also found that where a second or third loan for business purposes was given, that it was more likely that some of it would be diverted to household expenses, which may suggest greater pressure than before on borrowers to use their enterprise loans to cover household expenses perhaps because they have over-extended themselves in terms of their ability to repay the first loan. However, Durnford (2013) who terms this “consumption smoothing”, asks a key question in this regard: “What could be more fundamental to poverty reduction than helping the poor make sure they have enough to eat and other basic necessities throughout the week, the month and the year?” He then goes on to say that

From that stable ground, the poor are in a much better position to seize whatever opportunities are provided by health and education services and a decent economy. If financial services by themselves cannot provide these opportunities, they do seem quite capable of helping the poor provide the stable ground to stand and build upon. That is the significance of consumption-smoothing, risk mitigation and resilience in poor households.

Due to certain circumstances, the borrower is compelled to use the loan for purposes for which it was not intended. Unfortunately, this may be due to acute poverty. In other circumstances, the loans are used immediately to help others in difficulty, to address problems of illness among family members, educational fees, household expenses and so on. Wakuloba writes that the main causes of debt default are poor business performance, diversion of funds and domestic problems. He mentioned that diversion of loan use among poor borrower households causes 50 per cent of defaults, and among all defaulters, 10 per cent of defaults occur due to diversion of loan use (Khaleque, 2010).

Gill (2004) established a linkage between economic hardship, indebtedness and increasing number of suicides in the farming community of Punjab. Ashta, Khan and Otto (2011) found that there is a direct correlation between microfinance penetration and increased suicides. Biswas (2010) provides evidence of a suicide epidemic in India relating to the inability of borrowers to repay their loans which is attributed to the high interest rates charged on loans and the diversion of loans to non-productive purposes leading to a debt trap from which people could see no escape.

4.5 CHAPTER SUMMARY

This chapter has provided a discussion of two problem areas with regard to microfinance that are specifically problematic for Shariah-finance, namely interest rates and loan diversion. Case studies showing the way in which interest rates are charged and justified were provided. The reasons for and the consequences of loan diversion were highlighted.

CHAPTER 5: METHODOLOGY

5.1 INTRODUCTION

This chapter will discuss the actual procedures that were used to collect and analyse the interview data. The research design is qualitative as opposed to quantitative,

This type of research is best used to answer how and why questions and is not well suited to generalisable what, when and who questions. Revisiting the objectives of the study will show that the qualitative method is preferable to the quantitative method:

The objectives are:

- To understand the provision of microfinance in Uganda;
- To understand the principles of Shariah-compliant microfinance;
- To investigate the main problems with microfinance;
- To compare conventional finance with Shariah-compliant microfinance; and
- To determine the extent of Shariah-compliant microfinance provision in Uganda.

These are complex issues that require the input of the participants in order to fully understand them. This is one of the strengths of qualitative research. Another strength is that it allows for multiple methods for gathering data on sensitive subjects. For example, interviews conducted with individuals who could possibly be in financial difficulty would raise sensitive issues for most people.

This is not to overlook the limitations of qualitative research which are that:

- Findings usually cannot be generalised to the study population or community;
- More difficult to analyse; don't fit neatly in standard categories;
- Data collection is usually time-consuming.

Qualitative research using interviews puts the researcher in direct contact with the subjects of the study. A carefully designed set of questions are prepared to guide the interviews toward the objectives of the research study.

Some of the advantages of the interview method are:

- Data can be based on the participants' own meaning of microfinance terms and practices;
- Useful for studying a limited number of cases in depth;
- Provides individual and group case information in local settings;

- Can determine how participants interpret microfinance; and
- Qualitative approaches are especially adaptive to local situations, conditions, and interests.

The flexibility and adaptability of this method make it a useful tool for drilling down on specific areas of research interests.

There are also limitations to this approach that need to be considered. For example:

- Knowledge produced might not be easily generalised to other people or other settings (i.e. findings might be unique to the relatively few people included in the research study);
- It is difficult to make quantitative predictions from the data;
- It is more difficult to test hypotheses and theories with large participant pools;
- Some assign less credibility to this method than to survey questionnaire data;
- It generally takes more time to collect the data than does quantitative research;
- Data analysis is often time consuming; and
- It is possible for the results to be influenced by the researcher's personal biases and beliefs.

5.2 SELECTING THE RESEARCH SAMPLE

The population of the study was all people in Kampala who made use of microfinance. Since this number is, to all intents and purposes, infinite, a sample was selected. The sample came from microfinance organisations who conduct business in and around Kampala, the capital city of Uganda. The sample consisted of 150 clients and 100 employees involved in microfinance programmes with these MFIs. The participants were selected at random from organisations that agreed to participate in the study. In addition, representatives of government were included. This meant that there were three groups of people included in the study: microfinance borrowers, MFI officials and representative and government officials.

5.2.1 Sampling Procedures

In order to get the most representative sample, the following sampling methods were used:

- Fifty MFIs were selected. This was a convenience sample as these MFIs operated in Kampala and were easily accessible to the researcher. The MFIs included 5 microfinance banks, 5 ROSCAs, 5 Grameen bank solidarity group model institutions and 35 SACCOs.

- Once the participating organisations were known, a random sample of their clients was selected to represent a cross-section of participants from across all types of people in the pool. The sample consisted of 150 clients involved in microfinance programmes with these MFIs. The participants were selected at random from the three participating organisations. All of those selected were either asked to participate in a semi-structured interview or a focus group interview.

5.2.2 How Subjects were Solicited

The researcher initially approached the MFIs and made an appointment with the relevant person in authority at each one to discuss the research and request that they advise their clients about it. A representative from the host MFI notified their clients (prospective subjects) that a study was being conducted and requested their voluntary participation. They described the study, its objectives, and the time requirements. If the clients agreed to participate, they were told when and where the session would take place.

Secondly, the person in charge of the MFI was also asked to participate.

5.3 DESIGNING THE INTERVIEW QUESTIONNAIRE

The approach required the concurrent development of a set of interview questions for each sample. The questions were designed to address the issues in ways that the responses could be aggregated for analysis and reporting at the conclusion of the study.

5.3.1 Themes

The interview questions (Appendix A) followed similar lines of questioning. Each began with a series of demographic questions followed by list of questions that probed the respondent's perceptions of microfinance programmes they were involved with.

There were three sets of questions that varied with the target of the questioning.

Set 1 – For Loan Beneficiaries, Clients and Potential Clients of MFIs

Demographic Questions – 4 items (e.g. name, age, and household information)

Program Experience – 12 items (e.g. ease of access, terms, collateral, overall satisfaction)

Client Perspective – 7 items (e.g. suggestions for improvement)

Set 2 – For Directors, Head of Credit, Loan Officers

Demographic Questions – 5 items (e.g. name, title, organisation tenure)

Microfinance Programme – 48 items covering such items as:

Programme Characteristics – terms, conditions

Loan Characteristics – size, term

Outreach – areas served, target clients

Price and Competition – rates, fees, competition

Service Delivery – average group size, loan officer case load

Repay and Collateral – collateral types, dropout rates

Profitability – how costs are covered

Portfolio Quality – loss rates, write offs

Shariah Board – extent of involvement

Future Shariah Law Compliance Microfinance Programmes – 7 items

Anticipated challenges, changes, outlook

Set 3 – For Government Officials, Representatives

Demographics – 3 items (e.g. name, title, organisation tenure)

Role of Government – 9 items

Microfinance programmes supported by the government

Issues with Shariah finance

Suggested changes with Shariah compliant programmes

There are several duplicated questions in the three sets of questions as well as unique questions for each group. The intention was to cover many of the same themes with each group while also probing the unique expertise of each group concurrently.

5.3.2 Number of Interview Questions

The number of interview questions ranged from 12 items for government officials to 23 items for the loan beneficiaries, to 60 items for the microfinance organisations involved in the study. It was intended to allow the participant to allocate a minimum of an hour's time for a semi-structured interview and enable the interviewer some flexibility in follow-up questioning.

5.3.3 Preliminary Test Runs – Questions and Protocols

Once a draft of the interview questions was developed, it was submitted to the ethics committee for approval.

5.4 SEMI-STRUCTURED INTERVIEWS

Semi-structured interviews were held with:

- 150 MFI clients;
- 100 employees of MFIs; and
- 5 government officials.

The interviews used an interview guide (Appendix A) with a series of questions on the topic while allowing some flexibility for follow up questions, depending on interview responses. The interview themes reflected the main topics of interest and the questions were sequenced in an order to facilitate the analysis and aggregation of data for reporting results.

The researcher developed note-taking procedures that helped ensure consistency of data collection and reliable interpretation methods. These notes were later coded and interpreted in the results section.

After the first few interviews, it was necessary to slightly revise the procedures, particularly with regard to how the questions were asked, depending on local experience. Changes that were made early enough in the process did not have a material effect on the overall integrity of the data or invalidate the first interviews that were conducted. Any changes that were made were documented and noted in the analysis that is included in the final report.

5.5 FOCUS GROUPS

Five focus groups with 20 client participants each were held. Focus groups consist of people selected by a non-random method who share some characteristics or experience relevant to

the research. Ideally participants do not know each other and respond to questions from a group facilitator. The benefit lies in using group dynamics to generate data, insights, ideas and strategies and defining problems in project implementation. Open-ended questions or topics are designed to stimulate discussion.

5.6 DATA ANALYSIS PROCEDURES

Methods for doing content analysis of interviews, such as thematic analysis or discourse analysis, were used so that timely and appropriate analysis of interview notes could be done efficiently and effectively. Recurrent words or themes were noted and included in the analysis of results.

Notes from each of the interview sessions were consolidated into a single transcript of the sessions in such a way as to facilitate the analysis of overall results.

5.6.1 Alternative Methods for Interpreting Qualitative Data

Qualitative research by its nature places the researcher in the midst of the reality he or she is studying. As Denzin and Lincoln (2005: 3) observed, “qualitative researchers study things in their natural settings, attempting to make sense of, or to interpret, phenomena in terms of the meanings people bring to them.” To extract meaningful reality from such observations, qualitative research has developed many rigorous analytical techniques that can be used independently or in tandem with one another in ways that systematically answers research questions. Some of these techniques include thematic analysis, interpretivism and grounded theory techniques. Each has a different perspective of how it accounts for reality. Thematic analysis is a “rigorous, yet inductive, set of procedures designed to identify and examine themes from textual data in a way that is transparent and credible,” (Guest, MacQueen & Namey, 2012: 15). Interpretivism relies heavily on naturalistic methods (such as interviewing and analysis of existing texts) to collaboratively construct a meaningful reality that emerges from the research process in which they “attempt to understand the way others construe, conceptualise, and understand events, concepts, and categories, in part because these are assumed to influence individuals’ behaviour,” (Kaplan & Duchon, 1988: 571). Grounded Theory using interviews with subjects may start with a phenomenological interest in subjective understandings, but the primary interest is to elicit information on the particular situation under examination. A common theme in these three methodologies is that the researcher makes direct personal contact with the subjects in order to elicit the meaning and understanding the subjects themselves have about the various interview topics, rather than an

empirical determination as a quantitative researcher would do, when testing hypotheses that may seem logical but have no relevance to the mindsets of the survey respondents. The researcher took an eclectic view of these various methodologies and combined them in the analysis that was done from all of the interview sessions.

The strength of the interview approach is that it offers an internal view of the motivations and beliefs about the experience of microfinance on a personal level and by groups of individuals (i.e. through interviews), as well as the ability to profile similar populations as defined by their views and personal attributes (i.e. through demographic data).

5.6.2 Qualitative Data Analysis Packages

There are several data analysis packages available for analysing textual data obtained through interviews. Each of them have unique advantages and limitations. In order to use these packages, a verbatim transcript needs to be made of all interviews using a transcription package. There are many choices to choose from, ranging from free, open source packages such as QDA Miner Lite with a proprietary license, free version with reduced functionality (Windows) to a proprietary license like NVivo (Windows; Mac OS). However, they are expensive and time consuming to use. After considering these options, it was decided to do a manual thematic analysis of researcher notes taken during each session. The repeated use of certain words or phrases from sessions that were independent of one another made it possible to discern patterns that provided insights into the thinking of the participants whose thoughts were included in the final report.

5.7 TESTS FOR VALIDITY AND RELIABILITY

Validity and reliability are often paired together as though they offer a complete basis for speaking to the utility and appropriateness of a research project. And yet, the terms are not always clearly understood. They have many different definitions. Arguing the subtle distinctions of various meanings is beyond the scope of this research. One of the earliest and most enduring definitions of validity was offered by Hammersley (1987: 69) whose definition is “An account is valid or true if it represents accurately those features of the phenomena, that it is intended to describe, explain or theorise.” Reliability, on the other hand, is most commonly construed to mean “Reproductibility of the measurements...stability,” (Lehner, 1979: 130), meaning that two or more people measuring the same object using the same measurement technique would get essentially the same results, or, in the case of two people

analysing the same content of interview data, using the same techniques, would come up with the essentially the same interpretations of meanings.

5.7.1 Validity

Validity is the extent to which the findings accurately reflect the way things really are (Denscombe, 2014). Thus, validity is strongly linked with the credibility of the study. It also reflects how well its results are able to provide right answers for the research questions. In this thesis, information was collected from previous studies and other sources, covering all areas of the subject matter. From these studies, the theoretical framework was established and then applied to develop a questionnaire that would allow us to find the right results for our research questions.

The qualitative approach was, in our opinion, the most appropriate way to analyse the retrieved data. If we want to understand the impact of microfinance, figures often fail to reveal an accurate image of how a particular phenomenon or set of circumstances or situation is perceived by users. Thus, the questionnaire was devised to be used in semi-structured interviews. This is confirmed by the fact that the results from our analysis have allowed us to answer the research questions and to achieve our research.

5.7.2 Reliability

Reliability is the extent to which data collection techniques and analytical procedures yield consistent findings (Yilmaz, 2013). It can be assessed by posing three related questions:

- (1) Will the measurement of variables yield the same result on every occasion?
- (2) Will all observations reach similar findings?
- (3) Has the raw data used to draw conclusions been treated in a transparent manner?

We believe that the results of our study are reliable and carefully respect the criteria established for the sample. As has already been mentioned, the sample of clients was randomly selected with the help of the local branches of MFIs and other people from the specific area. Interviews of individuals already involved in microfinance activities were carefully conducted and the researcher accurately wrote down their responses. While some may think that this process could affect the reliability of the data, this method was chosen because most of the people involved in microfinance programmes were illiterate and unable to write down their own answers. In every instance, the local languages were used and the questions were repeated as many times as necessary to get adequate answers and avoid

confusion. Thus, the data collected accurately reflects reality. Moreover, based on this, data findings agree with the conclusions of previous studies. Throughout the study, the data have been analysed and interpreted on the basis of the theoretical framework and have been related back to the most reliable literature in the field.

5.7.3 Transferability

Transferability (or generalisation) refers to the applicability of a study in a different context from the one already under investigation (Marshall & Rossman, 2014). It is vital to identify the specifications related to the observable fact taken into consideration for the research, in order to be able to define under what context the study can be generalised. One can investigate microfinance in various contexts, such as from the clients' or from the MFIs' point of view, or from both sides. Although both clients and employees of MFIs were interviewed, the research was mainly focused on the clients' perspective of microfinance and on its influence on their living standards.

A way to ensure generalisation is to interview everyone in the population, but it is obviously not possible to study a whole population. Therefore, the random sampling technique, which was delimited, bearing in mind the availability of limited resources and the time constraints, to the capital city of Kampala. Moreover, only poor individuals were targeted, not the medium and upper classes of Uganda. Despite this, if someone were to carry out the same research on the poor class of another country, the results obtained could very well vary from these findings, as different cultures and social systems are likely to show different results.

5.8 CHAPTER SUMMARY

This chapter provided details of the research design using a qualitative research approach, with semi-structured interviews, focus groups and a questionnaire as the data gathering tools. The sampling procedures were outlined as were the approaches to data analysis where the main themes were presented. Finally, the validity, reliability and transferability of the study were considered. The next chapter presents the findings of the empirical research.

CHAPTER 6: RESEARCH FINDINGS

6.1 INTRODUCTION

In this chapter, the findings and results of this study are reported. We will show how this research helped to answer our research questions and what we learned about the microfinance industry in general and Shariah-compliant microfinance in particular. We will also describe the nature of the microfinance business in terms of such factors as: number and type of MFIs, geographical distribution, types of products as services, tiers of MFI classifications, business competitors, and the future outlook for MFIs from their perspective.

The goal of this research was to study the impact of microfinance on poverty reduction through the improvement of living standards and the empowerment of the poor and marginalised sections of society.

This section addresses two key questions:

- What is the impact of conventional MFIs on the socioeconomic level of participants?
- Can Shariah-compliance solve the problems raised by conventional MFIs?

In order to further understand these questions, the influence of geographic location and gender are addressed.

In what follows, several key topics are discussed including the basic characteristics of respondents and their households, sources of income, uses of income, financial services and loan uses, empowerment, and agricultural sector linkages.

As mentioned earlier, the respondents lived within a 40 km radius of Kampala, the capital city of Uganda. Throughout this section Kampala is used to refer both to the urban area and its periphery.

6.2 DEMOGRAPHICS OF THE RESEARCH PARTICIPANTS

There was a total of 250 participants in the study. All resided in the Kampala area. Of the 150 clients that were interviewed, there were 90 who participated in group interviews and 60 were interviewed individually. The participants were 70 per cent female and 30 per cent male. A total of 100 employees from 50 MFIs also participated.

Table 6.1: MFI Interview Profile

Samples	MFI Clients	Focus groups	Individuals	Totals
	150	90	60	150
Gender	% Male	% Female		
	30	70		
MFI Type	Conventional MFIS	Shariah-Compliant	MFI employees	100
	50	0	100	
			Government Officials	5
			5	

Each participant responded to a series of interview questions that are listed in Appendix A.

6.3 DESCRIPTION OF RESPONDENTS

This section addresses the objective: to understand the provision of microfinance in Uganda.

Descriptive statistics are generally associated with quantitative research methodology, but according to McGrail and Rieger (2014) can be used in qualitative research. Sandelowski (2000: 336) refers to qualitative content analysis and qualitative description, which includes aggregated data and entails the presentation of the facts of a case in everyday language.

The aggregated data in this study are as follows:

6.3.1 Clients of MFIs

- In terms of the clients, 70 per cent of respondents were female and only 30 per cent male. This seems to indicate that institutions are not making enough effort to entice men to acquire loans, or it might indicate that men do not want to take up loans and would prefer women to manage them.
- 65 per cent of respondents were illiterate.

6.3.2 MFI Employees

The MFI employees consisted of directors, heads of credit and loan officers

6.3.3 Officials

The officials are from the Ministry of Finance, and other governmental bodies.

6.4 SIGNIFICANCE/IMPLICATIONS

6.4.1 Aggregated Findings on Clients

- On average, rural borrowers received smaller loan amounts than their urban counterparts.
- Above 90 per cent of respondents reported that their repayment schedule was suitable. This belief is likely to have a positive impact on loan repayment. All respondents believed that a microfinance loan should be paid back. Similarly, all of them reported that their loan was released on time.
- Regarding group formation and peer pressure, almost all respondents reported that they knew each other, monitored each other's actions, and imposed sanctions on members that defaulted. This may have contributed to the relatively high repayment rate of 88 per cent reported in the interviews.
- Regarding loan utilisation, 25 per cent of respondents reported having violated their loan agreement at some point. The main reasons alleged are the inconsistency of the agreement with their initial intention and market problems.
- 60 per cent of respondents owned livestock. Out of these, 20 per cent were rural borrowers. More than half of the respondents had some source of income before participating in the loan scheme, especially from the sale of farm produce.
- 91 per cent of respondents reported having some amount of money saved in the microfinance institution. Only one, however, had personal savings before participating in the credit scheme. This is one area where microfinance seems to have made a positive contribution, even if most borrowers were only saving the amounts required by the group and the MFI.

6.4.1.1 Loan applications

The analysis of the data obtained in this thesis indicates that the procedure for obtaining a loan from an MFI in Uganda is easier than the one required by conventional banks. Based on first-hand experience and direct observations, MFIs do not always require collateral to extend a loan and might rely on guarantees instead. This makes it possible for everyone to access

financial services and credit, and it is obviously one of the main reasons why people apply for loans from MFIs instead of using conventional banking, where collateral is usually the first and foremost requirement. Loan products ranged from Solidarity Group Loans; school fee loans; agriculture loans; asset financing loan; salary loans; education loans and business loans. It should be noted that Shariah finance also relies on collateral since loans must be backed by assets, so this might be a hindrance in establishing Shariah-compliant MFIs.

Clients reported that the procedure of acquiring the loan in most MFIs is the same; they require letters, guarantees and many other documents, for that reason it takes the borrower at least two weeks to provide the documents, and another two weeks for the cash to be disbursed. This is understandable to reduce the rate of uncollected loans. All MFIs require collateral, and it can be in a form of a land title, or a guarantee. The clarification of the contract usually takes time, by explaining what are rights, and liabilities towards the MFI. It is essential to be informed of every clause since we are dealing with money. The MFI staff are not usually in a hurry because at the end of the day they want to ensure that the borrowers are able to repay back the loan.

No MFI offered unlimited loan amounts as all the MFI went by grades, depending on the clients' savings in the bank. For example,

You need to save 20% at least of the amount you want to borrow which must be secured until the loan is repaid, then after repaying the loan, you may request a higher loan, but you can't from the first day go for the highest bar.

The loan is granted for the reasons you have mentioned in the application form; you cannot go against it.

Most of the MFI representatives were friendly since they are dealing with those who are desperate to uplift their current situation. However, according to one client,

You can find unfriendly attitudes especially when the borrowers fake documents, or try to bribe the representatives.

Another nuance in terms of loan applications was spousal agreement which was reflected in the following statements:

The conventional microfinance will usually provide the loan to the wife, while the shariah-compliant microfinance will provide the loan to any partner in the condition of informing the other partner.

This demands the agreement of the other partner to ensure there wouldn't be any conflict.

When someone acquires the loan it is their solely decision; however, having the support of the partner is an encouragement that the MFI would always persuade you to get.

6.4.1.2 Interest rates

The results show that a significant portion of the respondents considered that the interest exacted by MFIs were above average. This tallies with the discussion of the fact that microfinance interest rates are generally higher than those found in commercial banking, as discussed in chapter 4. Charging of interest is not in line with Shariah principles (see earlier discussion of *riba*) and this was an indication that there were no Shariah-finance MFIs in the sample.

Examples of respondents' feedback:

Respondent 1.

The interest rates are reasonable since we have no other choice. If we did have other choices then we can compare the interest rates from different MFIs.

Respondent 2.

It is depressing to say that the average interest rate is 30 per cent for MFI clients. Let alone the other additional fees on top of the high interest rate. Overall we are paying back more than the normal rate in the commercial banks. That's why we are unhappy with the extraordinary high interest rates.

Respondent 3

There is certain flexibility the longer the repayment period, the higher the interest, and vice versa, it is totally your choice. The repayment rate depends from a MFI to another but pay an average of 3% interest per month.

There were, however, some contrasting views that referred to lower interest rates, which may indicate that interest rates are charged at the discretion of the MFIs. According to interviews with MFI staff, the price that a client pays includes interest and all required fees, insurance, taxes and security deposits. None of the MFI staff indicated that there were any other pricing options considered by the MFI they worked for. Interest rates ranged from 24 per cent per annum to 80 per cent per annum and appeared to depend on the size of the MFI (the larger

MFIS charged lower interest rates) and the nature of the borrower, e.g. group or individual (groups paid less interest than individuals).

6.4.1.3 Competition

In recent times, growing competition has forced MFIs to become more responsive to clients' needs, to improve the quality of their service, and to engage in the development of new products.

It is not easy to determine with precision how much each of these factors has contributed to the observed success of microfinance in Uganda. Governments and donors have learnt that supporting a favourable environment for microfinance pays off and helps to reduce poverty. While factors such as population density and climatic conditions are generally outside their control, governments, with the support of donors, can promote macroeconomic policies, financial sector reforms, regulatory initiatives, and other measures to develop the private sector, all of which can make microfinance work. In this sense, Uganda can be seen as a model for donors in other parts of the world. Donors in Uganda have not only supported the government in its efforts to create the right conditions for microfinance, but they have also shown a commitment to coordinate with other stakeholders and have invested significant resources in capacity building.

6.4.1.4 Income-generating activities

Those Ugandans who find it difficult to meet their subsistence needs commonly undertake multiple income-generating activities. Microenterprises, as well as wage or salaried employment, are part of these activities. As the data from the interviews with clients and employees of MFIs show, the participation of women in income-generating activities plays a significant role in the household economic portfolio. Both client and non-client households receive income from more than two sources. More than 75 per cent of respondents reported that their microenterprise was the top contributor to their household cash income. Given that 60 per cent of respondents were women, the importance of female economic activity in the household economy is emphasised.

Geographic location is an important factor in determining the types of income earned by households. More urban Kampala households reported earning income from wages, salaries, rentals, and remittances than respondents from outlying areas.

6.4.1.5 Uses of income

A household uses its earned income to provide for its basic needs, to maintain or expand its income-generating activities, to increase its asset base, to improve the living standards of its members, and/or to maintain their social network. From the information gathered in this study, we tried to determine the spending patterns of MFI clients. The procedure was as follows:

Data on the application of revenues generated by the respondents' enterprises during the month prior to the field study as a proxy indicator of the main, recurrent uses of their financial resources were used. Extraordinary purchases were captured from the data on the sources of funds for the acquisition of fixed assets and consumer durables.

Information was then obtained on the amount and sources of the funds spent on the education of household members. Education can be considered both a basic need and an investment in human assets. Moreover, we tried to ascertain the sources of the food consumed by the household during the three days preceding the field study, in order to determine expenditure patterns on this important basic need.

Next, it was determined that a household's ability to cope with unanticipated financial events was a function of existing income and savings that allowed them to meet these extraordinary expenditures.

Finally, data on the monetary value of cash and in-kind remittances to rural areas in the three months preceding the field study were used to assess the pattern and levels of assistance to non-household members.

6.4.1.6 Transaction costs

Participants in microfinance programmes face high transaction costs, many of which derive from the need to maintain financial discipline. These costs include effective loan interest rates of between 24 and 80 per cent, mandatory savings accounts, and compulsory attendance at weekly group meetings. Due to the small loan amounts and the high frequency of repayment, most borrowers are constrained to pursue buying and selling activities that require little initial investment and guarantee a quick turnover of goods. There are no incentives in the lending programmes that would induce clients to repay their loans early. In fact, clients tend to pay a penalty if they do so, given that interest is charged on the basis of a pre-established loan period. Although programme clients keep records of their loan payments, together with their

balances and mandatory savings contributions, they are often unable to explain these entries, and in many cases they are hardly able to distinguish between mandatory and voluntary savings.

Respondent 3.

I wish that they would reduce the transaction costs. We are paying excessive amount of money for application fees, administration fees, and the list goes on forever paying ridiculous amounts.

6.4.1.7 Loan repayment

Several factors appeared to be significant in determining loan repayment performance: education, loan size, loan diversion, availability of alternative credit sources, loan supervision, and the suitability of the loan repayment schedule, income, and value of livestock. All of these factors, except loan diversion and loan size, tend to increase the probability of loan repayment. The number of dependents and the fact of being male, as well as loan diversion and loan size, tend to reduce loan repayment performance.

Moreover, the empirical evidence shows that the screening technique used was adequate, even if there were some problems in distinguishing borrowers in terms of their creditworthiness.

6.4.1.8 Loans to farmers

In the microfinance industry in Uganda, farmers are considered as credit risks although other studies have shown that they are granted loans and manage them quite successfully (cf Chapter 4, Section 4.1). There are, however, some MFIs that grant agricultural loans. In Uganda, the agricultural sector represents approximately 40% of GDP, but is recipient of only about 10% of the credit (Scholer, Stanculescu & Gibson, 2011). This is because their production cannot be predetermined with any certainty. Farming activities are riskier than non-farming activities, insofar as their output depends on weather conditions and other unforeseeable events, such as plagues or diseases. In the case of animal husbandry, for instance, cattle are at risk of suffering an epidemic that may lead to heavy losses if it is not well-handled. Thus, MFIs generally consider that it is too risky to grant loans to farmers, although those with enough collateral have less difficulty to obtain financing.

6.4.1.9 Urban Poor

The research shows that the urban poor earn their living primarily through their labour. Their main physical asset is the housing stock, which often serves both as a place to live and to carry out a business. Social relations, including social claims and social obligations, are important and intimately tied to the provision of informal financial services. Only a few poor households have access to formal financial services. In general, they can only rely on informal borrowing, savings, mortgaging or pawning of assets, as well as insurance, which they find through vertical and horizontal social ties. In order to access this form of financing, social norms relating to caste and gender are quite important. An elaborate social system that confers advantage or disadvantage based on a person's gender and caste is still pervasive in both urban and rural Uganda.

6.4.1.10 Training and Information

What is really needed is financial literacy.

One respondent stated:

We need to know how to deal with money, that starts with idea, to business plan, to feasibility studies, along to saving investing and spending. Financial literacy will make a big difference in our lives.

Another respondent stated:

The problems that we are facing is that we need someone to invest in our abilities, we need smart intelligent businessmen that would provide us with information on the latest markets to sell for good prices, and buy cheap raw materials from suppliers.

With regard to information, clients stated that in Uganda almost everyone has a mobile phone, and this was the preferred method of communication. It was also apparent that clients had access to the internet which had “*become part of our life, we eat, drink, bath, sleep, and browse, receive messages, so the internet is the future. Any information is good for us because we are new to technology, and plus the technology is updated daily*”. This may be because all the participants were located in the urban environment of Kampala and it is unclear whether the same level of technology use would be evident in rural communities.

6.4.1.11 Preference for Shariah-finance

When asked if Shariah-financing would be preferred, one client stated

I prefer Shariah compliant finance as I am a Muslim, but at the same time there should be incentives, and since the Shariah is driven by a religious perspective, they provide better loan rates, and that is why I prefer it. Even the Christians would prefer the Shariah MFI when they are able to get money with cheaper rates than the conventional.

The general consensus of opinion was the program of MFI is making a huge impact on the society there were countless businesses that had been started with the support of the MFI.

6.4.2 Aggregated Findings for MFI Employees

All the MFIs were profit based, offering finance to individuals and groups. None of them had been in existence for very long. On average, MFIs had 500 clients of whom 35% were female. The area served was central Kampala.

Loans were provided at a flat rate of interest of 3% with 10% of the loan being allocated for administrative costs. This was regarded as being sufficient to cover the costs and provide a profit. One employee stated that requirements stipulated for clients were that they should save 20% of the loan, and provide all the necessary documents that are demanded by any MFI. Collateral was required by means of land title and guarantees; if these were not forthcoming, the loan would be denied.

On average it took about one month to approve loan applications. Financial advice was offered to clients, in the offices of the MFI or to groups in the villages, but no training courses were offered and there was no specific provision to assist those who were illiterate, dyslexic or unable to understand the application forms; this was attributed to the limited by the number of employees the MFI was able to hire (this averaged between 4 and 7 employees) and the limited number of branches. Expansion of services was determined by levels of demand and there were no fixed plans, so this was an ad hoc arrangement. The lack of capacity also limited access to the Internet as a means of interaction with the beneficiaries. The main means of communication was by means of leaflets distributed by messengers on “boda” motorcycles.

The loan characteristics were generally below 1 million Uganda shillings, lent for a 1-year period with a monthly repayment schedule over 12 months. Disbursements were made in the form of cash as most borrowers were unbanked. If the loan funds were used properly, and payments were made according to the schedule, the borrower would be regarded as eligible for a second loan. The general experience was that approximately 95% of loans were repaid within the required time which was regarded as satisfactory. No cases of disputes between spouses were noted, and the main problem was that there is a greater demand than funds available. There did

not appear to be any insurance for borrowers who might experience natural disasters and the consequent loss of the collateral assets – this seemed to be a case of “it hasn’t happened yet”.

6.4.3 Aggregated Findings for Officials

The officials maintained that they were regulating the microfinance institutions to the best of their ability. They look forward to emulate Kenya since it is the leading country in East Africa in terms of micro-finance. They stated that the microfinance industry is based on conventional methodology which is why there is minimal provision of Shariah-compliant microfinance in Uganda.

Having said that, they were not against any methodology that would provide loans to the public and eradicate poverty. They certainly consider Shariah microfinance as one of the tools to persuade the rich Muslim countries to fund microfinance projects in Uganda. Basically the government of Uganda follows a liberal market policy which provides opportunities for others to invest freely unlike other socialist African states.

6.5 IMPLICATIONS FOR SHARIAH FINANCE

This section addresses the following objectives:

- To understand the provision of microfinance in Uganda; and
- To determine the extent of Shariah-compliant microfinance provision in Uganda.

It is quite clear from all these findings that very little if any Shariah finance is provided to borrowers by Ugandan MFIs. This is mainly evident in the fact that most respondents mentioned interest rates – if Shariah finance had been offered, then one would have expected to find mention of other types of financial arrangements. However, it should also be noted that the questions in Appendix A, for loan beneficiaries, clients, potential clients focussed on microfinance arrangements in general, and did not probe for information on Shariah-products. What this also implies is that Muslim clients are generally not catered for which means that they clearly do not approach the registered MFIs for financial assistance. Perhaps this was an oversight in compiling the questionnaire for this sample which did not ask the respondents to indicate their religion.

6.5.1 The Status of MFIs

Our analysis of randomly selected MFIs in Uganda has shown that the numbers of both employees and clients have substantially grown during the past decade as a consequence of increasing demand for microfinance services.

It has also shown that women have been especially encouraged to participate in microfinance institutions. Moreover, loan portfolios may have increased due to the success of group-lending schemes, where repeated interaction between participants helps to create well-functioning repayment systems despite the lack of standard collateral requirements.

6.5.1.1 Microfinance in Uganda

In many ways, the state of microfinance in Uganda – and its development over the past four to five years – mirrors current debates, victories as well as deficiencies of how microfinance operates in other parts of the developing world. In particular, the ideological tensions between poverty alleviation goals and the social and economic emancipation of women and marginalised groups (discussed in Chapter 2, Sections 2.3 and 2.4) are writ large in the case of Uganda. This will be further discussed below.

In this section, I address two aims: first, a comprehensive 6.8 of the structure, mechanisms and institutions involved in microfinance in Uganda, including individual and group lending, microcredit institutions, and savings and cooperative credit unions (SACCOs). Second, the cultural and economic and political dimensions of microfinance are tackled. Finally, a summary of key points is presented before the next chapter on findings of the fieldwork undertaken.

6.5.1.2 Overview

A decade ago, only a few MFIs existed in Uganda and their performance was rather weak. Today, the country is endowed with one of the strongest and most dynamic microfinance industries in Africa. Uganda Bureau of Statistics (UBOS) (2010) reported a 70% growth rate in the number of MFIs since 2001. Uganda's microfinance providers do not serve as many clients as similar institutions in Asia and Latin America, but the industry has reached a stage of development in terms of sustainability, outreach, and coherence that is unmatched in other parts of Africa. The main reasons for this success include a favourable environment and the weakness of the formal financial sector. Taking advantage of the shortcomings of other

financial institutions, MFIs have exploited their competitors' weaknesses and built a solid business base.

Macroeconomic stability, high population density in urban, peri-urban, as well as some rural areas have provided a favourable economic and physical environment for the development of microfinance. An enterprising population, combined with massive formal sector lay-offs in the era of President Museveni's leadership, has resulted in the rapid growth of the micro and small enterprise sector. The population's experience with informal financial arrangements has further contributed to its willingness to access microfinance services.

Another important factor in the growth of the microfinance industry in Uganda has been the weakness of formal financial institutions. After a number of commercial banks failed (Brownbridge, 2002), microfinance came to be viewed as the most convenient vehicle for delivering financial services to the poor and was expected to fill the finance gap existing in the country.

The microfinance industry in Uganda is comprised of formal and informal MFIs. The formal institutions include (1) companies organised under the banking laws, (2) financial intermediaries that are not banks but are monitored by the government as microfinance deposit-taking institutions (MDIs), (3) non-regulated companies that only offer credit, and (4) formally registered cooperatives and societies that only serve their members. The formal institutions are members of the Association of Microfinance Institutions of Uganda (AMFIU). There are two banks, four MDIs, thirty-one credit-only MFIs, and forty-one savings and credit cooperative societies (SACCOs). The informal institutions include SACCOs that are not registered by the government. All of these institutions have been ranked and categorised by the Bank of Uganda and the AMFIU, based on their size and level of operation. Figure 6.1 shows the distribution of MFIs.

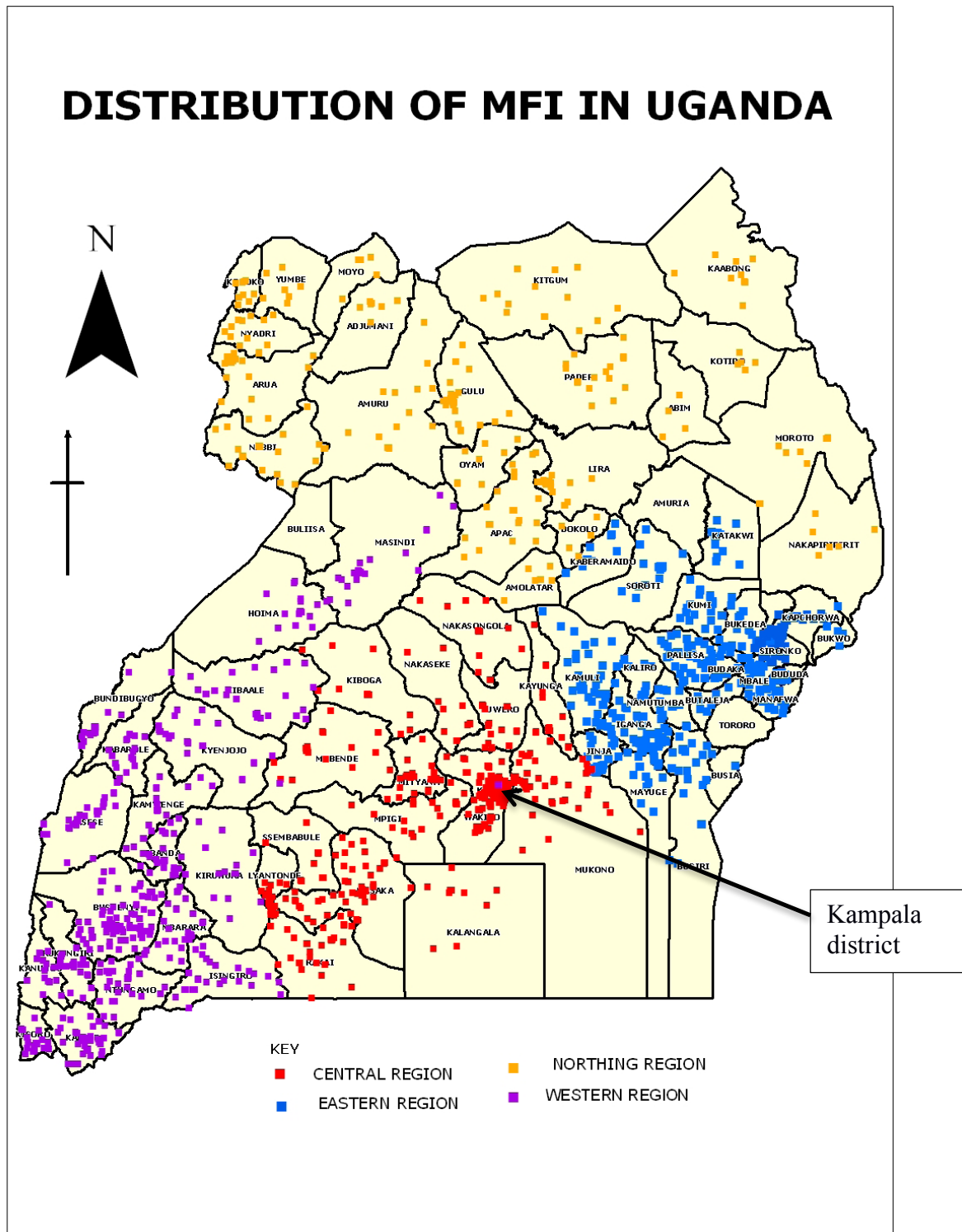


Figure 6.1: Distribution of MFIs in Uganda

Source: Uganda Bureau of Statistics (UBOS) (2010: 3)

Geographically, MFIs are distributed throughout the country. MFIs by district shows that Kampala district has the highest proportion of MFIs. Distribution of MFIs by district shows that Kampala district has the highest proportion of MFIs (32%).

MFIs are classified as Tier IV institutions. Table 6.2 below shows this in the context of the whole Ugandan financial sector.

Table 6.2: Uganda’s financial sector presented in tiers

Tier	Type of Institution	Applicable Law	Regulator	Number
Tier I	Banks	Financial Institutions Act, 2004	Bank of Uganda	24
Tier II	Credit Institutions	Financial Institutions Act, 2004	Bank of Uganda	4
Tier III	MDIs	MDI Act, 2003	Bank of Uganda	4
Tier IV	Other MFIs and SACCOs	Companies Act, 1961	None	49
		NGO (Amendment) Act, 2006	None	81
		Cooperative Societies Act (Cap. 112), 1991	None	2 065
		Informal Institutions	None	Unknown
		Money Lenders Act, Cap. 273,1952	None	Unknown
		Total known		2 195

Source: UBOS (2010)

Figure 6.2 below shows the structure of the microfinance industry in Uganda as described in Uganda Bureau of Statistics (2010).

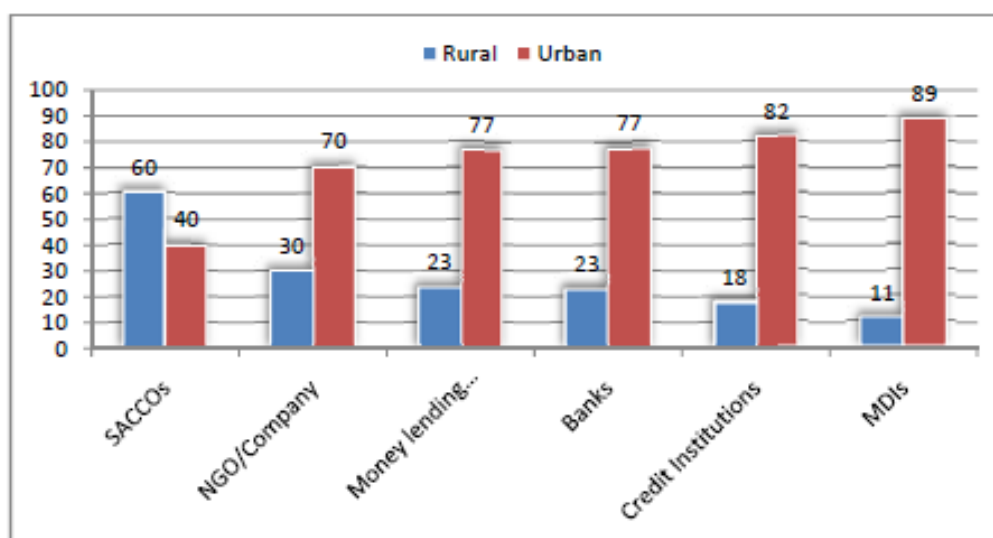


Figure 6.2: Percentage Distribution of MFIs by location (rural and urban)

Source: UBOS (2010: 11)

The largest number of clients is served by registered companies in Category A and B who offer an array of microfinance products and services. Category C and D MFIs are small, poorly equipped organisations that serve niche clients. Rotating savings and credit associations (ROSCAs) tend to be female-dominated organisations with a limited amount of savings, gathered in a common pool, from which members can borrow on a rotating basis. These types of organisations or self-help groups have often been used by MFIs as a basis for group lending between the members. Table 6.3 below provides a summarised 6.8 of the characteristics of Tier IV MFIs in Uganda.

Table 6.3: Characteristics of MFIs in Uganda

Category	Characteristics
A	At or nearing operational and financial self-sustainability. Well-documented operational procedures. Fairly good MIS. Well-qualified management and staff. Applying microfinance best practices. Often registered as companies limited by guarantee. Active clients over 10,000.
B	Mainly NGOs. Also registered as companies limited by guarantee. They have adopted a business-oriented approach to poverty alleviation, charging market interest rates and moving towards operational self-sufficiency (OSS). Fair documentation of procedures and MIS. Good management. OSS at levels between 50 per cent and 85 per cent. Active clients from 5,000 to 10,000.
C	Mainly small local NGOs with limited resources and client base. Fairly familiar with best practices and participate in the industry's information loop. However, most have modestly qualified management and are still far from reaching OSS (35 per cent to 49 per cent). Active clients from 500 to 3,000.
D	Small community-based organisations, generally not well-known in the sector. Largely alien to the national microfinance best practices. Focused on rural outreach. Minimal number of clients.

Source: Nanyonjo and Nsubuga (2004)

Those in categories A and B are mostly found in urban areas, while those in categories C and D tend to be in rural areas.

6.5.1.3 Forms of Microfinance in Uganda

Many MFIs offer and provide credit on a solidarity group lending basis without collateral, but they also follow a variety of other methodologies as well. Some of them start with one methodology and later change or vary to another one so as not to exclude specific socio-economic categories of clients. It becomes crucial, therefore, to have a basic understanding of the different methodologies employed by MFIs.

6.5.1.3.1 Group lending

Group-based or joint liability lending is one of the most popular innovative approaches to lending small amounts of money to a large number of clients who lack collateral. The size of the group varies, but most groups have between four and eight members. The group self-selects its members before applying for a loan. Loans are granted to selected member(s) of the group first and then to the rest of its members. Many MFIs require that a percentage of the loan be kept in the account, in order to ensure the borrower's ability to make regular payments and to serve as a form of collateral. Group members are collectively accountable for the repayment of all loans and typically meet weekly to collect repayments. Thus, peer pressure and joint liability help to ensure repayment, to the extent that the entire group would be disqualified and would not be eligible for additional loans if only one of its members were to become a defaulter. The creditworthiness of each borrower is consequently determined by the solidarity group members rather than by the MFI.

6.5.1.3.2 Individual lending

Over 60% of the money lending institutions lend money to individuals only, followed by SACCOs with 43% and NGOs with 34% (UBOS, 2010). There are, however, very few conventional financial institutions in Uganda offering individual loans to low-income people, given that vulnerable individuals are considered higher risk clients due to their lack of collateral. Another factor is the labour-intensive nature of the credit business and hence the lower profitability of small credits.

6.5.1.3.3 Credit unions

Credit unions such as the Uganda Savings and Credit Union Limited (UCSCU) are organisations established on the basis of a financial relation between their members, who act both as depositors and borrowers. Credit unions gather savings from their members and offer short-term credit to those members who need it. In most rural areas, apart from the informal

financial market, credit unions are still the sole source of deposit and credit services. Since credit unions have social as well as commercial goals, they can have a major role in providing financial services to vulnerable people. It has been observed, however, that women have not benefited greatly from credit unions, largely because the level of savings required to participate in them tends to be high.

The Uganda Cooperative Savings and Credit Union (UCSCU) is an umbrella body of the savings and credit cooperative societies (SACCOs) discussed below. It was registered in 1972 under the Uganda Cooperative Societies Act of 1970. It aims to organise SACCOs, educate and advocate for SACCOs' members, promote microloans and savings services, and network with like-minded organisations. There are approximately 2000 SACCO members across the 82 regions of Uganda (Millan, 2012). Despite a rigorous search of the literature for the number actually based in Kampala, no information could be found. Kyazze (2010: vii) reports that "its spidery network consist[s] of active, semi active, dormant and extinct cooperatives that total over 10,000 primary cooperatives and 40 cooperative unions that fall under one apex cooperative organisation" namely UCSCU, but these figures relate to the whole of Uganda and not specifically to Kampala.. Of these 6 469 are active, with the remainder either being dormant or under probation.

6.5.1.3.4 Savings and credit cooperatives (SACCOs)

SACCOs vary in size from a few to thousands of members. Most SACCOs are organised around the workplace (formal employers), markets or vendors of a specific product (the most prevalent being coffee). In several ways, SACCOs are well poised to offer savings and credit services to vulnerable people, especially in rural areas. However, they have been fraught with all kinds of internal problems, from managerial incompetence to fraud (Sekabira, 2013). Around 65 per cent of their members are men and only 35 per cent are women which is a reflection of their risk preferences and target clients (Carlton, Mandorff, Obara, Reiter & Rhyne, 2001).

Some of the existing SACCOs receive technical support from the Uganda Cooperative Alliance or the Uganda Cooperative Savings and Credit Union (UCSCU). Most of their users are net borrowers, while no more than 10 per cent are net savers. Amongst members, SACCOs are well-known as a source of cheap and easy loans compared to banks. They are accessible and often located near members' homes and workplaces. They offer daily deposit collection services and extend quick short-term loans that can be used to ease cash-flow

pressure and facilitate consumption. From a legal standpoint, SACCOs have the advantage of being entitled to mobilise savings and use them for on-lending (Distler & Schmidt, 2011).

As in many other regions of the developing world, SACCOs in Uganda have encountered a series of problems that have tainted their reputation as financial services providers. They have traditionally suffered from an opaque governance structure and the lack of transparent operational procedures. The separation of management and ownership does not always function and some chairmen consider themselves the owners of the institution. As most users are disengaged from the affairs of the institution, there are many opportunities for the board members and their friends to take loans without fulfilling their repayment duties. Accounting systems are often unnecessarily complex and only partially understood and partially followed. Audits are infrequent and incomplete.

Being net borrowers, many users of SACCOs seek to lower their interest rate charge on loans, resulting in inadequate incentives to save and insufficient revenues to run the organisation. Moreover, SACCOs usually lend out both savings and share capital, which leads to liquidity risks. In general, lending policies are weakly enforced and systems to track and manage arrears barely exist. Thus, many SACCOs in Uganda have large portfolios in arrears, with overdue loan repayments stretching back into the distant past. Most SACCOs have also experienced considerable difficulties to realise collateral. As the institutions are based, managed and owned by the community, the officers responsible for collecting collateral from defaulting users, often their own neighbours or relatives, are unwilling to seize and sell those assets (Dichter, 1997; Wright, 2000).

Many key figures in the Ugandan microfinance community believe that SACCOs and other community-based organisations have, at least in theory, the capability to make a positive contribution to the expansion of financial services to the vulnerable, especially in rural areas. Nevertheless, due to their poor performance to date and their governance problems, many stakeholders, including government officials, are rather wary about the future of community-based organisations (CBOs). An executive manager in a big microfinance provider, for instance, stated that democracy was fine in the polling-booth, but that it did not work well in financial institutions.

Nonetheless, an increasing number of SACCOs appear to operate rather well. Interviews revealed that most managers and owners of MFIs stated that their businesses were making a sustainable profit. Overall, there seems to be a renewed interest in community-based credit

and savings organisations in the country. The restructured Rural Microfinance Support Project (RMSP), as well as DANIDA's Rural Financial Services Component (RFSC) initiative, should give support to CBOs.

Other CBOs, such as the financial services associations (FSAs), have encountered problems similar to the ones faced by the SACCOs. Nevertheless, thanks to their different institutional set-ups and management structure, as well as to the technical assistance they have received, some FSAs have performed outstandingly well, despite the fact that they operate in difficult rural environments. Their business-oriented approach gives them a comparative advantage over SACCOs and makes them potential vehicles for offering financial services to clients in areas that are usually not served by traditional mainstream MFIs (DIFID, 2000).

6.5.1.4 Regulation and supervision of microfinance institutions

In order to successfully and sustainably fulfil their role of intermediation, MFIs have to operate in a financially safe and sound manner. Hence, there is a need to subject them to bank supervision and prudential regulation. In 2003, the Microfinance Deposit-Taking Institutions Act was legislated. The MDI Act, embedded in an overall supervisory and regulatory framework composed of four tiers, clearly establishes the responsibility of the Bank of Uganda (BOU) in licensing, regulating, disciplining, and supervising all deposit-taking MFIs, which are included in Tier III. A number of prudential and regulatory guidelines have been set under the MDI Act to ensure that MDIs operate in a sound manner and do not expose themselves to excessive risks.

6.5.1.4.1 Tier III financial institutions

This class includes MFIs that are allowed to take deposits from clients in the form of savings accounts. These MFIs are also known as microfinance deposit-taking institutions or MDIs. MDIs are not authorised to offer checking accounts or to trade in foreign currency. There are three institutions in this category operating in Uganda that are listed as follows:

- FINCA Uganda Ltd: This organisation is a not-for-profit MFI based in Washington D.C. (USA) that has been licensed as a micro bank in Uganda and several other developing countries. Village banking, including credit and savings products, is an essential service in many African countries. FINCA cooperates with leading insurance companies to provide life and health insurance products, health care, and business-interruption coverage in response to the African AIDS crisis. FINCA Uganda is an international

pioneer in micro insurance and has partnered with AIG to offer life-insurance products that help ensure that the death of a village bank member does not lead to hardship for the other village bank members or for the family of the deceased as the outstanding loan is paid off.

- **Promotion of Rural Initiatives and Development Enterprises Microfinance Ltd (PRIDE):** This institution was established as PRIDE Africa in late 1995, but the major donor-funded project changed names in 1999 to become PRIDE Africa Uganda Limited, after it was incorporated as a limited company. The company, reinforced by the Norwegian Agency for Development Cooperation, was founded to provide credit to the poor, aiming at those in the agricultural sector. By 2003, however, the Ugandan government took over the company, changing its name to PRIDE Microfinance Limited. The company, which is limited by shares, was later reinforced by AfriCap Microfinance Fund, a private equity fund that made a \$1 million investment in 2008 (Dzineku, Johnson, Ticas & Kiai, 2009). The government has been looking for a private investor to take over the company, which is one of the reasons why it was granted Tier III status. PRIDE is Uganda's most profitable MDI (UBOS, 2010).
- **Uganda Finance Trust Limited:** Uganda Finance Trust is one of the oldest microfinance institutions in Uganda, having begun its operations in 1984. The company is regulated and licensed by the Bank of Uganda as a microfinance deposit-taking Institution (MDI) and is considered a key player in Uganda's formal financial sector. The company has one of the largest branch networks in Uganda, with 28 interconnected branches strategically located all around the country, and serves over 1407,000 clients, offering a variety of banking solutions that include business loans, school fees loans, savings accounts, salary loans, fixed deposits, and a money transfer service through MoneyGram International. The company has a diverse shareholder base, including both domestic and international players. The local NGO UWFT owns 29.8 per cent of its capital, Oiko Credit from the Netherlands owns 24.1 per cent, I&P from France owns 20.5 per cent, a founder group of prominent Ugandan women entrepreneurs owns 13.5 per cent, and the employee cooperative society Sun Mutual owns 12.1 per cent.

6.5.1.4.2 Tier IV

The institutions in this group are not controlled by the Bank of Uganda. They are not licensed to take deposits from the public, but they may provide collateralised and non-collateralised loans. In 2008, it was estimated that there were over 1,000 such institutions in the country.

6.5.1. Characteristics of Ugandan MFIs

6.5.1.5.1 Legal status of MFIs

According to our literature review (Chapter 1, Section 1.10), the legal status of MFIs in Uganda can be categorised as follows: member-based MFIs, domestic social NGOs, international social NGOs, companies limited by guarantee, church-owned MFIs, government credit programmes, and companies limited by shares. In some cases, however, the legal status of the MFI was not clear or the institution itself was unable to determine it. This could be attributed to the poor organisational structure of some of these institutions.

6.5.1.5.2 Registration of MFIs

As shown in our aforementioned review, most MFIs had undergone some form of registration, either at the Ministry of Trade, Industry and Cooperatives, at the Uganda Registration Services Bureau, or at any of the district or sub-county administrative levels. The eastern region had the largest number of registered MFIs, whereas the northern region reported the lowest number of registered MFIs. This is mainly due to the distance away from urban centres. It is more convenient for the MFIs to operate close to the city regions than to be far in the north. Overall, more than 77 per cent of the MFIs covered in the study were registered, which implies that they had at least some degree of organisation.

6.5.5.1.3 Human resources and management

Interviews indicated that all the management teams of major MFIs, both in urban and rural areas, are composed of persons holding university and other tertiary degrees. Nonetheless, many of the member-based MFIs lacked business management skills. The experience of management teams tends to decrease in proportion to their loan portfolio, and most MFIs engage more females than males in their routine activities. Several crucial implications of the increasing professional status of institutions involved in microfinance are, therefore, becoming clear. These institutions are not only providing financial services to those without access to the formal financial sector, but are also providing employment to those with the relevant skills and interests.

6.5.5.1.4 Capital and funding sources

Interviews with MFI staff and owners revealed that the following sources of financing were available:

- Retained earnings

The percentage of net earnings not paid out as dividends, but retained by the company to be reinvested in its core business or to pay debt. It is recorded under shareholders' equity on the balance sheet.

- Donor funds

A private fund administered by a third party and created for the purpose of managing charitable donations on behalf of an organisation, family, or individual.

- Compulsory savings

A compulsory saving scheme where the borrower has to save some money on weekly or monthly basis.

- Voluntary savings

A voluntary saving scheme where the borrower has the choice to save some money on weekly or monthly basis.

- Secured physical assets

The secured physical assets are the assets such as a house or land title. It is an asset that cannot be touched and guaranteed to until the loan is repaid back.

- Local donations and contributions

This category relates to the donations from the local community.

- Loans from commercial sources

The loans from commercial sources are acquired mainly from SACCOs.

- Paid-in equity

Paid in capital represents the funds raised by the business from equity, and not from ongoing operations.

The government is another source of capital, particularly loan capital in the form of revolving funds and rural farmers support schemes. Financial support from the government and donors is obtained at concessional terms. The underlying risk of these donor funds is that they may dry up in the future and the MFIs could find it difficult to mobilise funds from other sources.

If we compare these findings with Shariah-finance principles, a number of them would be acceptable forms of financing, as shown in Table 6.4 below.

Table 6.4: Current MFI offerings and Shariah finance

MFI financing method	Shariah principles
Retained earnings	Risk-sharing: <i>Mudarabah</i> (or capital trust) is a profit or loss (equity-based) Shariah instrument. It is “a mode of financing through which the bank (the owner of the capital or <i>rabb-al-mal</i>) provides capital finance for a specific venture indicated by the customer (the entrepreneur or <i>mudarib</i>). (cf. Section 3.3. <i>Musharakah</i> arrangements also apply here.
Secured physical assets Paid in equity	Materiality identified by <i>musharaka</i> agreements (equity participation (<i>musharaka</i>), similar to a joint venture) (cf Section 3.3) In the <i>musharakah</i> model of fund-raising, investors can buy shares and participate in the ownership of the whole microfinance programmes initiated by Islamic banks or choose specific financing projects. Any profits realised from the project are distributed annually to shareholders, while losses incurred are shared in proportion to the amount of capital contributed by each participant.
Donor funds Local donations and contributions	Morality: profit-free loans or <i>Al Qard Al Hasan</i> (cf Section 3.3)

6.5.5.1.5 Offer of products and services

Most MFIs provide two main categories of financial products: credits and savings. These services can be further categorised by size, loan terms, and type of deposit. From the literature review, it was estimated that the active loan portfolio of MFIs stood at UGX97 billion (US\$53.3 million), with an average loan size of UGX283 (US\$161). Of this portfolio, 91 per cent is distributed among the 17 districts classified as high borrowers and the remaining 9 per cent among the medium and low borrowing districts. It should be noted that several districts are net borrowers, as their savings cannot entirely meet their demand for loans.

Liquidity risk is high in deposit-taking MFIs, insofar as they lack appropriate liquidity management techniques (Ledgerwood & Earne, 2013). Typically, loan terms can vary from one to twelve months. While there is wide disparity in the loan sizes and terms provided by the different MFIs, many loans tend to be of three months' duration. The majority of MFIs report a relatively high recovery rate of about 85 per cent on their loan portfolios. This could be attributed to the importance attached to the recovery of the money lent out as a means of guaranteeing the sustainability of the institution. Many MFIs employ two main methods of delivering their products to their clients: group and individual lending. Usually, the potential borrower is required at the outset to become a member of a group. The borrower must also deposit a percentage of the expected loan directly in the MFI, or at least in a linked bank or in another formal banking institution.

With regard to the volume of savings, our literature review found the existence of 909,272 active savers in MFIs countrywide, with an estimated total savings volume of UGX107 billion (US\$61 million). These indicators have nearly doubled in a period of five years. Around 65 per cent of active savers are women. One of the traditional saving mechanisms among communities in Uganda is the rotating savings and credit system (ROSCA) whereby members contribute a fixed amount into a pool and the total amount is lent out to every member on a rotating basis. Under this mechanism, money is saved on a daily, weekly, or monthly basis, and borrowing takes place at the end of the month or year. Another form of savings mobilisation is the accumulated savings and credit system where the collected sums are lent or invested with interest throughout the cycle. Moreover, several MFIs use a village banking method where people within communities form groups to mobilise their own savings and extend credit to one another among themselves.

6.5.5.1.6 Product and service innovation

Lately, many MFIs have begun to diversify their offerings of products and services to fit the increasing needs of their customers. Recent innovations include:

- Price protection for coffee farmers: A pilot price protection programme, set up by Uganda Cooperative Alliance (UCA) and Union Expert Services (UNEX), allows farmers to purchase a price insurance policy which will guarantee them a certain price for their coffee products. The farmers' production is then insured at a minimum fixed price through an international broker trading at the London market.
- Health-care schemes: MicroCare Limited has initiated a health-financing programme aimed at the clients of MFIs and their direct families, which allows them to access better health-care at reasonable prices through agreements between hospitals and MFIs. Clients need to make groups and pay a minimal quarterly premium to MicroCare in order to participate in the programme.
- Salary-based loan products: Here, employers are required to subtract loan repayments from the borrowers' monthly salary cheques and transfer them to the participating MFIs. The salary Based loan is a small, short-term, loan secured against your salary. For example, the maximum loan depends on the net pay. The more you earn, the higher the loan amount.
- Individual loan products: While most MFIs employ the group lending methodology as their basic approach, particularly for small loans repayable over 4 to 6 months, a number of MFIs have introduced individual loan products targeted at clients who need larger loans for growing their businesses.
- Farmer-tailored loan products: Many MFIs are testing products specifically suited to agricultural borrowers, in particular smallholder farmers, where repayment schedules are designed to complement seasonal cash-flows.

6.5.5.1.7 Prospects

A number of respondents feel that MFIs have given more importance to quantity in terms of client numbers than to quality, and that blueprint replication, without taking notice of the local conditions and environment is now the norm. Many MFIs provide financial services following the Grameen approach, which was developed in a distant land and culture, with little consideration for the clients' needs or for the Ugandan context. One respondent stated:

"MFI's are driven by profit: that's why they are willing to lend in large quantities to benefit from the interest".

Conservative products and systems that do not respond to the needs of clients are the major reason for the high drop-out rates in the industry. This is a considerable problem for all large MFIs, as the cost of acquiring a new client exceeds by 17 times the cost of retaining an old client, according to the calculations of one provider according to one microfinance support centre official.

Reasonably well-off clients tend to leave institutions to seek larger loans, usually on an individual basis. One respondent stated, *"I have acquired a 3 loans from the same MFIs that reached up to 1 million Uganda shillings (UGS) and they cannot give me more money; that's why I am going to a larger MFI to acquire a larger loan for my business to expand"*. Another said, *"I am looking for a bank that would support my farm to produce cassava on a larger scale as I'm going into whole sale now instead of retail, so by changing my strategies I have to acquire a larger loan to gain profits"*.

In contrast, relatively vulnerable clients leave or are forced out as the size of their loan and the weekly repayment increases. The most vulnerable clients, having less diversified sources of income, drop out from MFIs when they find difficulties to repay their loan, for example in cases of illness or death. So far, most microfinance providers have not adjusted their products according to the different characteristics of their clients (Wright, 2000). Nevertheless, as many observers of the Ugandan microfinance industry have remarked, the methods employed by Ugandan MFIs have attracted significant numbers of clients.

6.6 MAIN ISSUES WITH MICROFINANCE

This section addresses the objective: to investigate the main problems with microfinance.

Although there are numerous successful stories that show how microfinance institutions can help the poor, the truth is that MFIs have to face many problems. These problems can often be solved or managed, but sometimes they cannot be easily avoided. Critics of microfinance have pointed out several of these problems.

6.6.1 Government Commitment

Without government support, the microfinance industry cannot thrive in any country. Banking regulations are needed to ensure the macroeconomic stability of the country. The

government of Uganda has been particularly committed to promoting the development of the private sector. While its initial approach to microfinance was less beneficial (supporting bad practices and politicised credit programmes), the government is now acknowledging that its role in microfinance should be mainly limited to the provision of an appropriate legal environment. This should stop the unethical practices such as the loan sharks in the villages abusing the poor. The government is trying to push the lenders to add value on the product which is called value addition and that will all boost their income and the economy by in large

6.6.2 Impact on Women

The empowerment of women has been a major focus of all microfinance schemes. Providing women with access to financial services can empower them financially, socially, and in other ways (Mayoux, 2008). Nonetheless, the women in our research sample were not prototypical clients of MFIs who are often assumed to be entrepreneurs asking for an amount of loan capital to start or expand a productive business (Allman-Gulino, 2010). A few of them were micro-entrepreneurs hiring other people, but many were self-employed and worked on their own or in family businesses. Others were wage workers of different kinds. Yet, all of them needed access to credit, savings, and insurance, and most of them used these services responsibly.

The analysis of our data shows that almost 60 per cent of MFI clients were women and most of them had only reached primary education. Most of the women had started their business by taking a loan from an MFI instead of using other sources. Thanks to this financing, they were able to increase their income and provide financial help to their families, as well as having a positive impact on other aspects of daily life around them. Thus, more than just bringing about a positive change in their financial and social situation, these women began to take an active role in the decision-making process of their families and of society in general. In this sense, our analysis of the data reveals that microfinance schemes are associated with an increase in social and economic empowerment.

We have looked at the specific ways through which microfinance programmes empower their clients. The elements identified in this assessment are: control of the use of loan funds and monies derived from income-generating activities; client perspectives on the positive consequences for the household's economy; ownership of consumer durables; financial

discipline; leadership and acquisition of information; improved health and nutrition practices; and rates of enrolment of female children in school.

6.6.3 Impact of SACCOs

A serious competitor in microfinance provision in general and Shariah-compliant microfinance in particular, is the SACCO movement in Uganda, which has been the inspiration for many new projects. However, little information on Shariah-compliant microfinance is available in the field in that it is a new concept to them. At least 99% of clients have no idea of what Shariah is in the first place. If these SACCOs are successful, the competitive environment, particularly in the salary loans category, is likely to change even further. Since SACCOs offer loans at lower interest rates and with more flexible repayment schedules, they could become the financial services providers of choice for many Ugandan households. Although SACCOs tend to be plagued with governance and management problems, they have the potential to become significant players in at least some markets. Their capacity to disrupt markets is also quite high, particularly in the short run, as they could become major outlets for the funding of the Microfinance Support Centre's rural outreach plan. Nevertheless, SACCOS are growing in a large scale with huge number of clients, supported by the government finding the need to regulate the SACCOs which are becoming more widespread in the rural areas.

6.6.3.1 Products

To remain competitive, MFIs will need to continue to scrutinise their products to make sure that they match their clients' ever changing needs and expectations. For instance, NGO-MFIs, particularly those offering group-based lending products, will also need to refine the loan terms, the frequency of payment, and the grace periods they offer, in order to respond to the changing marketplace and competition.

Product branding and marketing of savings products will be particularly important for MFIs looking to become microfinance deposit-taking institutions. Branding and marketing is important, not only to achieve differentiation in a market dominated by commercial banks, but also because clients want to be sure that their voluntary savings deposits are not at risk and will scrutinise providers before opening a savings account. Thus, MFIs that aspire to become MDIs will have to work very hard to differentiate in a clear manner voluntary from compulsory savings, or even to drop the compulsory savings requirements entirely.

6.6.3.2 Price

Conventional wisdom in the microfinance industry suggests that clients are not price-sensitive and are more interested in prompt, reliable service. This is less so in East Africa where the effective interest rates charged by MFIs are very high in comparison with the rest of the world (Section 6.4.2). This is one of the reasons why salary-based lending, which has lower costs, is growing so much in microfinance portfolios. MFIs should consider incentives like prompt-repayment rebates for clients returning their loans on or ahead of schedule, or like a reduction in the pricing of larger loans to retain good clients. Faulu and Centenary Bank are already leading the way in this strategy and they appear to be reaping good results.

As the competition for savings clients increases, it is reasonable to assume that there will be some degree of pressure to pay more on larger savings balances and to reduce ledger/transaction fees. The experience in Uganda suggests two guiding principles for this reduction in fees:

- Clients dislike ledger fees but are willing to pay transaction fees in return for rapid, high quality service. They would pay higher fees if they are guaranteed that the money will be disbursed in few days, because in many cases they need the cash urgently, for example there is an immediate demand for a product that they are willing to provide, but the lack of cash is delaying their actions which might be a great loss to them. That is why they are prepared to pay higher fees and get the deal.
- The costs of high-transaction banking can be radically reduced by adopting appropriate technologies. For example, with mobile money transfer banking, cash can be transferred easily without the need of branches which cuts down on overheads.

Banks are already moving in this direction by installing ATMs. However, the potential of mobile phones (and their embedded smart SIM cards) to cut costs remains untapped. Several companies are already beginning to look at this option in South Africa. If successful, the technology will probably be available in East Africa in the next 3-5 years and help to substantially increase the institutions' outreach.

6.6.3.3 Promotion

Growing competition, especially in the salary lending market segment, forces MFIs to use more direct marketing than ever before. This means that staff must be trained in direct marketing strategies. Since the target audience is different, MFIs will need to develop

appropriate selling strategies. Such strategies require a good understanding of the challenges faced by most employers when employees request an advance against their salary. For most companies, employee loans represent a liquidity drain and an administrative problem. This is a recurring issue that MFIs and banks can address by working together with the finance department of targeted employers.

6.6.3.4 Place

In view of the growing competition in urban areas, MFIs should begin to examine options for expanding into the rural market in spite of the many challenges involved. A key difficulty at the moment is how to deliver more efficient and cost-effective services to rural areas. This affects both MFIs and banks that are exploring opportunities for expanding into the most remote rural areas through mobile banking services. Uganda's Rural Outreach Plan was set up by the Ugandan Ministry of Finance Planning and Economic Development in 2002 to address the problems in the rural financial sector where MFI services were largely underdeveloped, fragmented and not adequately integrated within the formal financial sector (UBOS, 2010). This may also create opportunities for MFIs that are able to provide wholesale lending and support services to their rural, community-based counterparts. The usual record-keeping problems faced by such community-based MFIs could be overcome through partnerships where the more established MFI employs its information systems to improve its partner's back-office operations. For example, in Uganda, a group of specialists from the IT industry, microfinance and rural development drawn from the private sector, government and NGOs recently came together to develop technology tools to assist microfinance institutions (MFIs) improve outreach to isolated rural clients more cost effectively (Greener, n. d.). However, information systems will not help in overcoming problems derived from poor governance and management. At the same time, by giving back-office support to the community-based MFI, the wholesaling MFI can gain quality information on the governance/management problems of its partner and use this information to refine its own lending and portfolio management decisions.

For MFIs and banks offering savings services, opening hours are an important component of place. As competition increases, there is also a mounting pressure to extend opening hours, or at least to implement systems such as ATMs to replace traditional customer services

6.6.3.5 Positioning

At the moment, most MFIs are perceived in Ugandan society as opportunistic and uncaring. There is a strong perception that most institutions are only interested in enslaving their clients to debt in order to make more profits (discussed above under Section 6.6.5.7). Successful MFIs would have to position themselves in order to be seen as business partners with an interest in their customers' needs and a readiness to respond to them. MFIs need to work hard to shed the image of being vultures preying on their clients' financial illiteracy.

A possible strategy might be to offer brief periods of training by loan officers or specialist teams on how to manage personal finances, and most especially credit instruments. These are likely to be more valuable than traditional business planning and accounting courses. Citibank has already funded the Washington-based NGO Microfinance Opportunities to work in this direction. Ugandan MFIs should seek to join or at least learn from this initiative.

Moreover, as discussed above, those MFIs that aspire to become MDIs need to reposition themselves in order to project an image of institutional stability that is convincing for clients seeking to entrust their savings to a microfinance institution.

6.6.3.6 Physical appearance

As part of their efforts to improve corporate image and positioning, there are already several MFIs willing to transform themselves into microfinance deposit-taking institutions. For example, Equity Bank used to be a MFI and with time and success it transformed to a commercial bank, which is a model that the Ugandans are proud of and wanting to imitate. In order to do this, however, they will need to work extensively on the physical appearance of their branches. Mobilising deposits from clients requires them to trust the institution. It is therefore important for branches to inspire such a sense of trust. It is not always easy to strike a balance between an opulent and a trustworthy branch image, but it is crucial for MFIs to convince their clients that they are dealing with a stable, professional institution that will be there for them in the long-term.

6.6.3.7 People

Customer care and speed of service are becoming the key considerations on which clients base their selection of MFI. As a matter of priority, MFIs should make investments in improving their customer care. This can be achieved by examining and re-engineering internal processes, in order to improve the speed and quality of customer service, but also by

implementing customer-focused incentive schemes and by improving staff training. For example, the Uganda Micro Finance Union provided us with all the information in hand to enhance the micro finance sector which shows that they support research and development. Some of their research showed that MFIs should consider providing their branches with customer service desks, which can offer advisory services and leave tellers to complete transactions as quickly as possible. Such a service is particularly important in a market where a significant proportion of users are financially illiterate. The help desks at Uganda Microfinance Union and Standard Chartered Bank provide good examples of the positive effects that this kind of service can bring, even in the context of a predominantly literate clientele.

6.6.3.8 Process

MFIs should make an effort to review systems and processes in the banking hall and back-office in order to increase their speed of service. In our interviews, this was one of the biggest complaints from clients. One respondent commented as follows: *“It takes ages in some MFI. They keep on asking about collateral and guarantees that had now exceeded 2 weeks”*.

It has often been documented throughout the world that moneylenders attract clients, in spite of their high interest rates, simply because they offer a fast service. In Uganda, Centenary Bank has already shown how such a change can be implemented through its Automatic Loan product, which offers fast loan processing to clients with a good track record. One respondent provided the following information: *“The automatic loan product is when you have fulfilled the first loan with no defaults or delays then you can be eligible for the automatic loan product”*. Another said, *“The banks take over a month to process my application and even then they ask for more documents, it’s a way to push us away”*.

Periodic mapping of internal processes with a view to improving efficiency will be a strong differentiating factor for MFIs. Moreover, any improvement in their speed of service should also increase client retention rates.

The competitive environment in Uganda has substantially increased the range of choices available for lower-income clients looking for a financial services provider, particularly for those living in towns and cities. The Ugandan marketplace has changed significantly in the last two years. A respondent commented: *“It has changed in a way that there become specific loans for specific needs, to the point where there is an agriculture bank, and other specialized products”*.

With banks entering MFIs' market segments, and some MFIs looking to offer savings products, the range of alternatives will continue to expand. As a result, the lower income segment of clients is already demanding and getting better quality services at more affordable prices. One respondent stated that she used MFI services because the prices are more affordable: *"The affordable prices because the option of banks became so hectic, they ask for greater collaterals and guarantees that cost the poor much, therefore, the MFI can be as a better solution"*.

The survival of banks and MFIs in this marketplace will depend on their capacity to identify market segments where they have a comparative advantage or to develop new services and products that can help them to establish such an advantage.

The days of product-driven MFIs are numbered as more and more banks and MFIs are responding to the demands of their clients and moving towards a market-driven approach. The winners in the Ugandan competitive marketplace will be those financial services providers with a strategic marketing focus, as well as the clients they serve. One woman said, *"Focusing on single mothers is a great strategy as they need the loans to look after their kids."*

6.6.4 High interest rates

The rates exacted by MFIs can be extraordinarily high. This is often justified by the high rates of inflation prevalent in many developing nations. Some observers also point to the law of diminishing returns, arguing that people receiving small amounts of money from microfinance often improve their revenue so dramatically that they are still capable of comfortably covering the loan. Nevertheless, such high rates of interest are sometimes seen as undermining the claim that microfinance is truly a social business. In 2012, the finance ministry of Uganda and AMFIU had organised a three-day conference to find solutions to high interest rates and low access levels to financial services. As the interest rates charged by MFIs ranging from 24 per cent to 80 per cent are high, the government is trying to maintain the interest rates at a reasonable level in order to provide financial services for the remaining 40 per cent of the Uganda's population who do not have access to financial services.

Respondent 4

Access to financial services provided by microfinance institutions, including commercial banks, stands at 60 per cent. About 40 per cent of Ugandans are not served by any financial institution.

6.6.5 Dependence on Subsidies

In order to be viable, many microfinance organisations require significant levels of subsidies. This is particularly true in their early stages, but many continue to rely throughout their life on financing from the state or from major shareholders, some of which are conventional investment or retail banks. One study into the role of subsidies in microfinance found that MFIs were receiving US\$1 billion per year, even though less than 5 per cent of them were “operationally sustainable.” An example is the Uganda Cooperative Saving Credit Union (UCSCO) which is a private company that relies on government financial support. In fact this is the case with many MFI’s, since the microfinance industry is in its infancy.

6.6.6 High default rates

Failure to correctly implement policies, as well as the recurrent incidence of income-destroying events that local governments are incapable of stopping (e.g. flooding), can have a critical effect on default rates. In many cases, it is also difficult to balance the social impact of defaults with the need to preserve the institutions’ sustainability.

Respondent 5

I defaulted because of unprecedented incident the death of a family member and I had to spend the loan on funeral which if I don’t then my reputation will be on stake, and probably abandon from the community.

This is a problem highlighted earlier when loan diversion was discussed.

Respondent 6

I am married and my husband has neglected his daughter, so therefore I started growing mushrooms in my house and unfortunately it was unsuccessful. This led me to lose all my savings. Consequently I was unable to repay back the loan.

6.6.7 Overzealous Group Enforcement

This is perhaps a minor aspect of microcredit. But sometimes the social stigma derived from a failure to repay the loan, which is often due to unfortunate but understandable situations, becomes unfairly high. In some cases, these financial failures have even sparked incidents of social oppression within communities. Respondents spoke of aggressive collection efforts against borrowers who were late on loan payments. In Uganda, defaulters can be incarcerated

for six months, which is extendable if they have multiple debts. Each creditor can seek a debtor's incarceration. This caused considerable social harm to borrowers.

6.6.8 Ethical Issues

Microfinance institutions are often viewed as profit-making organisations. The desire to transform MFIs into an industry, to commercialise micro lending, or to promote the profit-making incentive, should not distract these institutions from the reasons that justified their creation in the first place: their mission as a social service to enable vulnerable people to work on profit-making or small business projects. The absence of this motive can often lead MFIs to behave like the local moneylenders. Moreover, the effects of corruption should not be neglected. Finally, there is also the problem of lack of motivation amongst employees, which can be another source of failure. MFIs thrive on good economic conditions and a downturn can push them to suffer heavy losses, both financially and in terms of manpower.

Respondent 7

The major issue with the employees in the microfinance industry is that they have good intentions in helping the vulnerable and at the same time they face an obstacle in charging the borrowers high rates. The conflict between doing good and charging the borrowers is the major ethical issue.

6.6.9 Managerial Issues

Some of the main problems that MFIs have yet to solve are related to management. These problems tend to be quite straightforward and could easily be tackled. They include aspects like poor record-keeping, poor staff training, and poor management capacity.

Respondent 8

We need training in the many products we are offering to the borrowers. It is not professional when the employees conduct financial transactions with thousands of borrowers without being highly trained because that would have a negative impact on the MFI's itself and the borrowers.

6.7 FURTHER DISCUSSION OF FINDINGS

Our analysis shows that income and savings are positively related. As income increases, the client's ability to save also increases, and if savings increase, there will be a positive impact on the family's financial situation. Moreover, an increase in income and savings is associated

with economic empowerment, insofar as income, savings and employment opportunities are all interrelated.

Beyond this linear relationship between economic components, our thesis has also shown that MFIs have a positive effect on the successful management of their clients' businesses by offering them operational assistance. This is also one of the reasons why microfinance schemes have become so popular. Microfinance constitutes an effective mechanism both for lenders and borrowers. The latter can obtain useful guidelines from the MFI's workers to develop or to run their small businesses, a service that can hardly be expected from a conventional bank.

Our study has also found that MFIs have a positive effect on the creation of employment opportunities. Moreover, our observations have revealed that most family members of borrowers were contributing to the running of the household business, whether directly or indirectly, and this was regardless of which member of the family had received the loan.

To sum up, we note that microfinance activities have a significant impact on the improvement of living standards amongst poor households, not only in economic but also in social terms. This relationship between social and domestic factors has only become evident and clear with the appearance of MFIs, but was largely neglected while conventional banking was the only option available. Based on our study, we have come to the conclusion that microfinance activities have a significant and positive impact on society by improving living standards, empowering people, and alleviating poverty.

As the above findings show, both MFIs as well as borrowers have to address some moral and cultural issues. Among the MFIs interviewed, professionalization and training appeared to be major concerns: 'we need training in the many products we are offering to borrowers,' as stated by one respondent. There is also a moral conflict faced by MFI employees. This is a key finding because the conduct of MFIs is clearly having an impact upon how employees perceive both their organisational identity as well as their personal ethical values within the organisations.

Among borrowers in Uganda, several outstanding issues have been highlighted by my findings.

Respondent 9

We are paying excessive amounts of money for application fees, administration fees, and the list goes on. We are forever paying ridiculous amounts.

As we will see, the findings of this study show that most of the self-employed, not just the micro-entrepreneurs, tend to invest business loans productively. Our findings also show that loans taken by individuals who do not run enterprises or take up loans for purposes other than running an enterprise may end up being used to run enterprises by other members of the household. Finally, our findings show that credit is fungible within the household, given that it is used for life cycle events, emergencies, housing, education, and business investments, as needed. By accepting this fact, MFIs can expand their potential client pool or market. They can now deal, not just with micro-entrepreneurs who want to expand their businesses, but also with other individuals or households that want to improve their housing, smooth consumption, or reduce risk.

6.8 CHAPTER SUMMARY

Chapter 6 provided a brief overview of the demographics of the participants. The chapter also showed that there are four forms of microfinance in Uganda, namely group lending, individual lending, credit unions and Savings and Credit Cooperatives (SACCOs). Most MFIs were Tier III or Tier IV institutions. A profile of these institutions in terms of their legal status, registration, human resources and management, capital structuring, products and services was provided. The problems with microfinance were highlighted. It was found that none of the MFIs in the sample were Shariah-compliant because they all charge interest, but there is potential for a system of Shariah-finance to be introduced by restructuring the product packages.

CHAPTER 7: CONCLUSIONS AND RECOMMENDATIONS

7.1 INTRODUCTION

In Chapter 1 of the thesis, five objectives were stated as follows:

- To understand the provision of microfinance in Uganda; this was dealt with in Chapters 1, 3 and Ch 5;
- To understand the principles of Shariah-compliant microfinance; this was dealt with in Chapter 4;
- To investigate the main problems with microfinance; this was dealt with in Chapters 1 – 5
- To compare conventional finance with Shariah-compliant microfinance; this was dealt with in Chapters 1 and 2; and
- To determine the extent of Shariah-compliant microfinance provision in Uganda. This was dealt with in Chapter 6.

This chapter reviews whether these objectives have been achieved in conducting the study.

Microfinance does not address or solve all the problems of the poor, but it serves as a means of helping them to enhance their economic activity and improve their social standing. As described in earlier chapters of this thesis, it helps to develop new markets, increase income, create and accumulate assets, and promote a culture of entrepreneurship.

According to Chirkos (2014), microfinance schemes can be very effective at the initial stages of the targeted problems, but are less effective when these problems are entrenched or long-standing. In fact, microfinance is only a partial solution to foster enterprise activity in rural areas where poor people are generally unable to get the necessary assistance from commercial banks.

The success of MFIs can be explained by the type of products and services they offer, as well as by their convenience of access. Although they tend to charge high interest rates, even if sometimes these are subsidised by governments or NGOs, their products and services are still in great demand. The main reason for this is that commercial banks generally do not offer small loans to poor clients located in rural areas.

In spite of their success, however, it should be noted that microfinance institutions are far from being completely or uniformly efficient. There are many areas where their services, missions and operations can be improved. The aim of this chapter is to examine, based on the

lessons learned from our field research in Uganda, the main limitations and possibilities of both microfinance offerings in Kampala, and to present some recommendations to improve microfinance services and products. Key implications for the practice of microfinance in specific contexts will be discussed based on this consideration and recommendations made. Finally, we will discuss the challenges lying ahead and avenues for further research

7.2 SHARIAH-COMPLIANT MICROFINANCE

This section addresses the objective: to determine the extent of Shariah-compliant microfinance provision in Uganda.

7.2.1 Compatibility

The models described in Chapter 4 provide significant evidence that Shariah-compliant financial principles can be compatible with microfinance, at least from a technical standpoint. Standard Shariah-compliant microfinance arrangements can be operationalized through a *murabaha* agreement, or possibly even a *mudaraba* agreement. Equally, the leasing or purchase of property or other goods can be accomplished via an *ijara* agreement. Elsewhere in microfinance, we have seen that bank accounts can still be provided under an *amanah* or *wadia* contract, while the community-based solution found in a *takaful* contract is ideal for providing microinsurance.

Nevertheless, we should ask ourselves to what extent the models contained within Shariah-compliant microfinance are compatible with the philosophy of microfinance, and vice-versa. We have already discussed the fundamental importance of *zaqat* in Islam. As the Quran (Surat Al Baqara, verse 215) says:

They ask you what they should spend [in charity], say “whatever you spend on good [let it be first] on your parents, and [then] your close relatives, the orphans, the poor, and the children of the path.” And whatever good you do, God surely knows.

The idea of responsibility to the community is deeply ingrained in Islam, and thus throughout many Muslim communities. *Zaqat* may provide an opportunity in terms of aiding very poor communities to develop to the point where they can be helped by microfinance. It may equally provide a means to finance the start-up process for very small MFIs or community groups. Another angle to this concept is the disapproval of hoarding expressed in Islam. Once again, in the Quran (3:180) we find:

Let those who hoard the wealth that God has given them never think that they will benefit from it. It will bring them nothing but evil. The riches that they have hoarded will be their chains on Judgement Day.

As a result, there is a clear need within the Islamic community for both charitable contributions and investments that include a social aspect that are able to fulfil obligations to the community as a whole. Therefore, by looking beyond the technical aspects of Islamic Finance, it may be possible to envisage a social model whereby Shariah-compliant microfinance institutions are initially financed and later underwritten by the richest members of the community. However, this would only be feasible in those developing nations, like many of the Gulf States, where there is a wealthy elite.

We also mentioned in Section 3.4.2.2 the possibility of including mosques or other community institutions within Shariah-compliant microfinance. By using mosques as a meeting place for both the disbursement of funds and the payment of instalments, the impact of social collateral could be significantly increased. Furthermore, virtually every community in the Muslim world has a mosque, which acts both as a community centre and a store of local knowledge. Consequently, the risk of default and the cost of monitoring in microfinance contracts could be reduced, possibly to the extent that a *mudaraba*, or profit-sharing agreement, could be extended to many consumers.

7.2.2 Limitations

The most significant limitation for developing Shariah-compliant microfinance institutions is the issue of gender. As we have seen, the role of women is regarded as critical in the Grameen paradigm of microfinance. In fact, the Grameen Bank claims to have “8.1 million borrowers, 97 per cent of whom are women,” while various estimates place the proportion of women among all microfinance borrowers between 70 per cent and 85 per cent.

The women-centred approach is supported by considerable qualitative evidence. Even while taking into account the bias towards women that exists among the client base of microfinance organisations (Section 2.9.3.1), MFIs with higher proportions of female borrowers tend to have a lower portfolio-at-risk. These findings provide compelling evidence that the focus on women enhances microfinance repayment rates, and that women in general are a better credit risk than men.

However, the causes for this are yet to be clearly elucidated. The most commonly proposed arguments are:

- Social pressure: as women tend to be more susceptible to the estimation of others, they are more easily swayed by social collateral (Section 2.9.4).
- Conservative risk profiles: as several studies have indicated, women seem to be less likely to pick risky investments than men (Section 2.9.4).
- Empowerment: in societies that often deny women any significant authority, the economic power received from MFIs motivates them to work harder and use the funds in a more conscientious manner (Section 1.2.5; 2.6.1).
- Family units: as women are more concerned by the welfare of dependants, and more likely to be working from home while they look after children and elderly relatives, they will tend to work harder and be less mobile, making them easier for MFIs to monitor (Section 1.3.1, 2.9.1; 2.9.3).

Of course, all the above arguments, when taken one by one, can be countered. But in combination they give a convincing reasoning as to why conventional MFIs tend to focus on women. This focus is seen in many circles as one of the main social benefits of microfinance. By targeting women, MFIs are not only improving their status in unequal societies, they are also responding to the higher proportion of women among the very poor which are cited as being between 27 per cent in rural areas to 40 per cent in urban areas of Uganda (Basudde, 2013).

One of the more notable aspects of many Muslim societies, however, is the circumscribed role of women. In Saudi Arabia, for example, women are deprived of the right to vote, drive or even be in the company of unrelated men without a guardian. Amnesty International (2009) noted that this concept of male guardianship over women (*mehrem*) severely limited women's rights, notably in relation to marriage, divorce, child custody, inheritance, property ownership, and choices about residency, education and employment.

Similarly, another report on Qatar published in 2009 stated that women continued to face discrimination in law and in practice, and were inadequately protected against violence within the family. It has been claimed that family law discriminates against women, making it much easier for men than for women to divorce, thus leaving abandoned or divorced women at a severe economic disadvantage.

These kinds of limitations can be seen elsewhere in the Muslim world. In 2009, two Human Rights Watch reports (2009a; 2009b) on the status of women in Afghanistan concluded that: “Eight years after the fall of the Taliban, and the establishment of the Karzai government, Afghan women continue to be among the worst off in the world. Their situation is dismal in every area, including in health, education, employment, freedom from violence, equality before the law, and political participation”. In Uganda, although the Ugandan Constitution provides that the minimum legal age for marriage for both men and women is fixed at 18 years, according to customary laws, marriages are frequently arranged for minors, especially in rural areas. Furthermore, polygamy is authorised under customary and Islamic laws and women in polygamous relationships have no protection in the event of dissolution of the union. In some ethnic groups, custom also provides for men to “inherit” the widows of their deceased brothers (*levirat*). Further practices that infringe upon women’s rights in Uganda include early and forced marriage, abduction of girls, “widow inheritance” and “wife sharing” (Benedetti & Kijo-Bisimba, 2012),

There is, of course, little in the Quran or the Sunna that can justify such a limited legal and political status for women. However, it remains true that in many of the countries where consumers are likely to be most interested in Shariah-compliant microfinance, women have so little independence that a focus on them as clients or borrowers might easily be called into question.

Underlying this fundamental issue, there appears to be a choice between microfinance as a tool for social improvement and as a tool for enhanced economic performance. Should Ugandan MFIs insist on working exclusively in environments where women are able to sign contracts, own property, and run their own businesses, with the aim of improving their situation? Or should they simply aim to improve the economy of the region where they are operating, regardless of the social or legal condition of women?

7.2.3 Possibilities

Beyond the limitations mentioned above, the question remains as to whether Shariah-compliant microfinance is able to provide solutions to some of the problems plaguing microfinance as a whole.

When discussing the limitations of microfinance, we first mentioned the issue of high interest rates. Of course, such interest rates are not (or should not be) simply imposed upon borrowers, especially in the context of microfinance, to make excessive profits. Instead, they

should fairly reflect the high costs involved in setting up and operating microfinance operations in developing, or even developed nations. In Shariah-compliant microfinance, the fact that interest rates are not clearly stated as such, but are instead reflected in the mark-up of a *murabaha*, or in the required rate of return of a *mudaraba* agreement, will not eliminate them as a cost for the consumer. However, even though a model like the *mudaraba* would require further monitoring, it may at least provide greater social benefits by involving the financial institution in the gains and losses of the consumer. The problem is that Islamic finance seems to be a completely unknown concept in Kampala. This was evident in the answers to the questions on Shariah-finance that were asked during the interviews. None of the clients interviewed knew anything about it, and the MFI representatives were ignorant in this regard and were unable to provide any information. This could be due to the fact that the approval of Shariah-finance was only granted by the regulatory authorities in Uganda in 2014.

At the same time, the risk premium makes high interest rates an unavoidable necessity for all but the very largest of microcredit institutions. Even if the profit motive were to be removed – itself an unlikely scenario – the operating and transaction costs alone make very high interest rates the more likely option for now for lending institutions. As pointed out earlier, however, the high rates do not, interestingly, deter the poor and very poor from accessing finance.

Another problematic area is the role of subsidies in microfinance. As previously mentioned, subsidies still play a significant role in the industry. While this work does not intend to discuss whether it is morally or economically justifiable to subsidise social businesses, Armendáriz de Aghion and Morduch (2005) point out that many studies support the idea that it is better to “subsidise start-up costs, not on-going operations.” This suggests that subsidies have at least some role to play in microfinance. In this sense, the substantial role that *zaqat* plays in Islam offers an easy route, both in theory and in practice, to support start-up costs at ground level among vulnerable communities.

Finally, we mentioned the difficulties of reaching an optimal equilibrium between the extremes of high default rates and an overzealous enforcement. This is an issue faced by every model of microfinance. One solution may be to involve local institutions, such as mosques or tribal leaders (Section 3.4.2.2), in order to ensure that both consumers and representatives behave in a proper manner.

Ultimately, all of the above problems relating to microfinance are symptomatic of the challenges involved in working with MFI clients, and as such are unlikely to be entirely solved by any single model. However, Shariah-compliant microfinance can perhaps alleviate them in some respects (Section 6.4.2; 6.5.5.4), while providing a solution for those consumers who feel excluded from microfinance due to their beliefs.

7.4 RECOMMENDATIONS

There is no doubt that microfinance can be a powerful instrument to fight poverty. Access to financial services can help poor and low-income clients increase and stabilise their incomes, build assets, and invest in their own future. In this chapter, we present some recommendations to improve these services with the aim of enhancing their role in poverty alleviation.

The following recommendations are tied closely to my findings and analysis as described in previous chapters. Key findings related to how respondents perceived the benefits and limitations of microfinance in terms of interest rates charged, transaction costs, access to services and, importantly, how microfinance was playing a role (or not doing so) in poverty reduction.

7.4.1 Extend access to microfinance services for the rural poor

The issue of access is a very real one for the rural poor in Uganda as for many other Third World or developing countries. MFIs should be incentivized to extend their services (savings and credit) to remote rural areas where the poorest of the poor live. These incentives, which must be time-bound, could include the refund of genuine first-year branch operational losses (with the expectation that the rural branch would then break-even). Such an instrument fits well with the liberalisation policy, which requires that operations be market-driven, thus offsetting the need for them to be continuously or even permanently subsidised by governments or aid agencies.

Future research could consider how further outreach and new avenues of access can be provided to areas where MFIs have yet to establish their operations. Parts of the Middle East, for instance, hold the potential for greater provision in this area and if economic rebuilding efforts are to take root alongside military and political intervention, such schemes should form part of the strategic thinking on these areas of conflict.

7.4.2 Publish the interest rates and commissions of MFIs

In order to enhance transparency and efficiency in the microfinance sector, it is necessary to adopt a policy of mandatory publication of interest rates and related charges, at least for regulated MFIs (Sections 4.3.2; 6.6.3.4). For the unregulated MFIs, this information could be published by third parties (in the case of Uganda, the Central Bank for Tier 3 MFIs and the umbrella organisations to which they belong for Tier 4 MFIs). The policy of publication of interest rates and fees has two important benefits for poverty alleviation. Firstly, it forces MFIs to improve on their levels of efficiency, resulting in lower interest rates for the poor. Secondly, it improves decision-making at the household level and facilitates access to cost-effective sources of credit.

Open and transparent publication of information can help filter the effects and benefits of microfinance to the poorest in society. Future research can elaborate on ways of doing this to encourage public/private partnerships in this area.

7.4.3 Promote micro savings and micro insurance

The promotion of micro savings as part of the strategy of microfinance has already been going on for over 20 years. Where possible, it would also be a good idea to provide micro insurance products as well. Vulnerable people can effectively use these services to build assets and cope with life's emergencies. It has already been explained earlier in the thesis that Shariah-compliant financial principles can be compatible with microfinance, at least from a technical standpoint. A *murabaha* agreement, or possibly even a *mudaraba* agreement can provide the template for such microfinance arrangements. Equally, the leasing or purchase of property or other goods can be accomplished via an *ijara* agreement. Elsewhere in microfinance, as I have suggested, bank accounts can still be provided under an *amanah* or *wadia* contract, while the community-based solution found in a *takaful* contract is ideal for providing micro insurance. Carpenter, Beichl and Steinmann (2013) state that this is still a nascent industry in Uganda, so further research needs to be done as to how this would work.

Shariah-compliant products and services can be taken up by other researchers to provide much greater detail on how Islamic principles can play a more active – and ethical – role in shaping the future development of such products. In particular, women and other marginalised groups should be co-opted actively into such decision-making processes.

7.4.4 Improve Monitoring

The creation of credit bureaus to monitor the industry and effectively head off microfinance “bubbles” that may lead to over-indebtedness (not unlike the recent subprime mortgage crisis in the U.S.) should be a priority. Adequate monitoring of household indebtedness as well as institutional liquidity and systems of checks and balances is extremely challenging to achieve in the Ugandan context with so many MFIs not falling under any of the regulatory systems (Table 6.2).. NGOs could possibly step into this role but they would require relatively free and open access to information that may be very hard to obtain.

Future research should consider how other partners may be brought into the supply chain in order to monitor and recommend checks and balances. If clear guidelines and good incentives can be given to do this, then volunteers from NGOs can perform this function with adequate training and development.

7.4.5 Limit Inappropriate External Funding

Easy money (i.e. large amounts of loans and equity flowing to MFIs in short periods of time), especially when it comes from overseas agencies, can end up spurring unsustainable growth and retarding innovation in critical areas such as micro savings mobilisation (Section 2.5). Levy (2011) states that easy and cheap access to apex funds undercuts MFIs’ incentives to mobilize resources themselves from the market. This is supported by Guntz (2011) who posits that large-scale, sustainable microfinance can be achieved only if financial services for the poor are integrated into overall financial systems, and that donor funds should not simply be seen as a handout creating a dependency by the MFI on donor funding. CGAP (2006) maintains that donor funds should complement private capital, not compete with it. Donors should use appropriate finance instruments on a temporary basis to build the institutional capacity of financial providers, develop support infrastructure, and support experimental services and products. The key to the effectiveness of donors and socially oriented investors is to complement private capital and to accelerate innovative domestic market solutions.

Therefore, it would be a good idea to control and limit these funds as much as possible. Increased credit controls in many countries, coupled with the global threat of terrorism, make the danger of money laundering a real issue for many financial institutions. Microfinance, given its difference(s) from other forms of banking, requires a stable base of liquidity and a clear sense of a social – rather than purely commercial – mission. If there is heavy reliance on ‘easy money,’ the risks of default on the part of MFIs also increase, thus creating a vicious

cycle of risk that ends up being passed on to borrowers (i.e. the poor) in the form of higher instalments, increased interest rates or both.

The high interest rates and transaction costs that users complained about during the interviews and accept because, as one told me, they feel they “have no choice” should be moderated as a result of lower reliance on loans and sponsorships. Corruption, a big problem, can also be controlled this way.

7.4.6 Promote Technology

Information technology, including mobile money (i.e. the ability to make payments over the phone), has the potential to become a game-changer if it is properly leveraged. Currently, in Uganda, this technology is almost non-existent (Section 6.7.2). This new technology could magnify the most positive elements of microfinance while curtailing some of its weaknesses. Cheap handsets are already widely available throughout India, Bangladesh and many parts of African, including fast-growing economies like Ghana, Kenya and Nigeria. Cyber-security becomes an issue, however, and mobile platforms need to be reliable and secure for the technology to take off. Apps have already been developed to allow users to pay bills online, check their balances and make payments: these can be further developed for users in developing countries.

Mobile technologies, complemented by ATMs in rural areas, can be leveraged in innovative ways to develop new behaviours among the borrowers in these areas. For instance, electronic reminders about payment issues as well as e-information through e-government portals can be available through secure platforms, allowing users to access and manage their portfolios wherever there is either GPS or broadband connectivity.

7.4.7 Minimise Reliance on Self-Help Groups

While self-help groups may be considered cost effective as they reduce the cost of manpower, the quality of management and products (i.e., loan portfolio) is generally not up to standard (Section 4.1). Certainly, it would be expected that an improperly supervised portfolio would incur higher costs in the long run. As my thesis explains, the Grameen model, in particular, relies on group payments and is facilitated by community monitoring. For more formal mechanisms, this has been found to be less effective. A model that is more geared towards competencies and effectiveness monitoring would be more appropriate.

7.4.8 Promote the Partnership Model

The partnership model, which has the MFI as the service provider, seems to be the most effective as it relies on MFIs sound operating policies for collection and supervision (see Preface). There is evidence that partnerships between MFIs, government, private investors, and information technology organisations, facilitate the integration of new technologies in the microfinance sector, thereby reducing costs and maximising outreach to clients. In the long run, through this model, defaults and operational costs can be kept to a minimum, with the implicit benefits to users of microfinance services.

The partnership model, as explained in my analysis, works well on a number of fronts. For example, partnerships between different providers and community groups would be appropriate in the areas of mobile banking and the setting up of rural hubs in remote areas. Mobile banking, facilitated by software companies, network service providers and private-public partnerships would be a boon to rural users and help them make payments and monitor their portfolios online. The partnership model is also acceptable in terms of Shariah-finance (Section 3.8.8.2).

7.4.9 Support Initial Costs

MFIs in general have higher working capital and debt costs. However, when they take time to build a reasonably large deposit base, compared to other forms of more costly debt, they can be better positioned to pass onto the borrowers the lower funding costs of those savings. It would be a good idea, therefore, for the MFIs to understand the issue, even if there is very little that can be done to reduce borrowers' commitments in this area at the present time. One idea would be for the Kampala government to guarantee a certain amount of borrowing (Sections 3.4.1.2; 3.5; 6.6.5.5). However, it must be borne in mind that, a successful plan for implementation and creditworthiness of the authorities are issues to be carefully considered.

7.4.10 Support Household Financial Management

Poor working families, like those in our study, face difficult problems of household financial management. They must increase their meagre incomes as much as they can through microenterprise and other forms of informal economic activity in order to deal with the unremitting problems of feeding, clothing, and housing family members. It would be necessary, therefore, to support the development of financial management skills amongst poor households (Sections 1.9; 2.3; 3.3.1; 3.4.1.1; 6.8.1.6). Since a fair percentage of

borrowers are either illiterate or have received only minimal education, intermediaries such as community networks or hubs should provide information in a viable form.

7.4.11 Reduce Membership Fees

The membership fees for new applicants should be reduced so as to incorporate the very poor into the system of microfinance. This would enable them to gain access to the products and services enjoyed by individuals and households that lie just below or just above the poverty line. As noted in my analysis, the MFIs already suffer from the image of being exploitative rather than genuinely sympathetic to the needs of small borrowers (Sections 4.3.4; 6.8.1.2; 6.9). Respondents had expressed the view that they thought the MFIs were ‘greedy’ and that terms were often not as fair as they could be, although many of them also felt that the interest rates were fair. Reducing membership fees would go a long way to addressing the image problem of MFIs and enhance their credibility as good community partners.

7.4.12 Increase Frequency of Repayment

The mode of repayment should also be revised so that the poorest can borrow without collateral. This should be done in a way that increases the frequency of repayments, as this is known to reduce the risk of default.

7.5 CHALLENGES

Everywhere in the developing world, the microfinance industry is expanding rapidly to facilitate development of the private and agricultural sectors. But the growth of the microfinance industry is not without challenges. In this section, we review the main challenges faced by microfinance, which have been identified in the course of our research.

7.5.1 Poverty Reduction

As we have seen, MFIs today are not having as much of an impact on poverty alleviation as would be desirable due to their excessive emphasis on financial sustainability over social objectives and because of their failure to work with the poorest in society (Sections 2.5.2; 2.8.1). Thus, MFIs should design their services more carefully in order to meet the needs of the poor.

While the impact of microfinance on poverty alleviation is a keenly debated issue, it is generally accepted that microfinance is not a panacea and has not lived up to its expectations at least in Uganda (Section 4.3.2.2) as well as other parts of Sub-Saharan Africa. However,

when carefully implemented and managed, and when its services are designed to meet the needs of poor clients, microfinance has had positive impacts, not just on clients, but also on their families and on the wider community. Yet, there is a need for greater assessment of these wider impacts if the true value of microfinance for development is to be understood (Zohir & Matin, 2004). One such tool for measuring the wider impact of microfinance is livelihood security analysis, based on a livelihoods framework that tries to understand how a given project impacts on the livelihoods of its beneficiaries. For instance, I have cited Kabeer's (2003: 109) argument on how broader impacts on the community, market/economy, and national/state levels can and should be measured. These "domains of impact" help researchers understand macro-level effects of microfinance beyond the individual or household level. Importantly, it was also noted previously that microfinance has highly significant impacts upon children and their education (Section 2.3.2).

7.5.2 Payment Systems

Payment systems allow the transfer of money among participating financial institutions (usually banks). Although safe, efficient, reliable and critical for the effective functioning of the financial system, most of the Shariah-compliant MFIs or their conventional counterparts do not have access to such systems (Sections 2.2.3; 6.7.2). In the Islamic Development Bank member countries, only a few Islamic banks have access to systems allowing for electronic funds transfer and real time gross settlement. The smaller MFIs working for the poor are often not in a position to implement such systems on their own. A range of partners, such as mobile network service providers, information software developers and community advisors, would be needed to expand the scalability and effectiveness of smaller MFIs. It would also not be unfeasible for consultants to be brought in from various world agencies to facilitate and broker such networks and relationships.

7.5.3 Transparency and Information Infrastructure

Financial transparency is defined as the widespread availability of relevant, accurate, timely, and comparable information about the performance of financial institutions. Transparency helps to attract funders. Accurate, standardised information allows private investors and public donors to make informed funding decisions. Finally, transparency also informs clients, leading to increased competition among financial service providers, as clients gain knowledge and are able to compare the available options. The benefits of transparency critically depend on the availability of related services and tools, including reliable

information software, high-quality auditors and rating agencies, and credit bureaus that capture clients' credit histories. Unfortunately, these services are still not widely available for Shariah-compliant MFIs. As indicated in Chapter 1, Section 7, Shariah-finance was only approved by the Ugandan government in 2014 and this may well be the reason why Shariah-compliant MFIs are not yet a major feature of the financing landscape in Uganda. MFIs could work with the Ugandan government and relevant agencies to tap into the expertise of commercial providers to set up mobile kiosks for rural borrowers to access. These would be available 24/7 and funding for this could be made available through the World Bank or the Asian Development Bank, for instance. The logistical, physical and financial implications of such schemes should not be underestimated, of course, but a clear roadmap can certainly be implemented if all stakeholders can see the benefits.

7.5.4 Education and Training

The lack of adequate education and training among clients and organisation personnel constitutes a major challenge for the microfinance sector. Poor training of their workforce is a major constraint for the growth, expansion and consolidation of MFIs (Sections 1.9; 2.6.3; 6.7.5; 6.8.1.6). Presently, there are only a handful of resource centres, and even fewer training programmes offered in the native languages of the regions where MFIs operate. Thus, there is an urgent need to develop resource centres and training materials in local languages. We took an important step towards doing this in our own research.

7.5.5 Networking

Another challenge is the lack of effective networking. Networks are important because there are a large number of activities that cannot be undertaken individually and need to be carried out collectively through established networks. Many activities are subject to economies of scale and scope, such as initiating dialogues on legal frameworks, regulations and taxes, creating and updating information databases, conducting training programmes, etc. While Islamic countries lack a coordinating body in the area of Shariah-compliant microfinance, there are a few active regional as well as national networks such as FINCA, PRIDE and the Uganda Financial Trust (Section 6.6.4.1) that could be approached. The Association of Microfinance Institutions in Uganda (AMFIU), for instance, is a national network with branches all over the country. In relation to the size of the Islamic world, however, their number is still quite small and there is little coordination between them, resulting in duplication and the lack of effectiveness.

7.5.6 Governance and Policy

Another challenge for MFIs, especially for those in Tier 4, is the need to build good corporate governance. Additionally, there is the need to provide medium and long-term finance for small and medium enterprises rather than people having to apply for multiple small loans (Section 6.6.5.7). With regard to corporate governance, a code of conduct for Tier 4 MFIs could be put in place by the AMFIU.

7.5.7 Remaining challenges for Ugandan MFIs

As outlined throughout this thesis, Uganda has a well-established and vibrant microfinance industry. Still, there are some specific challenges that remain to be tackled. In particular, Ugandan MFIs need to:

- Reach out to rural areas in a sustainable manner; as described in a previous chapter, mobile banking can be trialled in many more areas than is currently the case. Extended opening hours are also very important to increase the access to their facilities not only in towns but in more remote areas. Apart from physical infrastructure – a notable challenge in rural areas – more partnerships can be forged between MFIs and network service providers.
- Strengthen community-based organisations so that they can become a viable option to reach poorer and more remote clients. One of the key findings was that respondents already knew each other and often acted as informal ‘eyes and ears’ on the ground to help monitor repayments and provide support. These informal networks can be loosely organised to work in partnership with existing local associations: women’s groups, organised talks by MFI representatives and so on.
- Develop new products that are more responsive to the needs of different client groups, including savings services, payment systems, emergency loans, housing loan products, investment loans, insurance products, agricultural loans, and leasing;
- Prepare themselves for the transformation from NGOs to licensed microfinance providers;
- Explore and promote commercial funding sources and reduce dependence on subsidies by donors;
- Develop a stronger network to effectively coordinate the industry; this network would derive strength not only from a greater number of partners but also include voices from business group representatives, NGOs and service users.

- Educate stakeholders in order to prevent negative publicity from the press, politicians and the public. As described in my analysis, MFI staff can undergo specific training programmes on how to provide clear, factual information to borrowers. Giving information on the history of the bank, its mission and some examples of successful lending, for instance, would go a long way in improving the image of MFIs. Since many borrowers are not well-educated, this kind of information can use more visual rather than purely written formats.

7.5.8 Challenges for Shariah Finance in Uganda

The dearth of knowledge and understanding of Shariah-finance in Uganda should be a matter of concern for the Islamic community who comprise about 12% of the population. This is evidenced by the fact that none of the interviewees or the MFI staff mentioned anything about Islamic finance. Thus it appears that all the challenges mentioned above for conventional MFIs are probably compounded for Shariah-based MFIs by this lack of knowledge and the Islamic authorities should embark on an educational strategy, especially among the Muslim population. At the same time, they should educate the MFI staff about Shariah-finance and could also possibly establish Shariah-finance MFIs themselves, for example at the mosques, especially now that the authorities have formally recognised Shariah-finance as an option in Ugandan banking.

7.6 AREAS FOR FURTHER RESEARCH

A comprehensive and contextual assessment of the processes of microfinance interventions from the perspective of service users seems to be the most recent method for researching microfinance. In this direction, further studies employing larger sample sizes and encompassing wider and different geographical, cultural and economic aspects are required.

Specifically, there is the need to conduct more research into the ways that microfinance interventions are designed, for example, the replacement of interest-based financing arrangements with *mudaraba*, *musharaka*, and *murabaha* agreements (Section 3.3.8.2). As argued earlier, there is still only scant literature on the factors underlying the design of Shariah-microfinance interventions and how they should be successfully implemented. Investigations into the implementation gaps should be incorporated in microfinance research. Importantly, there is a need for more impact assessments, because these could provide explanatory factors to better understand research findings.

The effects of group activities on poverty outcomes is an innovation in microfinance research and further studies will be required to assess the fertility of this line of investigation. In this study, for example, we could not adequately explain how decision-making influences poverty outcomes. This could become a research problem for future studies to address. In addition, our research has demonstrated the importance of group formation in microfinance interventions. This constitutes a significant contribution to the microfinance literature and requires more rigorous research if it is to inform policy. The findings of this study suggest that successful service users do not appreciate the use of joint liability in microfinance – a key Shariah principle. Further studies are required to confirm this finding, especially given the central role that joint liability plays in conventional microfinance.

Finally, it is necessary to conduct more studies that are sensitive to service users and are able to amplify their concerns and appreciations. Poor people often consider that microfinance is doing them a favour, so they seldom complain about the quality of these interventions. Therefore, studies need to pick up the faintest complaints from service users in order to improve microfinance interventions and make them suitable for service users.

7.7 CONCLUSION

When Mohammed Yunus tested his ideas about helping the very poor through his loan to some Bangladeshi women in the 1970s, he set in motion a chain of developments that would transform the way policy makers, banks, credit unions, governments and the poor themselves perceive the problems of world poverty. As this thesis has shown, new ideas about how to introduce innovations and improvements to existing arrangements and mechanisms continue to evolve.

This researcher's key findings show that much more can be done to alleviate the high costs of taking out and repaying loans and that other services can be provided to the poor to help them.

The models described in the previous chapters provide clear evidence that Shariah-compliant financial principles can be compatible with microfinance and technical standards can be put in place, for example, through standard Shariah-compliant microfinance arrangements such as a *murabaha* agreement, or possibly even a *musharaka* or *mudaraba* agreement. As shown too, the leasing or purchase of property or other goods can be accomplished via an *ijara* agreement. Elsewhere in microfinance, we have seen that bank accounts can be offered by

banks under an *amanah* or *wadia* contract, while the community-based solution found in a *takaful* contract is ideal for providing microinsurance.

These models contained within Shariah-compliant microfinance compatible with the philosophy of microfinance. We have already discussed the fundamental importance of *zaqat* in Islam. As the Quran (Surat Al Baqara, verse 215) says:

They ask you what they should spend [in charity], say “whatever you spend on good [let it be first] on your parents, and [then] your close relatives, the orphans, the poor, and the children of the path.” And whatever good you do, God surely knows.

The idea of responsibility to the community is deeply ingrained in Islam, and thus throughout many Muslim communities. *Zaqat* may provide an opportunity in terms of aiding very poor communities to develop to the point where they can be helped by microfinance. If these issues can be resolved, then Shariah-compliant microfinance will very likely become far more attractive to banks and other institutions in the years to come, marking an important milestone in the fight against poverty in developing countries.

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APPENDICES

APPENDIX A: INTERVIEW QUESTIONS LOAN BENEFICIARIES, CLIENTS, POTENTIAL CLIENTS

I. Questions about the beneficiaries:

1. What is your name?
2. How old are you?
3. What do you do for a living?
4. How many are there in your household?

II. Program experience:

1. How is it possible to borrow quickly and with ease of access?
2. Can you borrow any amount/large amounts?
3. Was the loan given to either the husband or the wife?
4. What are the restrictions of the loan use?
5. Is collateral required?
6. How is the flexibility of the loan terms and conditions of repayment?
7. What is the repayment rate/loan procedure?
8. Are you forced to save?
9. Is the decision for using the loan made by both the husband and wife?
10. Was there an unfriendly attitude by organisation officers?
11. How were the services while completing the application, such as clarifying the conditions of the contract?
12. Were too many documents required for the loan application?

III. Client perspective:

1. What do you think is needed to improve the program?
2. What kind of problems are clients facing?

3. Do you think the program is making a difference?
4. Would you prefer Shariah law compliance program? Why?
5. Do you feel comfortable if we use technology to contact you?
6. Is it possible for you to access the internet to update us with your progress?
7. Do you need training courses to be introduced for the new format of microfinance-techno program?

APPENDIX B: INTERVIEW QUESTIONS – DIRECTOR, HEAD OF CREDIT, LOAN OFFICER

I. Questions about the employee:

1. What is your name?
2. What is your occupation / occupational title?
3. For how many years have you worked for this organisation?
4. Are there any restricted working hours?
5. Were there any unexpected gifts/benefits by the organisation officers?

II. Current microfinance program:

Shariah

1. Is the microfinance program for-profit or non-profit?
2. What methodology does the MFI use i.e, individual, solidarity group, Village banking, men/women, etc.?
3. What are the terms and conditions for savings and loan?
4. How long does the transaction take?
5. Do you offer any assistance to those facing dyslexia or who are unable to understand the application forms?
6. Do you offer training courses/technical advice to the poor?
7. Are there any branches in the area for people in need?
8. If yes, how are they operated and managed?
9. What would you do if the loan funds were used properly?
10. What would you do if there were a dispute between the husband and wife?
11. Are you using the internet to interact with the beneficiaries?
12. Is there any donations online for the program?

Loan Characteristics

1. What is the average loan Size?
2. What is the effective loan term?
3. What is the disbursement schedule and repayment frequency?

Outreach

1. What are the means of providing information about the program?
2. What kind of people does the MFI's target?
3. How many active clients does the MFI have?
4. What percentage are female?
5. What is the value of loans outstanding?
6. Which geographical areas and sectors does the MFI serve?
7. How strong is the demand for products and services?

Price and competition

1. What interest rate does the MFI charge?
2. Which method does it use to calculate interest?
3. What fees does the MFI charge?
4. Does the effective interest rate charged by the MFI cover its costs?
5. Who are the competitors?
6. How strong is the competition?

Service delivery

1. What is the average group size?
2. How many loan officers are employed by the MFI?
3. What is the loan officer caseload?
4. How many branches does the MFI have?
5. How are products such as training, savings, loan application delivered?
6. Where are disbursements and repayments made?

Repay and collateral

1. What are the collateral requirements?
2. If someone has the expertise but no collateral what would you do?
3. What are the types of repayment?
4. What is the repayment rate?
5. If the borrower cannot repay back the loan is he/she eligible for a second loan?
6. What is the client drop-out rate?
7. In the case of natural disasters, are the borrowers offered compensation?
8. Is the amount received in payment equal to the amount due and past due? i.e, is the repayment rate satisfactory?

Risk management

1. What loan appraisal methods does the MFI employ i.e, character assessment, recommendation of local authorities, business plan appraisal, group screening?
2. What security does the MFI require i.e , collateral, group guarantee, co-signers, blocked savings?
3. What is the recovery process?

Profitability

1. Is the MFI covering its personnel costs, administrative costs, and loan losses? i.e, is it achieving operational self-sufficiency?
2. Is the MFI covering its operating costs, cost of funds, devaluation of its own capital, and imputed interest subsidy? i.e, is it achieving financial self-sufficiency?
3. Is the MFI generating net income greater than its equity investment? i.e, is it achieving sustainable return on equity?

Portfolio Quality

1. What percentage of the average value of loans outstanding are written off? i.e, what is the loan loss rate?
2. What percentage of the value of loans outstanding are past due? i.e, what is the portfolio at risk?

Shariah board

1. What are the limits of the Shariah board?
2. Are the loan application forms and process authorized by the Shariah board?
3. Is there a Shariah administrative officer to track the daily documentation process?

III. Future Shariah law compliance microfinance programmes:

1. What are the major changes you are willing to make regarding the organisation structure, loan products, etc.?
2. What are the major challenges the program is facing?
3. Do you expect any government support?
4. What are the impacts of the program regarding the people, economy etc.?
5. What are the main problems with the clients?
6. What are the future prospects of the organisation?
7. Are there any problems the organisation may face?

APPENDIX C: INTERVIEW QUESTIONS – GOVERNMENT OFFICIALS, REPRESENTATIVES

I. Questions about the officials:

1. What is your name?
2. What is your occupation/occupational title?
3. For how long have you worked administrating the microfinance programmes?

II. Role of government:

1. What is the role of the government towards the poor?
2. Are there microfinance programmes funded/supported by the government?
3. Why or why not?
4. Is there any assessment by the government of the current microfinance programmes?
5. What are the impacts of Shariah law compliance microfinance?
6. What do you think about the organisation delivering the service?
7. What are the problems you are facing with Shariah law compliance microfinance?
8. How can Shariah law compliance microfinance be improved?
9. What are the effects of Shariah law compliance microfinance on the economy?