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# EFFECT OF MICROFINANCE ON POVERTY REDUCTION: A CRITICAL SCRUTINY OF THEORETICAL LITERATURE

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## Abstract

The provision of micro-credit to the poor more especially to the youth and women in the rural poor is an important factor on poverty reduction through empowerment. Most research studies done, have indicated some improvements in job creation as well as increase in income levels through self-employment. There has been signs of independence on the side of the women as well as the youth, on matters concerned with household expenditure on the side of women and education expenditure on the side of the youth being able to raise incomes from self-employment. The researcher has also discovered that most researchers have used at least two to four models the popular ones being: Grameen solidarity group model, targeting women groups' model, regular repayment schedule model and village banking model. The researcher has dealt with various discussions, the major ones being: that micro-credit has been able to uplift at-least 55% of its customers out of poverty, they are being supplied by clean drinking water. It is also coming out clear that the poorest of the poor are not benefiting because the majority of these people are not able to repay their loans making them even loose the little they had. It is also advocated that the microfinance institutions should open their businesses to the middle level customers like teachers, clerks, nurses so that they may enable the institutions to operate profitably. Finally the studies have given a warning to their clients that micro-credit is not medicine to the poverty. The favorable recommendations have been to diversify their facilities to be able to cover more clients, to provide training to both their staff and customers for efficient utilization of the loans, and also be able to charge reasonable rate of interest rate.

***Keywords****: microfinance, micro-credit, poverty, employment.*

## 1.1 Introduction

The microfinance revolution has changed attitudes towards helping the poor in both Asia and Latin America and in some countries has provided substantial flows of credit, often to very low income groups or households, who would normally be excluded by formal financial institutions and in turn a great number of studies have attempted to assess the outreach and poverty impact of such schemes. This literature review will examine the extent to which microfinance as achieved its own objectives to reach the poorest of the poor, to ensure a positive measurable impact on the lives of clients and their families, to build financially self-sufficient institutions, and to reach and empower the women and the youth in society who are believed to be among the poorest in society. Poverty reduction was institutionalized in 1944, with the establishment of the World Bank at the birth of the Bretton Woods system. With the IMF and GATT assigned the tasks of stabilizing the world's economy and promoting free trade in the post-world war II. The problems of poverty was delegated to the World Bank.

The industrial nations felt some responsibility for the world's poor, after all since Africa and parts of Asia, including India, had been colonies of European empires and they needed some help once they gained their independence. The strategy with the U.S. as a leader was to bring free trade to the developing world with the hope of integrating them into the formal economy. Since the World Bank's earlier days trial to reduce poverty have centered on large global Organizations that is the IMF and the World Bank. Working through state governments and other formal institutions, credit was distributed to developing countries as long as they adhered to policies prescribed by the World Bank. The focus of poverty reduction from the 1950s-1980s was to integrate poor populations into the economy through better macroeconomic practices. Most economists had identified the poor as part of an enormous "informal sector" that remained "essentially invisible in government plans and budgets.

The attempt to reduce poverty seemed hopeless and this led to the introduction of various programs by the Bretton woods institutions. These programs were called structural-adjustment programs and they were highly successful. Its weakness was that much of the funds were diverted to the politically powerful. As reports of corruption surfaced and decades of aid proved fruitless, many came to believe that government assistance created dependency and that led to doing little to help communities to come out of poverty (Morduch 1999a, Diop et al. 2007). If such grand global organizations and state governments did not solve the poverty problem, and therefore microfinance emerged at the beginning of a shift in development thinking. This shift brought change in economic thought at the time. The movement that brought Thatcher and Reagan to power promoted free market solutions and a general distrust in formal institutions. The ideological swing had shifted to the right, providing an opening for microfinance. With microfinance at the wheel focus moved towards the fostering and support of the "informal" sector, in hope that a helping hand would allow people to fundamentally pull themselves above the poverty line.

### 1.2 Definition of Key Concepts

#### *1.2.1 Microfinance:*

Microfinance refers to provision of financial services: loans, savings, insurance, or transfer services to low-income households."(Morduch, 1999b. Simeyo et al 2011) further describes microfinance as small loans, savings mobilization and training offered to the poor to enable them to create self-employment by starting their own businesses and thus generating income. Equally, (Webster and Fidler 1996) argue that basic business skill training should accompany the provision of micro-loans to improve the capacity of the poor to use funds. Microfinance gives financial services like loan facility, saving opportunities, transfer of money and insurance of health and business assets to the poor people which are ignored by commercial banks. Microfinance helps the poor for smooth working of their business and makes their own investments. According to James Roth, Micro-finance supports people especially women to move out of poverty as it rewards productive capital to the poor who have been omitted from the formal banking sector. (Sara, 2011) confirms that micro-finance is a powerful tool of self-empowerment to the poor at the world level particularly women in developing countries. As far as gender equality is concerned, (D'espallier et al, 2012) have defined micro-finance as an effective tool that promotes women and the youth empowerment.

#### *1.2.2 Objectives of Microfinance:*

Ledgerwood (1999) identifies the following objectives offered by MFIs in developing countries they include the following: (i) Eradication of extreme poverty and hunger; (ii) Achievement of universal primary education, (iii) promotion of gender equality and women empowerment, (iv) Reduction of child mortality; (v) Improvement in maternal health; vi) Creation of income production activities (employment creation) vii) Building assets vii) Stabilization of consumption iv) Protection against risks, viii) Encouragement of new businesses, ix) Come up with a strategy to build global financial systems that meet the needs of the poorest people. Referring to various case studies, they show how microfinance has played a role in eradicating poverty. It principally achieves the above objective through: a) Microcredit, b) Micro Savings, c) Micro-Insurance and d) Money Transfers for the poor.

#### *1.2.3 Micro-credit:*

It is a component of microfinance and is the extension of small loans to the poor including women and the youth in general who are too poor to qualify for loans in commercial banks, especially in developing countries. Micro-credit enables every poor person to engage in self-employment projects that generate income, thus allowing them to increase their standard of living and for their families. The impact of micro-credit is a subject of much controversy, its proponents state that it reduces poverty through job creation, increase in incomes etc. This is expected to lead to improved nutrition and improved educational levels of the borrowers as well as the borrowers' children. Some argue that microcredit empowers women and the weak financially. The available evidence indicates that in many cases microcredit has facilitated the creation and the growth of businesses by often generating self-employment.

#### *1.2.4 Micro Finance Institutions (MFIs):*

In October 2006, the Nobel Peace Prize was awarded to Muhammad Yunus and his Grameen Bank, and as a result, microfinance gained huge attention from all over the world. But in fact much experimentation and research had been carried out on MFIs being regarded as a tool for realizing the potential of the poor. Microfinance therefore has been giving a great deal of hope to those people who are dedicated to poverty reduction, while the practice of microfinance has expanded globally, debates around the topic have never stopped. Traditional banking sectors in developing countries tend to cater for the rich people, and therefore microfinance wants to say that "the poor are also creditworthy". Through innovative financial methods, microfinance allows poor people to access credit. The invention of microfinance is inspiring, especially in the context of efforts to end poverty internationally. Lasting peace cannot be achieved unless large population groups find their way in breaking out of poverty, micro-credit is one such means, the Norwegian Nobel Committee, Oslo, 2006).

### 1.3 Historical background of Microfinance in Asia and Latin America

Modern microfinance was born in Bangladesh in the 1970s, in the repercussion of the country's war of independence, when Muhammad Yunus, an economics professor at the University of Chittagong, where he began an experimental research project providing credit to the rural poor, that experiment, driven by a strong sense of developmental idealism, developed into what is now the world's most famous microfinance institution, the Grameen Bank, and institutions that replicate its pioneering methodology worldwide. Microfinance in Latin America developed under quite different conditions. In Bolivia, a collapsing populist regime led to widespread unemployment. Banco Sol, a pioneering microfinance institution in the region, developed to address the problem of urban unemployment and provided credit to the cash-strapped informal sector. The notion of commercial profitability was embraced relatively early in this approach. As a result of the different conditions under which the very first MFIs were founded, the industry in the two regions developed distinctive characteristics.

In comparison with Bangladesh, the Bolivian intervention was typically urban rather than rural, less concerned with poverty and more focused on micro-enterprise. It targeted the 'economically active poor people with established businesses that needed capital to grow. Bolivian microcredit was itself seen as a business, a branch of commercial Banking, (Rutherford, 2003). Many of these differences still characterize the industry in the two regions today, for example, data from various sources suggest that Asian MFIs lead the world in terms of both number of clients and the depth, relative poverty of clients of outreach. In their analysis of over 1,500 MFIs from 85 developing countries, (Lapeneu and Zeller 2001) find that Asia accounted for the majority of MFIs, retained the highest volume of savings and credit, and served more members than any other continent. The most recent data from the Micro banking Bulletin2, reinforces these findings. Regional data of course cover up some wide disparities within each region. The strong financial performance of the larger MFIs in Latin America is linked with a trend toward commercialization of microfinance in the region. In 1992, Banco Sol became the first example of an NGO becoming a commercial bank, and thus became the first regulated microfinance bank. Banco Sol surpassed other Bolivian banks in profitability and became the first MFI to access international capital markets.

## 1.4. Poverty

### *1.4.1 Poverty reduction:*

At a UN Summit on social development, 'the Copenhagen Declaration' 1995, poverty was described as a condition characterized by severe deprivation of basic human needs including food, safe drinking water, sanitation facilities, health, shelter, education and information. To the (World Bank, 2002), a person is said to be poor when his or her consumption level falls below the poverty line of $1 per day. (Narayan et al. 2000) identified poverty as being complex and interwoven, including a material lack and need for shelter, assets, money and often characterized by hunger, pain, discomfort, exhaustion, social exclusion, vulnerability, powerlessness and low-esteem. To rural people, poverty means lack of food, insecurity, infertility and inability to participate in social activities. Urban dwellers see poverty as lack of employment, inadequate social services, lack of capital as well as lack of training skills, (Appiah, 1999, Nkum & Ghartey, 2000). According to Sarkar (2001), Professor Muhammad Yunus observed that conventional banking practices had in-built constraints and were aimed only at those who were already well off. In this context. Professor Yunus contemplated an alternative institutional framework that could be used to raise the wellbeing of impoverished sections of society. This review of literature tests the effectiveness of microfinance programmes in the hypothesis that, if financial resources were made available to the poor at reasonable terms and conditions, the poor could generate productive employment without external assistance.

Poverty is a multi-dimensional problem and hence needs multifaceted Intervention. Breaking the vicious circle of poverty demands. Recent reports by (State of Micro credit Summit Campaign, 2009) reveals that in the year, 2011, more than 150 million of the world's poorest families received a micro loan and achievement of this goal touches the lives of an estimated half a billion. When the United Nations designated 2005 as the International Year of Microcredit, heated controversies, whether should it be year of microfinance or microcredit, among supporters of poverty and sustainability camps reached high stage and this year can be considered as a land mark for the MF division (Morduch, 2005). It is in human and unfair to see a world where a few hundred million people enjoy access to all the resources of the planet, while over billions struggle to survive. Yunus cites one study that concluded in the year 2000, "the 1 percent richest persons owned 40 percent of the world's assets, and the richest 10 percent owned 85 percent of the world's resources (Yunus, 2007).

### *1.4.2 Poverty results:*

Poverty contributes to physical weakness through lack of food, small bodies, malnutrition leading to low immune response to infections and inability to reach or pay for health services. Chambers has recorded the many forms of deprivation that the very poor people identify themselves as experiencing that are not captured by income poverty measures. These includes: i) physical weakness through lack of food, ii) small bodies and malnutrition. The physical weakness of a household contributes to poverty in several ways: through the low productivity of weak labour, an inability to cultivate larger areas or work long hours, through lower wages paid to women and to those who are weak. It sustains isolation because of lack of time or energy to attend meetings, lack of education, remoteness, being out of contact, sustains poverty, services do not reach those who are remote, illiterates cannot read information of economic value, and find it difficult to obtain loans. Isolation means lack of contact with political leaders and therefore misses government development policies. iv) Vulnerability is part of the many links. It relates to poverty through the sale of productive assets, to physical weakness to handle contingencies, time and energy have to be substituted for money, isolation through withdrawal. v) Powerlessness contributes to poverty in many ways, through exploitation by the powerful.

### *1.4.3 Indicators of poverty levels:*

Wealth status, principal occupation, food sufficiency, literacy status, educational levels, Schooling of

Children, Consumption of Nutritious Food, Social and Political Participation, Decision making role in Family, Self Confidence, awareness of Social Issues, awareness in Health issues and sanitation.

***1.4.4 Causes of poverty.***

i) Lack of employment: not having any productive activity which may ensure a steady flow of income. ii) Vulnerability to Income Fluctuations: There is income fluctuations in many families and may have to go to bed without food for family members, this can basically be influenced by many factors including the chance of one getting the job each day, price fluctuation of the products, such as being paid on commissions etc.. iii) Lack of Access: It is not having access to resources to create products or earnings e.g. not having bamboo for a person who weaves. iv) Powerlessness: inability to change things or do anything to change the current situation.

**1.4.5 The role of Microfinance on Poverty Reduction:**

Attempts to alleviate poverty were carried out worldwide through micro finance programmes that are aimed at helping the poor to accumulate their own capital and invest in employment generating activities. What is meant by poverty and how it is measured and who constitute the poor are aggressively contested issues. In the poverty discussion, the question whether poverty is largely about material needs or whether it is about a much broader set of needs that permit well-being. According to (Sida 2005), Poverty has a multiple and complex causes, the poor are not just deprived of basic resources but also they lack access to information that is vital to their lives and livelihoods that is: information about market prices for the goods they produce, information about health, information about the structure and services of public institutions, information about their rights, they lack political prominence and voice in the institutions and power relations that shapes up their lives, they lack access to knowledge, education and skills for development that could improve their livelihoods, they often lack access to markets and institutions, both governmental and societal that could provide them with needed resources and services. They lack access to and information about income-earning opportunities etc.

The majority of the poor in developing countries especially women lack access to the basic financial services which are essential for them to manage their lives. The poor are excluded from the opportunities of financial services only the informal alternatives that are considered unsuitable left to them. Microfinance is therefore considered as a vital tool to break the vicious circle of poverty which is characterized by low incomes, low savings and low investment. According to (Hulme et al. 1996) most institutions regard low income households as “too poor to save”. In order to generate higher incomes, high savings and more investments, Capital is only one ingredient in the mix of factors necessary for a successful enterprise. Most importantly it requires: entrepreneurial skills and efficient markets to reduce poverty. According to (Ismawan 2000) the real idea of microfinance is to help the weakest members of civil society who in this case is the poor. A rural micro- entrepreneur may need access to one or more of the following: transport, communications, power, water, storage facilities, a legal system for enforcing contracts and settling disputes.

Apart from infrastructure, micro entrepreneurs need access to information about market trends and skills to run their macro enterprises. (Weber 1958) who argues that hard work, skills and enthusiasm are essential ingredients for an enterprise to be successful. (Ismawan, 2000) calls for differentiation between two categories of the poor, some are able to increase their income by themselves, create business activities that would enable them to move above the poverty line. Those in the second category are unable to do so and would need permanent financial support from microfinance. The latter category would include the poor who have no capacity to undertake any economic activity, either because they lack personal skills or because they are so destitute that they are in no position to develop any meaningful economic activity in the environment in which they live. Those in the first category are described as the “entrepreneurial poor”. The entrepreneurial poor do not need assistance for themselves, but they do need help in setting up an activity that will eventually increase their income. In particular they need assistance in accessing the resources to develop this activity, and to some extent managerial assistance. The non-entrepreneurial poor require direct and continuous assistance to survive. The transfer of resources in terms of credit does not only give the poor access to resources but also the economic empowerment and increased self-reliance.

**1.4.6 To help the poor out of poverty:**

It is argued that stimulating economic growth, making markets work better for the poor and building their capacity is the key out of their poverty situation. There is need to change the whole context of the lives of the poor and economic activities which do not produce enough surplus to lift their standard of living. Some critics argue that the necessary infrastructure has been put in place in some areas for microfinance to trigger economic growth but very little success has been recorded which makes the problem of poverty and the poor very tricky. Indeed, microfinance is not a panacea to the problem of poverty but improved access to capital and other financial services are significant to the poor. The problem is that market failures weaken the effectiveness of microfinance, this is because if the market is no efficient then it will not enable the producers to sell their goods and services and therefore they will be unable to make enough revenue to reinvest back to business at the same time be able to pay back their loans in time and this will lead to depression thus creating unemployment, but efficient market operations will lead to high market demand which will result to more revenues enabling the clients to pay back their loans in time and the excess reinvested back to business bringing creation of more jobs leading to high economic growth. According to (Ferrand, et al 2004) argues that efficient functioning market is critical for poverty alleviation. The danger is that it does not work effectively for the poor. Ferrand outlines three steps for the markets to work efficiently, namely: i) Understanding markets, ii) Focusing on factors that inhibit their improved performance and opportunities for their development and iii) Developing a vision of the future, a picture of how markets can work effectively, acting to build markets, to make markets more effective and inclusive.

**1.5 The Importance of Microfinance on Poverty Reduction**

Robinson (2001) explains, until 1980s the presence of in-formal microenterprises, street vendors, home workshops, market stalls, providers of informal transportation services, was generally perceived by policymakers and economists to be as a result of economic dysfunction. Microenterprises were thought of as little more than an indicator that the structure and growth rate of the formal economy were inadequate to absorb the national labor force, and so were perceived as a concealed form of unemployment. Microfinance supported these informal microenterprises through microcredit. The microcredit approach to poverty reduction is "the provision of small loans to individuals, usually within groups, as capital investment to enable income generation through self-employment" (Weber, 2006). The following are the major importance of microfinance in poverty reduction.

***1.5.1 Job creation:***

Employment opportunities had increased at a moderate rate. The clients started their own business and earn more profit. The Living standard is very important issue in all developing countries. In many developing countries like Bangladesh, Pakistan and India, microfinance is now being used as a tool to increase the living standard of poor societies. There is a positive impact of micro financing on income level and better services of microfinance institutes on increase in satisfaction level of customer (Akram & Hussain, 2011). Microfinance gives the unemployed and the poor some opportunities, hope and self-esteem. Being employed whether self-employed or by an employer gives a person a significant boost to his/her sense of self-respect and dignity. Furthermore, microcredit allows people to signal their creditworthiness. If their success makes banks more willing to lend them larger sums of money and leads to more economic activity, then that should help reduce poverty in the long run. Being successful business ventures, MFIs themselves have also created a large number of good paying jobs. In the words of (Roodman and Qureshi (2006) "We should not lose sight of the fact that commercially successful microfinance institutions are remarkable organizations, employing hundreds and thousands of people at tasks once thought impossible". Good jobs created by successful MFIs should have considerable multiplier effects**.** Microfinance is making some important positive contributions to economic development. To be able to serve as a viable poverty reduction strategy, micro-credit financed enterprises must expand and create decent jobs for the growing labour force.

It is argued that improving the access of the poor to financial services enables these agents to build up productive assets and enhance their productivity and potential for sustainable livelihoods, (Green, Kirkpatrick, & Murinde, 2006) says that microfinance would correct the market failure, by providing access to credit to the poor. Credit would create economic power that would generate into social power, lifting the poor out of poverty (Yunus, 1999). In 2008 it was estimated that there were 2,420 microfinance institutions (MFIs), representing 99 million borrowers in 117 countries (Gonzalez, 2008). Many of these programs did not require collateral, since it has been replaced by social relationships, which may either be group based in which case peer pressure within the group is an important element. Peer pressure, which has substituted collateral by putting pressure on the borrowers to repay loans and loan repayment rates had been reported to have reached above 95 percent, and reached the poor individuals who had formerly been difficult to reach. Professor Mohammad Yunus, the founder of Grameen Bank in Bangladesh and the originator of the concept of microfinance, believes that 5% of Grameen Bank's clients exit poverty each year. The Grameen Bank's main objectives according to (Sarkar, 2001) are: i) Extending banking facilities to the poor men and women. ii) Eliminate the exploitation by moneylenders. iii) Create opportunities for self-employment among Bangladesh's vast and underutilized manpower resources. Tazul Islam asserts a positive influence of microcredit on the level of education, health and nutrition. In the US, microcredit has created jobs directly and indirectly, as 60% of borrowers were able to hire others. Business owners in the US were able to improve their housing situation after their income improved due to business expansion facilitated by microloans, 70% indicated that their housing has improved. Ultimately, many of the small business owners that use social funding are able to graduate from government funding. According to reports every domestic microcredit loan creates 2.4 jobs. These entrepreneurs provide wages that are, on average, 25% higher than minimum wage.

***1.5.2 win-win proposition:***

Microfinance appears to be a "win-win" situation, where both financial institutions and poor clients profit. The "win-win" appearance of microfinance creates an equal excitement in the world of economic development. In this case the researcher means that the poor benefit by getting micro loans which they invest in businesses creating self-employment thus an increase in revenue while the financial institutions also makes profits which enables them to sustain themselves. (Pitt and Khandker, 1998). Their main argument is that participation in microfinance program increases consumption, which they believe is the first step in coming out of poverty as indicated by (Yunus, Khandker (2001) judges whether the World Bank's 1996 investment of $115 million in a Bangladesh microfinance project was a good decision in spite of the fact that less than 5 percent of borrowers lift themselves out of poverty each year" (Khandker, 2001). Khandker finds that "microfinance participants do better than non-participants in both time periods in per capita income, per capita expenditure, and household net worth. He argues that easy loan repayment terms help the poor by leveling off consumption, by building assets and net worth, and by helping the unemployed to become self-employed (Khandker, 2001). They found that household welfare is increased in terms of net worth and per capita consumption, but effects are much larger for female borrowers. They also found that the labor supply of both men and women is increased by microfinance, supporting the view that the programs generates employment.

### *1.5.3 Increase in consumption:*

Unproductive use of human resources, financial and other resource are root cause of poverty. Poverty has multi dimensions and persists due to this reason. Major hurdles in improving living standard are lack of finance. So the poor do not take any part in the economic development activities due to the lack of credit for improving their standard of living. Microfinance services such as: savings and micro-loans have direct impact on GDP (Gross Domestic product). An organized support to the microfinance is necessary to start smooth trend for poverty alleviation and economic growth (Awojobi & Bein, 2011). Five basic reason which cause poverty are low profit, high prices of commodities, hard economic times, lack of finance to start or expend their business, and lack of entrepreneur skills.

### *1.5.4 Increase in per capita income:*

As more micro-credit flow to the economy, enterprises starts to flourish and productivity increases which leads to increase in profits thus increase in per capita income, thus micro finance has positive impact on the economy. After taking loan borrower's income and their expenditure on family had also increased extensively. Customer's income had increased which shows that they become able to cross only the extreme poverty line while they remain near poverty line.

### *1.5.5 Increase in skills:*

Microfinance Institutions tends to offer some training to its clients, more especially on entrepreneurs' skills, this is basically to impart knowledge to enable their clients to utilize the loans efficiently so as to be able to expand their businesses and be able to pay back their loans. Microfinance sector required innovative ideas beyond traditional financial system. Social intermediation increase human capability and group based lending schemes reduce processing cost and decrease financial risk in relation to providing credit to poor.

### *1.5.6 Increase in productivity:*

Yunus explains that microcredit in Bangladesh had a "positive impact on enterprise and household income and asset accumulation". Microloans in the US have allowed small business owners to make their businesses their primary source of income with 67% of the borrowers showing a significant increase in their income as a result of their participation in certain micro-loan programs thus increasing the demand for goods and services which leads to high productivity in an economy.

### *1.5.7 Increase in household net-worth:*

The available evidence indicates that in many cases microcredit has facilitated the creation and the growth of businesses thus increasing profits which improves their household net worth. It has often generated self-employment:

## 1.6 Microcredit Summit

In 1997, Mohammad Yunus helped to organize the first international Microcredit Summit. At the conference 137 countries were represented and they agreed to build will, build capacity, and end poverty in the world (Yunus, 1999). In the Summit's Declaration, co-written by Yunus, the message was clear: Microfinance, as part of a much larger effort to end poverty, will provide "microfinance services, specifically credit for self-employment and savings capabilities" and shall focus on the world's poorest people. Women's access should be prioritized, as they are "very skillful at saving, highly creative entrepreneurs, and consistent in ensuring that earnings go directly to meeting family needs." Microfinance is an important tool for sustainable social and economic progress and a key strategy in ending poverty ("Declaration", 1997) (Yunus, 1997). The goals of the movement were further refined when the Microcredit Summit Campaign established four core themes: i) reaching the poorest, ii) ensuring a positive measurable impact on the lives of clients and their families, building financially self-sufficient institutions, iii) reaching and empowering women and the youth (Daley-Harris, 2002). These are the goals of the microfinance movement, first established at the Summit, and later refined in the four core themes.

### 1.7 Targeting the Poor

In microfinance, there is debate about whether institutions should target simply the "poor" or the "poorest" segments of the population. The poor are those who live below the poverty line established by each country, and the poorest are those in the bottom fifty percent of that group ("Declaration…" 1997). Although there is a consensus that microfinance should target the poor, there are different schools of thought on who should be targeted essentially, should the poorest or the poor be targeted? The first school of thought believes that microfinance should target the poor, those closer to the poverty line. Since the poor are most likely to have income-generating activities, their loans are theoretically more likely to lead to the creation of jobs in the local community, and benefits will trickle down to the poorest. In this case, financial efficiency is a goal because it allows the MFI to expand its financial services, reducing poverty on a larger scale than in the case of the poorest group.

The second school of thought criticizes this strategy because "redistribution by the creation of jobs or consumption does not necessarily benefit the poorest" (Diop, Hillenkamp & Servet, 2007). This second school prefers MFIs to target the poorest directly, no matter how costly it would be. The theory behind targeting the poorest is that the inability to invest is the principal block to productive activity. Increasing productivity in turn increases income, enabling the borrower not only to repay the loan and interest, but also to save and invest. Some methods for targeting the poorest have been to target women because they are generally poorer than men, or to target rural populations because they are generally poorer than urban areas. (Diop et al. 2007) argue that these methods are insufficient because the poorest can only be identified through considering local knowledge. If MFIs wish to target the poor, they have to employ staff with good local knowledge.

Other studies question the ability of microfinance to effectively reach clients significantly below the poverty line or suggest that poverty impact may be greater for non-poor than for poor clients (Mosley and Rock, 2004; Chowdhury, Mosley, & Simanowitz, 2004). As a result of the difficulty in making a distinction between the poorest and the poor, however, most academic studies discuss only microfinance as it affects the poor versus the non-poor: those below the poverty line and those above it. Why are the poorest least likely to benefit from microfinance? One possibility is that some MFIs may not even think about the poorest of the poor when defining their eligibility standards, placing bias in the design and management of MFIs toward better off clients at fault. A second possibility is that the standard model of microfinance is simply inherently incapable of reaching the very poor. A third possibility is that other institutions may simply not succeed in gaining the poorest clients because of problems of self-exclusion, or lack of sustainability of their participation (Diop et al., 2007, Chowdhury et al., 2004). The literature has shown that the poorest are least likely to benefit from microfinance. Since microfinance participants number in the hundreds of thousands.

### 1.8 Impact of Grameen Bank in Reducing Poverty

The Grameen Bank awards its branches up to five actors for their performance. Three indicators are related to financial performance: profitability, saving mobilization, and portfolio quality. Two stars are awarded on social impact measures, whether all school going children of Grameen borrowers are in school, and whether all Grameen families have left poverty. To make it easier to measure the final performance indicator, Grameen developed ten easily observable indicators that, when all are met, strongly suggest that a family has escaped poverty. These indicators are as follows: i) the family lives in a house worth of at least $380 at current exchange rates or a house with a tin roof, and each member of the family is able to sleep on a bed instead of the floor. ii) Family members drink pure water, boiled water or purified water. iii) All children in the family over six years of age are all going to school. iv) The minimum weekly loan installment of the borrower is $12 or more. v) The family uses a sanitary latrine. vi) Family members have adequate clothing for everyday use, warm clothing for winter, and mosquito nets to protect themselves from mosquitoes. vii) The family has sources of additional income, such as a vegetable garden, fruit bearing trees, etc., so that they are able to fall back on these sources of income when they need additional money. viii) The borrower maintains an average annual balance of about $75 in her savings accounts. ix) No member of the family goes hungry any time of the year. x) The family can take care of its health. If any member of the family falls ill, the family can afford to take all necessary steps to seek adequate healthcare.

### 1.9 Markets and the Poor

It has been argued that the role of the market is critical to understanding and addressing poverty. Different types of market situation impact on the lives of poor on daily basis, for example factor market of labour, land and financial services, commodity and product markets such as agriculture, service markets such as infrastructure and business services, and markets for services that are traditionally seen as more public in nature. (Ferrand, et al 2004) argues that countries that have succeeded in reducing poverty have used and shaped markets to provide for the right conditions, opportunities, services, information to allow people to raise their incomes. Furthermore, markets are at the heart of a successful economic growth because markets offer the means through which poor people can participate in economic activity. Several problems have been identified that hinder the role of markets in Kenya like accessibility to banks, the distance from rural areas to urban centers where banks are located is long and expensive for the poor, know how, how to open a bank account or providing references from existing account holders may present even greater constraints than the real distance, the personality of the poor, they have low esteem, their literacy level is too low for the formal bank systems and lack of the collateral that the formal banks demand.

**1.10 Informal Finance**

According to Beijuka (1999) the informal financial sector consists of a large number of small, non-registered micro-finance service providers, including: loans to relatives and friends, money lenders and a network of savings and credit cooperatives. Providing to the poor the financial services is one of the ways to help the poor to increase their incomes. The formal system requires collateral and it has complex legal and operational procedures, involving a lot of paper work. Credit disbursement is time consuming and the stigma attached to the poor people is so bad that the bankers do not think that they are credit worthy and their recovery rate is unsatisfactory. This has left the poor with little room for maneuver. Lack of savings and capital make it difficult for many poor people to undertake productive employment generating activities. In response to missing credit markets for the rural poor, microfinance institutions (MFIs) have attempted to bridge the gap by extending small loans for income generating purposes. Informal finance involves savings, borrowing and lending activities. It also involves short term small loans and deposits. Operations without collateral, provides easy entry and quick access to credit and is not regulated by formal laws. Informal finance caters to specific needs of clients, and the funds are locally generated and circulated within the group or community. In most low income countries, informal finance flourishes because formal financial systems often exclude the poorer sections of the society. The informal system has advantages for example the credit disbursement is easy and relatively quick. No collateral is required and there is least paper work. Credit can be given for any activity, especially for consumption and emergency purposes without any complication.

**1.11 Financial Markets**

In order to mobilize capital, the Kenyan government has realized the need to develop capital markets. Financial services do not only play an important role in economic development but also the pace and pattern of rural development are influenced by the efficient functioning of markets. The role of the financial sector from the financial markets perspective is crucial because it encourages productive use of resources and enforcing of contracts. It helps to mobilize and allocate resources, coordinate savings and investments. It is widely believed that both the formal and informal financial institutions represent one of the most important institutional infrastructures necessary for the efficient operation of the financial markets. The existence of efficient financial markets is a security against future shocks and vagaries of nature. It facilitates and intermediates between investors and savers leading to capital formation both in group and at individual levels. It has been argued that capital investment is a key factor in determining economic growth and increasing income. It has been argued that capital markets will improve domestic resource mobilization and consequently promote its efficient use. In most African countries, their governments have been responsible for the financing of the public sector using mostly donor resources.

**1.12 The Role of Microfinance in Development**

Microfinance has an important role to play in development, according to proponents of microfinance. Studies have shown that microfinance plays three key roles in development: i) It helps very poor households to meet basic needs and protection against risks, ii) It is associated with household improvements in economic welfare and iii) It helps to empower women by supporting women's economic participation and so promotes gender equity. Various ways in which microfinance contributes in combating poverty, she states that microfinance creates access to productive capital for the poor, which together with human capital, addressed through education and training, and social capital, achieved through local organization building, enables people to move out of poverty. MFIs by providing material capital to a poor person, their sense of dignity is strengthened and this can help to empower the person to participate in the economy and society (Otero, 1999). (Mayoux, 2001) states that while microfinance has much potential, the main effects on poverty have been: credit making a significant contribution to increase incomes of the better-off poor, including women, microfinance services contributes to the smoothening out of peaks and troughs in income and expenditure thereby enabling the poor to cope with unpredictable shocks and emergencies.

Hulme and Mosley (1996b) show that when loans are associated with an increase in assets, when borrowers are encouraged to invest in low-risk income generating activities and when the very poor are encouraged to save; the vulnerability of the very poor is reduced and their poverty situation improves. (Johnson and Rogaly, 1997) also refer to examples whereby savings and credit schemes were able to meet the needs of the very poor. They state that microfinance specialists are beginning to view improvements in economic security, rather than income promotion, as the first step in poverty reduction. We have seen that when MFIs understand the needs of the poor and try to meet these needs, projects can have a positive impact on reducing the vulnerability, not just of the poor, but also of the poorest in society.

**1.13 Research Evidences on Poverty Reduction**

As per the report of Center for Policy Studies and Rural Development, 2004, indicated that were changes in the wealth status after participation in the micro-credit program, however the results of MF programs has not been consistent throughout the globe. It seems to have more positive impact in Asian Countries than other part of the world. Some of the findings of studies carried out throughout the word are presented here: In Malaysia: micro-finance has a positive impact on household income of women borrowers who spent three years in the scheme as compared to new borrowers (Samer, Majid, Rizal, Muhammad, Halim, and Rashid, 2015). Poverty reduction can be achieved through alleviation measures that is the use of micro-credit and entrepreneurship development. The extensive use of micro financing has shown to reduce extreme poverty among the users of microcredit more especially in Bangladesh: Microcredit may be a more effective remedy against poverty and vulnerability if it is complemented by other interventions (Zaman, 2004). Pakistan microfinance Scheme helped people to improve their living standards and provided them with financial opportunity to expand their business (Ayuub, 2013) India: Access and efficient provision of microcredit can enable the poor to improved quality of life (Bansal and Bansal, 2012) in Bangladesh: Access to microfinance contributes to poverty reduction, especially for female participants, and to overall poverty reduction at the village level (Khandker, 2005). Studies in Bangladesh indicates that the extent of positive impact has not been equal for all program borrowers (Azad, 2004).

In February 2006, Secretary-General of UNDP (United Nations Development Programme) released a report saying that "the proportion of poor people living on less than one dollar a day in developing countries declined from 27.9 to 21.3 per cent between 1990 and 2001, a transition of roughly 118 million persons out of extreme poverty. This inspiring result lit up the Millennium Development Goals (MDGs) which target halving extreme poverty at the national level by 2015. "Review of the first United Nations Decade for the eradication of poverty (1997-2006)" UNDP. The Millennium development Goals are eight goals that 191 United Nations member stated to have agreed to try to achieve by the year 2015. As the UNDP report said, "Global poverty reduction has been driven by China, in fact, China has already achieved the poverty reduction target: the number of people living in extreme poverty there fell from 377 million to 212 million between 1990 and 2001, or from 33 per cent to 16.6 per cent of the population." However, China makes up about 22 percent of the earth's total population, so the moderate percentage of 16.6% still means a huge absolute number living in poverty.

In 1974 Grameen Bank (GB) made its first small loan of $27 to a group of 42 families. Nowadays, the cumulative investment of the GB in 2005 in rural Bangladesh is more than five billion dollars, disbursed among 5.3 million borrowers, 96% of whom are women (Grameen Bank, 2005), and the GB operations have contributed between 1.1 to 1.5 percent of GDP of Bangladesh (Grameen Bank, 1999). By way of comparison, the small scale industries sector contributes less than 4% and agriculture and fisheries around 3% of GDP, suggesting that the Grameen Bank's contribution is quite substantial (Wright, 2000). Incredible cases such as this made microfinance attractive for countries which are pressed by chronic poverty and inequality. It is understandable that developing countries should be concerned with poverty reduction. Poverty alleviation has not been greatly emphasized as a policy objective in these countries.

During the past two decades, China has rapidly become one of the most important engines of growth in the world. Data from National Bureau of Statistics of China shows that from 1979 to 2004 the average annual GDP growth rate was 9.6%. Like many other developing countries, some problems appeared in China, along with the rapid yet uneven growth: i) the gap between the rich and poor. According to research by the Treasury Ministry of China in 2003, the Gini Coefficient for the National Income of China has reached 0.46, which has surpassed the international alerting line 0.4. Though a debate arose around whether it reflected the real condition in the country, research still conveyed that the inequality between rich and poor in China is very serious. Despite the rapid growth rate, there are still huge numbers of people living under poverty line.

Morduch (2002) carried out a study on microfinance and poverty reduction using independent variables such as: assets, education, microcredit, family size and income of household as dependent variable. According to (Morduch and Hashemi 2003) indicated that there have been an increase in income and assets, and decreases in vulnerability of microfinance clients. The reference projects in India, Indonesia, and Uganda that have been able to reduce poverty among the poor and improve their general wellbeing. (Asemelash, 2002) in Ethiopia confirmed a positive impact of microfinance on beneficiaries as compared to non-beneficiaries. He showed that microfinance has impacted positively on income, asset building, access to schools and medical facilities in the study area. (Goldberg 2005) observed that with introduction of microfinance in Bangladesh, the poor no longer remained as poor. (Mawa 2008) confirmed that microfinance is an innovative step towards alleviating poverty. In Ghana, evidence exists on the positive impact of microfinance and generally on women empowerment, increase in respect and decision-making, rights within the family as well as increased self-esteemed (Cheston and Kulhn, 2002).

Poverty alleviation has been an important issue of many civilized society in all over the history. For this purpose different methods and policies have been adopted in Pakistan, for example special programs and short-term measures target for the increase in living standards of a large number of people and provide them with sense of social security. The hope is that the provision of savings and credit is both effective in fighting poverty and more financially viable than other means. Microfinance allows poor people to protect, diversify, and increase their sources of income, the essential path out of poverty and hunger. Various studies of microfinance programs are largely supportive in reducing poverty. In Zimbabwe, extremely poor clients of Zambuko Trust, a local MFI increased their consumption of high protein foods when food expenditures across the country as a whole decreased (Barnes 2001). In India, in addition to increased economic wellbeing, MFI's clients showed a striking shift from irregular, low-paid daily labor to more diversified sources of income, with a strong reliance on small businesses (Simanowitz and Walters, 2002).

In Ethiopia, a study commissioned by the Dedebit Credit and Savings Institution (DECSI) and Norwegian People's Aid find that compared with non-clients, the DECSI clients experienced improvement in income, asset holdings, consumption and assets. The DECSI clients also seemed to have more food security and were less vulnerable to food emergencies (Alex, Joe, Weldehana and Tassew, 2003). In Tanzania, the income and assets values of borrowers are almost twice larger than those of non-borrowers (REPOA 2005). (Deininger and Lu 2010), World Bank researchers, also find that there are significant economic gains from program participation in the form of better nutrition, increased asset accumulation, higher levels of consumption and consumption smoothing. Despite the hype about microfinance being the best way to create jobs, increase workers' productivity and eradication of poverty.

**1.14 Criticism of Micro-Credit**

According to (Copestake 2002) microfinance discrimination in favour of the richer clients who have benefited from better access to credit, and the exclusion of poorer people in society. If one of the aims of microfinance is to assist the "poorest of the poor" then microfinance is not always the most appropriate intervention in poverty reduction. They state that microfinance is not a cure-all for poverty alleviation and that in some cases the poorest people have been made worse- off by microfinance. However (Roth 1997) has another view. He argues that microfinance programmes often treat the symptoms and not the causes of poverty. Poverty is the result of powerlessness. He argues that credit is only one ingredient in the mix of factors necessary for the successful enterprise. He is critical of the microfinance evangelists who create a vision of the rural poor as a collection of good entrepreneurs, a waiting for salvation from credit agencies, which on receipt of the credit, will develop successful micro enterprises and leave poverty forever.

It is observed that clients are using micro-credit for consumption and not for business, moreover, it is also a means to settle the existing debt and it eventually entails debt accumulation. It is so, since most borrowers are self-employed and work in the informal sector, their incomes are often erratic; small, expected expenses can make repayment impossible in any given month or year, other studies have witnessed that microloans are often used to finance consumption and domestic expenses. (Cowen and Boudreaux 2009) found that many borrowers use the money on personal expenses: fixing their roofs, sending kids to school, purchasing a mobile phone rather than on a small business. Apart from infrastructure, micro entrepreneurs need access to information about market trends and skills to run their macro enterprises. (Weber 1958) who argues that hard work, skills and enthusiasm are essential ingredients for an enterprise to be successful. (Ismawan, 2000) calls for differentiation between two categories of the poor, some are able to increase their income by themselves, create business activities that would enable them to move above the poverty line.

Rogaly (1996) finds five major faults with MFIs. He argues that: i) MFIs encourage a single-sector approach to the allocation of resources to fight poverty, ii) micro-credit is irrelevant to the poorest people, iii) an over-simplistic notion of poverty is used, iv) there is an over-emphasis on scale, v) there is inadequate learning and change taking place. (Wright 2000) states that much of the skepticism of MFIs shoots from the argument that microfinance projects "fail to reach the poorest, generally have a limited effect on income, it has driven women into greater dependence on their husbands and fail to provide additional services desperately needed by the poor. In addition, Wright says that many development practitioners not only find microfinance inadequate, but that it actually diverts funding from "more pressing or important interventions" such as health and education.

As argued by (Navajas et al 2000), there is a danger that microfinance may siphon funds from other projects that might help the poor more. They state that governments and donors should know whether the poor gain more from microfinance, than from health care or food. (Sinha 1998) argues that it is notoriously difficult to measure the impact of microfinance programmes on poverty. She argues, this is so because money is fungible and therefore it is difficult to isolate credit impact, but also because the definition of 'poverty', how it is measured and who constitute the 'poor' "are fiercely contested issues". Poverty is a complex issue and it is difficult to define, as there are various dimensions to poverty. For some, such as (World Bank, 2003) poverty relates to income, and poverty measures are based on the percentage of people living below a fixed amount of money, such as US$1 dollar a day.

Critics say that microcredit has not increased incomes, but has driven poor households into debt trap in some cases even leading to suicide. They add that the money from loans is often used for durable consumer goods instead of being used for productive investments, that it fails to empower the poor and that it has not improved health or education. Microcredit has achieved much less than what its proponents said it would achieve, but its negative impacts have not been as drastic as some critics have argued. A critical review of 58 papers covering experiences in 18 countries concluded that "there is no good evidence for the beneficent impact of microfinance on the well-being of poor people" and that "the greatest impacts are reported by studies with the weakest designs". Many early studies compared borrowers with non-borrowers, this is wrong because the borrowers choose among themselves with good abilities in entrepreneurship, meaning that they are likely to do better than those who never borrowed because he or she have no entrepreneurial knowledge and skills. But if borrowers are more entrepreneurial than those who do not borrow, such comparisons are likely to wrongly overstate the effect of microcredit. (David Hulme and Paul Mosley, 1996), Came up with this argument that the poor households do not benefit from microfinance, it is only the middle class borrowers with incomes above poverty lines who can do well with microfinance and enjoy sizable positive impacts. More worse is the finding that the majority of those with starting incomes below the poverty line actually ended up with less incremental income after getting micro-loans, as compared to a control group which did not get such loans.

According to (Vijay Mahajan, 2005), a social entrepreneur, writes “microcredit is a necessary but not a sufficient condition for micro-enterprise promotion. Other inputs are required, such as identification of livelihood opportunities, selection and motivation of the micro-entrepreneurs, business and technical training, establishing of market linkages for inputs and outputs, common infrastructure and sometimes regulatory approvals. In the absence of these, micro-credit by itself, works only for a limited familiar set of activities – small farming, livestock rearing and petty trading, and even those where market linkages are in place.” (Robert Pollin, 2007) has a similar view, and puts it in the following words: “micro enterprises run by poor people cannot be broadly successful simply because they have increased opportunities to borrow money. For large numbers of micro enterprises to be successful, they also need access to decent roads and affordable means of moving their products to markets. They need marketing support to reach customers”. This is important for people to note that only micro-credit without other factors in support may not necessarily lead to poverty reduction, instead it will increase poverty rate. As a matter of fact, most promoters of microfinance do not fully disagree that microfinance alone cannot do. (Sam Daley-Harris, (2007) Director of the Microcredit Summit Campaign, writes “Microfinance is not the solution to global poverty, but neither is health, education, or economic growth, there is no one single solution to global poverty. The solution must include a broad array of empowering interventions and microfinance when targeted to the very poor and effectively run it becomes one of the powerful tools in reducing poverty.

In the words of (Professor Yunus, 2003) emphasized that “Micro-credit is not a miracle cure that can eliminate poverty in one fell swoop, but it can reduce poverty for many and end its severity on others, if micro-credit is combined with other innovative programs that unleash people’s potential, micro-credit is an essential tool in our search for a poverty-free world. There is broad agreement about the need for complementary factors for microfinance to have some positive impact on poverty reduction. The supply of microcredit does not necessarily ensure the availability of complementary factors in adequate quantities and quality. Some microfinance institutions and non-government organizations (NGOs) seem to have understood the need for such factors and, therefore, also offer training to build management and entrepreneurial skills. There are also NGOs which provide basic education in rural areas using innovative methods. These are all potentially positive developments for poverty reduction efforts. The underlying reasons are perpetual cycle of debt, inability to reach the poorest of the poor, the infrastructural problem, overlapping, disbursing credit or use of credit to unproductive sector, extreme attention to loan recovery, ignorance of human capital, higher rate of interest (although it is still lower than village money lenders who charged on an average of 120 percent interest rate) and limited access of poor to the economic stream among the important factors.

The question, nevertheless, remains as to how long microfinance can continue to provide consumption smoothing support or extending the payments schedule. Thus, the continuing intense debate about the impact of microfinance on poverty reduction is not surprising. Market imperfection and the high fixed costs of small scale lending, limits the access of the poor to formal finance, thus pushing the poor to the informal financial sector or to the extreme case of financial exclusion. Opponents resist that microfinance does not address the economic problem of the poorest. They further claim that if it addresses at all, either it benefits the middle poor or it caught the poor in subsistence activities with no specialized skills (Cowen and Boudreaux, 2009*; Kondo* et.al., 2008; Banerjee and Duflo, 2006; Imai et al. 2006; Morduch, 2005) are some behind this proposition. Other studies have found that poverty is not reduced through micro-credit poor households simply become poorer through the additional burden of debt. Since more money for micro-credit in practice means less money for other programmes with similar aims, it is extremely important to carefully evaluate whether or not “small loans for poor people” in fact works.

In terms of credit, they found the potential for borrowers to experience diminishing returns to consumption; in other words, each new loan has a smaller effect on per capita consumption (Pitt and Khandker, 2001). Khandker (attributes the lower rate of poverty reduction among program participants is 8 to: 1, diminishing returns to additional borrowing that meant increases in consumption were not large enough to reduce poverty; Khandker argues that microfinance accounts for more than half of the observed annual reduction in poverty among participants and that there was growth in local income. The “average village poverty level fell by 1 percentage point each year” and, “microfinance continues to reduce.

### 1.15 Research Gap

Many outstanding specialists in this sector consider the entrance of the profit motive as threats than potential sources of capital and pronounce the issue of humanity. It is inhuman and unfair to see a world where a few hundred million people enjoy access to all the resources of the planet, while over billions struggle to survive. Yunus cites one study that concluded in the year 2000, "the richest 1 percent owned 40 percent of the world's assets, and the richest 10 percent owned 85 percent. By contrast, the bottom half of the world's population owned barely 1percent of the planet's assets" (Yunus, 2007). Therefore the broader shift towards the profit model began in the nineties, when Acción International, a network of Latin American institutions concluded that“ commercialization was the only way microfinance could serve large numbers of people, because commercial enterprises could tap the capital markets for the funds they needed to grow” (Morduch, 2005).

The reviewer however feel that research study needs to be done in order to investigate and find out whether it is possible for financial institutions to shift from nonprofit into profit orienting commercial banks that is private commercial banks by charging little bit high interest rates in order to earn profits so has to sustain its operations and be able to reach a large group of poor clients. There has been much criticism of the high interest rates charged to borrowers.

It has been said that microfinance has enslaved women rather than setting them free, being independent financially and not depend much on their husbands, hence a research study should be done to prove this out.

Microfinance institutions have been criticized for creating small debt traps for the poor in with high interest rates and coercive methods of recovery. Who are in a position of power locally and are remunerated based on repayment rates sometimes use coercive and even violent tactics to collect instalments on the microloans. The reviewer also suggest that a research study need to be done on determining to what extent the micro-credit has been able to improve the ability of clients in decision-making and the income promotion to bring about high standard of living.

## 2.0 Theoretical Framework

Despite the lack of data in the sector, it is clear that a wide variety of implementation methods are employed by different MFIs. The (Grameen Bank 2000) has identified fourteen different microfinance models of which the reviewer will focus on the common ones used in most research studies. The details are as under:

### 2.1 Individual lending model:

These are the loans given on individual basis: Individual lending is more flexible, but minimum loan sizes are given to always by larger members of credit groups. Within broad limits, loan sizes are negotiable, tailored to the borrower’s activity and the ability to pay. Loan amounts and maturities increase as the borrower demonstrates prompt repayment and acceptable loan use. It has been argued that group credit arrangements tend to deteriorate over time, while individual lending can go from strength to strength if good institutions are in place to provide incentives for repayment and it depends on individual ability to invest in viable businesses, and this is where MFIs are supposed to give entrepreneurial training.

### 2.2 The Grameen Solidarity Group model:

This model is based on group peer pressure whereby loans are made to individuals in groups of four to seven (Berenbach and Guzman, 1994). Group members collectively guarantee loan repayment, and access to subsequent loans depends on successful repayment by all group members. Payments are usually made weekly (Lidgerwood, 1999). According to (Berenbach and Guzman 1994), solidarity groups have proved effective in deterring defaults as evidenced by loan repayment rates attained by organizations such as the Grameen Bank, who use this type of microfinance model. Under the Grameen Bank variation of this model, groups contain five members and savings must be contributed for four to eight weeks prior to receiving a loan. Savings must also continue for the duration of the loan term. Only two of the group members receive a loan initially. After a period of successful repayment, two highlight the fact that this model has contributed to broader social benefits because of the mutual trust arrangement at the heart of the group guarantee system. The group itself often becomes the building block to a broader social network. Group lending is an “invention” of Grameen Bank, which opened up possibilities for microfinance to borrowers without collateral. There are three main ways through which group lending works:

#### *2.2.1 Self-selection model:*

Before the group lending contract is signed, those people who share a similar attitude towards risks and are familiar with each other’s credit level would form a group through peer selection. The high-risk borrowers are excluded because no one will want them in his or her group. “A group has to be formed very carefully by the individuals to weeds out bad borrowers who could jeopardize the creditworthiness of the group as a whole” (Ray, 1998).

#### *2.2.2 Joint liability model:*

The mechanism of group lending generates group responsibilities, which means risks of the loan are shared by members of the group. Letting down other members of a group and the accompanying of social sanctions are a strong disincentive to default. Also, the other group members can repay even if one defaults, in order to secure the loan, thus reducing the risk of default.

#### *2.2.3 Close relationships model:*

Group members are familiar with one another, and it can lessen adverse selection problems aroused by

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information unevenness, as group members can monitor each other's actions and apply social sanctions in advance if necessary.

***2.3 Rotating Savings and Credit Associations (ROSCAs):***

This is formed when a group of people come together to make regular cyclical contributions to a common fund, which is then given as a lump sum to one member of the group in each cycle (Grameen Bank, 2000b). According to (Harper 2002), this model is a very common form of savings and credit. He states that the members of the group are usually neighbours and friends, and the group provides an opportunity for social interaction and are very popular with women. They are also called merry-go rounds or Self-Help Groups (Fisher and Sriram, 2002).

**2.4 Village Banking Model:**

Village banks are community managed credit and savings associations established by NGOs to provide access to financial services, build community self-help groups, and help members to accumulate savings (Holt, 1994). They have been in existence since the mid-1980s. They usually 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, 2000c). The loans are backed by moral collateral which is the promise that the group stands behind each loan (Global Development Research Centre, 2005). The sponsoring MFI lends loan capital to the village bank, who in turn lend 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 percent of the loan amount per cycle (Lidgerwood, 1999). Members' 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 profits from the village bank's re-lending activities

**2.5 Credit and collateral model:**

Credit refers to a contractual agreement, in which a borrower receives something of value now, with the agreement to repay the lender at some date in the future. Credit can benefit both borrower and lender if the borrower has an investment opportunity with a higher expected return of revenue than the cost of providing the loan. The lender provides a borrower with capital in advance, under the expectation that they will pay back, with a price, the interest rate. To the lender, the aim is to have the capital back with a return that covers its cost, expenses and give some profit to the borrower. The borrower applies for the credit based on belief that he can gain a return higher than the interest rate. However, lending involves a risk of default. Defaults can be grouped into two types: involuntary default and strategic default. Involuntary default is as a result of failure in investment which makes the borrower incapable to repay the loan amount. Strategic default refers to a situation where the borrower has the ability to repay the loan, but he does not find it in his interest to do so. This often happens, especially in contexts where the legal system of loan enforcement is weak.

**2.6 Target groups:**

The clients of microfinance are mainly female households, small farmers and micro-entrepreneurs. Targeting women has always involved efficiency considerations because of high female repayment rates and the contribution of women's economic activity to economic growth. The targeted individuals are categorized as "the poor", even when a division into different kinds of poor is made: "destitute, extreme poor, moderate poor and vulnerable non-poor". The representation of poor people and how they are benefiting from microfinance services implies homogeneity.

**2.7 The poverty lending model:**

It concentrates on reducing poverty through credit, often provided together with complementary services such as skills training and the teaching of literacy and numeracy, health, nutrition, family planning, and the like. Under this model donor and government funded credit is provided to poor borrowers, typically at below market interest rates. The goal is to reach the poor, especially the extremely poor, the poorest of the poor with credit to help overcome poverty and gain empowerment (Robinson, 2001). Grameen is an example of these systems. It began as a poverty lending program, relying largely on donor subsidies, mandatory savings, and aimed to target the poorest of the poor. In 1998 Grameen stopped receiving donor funds and in 2002, Grameen II was launched, promoting greater outreach, and more flexible financial services such as individual loans and open savings accounts. Yunus sees the financial systems model as a method to reach greater numbers of people. Yunus dislikes enterprises dedicated to making money or profit maximization but promotes the use of profits as a method to build what he calls a social business: A social business is a non-loss, non-dividend enterprise, created with the intention to do well to people, to bring positive changes to the world, without any short-term expectation of making money out of it (Yunus, 1999).

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**2.8 Dynamic *incentives* model:**

In microfinance practice, dynamic incentives model have proved to be an effective way of reducing default rates, and have been widely used in group as well as individual lending. There are two main types: firstly, if the borrower repays the loan in time, he can get the same sum. Type two is an "aggressive loan". If the borrower repays the loan in time, the loan he gets next time will be bigger. For a borrower, to get a steady and bigger financial resource is a Practical incentive to fulfil the contract. This model inspires the borrowers to put more of their efforts in their business.

**2.9 Frequent repayment, or regular repayment schedule model:**

Many MFIs use this mechanism which means shortly after the borrowers get their loan, they should begin to repay part of the loan monthly or weekly. This method has several advantages. Firstly, when a borrower repays a percentage of loan every month, it conveys a signal that the whole loan or the majority of the loan is running well, and it helps the lender to know the condition of loan regularly. Secondly, this mechanism actually needs the borrower to own some property as a guarantee of frequent cash income, which also can help the lender reduce the risk of default.

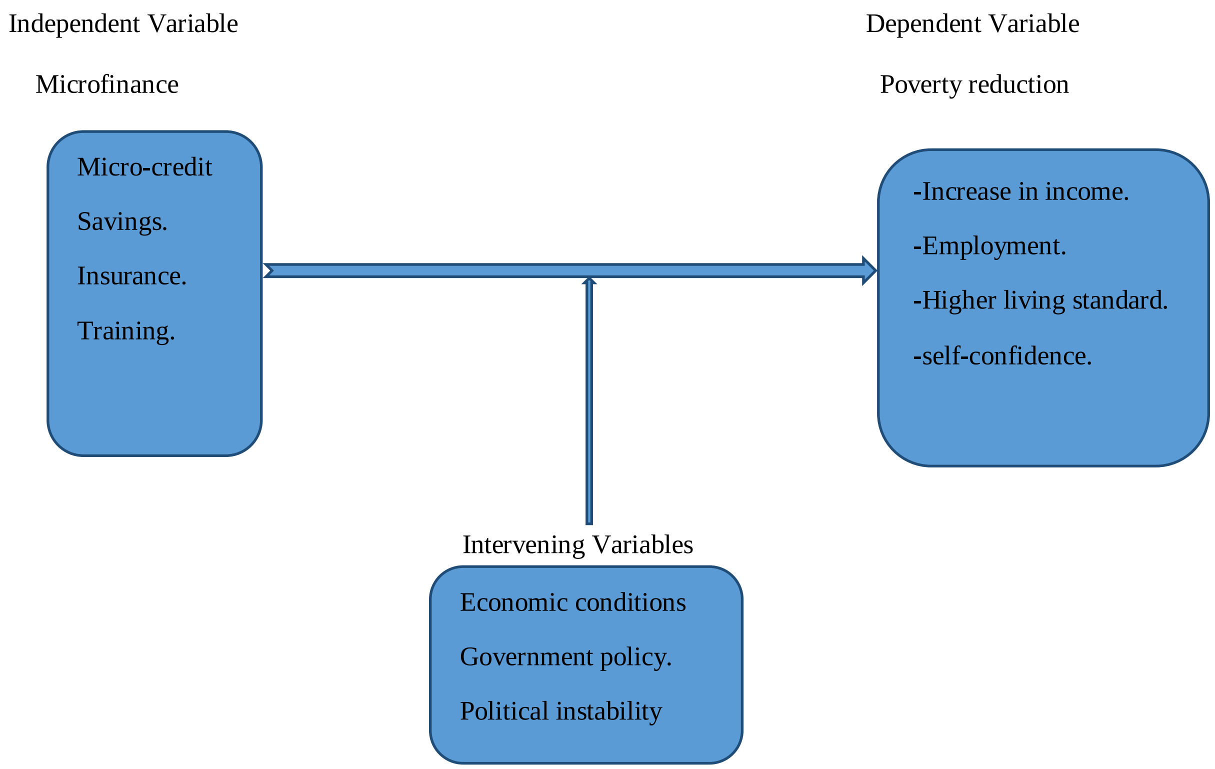
**2.10 Collateral substitute model:**

As MFIs' targets are low-income groups, so clients usually cannot supply conventional forms of collateral. However, the poor may be able to supply other forms of collateral. These collateral substitutes can be a 'group communal fund' or 'compulsory savings'. In some microfinance models, MFIs may ask the borrowers to put a percentage of a loan into a saving pool which acts as a collateral substitute to some extent.

**2.11 Targeting women model:**

More than 80% clients of Grameen Bank are women. In China, female clients of microfinance projects are almost 48.9% (Cao, 2006). It has been empirically analyzed that women have higher repayment rates and more stability socially and also, a woman's financial activities may influence the whole family through her role as a mother and a wife. Targeting women helps to improve repayment rates, and could fulfil the goals of poverty reduction more effectively. At the same time, microfinance, as it has surpassed its original term. Microfinance has become more extensive in terms of financial services, involving loans, savings, Insurance and transfer services. Multi-dimensional microfinance, not restricted to small loans, has proved to be more effective in poverty reduction. For instance, micro-insurance focuses on helping poor people deal with fluctuations of their production

## 3.1 Conceptual Framework



**3.2 Independent Variables:**

***3.2.1 Microfinance:***

"Microfinance refers to provision of financial services to low income earners and the poor in general to raise their income levels thus promoting their standard of life. These include the following:

***3.2.2 Micro-credit:***

These are the provision of small loans to clients for business purposes.

***3.2.3 Savings:***

They are small amounts of money, the clients are encouraged to save in the financial institutions.

***3.2.3 Insurance**:*

All entrepreneurs face risks in their businesses and therefore it becomes necessary for financial institutions to insure various businesses by the use of different policies to reduce the risks involved in running businesses.

***3.2.4 Training & skills**:*

Financial institutions offer various training programs to equip the clients with the required knowledge and skills necessary to run their business efficiently.

**3.3.0 Dependent variables:**

***3.3.1 Poverty reduction.***

The major objective of microfinance services is to empower the poor and this is done by giving various financial services to their clients. The following are the factors that contributes to the fulfilment of the above objective:

***3.3. Increase in income levels:***

It is obvious that as employment opportunities comes up, the unemployed will be able to get jobs which have been created and those who had temporary jobs may now get permanent jobs and this will obviously lead to an increase in individual as well as national income.

***3.3.4 Creation of employment opportunities:***

Better utilization of the loans given to clients of MFIs in most cases leads to expansion of businesses and this in turn will also lead to creation of employment opportunities to the society.

***3.3.5 Higher living standard:***

As the income of the people increases, individuals are able to purchase goods and services which in return leads to increase in the standard of living. Increase in the National income enables the nation to inject more money for the development of infrastructural development which also will see the standard of the people increasing.

***3.3.6 Self-confidence:***

When people have high incomes and their standard of living goes up, this builds in them self-confidence, people psychologically feel recognized and self-worth.

## Discussions

The poor have been borrowing from money lenders i.e. landlords from time immemorial. Micro-enterprises have been operating for a long time in many poor societies, and form the vast informal sector associated with developing countries. However, the real discovery is the concept of "group lending" which effectively overcomes the problems of collateral and adverse selection due to information irregularity through peer monitoring. Impact analysis of microfinance suggests that the majority of borrowers who already have some assets or business skills and education are more likely to succeed. Note that 55 percent of established Grameen clients never go hungry, have access to safe drinking water, and sending their children to school is important to Grameen. On the other hand, the rural poor may not benefit equally from economic growth. The point is that a simple "pre-post" before and after comparison can be useful, but does not yield enough information to definitively determine the impact of the microfinance programs. So long as Grameen members are raising their incomes faster than non-clients we can have some assurance that Grameen is having an impact.

The goals of microfinance as established in the 1997 Microcredit Summit have been largely unmet. The poorest are the least likely to benefit from microfinance and incomes are not increased though there is provision of microfinance, this is because a good portion of loans are being spent on consumption and the little which is left for investments are invested in projects which are not carefully thought. Important benefits have been identified, however, such as consumption smoothing and the establishment of social networks. These benefits can be equally as important. The argument for fiscal sustainability assumed for profit MFIs would reach greater numbers of poor, but for non-profit MFIs reach the poor at a lower rate compared to non-profit MFIs and the definition of profit is not as clear cut as previously believed. Microfinance has provided important contributions to the development world. It was found that savings are vital and are perhaps more important to the poor, that the poorest are probably better served by direct subsidies rather than loans. Although microfinance is certainly not a panacea for poverty, it can prove itself a useful tool in the fight against poverty.

There is much debate in the field of microfinance as to whether access to financial services benefit the "the poorest of the poor". It has been argued that while there are now many credit institutions serving the poor, there is less evidence of successfully indicating that the very poor, the destitute, and the disabled are well served. The poor are not just deprived of basic resources, but also they lack access to information that is vital to their lives and livelihoods that is: information about market prices for the goods they produce, about health, the structure and services of public institutions, their rights and they lack political prominence and voice in the institutions and power relations that shape their lives. The Scheme of Microfinance has been found as an effective instrument for lifting the poor above the level of poverty by providing them with jobs and self-employment opportunities thus making them credit worthy. The microfinance objectives in India has reached at top point similar to Bangladesh. With some effort substantial progress can be made in taking MFIs to the next track of significance and sustainability. People belonging to villages are still unaware about banking policies and credit system. So NGO should communicate to them and share their view with villagers. Banks should convert and build up professional system into social banking system for poor. Despite the apparent success and popularity of microfinance there has been mixed evidence on its effects on the social and economic wellbeing of the poor (Duvendack et al. 2011, Stewart et al. 2010, 2012).

Micro-finance is certainly not a medicine for poverty, it has proved itself as a useful tool to fight against poverty. It has provided important contribution in the countries like Nepal, Bangladesh and Malaysia but it is not fruitful in the most undeveloped countries of Africa. In Nepal, development of microfinance has improved the living standard of her rural people. Impact analysis of micro-finance suggests that the majority of borrowers who already have some assets or business skills and education, are more likely to succeed through MF intervention. Financial system approach and poverty lending approach both are beneficial for the poor. The extensive use of micro financing has perceived to reduce extreme poverty among the users of microcredit more especially in Bangladesh: Microcredit may be a more effective remedy against poverty and vulnerability if it is complemented by other interventions (Zaman, 2004).

## Recommendations

As a result of the difficulty in making a distinction between the poorest and the poor, however, most academic studies discuss only microfinance as it affects the poor: the following recommendations should be followed:

i) Loan size should be increased to meet the requirements of borrowers but this should be done very carefully depending on the ability of the client to pay and on the suitability of each project. This is important because the clients would be able to expand their businesses and this will also create employments thus achieving the objective of poverty reduction.

ii) The microfinance should enlarge their territories so as to reach more poor people this will in return create more opportunities thus bringing about an increase in income thus economic empowerment. MFIs have better understanding about the problem of rural areas so they can provide better and flexible services to increase satisfaction level of the clients.

iii) Microfinance institutions should provide training skills and knowledge in time in order to equip their clients in advance and this will enable the clients to better utilize their loans effectively, thus reducing the rate of default among the clients and benefit both the clients as well as the MFIs.

iv)) Customer orientation training to staff members must be conducted to teach them how to deal properly with their clients, and in return the staff should be able to train and impart the required skills to the clients in time so as to be able to utilize their loans as required.

v) The MFIs should reduce their interest rate, so that more and more poor applicants can be able to access these loan facilities thus increasing the impact of micro-credit among the poor.

vi) One observable problem in all MFIs is that they have no enough staff as compared to their clients. They must increase their staff members or adopt new advanced systems to deal effectively with their clients' demand.

vii) All Microfinance Providers if they want to reach to their all the real poor in the grass root level in rural areas then they must diversify their facilities by giving small loans to low level employed workers such as nurses, teachers and civil servants as well as pensioners.

viii) The microfinance institutions should simplify their application forms and procedures so that the forms should be easily understood and take be less time consuming.

ix) The MFIs should provide a broad range of financial products and services including Mobile Banking according to the need of clients, so that they are able to increase the number poor applicants to access loan facilities.

x) (David Hulme and Paul Mosley, 1996), Came up with this argument that the poor households do not benefit from microfinance, it is only the middle class borrowers with incomes above poverty lines who can do well with microfinance and enjoy sizable positive impacts. More worse is the finding that the majority of those with starting

incomes below the poverty line actually ended up with less incremental income after getting micro-loans, as compared to a control group which did not get such loans.
xi) MFI can also do joint venture with other MFIs or any other money transfer agency, which had already established branches in all over the country, to make their services be rendered effectively.
xii) MFIs should focus on Mobile banking because all Microfinance Institutes are considering the Mobile Banking as center of attention, this reduces the cost of transport and time wasted to travel to urban center for banking services.
xiii) Disbursement of loan and payment procedure must be flexible according to the requirement of customers. For example the farmer who has harvested a single crop can pay both principle and interest amount at the end of the season or harvesting period.
xiv)) If all MFIs wants to reach on the root level in rural areas then they must start giving small loans to salaried workers such as nurses, teachers and civil servants as well as pensioners.

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