



MICROFINANCE DEFAULTS AND THEIR IMPACT ON PARTNERS SUDAN EXPERIENCE

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Abstract

Microfinance is considered as an effective mechanism for poverty alleviation. However such a mechanism may face many challenges that may hinder its successful implementation. Default risk is a major challenge that such a program may face.

The purpose of this paper is to investigate and focus on microfinance defaults and their impact on partners. This study followed the analytical/ qualitative method to investigate the problem of this paper. Secondary data was used as the main data collection tool. The study was based on analysis of the collected data by focusing on the default risk that both microfinance partners can face, causes of defaults in microfinance, and how this risk can be mitigated.

Introduction

Microfinance is the provision of financial services such as loans, savings, insurance, and training to people living in poverty. It is one of the great success stories in the developing world in the last 30 years and is widely recognized as a just and sustainable solution in alleviating global poverty (Kate McKee, 2006).

Microfinance origin can be traced back to 1976, when Muhammad Yunus set up the Grameen Bank, as experiment, on the outskirts of Chittagong University campus in the village of Jobra, Bangladesh. Since then several microfinance institutions came up and have succeeded in reaching the poorest of the poor, and have devised new ground-breaking strategies with time for the fulfillment of their vision. Microfinance is now being considered as one of the most important and an effective mechanism for poverty alleviation. Moreover, microfinance improves the income of poor and provides them with opportunities that help them evaluate their living conditions. Above all, many micro-credit programs have targeted one of the most vulnerable groups in society – women, who live in household with little or almost no assets within the household. (Mohammad Arifujjaman Khan, Mohammed Anisur Rahaman, 2007)

Microfinance was recognized as a priority sector for Sudan in the mid - 1990. The demand for microfinance services is substantial. However the industry only covered 1-3 percent of the potential market. In 2007 Sudan has officially created a specialized microfinance unit at the central bank of Sudan. In 2009 the Central Bank of Sudan has encouraged development of microfinance, aimed at social needs such as housing and agriculture as well as the deepening of Islamic banking. (Laura Anderson 2009). Recently, the CBOS, North State branch has started the promulgation of microfinance project culture amongst institutions, sectors and citizens, making extra effort to improve the living conditions of the poor.

Size of microfinance

A survey by Paxton (1996) showed that there were about 200 microfinance institutions (MFI) managing around 13 million loans worth US\$7 billion and 45 million savings accounts worth US\$19 billion worldwide in 1995. At the end of 2006, the number of MFIs has increased to 704, serving about 52 million borrowers with US\$23.3 billion in outstanding loans and 56 million savers with total deposits amounting to US\$15.4 billion. Of these microfinance recipients, 70 percent were in Asia, 20 percent in Latin America and the balance in the rest of the world.

Based on the current market trend, microfinance can be categorized as a rapidly growing market as the support for it comes not only from the commercial aspect but also the social aspect. A movement seeks to establish credit as a human right and to raise \$20 billion to provide microfinance to 100 million of the world's poorest families by 2005 (Daley-Harris, 2002; Microcredit Summit, 1996). Today, microfinance has a global outreach and become the fastest growing and most widely recognized anti-poverty tool. Despite microfinance remarkable achievements, Microfinance borrowers and lenders face several weaknesses that need to be improved, to ensure its continuous development and successful implementation.

Microfinance defaults and their Impact on partners

Defaults risk refers to a situation where the lenders are unable to recover the loans that have been extended or the borrowers fail to fulfill their financial obligations at the stipulated time due to various reasons (Salina & Rahmen, Kassim, Md Mahfrzur, 2008) In Bangladesh for example, the concept of microfinance has been broadly accepted and applied as an element for poverty reduction but due to various defaults microfinance become a big trouble for both microfinance partners.

Reasons of Defaults

There are many reasons of Defaults:



- **Lack of post-disbursement supervision**

80 percent of the recipients of microfinance are illiterate women. Furthermore, around 82 percent of these women had no business experience before joining the microfinance program, while the rest 18 percent had some basic business experiences. The illiteracy of the recipients is rather serious to the extent that some do not even know how to count the amount of money that they received from the MFIs. Commonly, the MFIs provide loan without any technical assistance except for some briefing of around five to ten minutes to the recipients. Once the fund is being released to the receiver, there is no close supervision of how the fund is being utilized. Therefore the result is a moral hazard on the part of the recipients, who did not know how to direct a business and who will fail to pay back the installment of the microfinance loan.

- **Lack of training on basic business skills and knowledge**

Default happens due to lack of basic business skills and knowledge, such as book-keeping or recording of sale transactions. In Bangladesh, around 82 percent of respondents had no business experience before joining the microfinance program and only 18 percent had some business experiences. The lack of experience resulted that the recipients are unable to manage their business projects effectively which leads to business failure and big trouble in paying back the microfinance loan.

- **Lack of health awareness resulting in the need to spend MFI on medical expenses**

As a result of poverty and illiteracy, there is a general lack of awareness on the importance of sanitation and cleanness as well as the importance of healthy food intakes and disease prevention. Family member's illness is one of the reasons leading recipients to channel the funds provided by the MFIs for a certain business project, to be paid for medical treatment, resulting in default in payments.

- **Burdensome immediate repayment schedule**

The poor people have no incentive to give the best to ensure the success of a business project since their major concern is on meeting the daily consumption requirements or just to fulfill the basic needs. Due to lack of motivation, the recipient had no effort to really give out the best even though they were provided with the financial assistance. This would increase the likelihood of default of the loan being extended.

- **Multiple borrowings from different MFIs**

There are borrowers who go by various ways around the rule and borrow Microfinance loans from more than one source. While there is a clear rule that disallowed this from happening unless the first loan is fully paid-off, most the time project did not turn in a high profit as expected. As a result, the recipient faced difficulties to pay for the two installments simultaneously.

Causes of defaults in microfinance

Based on the defaults mentioned above, the causes of default can be divided into two categories:

- Weaknesses from the lender side, particularly in the funds administration by the MFIs.
- Moral hazard problem on the borrower side.

(a) Lender side -Weaknesses in funds administration

these are weaknesses relating to funds administration by the MFIs that provide the opportunities for the recipients to utilize the loans for other reasons than the original intentions. This increases the possibility of default by the recipients.

- Absence of post-disbursement monitoring system
- Lack of technical assistance given to the microfinance recipients
- Lack of experience and education
- Immediate payment system
- Lack of common accessible database of the microfinance recipients

(b) Borrower side - moral hazard problem

resulting from the lack of technical assistance and post-disbursement supervision, followings are the consequences which result in greater possibility of default by the loan recipients.

- Hiding business
- Family member's illness
- Lack of motivations



- iv. Over-stretched financial commitments due to multiple borrowings from MFIs

Problem Statement

Impacts of microfinance defaults on microfinance partners

Despite its remarkable achievements, there remained several weaknesses in microfinance that need to be improved to ensure its continuous development and successful implementation. A critical aspect of microfinance that needs to be focused on is the risks management aspect. Micro-finance is entrapped by various types of risks, such as default risk (Goetz and Gupta, 1995), disaster risks (Kumar and Newport, 2005), currency risk (Lewis, 2005), interest rate risk (Hughes and Awimbo, 2000; Rahman, 2005) and commercialization risk (Micro Banking Bulletin, 2003).

As microfinance in Sudan is still in its infancy stage, no accurate strategy or plan has been made concerning MFI defaults and their impact on partners. Mainly, microfinance problems in Sudan are the same, as in Bangladesh and many other countries in the global. Therefore quick sustainable solutions should be provided for both creditors and borrowers, so that microfinance could reach its main target and alleviate global poverty.

Significance of the Study

The significance of this study is conducted in order to

- Focus on the size of defaults from both lenders and borrowers sides
- Spotlight on the insufficient monitoring system of institutions
- Emphasis on the inexperience clients of microfinance, who have no idea of how to run a business
- Focus on the inexperienced workers in institutions, who need lots of training to implement their work properly
- Point on the unsystematic database records of microfinance borrowers, which lets recipients apply for more than one loan from different institutions and become very difficult to pay back the installments
- Highlight on microfinance loans which are spent on different matters i.e. medication and not in the project they are borrowed microfinance for

Objectives of the study

The general objective of this study is to

- Study carefully all the defaults facing microfinance lenders and borrowers more specifically.
- Microfinance institutions have to opt, train, monitor and supervise their work properly to reach the target to help the poor to elevate over poverty.
- Coordination must be between institutions in order to avoid the possibility for borrowers to apply for more than one loan from various microfinance institution sources.
- Assist and advice both genders specially women on how to utilize microfinance loans in profitable business.

Methodology

This study is based on analytical and qualitative methods.

- **Data collection**

Two types of data sources can be integrated; secondary data and primary data.

Secondary data is used to gain initial insight into the research problem; it is required in the preliminary stages of research to determine what is known already and what new data is required.

Primary data is data that did not exist before. It is designed to answer specific questions of interest of the researcher. In this study information was obtained through the collection of secondary data. It was obtained from the internet, text books, news and journals. This study is based on discussions and analysis of the collected data by focusing on the default risk that both microfinance partners can face and how this risk can be mitigated.

Hypothesis

This paper is concerned to spot light on an important issue which is the Impact of Microfinance defaults on Microfinance Partners. Sudan like many other countries in the world may face such defaults. The following hypotheses are portrayed to show how this risk can be mitigated:



- In efforts to reduce the moral hazard problem after the funds are disbursed, there is an urgent need for the MFIs to have a monitoring system of ensuring that the funds are being spent as has been agreed upon by the recipients. It is also suggested that it is best for the MFIs to directly purchase the relevant equipment for the business project and limit the amount of cash disbursement to reduce the default risk. The MFIs can also appoint a central purchaser for the business output and require that part of the sale payment goes for payment installment to the MFIs and the balance goes to the recipients. Hence, default risks can be reduced substantially. [1] (s. kassim 2008)
- With regard to reducing the possibility of default due to unsuccessful business venture, there is an urgent need for a strong training system for recipients of MFIs.
- Since health issue is highly relevant in microfinance, requiring the recipients to undertake health insurance policy as part of the microfinance package will prove to be beneficial. It is also important to increase the awareness on the importance of health among the recipients.
- In efforts to reduce the inability to repay due to burdensome fixed repayment schedule, it is suggested that repayment plan based on project-specific basis should be considered.
- On motivating, poor people will give out their best and this will ensure the success of the microfinance project and improve their standard of living, conducting motivational programs can be beneficial for recipients.
- The programs would also strengthen the creditor-borrower relationship such that the recipients are aware of their obligations to repay the creditors as promised, thus ensuring, the success of the business projects.
- Since microfinance has become a major anti-poverty tool in many developing countries, microfinance could be used to complement government's objective to eradicate poverty. Smart partnership between the MFIs and the government would help to expedite the successful implementation of microfinance in poverty alleviation on a national scale basis.
- There is also the need to have a common database of micro-finance recipients so as to avoid the possibility of borrowers defaulting due to over-stretched financial commitments resulting from multiple borrowings from MFIs.
- Last but not least, all the suggestions highlighted above can be implemented directly if the MFIs implement the concept of Islamic microfinance. Equity financing, namely mudarabah and musharakah (or a combination of both) can be adopted so that there will be active participation by both parties from the very beginning until the end to ensure the success of a business venture. (Muhammad Yusuf Saleem, Malaysia, IIUM, 2007)

Conclusion/Recommendations

- This paper has introduced an important issue which is the impact of microfinance defaults on microfinance partners whether from the lender or borrower side. Default risk is one of the most sever risks that such a program may face. Reasons of default risk, causes of such risk as well as the possible ways to mitigate such risk were portrayed in this paper. In conclusion to avoid the risk that borrowers may fail to fulfill the financial obligations at the stipulated time due to various reasons, microfinance borrowers can come together to form small groups and apply for financing. By doing so, repayment of the financing is a share responsibility of all of the group members. If one defaults, the entire group's members face a setback. This reflects the concept of risk diversification. i.e. Lenders have to give microfinance loans to groups as well as individuals to spread the default risk that they may face by providing loans to individuals only. Microfinance institutions have to conduct thorough assessment before providing any loan. This assessment will generally look at the prospective client character, business, their level of poverty, and their environment. This will reduce the default risk of microfinance and will ensure its continuous development and successful implementation.

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