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**Timeline**

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**Sample Size**

757 microenterprises

**Research Implemented by IPA**

No

# Asset-based Finance for Microenterprises in Pakistan

## Abstract

Lack of access to finance limits small business growth—a problem that is exacerbated for Muslim business-owners, many of whom do not take out traditional loans for religious reasons. Innovations for Poverty Action supported research in Pakistan on a lease-based product that features more flexible repayment schedules, allows businesses to share risk with a large microfinance institution, and complies with local Islamic financial norms. Participating clients were more likely to remain self-employed, and had larger businesses, better business management practices, and better business performance. These positive results also extended to households, with incomes rising by 8 percent and monthly spending by 6 percent. There was no significant difference in impacts between the two types of contracts.

## Policy Issue

Limited access to finance restricts the growth of small enterprises. Policymakers hoped that microfinance would overcome this problem, but research has shown that traditional microfinance products with high interest rates and immediate repayment requirements rarely increase business profits or have a significant effect on household income. However, loan products with increased flexibility (such as grace periods for missed payments) may improve business profits,<sup>[1]</sup> and grants have helped at least some types of microenterprises grow.<sup>[2]</sup> Lease-based contracts (in which a bank helps a client buy a fixed asset) fall between grants and traditional loans in terms of the burden they place on businesses; they provide access to capital without high interest rates or immediate repayment requirements.

Businesses also fail to grow when they avoid making riskier but potentially more profitable investments. Business owners may be more likely to take on these projects if they are able to share the risk with another entity, such as a microfinance institution (MFI), through lease-based finance. Shared risk may help in other ways, too. For example, when the MFI and the microenterprise take on such risk together, their incentives are better aligned, and the MFI has a clear motivation to consider the longer-term growth and survival of the microenterprise.

## Context of the Evaluation

In Pakistan, as in many countries with large Muslim populations, social norms against interest-based borrowing mean that many Muslim poor reject traditional microloans.<sup>[3]</sup> This coincides with large and sometimes increasing incidences of poverty and financial exclusion among Muslims; financial exclusion rates are as high as 88 percent in Pakistan.<sup>[4]</sup> CGAP surveys suggest that, for Muslims with access to microloans, up to 40 percent reject such loans on religious grounds.<sup>[5]</sup>

Akhuwat is a large nonprofit microfinance institution based in Lahore with over 570,000 active borrowers and a loan portfolio of over 8 billion Pakistani Rupees (approximately US\$77 million). It operates 500 branches in cities and towns across Pakistan. Akhuwat has identified a proportion of its clients who have successfully taken out and repaid loans and who own businesses with high-growth potential. These clients will be offered the chance to receive one of the asset-based finance products described below, which are both consistent with locally accepted Islamic financial norms.

## Details of the Intervention

Researchers conducted a randomized evaluation in Pakistan to test the impact of asset-based loan products on business growth. They randomly assigned 757 microenterprises to one of three groups:

- **Fixed-repayment contract** : Akhuwat offered to finance business owners' purchase of an asset that can significantly increase the businesses' productivity. Bank representatives stipulated that lending was conditional on the purchase of the fixed asset, which served as a collateral for the loan (this was enforced by accompanying the client to purchase the asset). The contract required the client to pay an initial 10 percent deposit, then purchase the asset through 18 monthly payments, each of 5 percent of the asset's purchase value. Clients were also required to pay rent each month on the share of the asset that they did not own. Apart from this, the contract was conventional, with a fixed repayment schedule that the client had to follow regardless of their business outcomes.
- **Flexible-repayment contract**: The flexible-repayment contract was identical to the fixed-repayment contract, except that clients could choose each month how much to repay (subject to a minimum repayment of 2.5 percent of the purchase price); the client's asset share and rental obligation was then adjusted accordingly. This allowed

entrepreneurs who experienced growth in their firms to buy back the asset more quickly in order to reduce rental payments, but clients with less successful businesses were not penalized for making small payments.

- **Comparison group:** The comparison group was not offered an asset-based loan product. However, they were eligible for the MFI's standard cash loan with \$475 borrowing limit and were given the same information about the asset as the other two groups, including the price of each item and information on where the item might be purchased.

Both asset-based finance products required Akhuwat to have some way to repossess the assets of clients who do not fulfill the terms of their contracts. Two witnesses were required for each contract; in the event that Akhuwat needed to repossess an asset, these witnesses were used to facilitate repossession of the asset.

By comparing sales, profits, employment, use of other forms of finance, and investment behavior of the microenterprises in each group, researchers evaluated whether a more flexible repayment contract stimulated growth more successfully than a traditional fixed-repayment-requirement debt contract, and whether clients who had the more flexible contract made riskier and more profitable investments. They also compared take-up of the product offers in each group, to evaluate the demand for the asset-based finance products. Finally, they evaluated whether the client's gender, the type of enterprise, their business and managerial skills, as well as behavioral characteristics (such as time and risk preferences) affected the efficacy of these products.

## Results and Policy Lessons

Researchers found large impacts from both the fixed-repayment contract and the flexible-repayment contract on business and household outcomes, relative to the group that received the standard MFI offerings.

Participating clients were more likely to remain self-employed, have larger businesses (as measured through business assets), have better business management practices (particularly in terms of inventory control and purchasing), and have greater business performance (on average, an increase in monthly business profits of approximately 9 percent). These positive results also extended to households, as incomes rose by 8 percent and monthly spending by 6 percent. This last effect was mainly driven by an increase in educational expenditure (particularly for girls) of 26 percent.

Researchers observed relatively high take-up rates for the two products (57 percent on average), and low default rates (under 5 percent for both contracts). They did not find a difference in impact between the fixed and flexible contracts. Data revealed risk preferences are important for differential contract take-up and use of the flexible repayment option.

The results suggest microfinance interventions, which offer a small one-off payment, do not significantly change household living conditions. By contrast, large transfers can lead to sustainable improvements in household wealth and income, while being financially

sustainable for microfinance institutions.

## Sources

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