ASIAN UNIVERSITY FOR WOMEN

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A Comparative Analysis of Microfinance in Socio-Economic Development: Evidence from Chittagong

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Abstract

The concept of Islamic microfinance is comparatively newer to the conventional microfinance system in Bangladesh. When the conventional microfinance system has its own benefits, the Islamic microfinance system provides some benefits too. There are borrowers who are taking loans from conventional microfinance system and there are borrowers who take the capital for investment from Islamic microfinance system. The purpose of the study was to find out the key differences between the two systems and how the institutions are impacting the socio-economic standard of their beneficiary. In this study, we have used qualitative analysis to carry out a comparative analysis between the two systems in Chittagong, Bangladesh. To reach a conclusion on the standard of living of the borrowers, we divided the data into four main sectors that are: income, expenditure, basic necessities and savings. We looked into the economic condition of the borrowers before and after taking the loans from the institutions. The questionnaire aimed to know their food habits, child's education, and availability of well-built toilet, income sources and health care facilities before and after they took loans from both types of microfinance institutions. As per our key findings, it turned out that the borrowers of conventional microfinance system had better socio-economic development because they communicate with their borrowers better than the Islamic microfinance institution and the Islamic microfinance institutions are not operating properly due to lack of understanding in the concept of Islamic microfinance in terms of Sharia law. The results are discussed elaborately below.

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Introduction

In recent years, microfinance has emerged as a renowned scheme for alleviating poverty in a global sector. According to Morduch (2000), microfinance is a type of banking service that is provided to financially insolvent or unemployed people who otherwise have no access to financial services. Providing loans or credits is the major work of microfinance institutions and it is also known as providing microcredit. Through providing loans to the low income people, these banks or institutions are helping in creating small businesses and making them entrepreneurs, which in turn serves in the socio-economic development of an individual. Due to microfinance, there appears to increase in the socio-economic segment of peoples' livelihood as there appears to increase in the income and savings of people and moreover, the access of people to basic necessities like food, health, sanitation also increase (Hulme, 2000). This microcredit system of microfinance has garnered concentration from the economic and financial sectors, which is why currently we see various banking systems following the system of microfinance. According to Abdelkader and Salem (2013), the conventional system of microfinance works in a way that the loan which is given to the beneficiaries has to be paid back in installments on a weekly basis with a definite and fixed amount of interest. The conventional system of microfinance also has limitations which include taking interest from the low income people because paying back with interest makes the poor people poorer (Gulli, 1998). For this reason, there is another type of microfinance system which is known as the Islamic microfinance system. Islamic microfinance system follows the Shariah law of taking no interest from the people and emphasizes to investing on the business of the beneficiaries and sharing a definite percentage of the profit or loss incurred from the business (Abdelkader and Salem, 2013). This system of Islamic microfinance has also been widely popular among the people as it seems to cover the drawbacks of the conventional microfinance system and more and more people of developing countries are choosing the Islamic microfinance system. However, this system also has some limitations and goes through controversies as well because most Islamic microfinance institution do not follow the Shariah law accurately (Abdelkader and Salem, 2013). It is seen that there exists clear distinction between the two systems of microfinance which is going to be analyzed in this paper.

This paper focuses on the comparative study on the two types of microfinance system to see the impact of each system on the socio-economic development of the beneficiaries, collecting evidence from Chittagong, Bangladesh. To see the socio-economic changes of the beneficiaries of both systems, we need to see the changes in the income and savings of people, the access to basic necessities such as food, housing, sanitation and more. This paper will look into the comparison between the two systems to determine the more convenient system of microfinance by evaluating the socio-economic development of the beneficiaries.

Rationale

Microfinance institutions have been playing a significant role in the reduction of poverty. In Bangladesh, the impact of the microfinance institution has been substantial in poverty alleviation and also in developing the socio-economic standard of living of the beneficiaries. However, the impact of conventional microfinance system has on the standard of living of the borrowers has debatable from many aspects due to their high-interest rate. Thus, there has always been a comparison in the performance and efficiency of conventional microfinance systems with the Islamic Microfinance system. Hence, the project is conducted to look into the prospect of conventional and Islamic microfinance institutions in Chittagong. The data collected from this study will be useful to learn and understand the working procedures of both the institutions and give people a wider perceptive of both the systems for them to select a better one to invest their future upon.

Objective

The objective of our study is to create a comparative analysis of the two different microfinance systems in contributing to social development. The standard of living of the borrowers of both the conventional and Islamic microfinance institutions will be compared to assess the schemes of the institutions. The assessment will examine which system has a better impact on the life of the borrowers.

Literature Review

Due to the complex structural differences and popularity of microfinance as a development tool, Islamic and Conventional Microfinance institutions have been studied by different scholars in the existing literatures Given the broadness of microfinance, the scholars had the opportunity to inspect the differences focusing on different aspects. However, the findings of the researches showed that the differences in the administrative and social performances varied from region to region. In this paper, a summary of the relevant studies has been given to get a better understanding of our research topic and to assess the scope of studies that these kinds of literature have opened.

One of the most important aspects of microfinance is its social and financial performance. Abdelkader and Salem (2013) in their paper terms financial performance as technical efficiency and comes to an opposite conclusion to their hypothesis, stating that conventional microfinance has better financial performance during a crisis in MENA region. However, Mahmood et al. (2014), shows that in the Pakistan region, the technical efficiency of Islamic microfinance overwhelmingly exceeds the conventional microfinance. They also state that Islamic microfinance slightly surpasses the conventional microfinance in terms of total factor productivity, establishing that Islamic microfinance has better financial performance in Pakistan. Conducting their research in the same region, Farooq and Khan (2014) proclaim that Islamic microfinance in Pakistan more cost effective. But also points out due to charging an interest rate, conventional micro-financing institutions have more financial support. In Indonesia, Sukmana and Febriyati (2016) finds out that the management of conventional microfinance is more efficient and Islamic microfinance needs more capital to tackle risk.

However, Abdelkader and Salem finds no specific difference in the social performance of both the institutions and also comes to an interesting conclusion, stating that usage of religion and Islamic product does not impact the efficiency of the micro financing system in MENA region. Farooq and Khan, on the other hand, shows that even in the absence of interest rate, the Islamic micro-financing system of Indonesia performs more sustainably and viably than the conventional micro-financing system.

Another important aspect is the study of banks' asset management and performance which is examined by Majid et al. (2014) in their research based on Indonesia, empirically and comparatively. They examine the quality of conventional and Islamic banks' asset management in Indonesia during the period 2009-2011. The study compares the quality of the Islamic and conventional banks' asset management with the CAMEL (capital, asset, management, earning, and liquidity) method. It proves that the Islamic banks in Indonesia have a better asset management quality compared to their conventional counterparts. The Islamic banks are also proved to be better able to withstand the risks, particularly the financing risk.

Besides, studies also compare the usage of loans by the borrowers of both the institutions because the impact of microcredit loans depends on their decision on how to use it. Bui (2013) conducts a study which explores differences in the usage of loans by the conventional and the Islamic microfinance borrowers in Jordan. The main objective of the study revolves around finding how the borrowers use their loans to increase productivity, focusing on two main criteria naming, business investment and home improvement. The study performed a quantitative analysis, with the help of the Linear Probability Model (LPM) and region-year fixed-effects. The result established two main findings. One of them is the increase in business investment and home improvement with the increase microfinance practice among the collective borrower. The second finding demonstrated that the borrowers of Islamic microfinance tend to use their loan more in business investments and less in consumer durables. On the other hand, the conventional microfinance borrowers are involved in both types of investments. Again, Suzuki et al. (2013) analyze the incentive and sanction mechanisms of the Islamic mode of banking and the Grameen Bank model of microcredit in Bangladesh, and how they help ensure their financial stability and efficiency. They point out how the informal sanction mechanisms embedded in the two modes of financial intermediation play important roles in lowering the transaction costs of screening and enforcing contracts. It further shows how bank rent opportunity is captured in each of the two modes, playing a further important role in maintaining their franchise values.

Since the intermediary role performance of the bank is characterized by its bank margin Nor et al. (2018) investigates the effect of bank specific characteristics and microeconomics variables on bank margin (NIM) which reflects the intermediary role of Islamic and conventional banks in Malaysia for the period of 2006 to 2014. By using static panel analysis, the results show that there are similarities and differences in terms of determinant factors that affect the bank margin between Islamic banks and conventional banks. These empirical results suggest an important policy on issues pertaining to how Islamic and conventional banks have to adjust the changes in the banking environment. The conventional banks have more comparative advantages specifically on management efficiency as its intermediary role performance is also not affected by size.

Another interesting study that came up in regarding this topic, conducted by Meraj (2016) encompasses the people’s perception on the hurdles faced by both type of microfinance, the credibility of both types of micro-finance and their effectiveness to alleviate poverty. The study was conducted in Pakistan and demonstrated that conventional microfinance is more popular in the region in spite of interest rate being for forbidden. The people in Pakistan consider Islamic microfinance to lack self-sufficiency since they do not charge any interest However, the mass population regards Islamic microfinance more effective in poverty alleviation institutions and rejects the claim of conventional microfinance that they are more prone to social wellbeing,

A complete comparative analysis of Islamic and Conventional microfinance institutions established in Bangladesh through a qualitative approach was conducted by Abdullah et al. (2017). The objective of the research includes finding the strengths and weakness of the institutions in order to provide the institutions with a platform to improve. The subjects of the study included the officers and borrowers of Grameen Bank and Islamic Bank Bangladesh Limited (IBBL) and data collection was conducted by interview. The comparison is conducted from 8 aspects such as institutional infrastructure, the process of getting funds, mode of financing, methods of targeting the borrower, risk management, marketing strategies, training, social development, and general overall performance. Substantial difference where found among both institutions. The Islamic microfinance lacks in marketing strategies whereas the conventional microfinance has a higher interest rate. In case of social development, it was seen that IBBL targeted the development of the family whereas Grameen Bank targeted the women. The study criticized the Grameen Bank’s method of only targeting women borrowers because women are hardly involved in economic activities. However, it also praised the effort of Grameen Bank to educate the people. The study also reaches a conclusion that both of the institutions improves the productivity, income, and nutrition of the houses.

As seen above the studies tell us that both the institutions perform differently in terms of aspects and regions. In case of some regions and aspects, Islamic microfinance has better performance and in some cases it's vice-versa. Thus, for our paper, we will focus on the comparative analysis of these two different types of micro-financing systems on the basis of clearly defined socio-economic development, which has been hardly inspected in existing kinds of literature.

Research Methodology

Data Collection

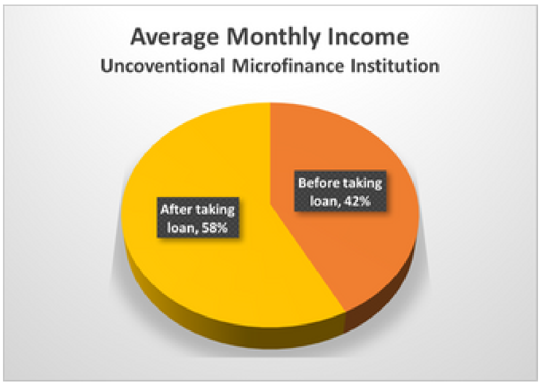
The data were collected from two rural parts of Chittagong, one area was Fatehabad and the other was Mirsarai. The sample size was 40, selected through convenient sampling. We had 20 participants from each of the microfinance institutions. The participants from Fatehabad belonged to the Islamic Microfinance Institution center and the participants from Mirsarai belonged to the Conventional Microfinance Institution center. For maintaining the privacy of both the institutions, we have kept the name of the institutions confidential. We attended the weekly meetings of the institutions with borrowers and also visited their homes to take their interviews on their standard of living. The questionnaire of the interview was semi-structured and basically focused on the standard of living of the borrowers before and after taking loans and their satisfaction from the microfinance institutions.

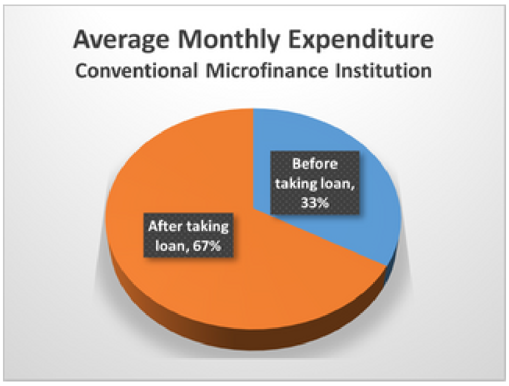
Methodology

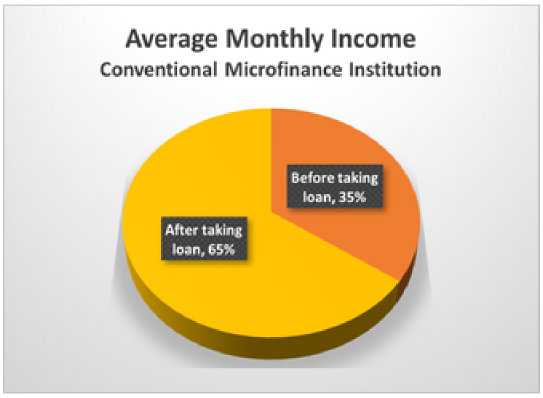
In this research, we have done a qualitative analysis to conduct a comparative analysis between the Islamic Microfinance Institutions and Conventional Microfinance Institutions in Chittagong. Since our objective was to look at the socio-economic development of the borrowers of the institution, the collected data from the respondents have been categorized into four factors of income, expenditure, basic necessities and savings to assess the socio-economic development. Again, the category of basic necessities consisted of different sub-topics such as access to food, nutrition, education, housing, health, and sanitation. We calculated the percentage of beneficiaries who had access to the given factors in both institutions. Then, we presented the percentages for the factor of basic necessities and savings in a table and the income factor was represented through the pie chart.

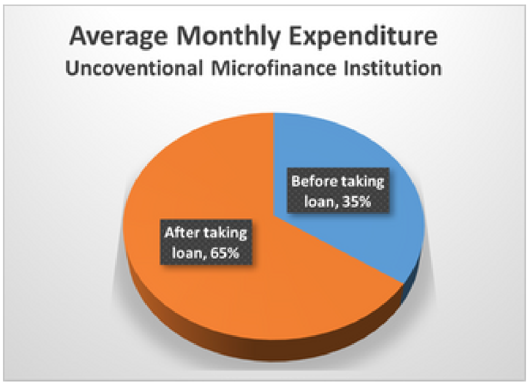
Result and Data Analysis

The pie chart below is the graphical representation of borrowers change in income and expenditure before and after taking the loan for conventional and Islamic microfinance:









In the attached pie charts it can be noticed that both the Islamic and conventional institution shows a gradual increase in income and expenditure, however, the increase in the conventional institution is more prominent.

The table below shows the borrowers access to basic necessities before and after taking the loan for conventional and Islamic microfinance:

Institutions				
Factors		**Conventional**	**Islamic**	**Difference in access after getting loan between both institution**
Food	**Before**	**65%**	**80.5%**	
	After	**94%**	**94%**	**0%**
Nutrition	**Before**	**76.4%**	**80.5%**	

	After		97%	94%	3%
Housing	Before		31%	58.3%	
	After		94%	87%	7%
Education of Children	Before		100%	100%	
	After		100%	100%	0%
Health	Access to Doctor	Before	75%	64%	
		After	100%	85.5%	14.5%
	Access to Medicine	Before	53.1%	85.2%	
		After	100%	100%	0%
Sanitation	Well-built toilet	Before	12%	81%	
		After	94%	100%	6%
	Maintenance of Hygiene	Before	12%	88%	
		After	100%	100%	0%

In the above table it is seen that both the borrowers of conventional and Islamic microfinance has better access to all the basic necessities after taking the loan. However, it is seen that the more borrowers has access to nutrition, housing and health under conventional microfinance whereas, for Islamic conventional microfinance, more borrowers has access to well-built toilet. Interestingly, all the borrowers from both the institutions had 100% rate of children education before and after taking the loan.

The table below shows the borrowers savings ability before and after taking the loan for conventional and Islamic microfinance:

		Institution		Difference
		Conventional	Islamic	
Savings	Before	10%	38%	
	After	90%	90%	0%

In the above table, it is seen that the conventional institution had a drastic boost in comparison to Islamic institution's 38% to 90%.

Discussion

As per the preliminary research on Islamic micro financing system, our hypothesis presumed that this system would have a better impact on the standard of living of its beneficiaries compared to the conventional system. Besides, in the literature review, there was a variance of results based on different regions and different aspects. However, the result found in this study was the opposite; based on the specific region and the two micro credit institutions we researched on, the conventional institution had a better impact. Mainly because the operating system of the Islamic microfinance lacked in the following aspects;

1. There was a visible communication gap between the beneficiaries and the institution, dissimilar to the conventional institution; which conducted weekly meetings with their beneficiaries to oversee their conditions. The Islamic institution was inconsistent in keeping track of their beneficiaries' financial statements of loss and profit. Moreover, the beneficiaries were unwilling

to disclose their condition as well. Hence the mutual averseness lead to the beneficiaries paying a higher amount of return to the institution even when they went through loss; which ultimately pinned them in more debt.

2. The institution wasn't entirely following the exact mechanism of an Islamic micro financing system. Even though the principle of sharing profit and loss with their beneficiaries was maintained by the institution, they charged a rate of 10%. However, as per the Islamic micro financing system, the collection and payment of interest are prohibited.

As per our findings, these were the prime reasons which produced drawbacks for the institutions. Otherwise, there were few interesting findings which grabbed our attention, such as the Islamic institution was very inclusive and had beneficiaries from religions other than Islam similar to the conventional institution. Besides, even though both the institutions' target population were women but in most of the cases, the women were simply acting as a mediator between the institution and their husband or son's business.

Ethical Implication

Voluntary informed consent was taken for each of the beneficiaries interviewed and their private information has been kept confidential. The names of the microfinance institutions have also been kept confidential as per their will. The project proposal and questionnaires of our study were submitted to AUW and the institutions beforehand.

Limitations

Due to budget and time restrictions, we had to decrease our sample size to 40, which might decrease the accuracy of our results.

Many participants were not comfortable to share their age due to it was difficult to calculate the exact age at which the participants have been associated with the institutions so the data could be a little biased.

During the data collection, the centers that we went for collecting the data were chosen by the institutions so they could have given us the centers that were performing well compared to others, so the results might be a little biased.

Due to time restriction, we could not explore more centers to see the effect of the loan on the families on a longer term. Rather we had to depend on the data provided by the institutions and collected from personal interviews of the borrowers.

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Conclusion

Both the institutions helps increase the income of the beneficiaries involved with the institutions but as we have come to know from our study both institutions have its benefits and flaws as discussed. What can be done is that the Islamic institutions should make their management system better by ensuring that they track the borrowers' conditions, as in is the loan benefiting them or not in lifting themselves up from poverty. In doing so this will help the institutions to understand whether the borrowers are making profit or loss and thus will help them understand the level of the situation and work with the borrowers to ensure the loans are used more efficiently, thus help the Islamic institutions to survive and work better. Also the conventional banking institutions should also work on increasing number of direct and actual male borrowers and give entrepreneurial and financial training to the borrowers, male and female both, to use the loan effectively since from our study we found that though the borrowers are largely female they usually give away the money to a male member of their family to build or expand their business. So the objective of women empowerment of the bank will actually work. At the end of the day both institutions work in alleviating poverty from individual households at different rates but if they work on their flaws the rate will eventually increase.

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