



Determinants of Financial Sustainability for Microfinance Institutions

Lessons for Islamic Microfinance Banks in Nigeria

Abdurrahman Abdullahi

Anwar Hasan Abdullah Othman

Abstract: Islamic microfinance institutions play a major role in the provision of financial services to the poor and underprivileged through non-interest, equity-based products and services. To achieve these critical objectives, however, they need to be financially sustainable, which is threatened by the current economic and financial crisis caused by the Covid-19 pandemic. The objective of this paper is to review the determinants of financial sustainability of microfinance institutions with a view to drawing lessons for Islamic microfinance banks in Nigeria. The paper utilized the literature review methodology to synthesize research findings in the area. The review revealed that the major determinants of financial sustainability of microfinance institutions are the capital structure, asset size, and financial innovation. Others are good risk management and corporate governance frameworks. The paper thus recommended that Islamic microfinance institutions in Nigeria should maintain a robust capital structure that relies more on equity, a lean but diversified Board, and utilize more technology-based services. Most importantly, they should emphasize profit and loss sharing principles in their operations.

Keywords: Microfinance; Islamic Microfinance; Financial Sustainability; Non-interest Banking; Nigeria

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@ Strategy Management Department, Central Bank of Nigeria, aakatsina@yahoo.com  0000-0002-2699-8679
Asst. Prof., International Islamic University Malaysia, anwarhasan@iiu.edu.my  0000-0001-5759-8216



Introduction

Microfinance Institutions (MFIs) play a significant role throughout the developing world in providing financial services to numerous small enterprises and households that possess little or no collateral. Hinrichsen (2018, p. 32) defined microfinance as “the provision of small (micro) loans and other financial services to people for whom traditional banking services are mostly unattainable.” According to the (World Bank, 2007, p. 3), microfinance “include products such as stand-alone micro-savings, remittances, and insurance. It has also gone beyond providing services to the poor alone, as was the case at its inception”. Through their activities, they expand the frontiers of financial inclusion among the poor and underprivileged by availing them access to credit and other financial services (Bogan, 2012; Chikalipah, 2017). This helps in fighting poverty and unemployment.

Alongside conventional MFIs are Islamic MFIs. Islamic microfinance is defined as “financial services delivered among low income / destitute people based on Islamic Shariah” (Nabi, Islam, Bakar & Nabi, 2017, p. 32). This allows the under-privileged and the low-income to access financing without paying interest and devoid of ambiguity. Accordingly, it “uses partnership, trade or lease-based financing structures that result in ownership or provides usage rights for physical assets in an enterprise” (Rhule, 2016, p. 16). Consequently, participants have the opportunity to participate in profit-sharing and risk-bearing financial activities. It is, therefore, “the Shariah-compliant way of providing financing to those rejected by the mainstream financial services, to help them start-up microenterprises or maintain their existing business” (Hassan, 2015, p. 360).

From the foregoing, it is evident that Islamic and conventional microfinance share some similarities. According to Hassan (2015, p. 363), “both advocate entrepreneurship and risk-sharing through partnership finance, developmental and social goals and advocate financial inclusion.” However, Islamic microfinance possesses even more advantages because it can leverage on Islamic social finance instruments of Zakah, Sadaqah and Qard Hasan for greater financial and social inclusion. According to Nabi et al. (2017, p. 43), “Islamic microfinance programs based on the principles of risk-sharing and redistribution of wealth may be used as an effective tool for eradication of poverty and inequality in the society.” This helps in boosting access to financial services, thereby reducing poverty and income inequality.

To achieve their objectives of poverty reduction, financial inclusion, and social finance, MFIs must, however, be financially sustainable. Financial sustainability is defined as the ability of an MFI to survive on its cash flow, grow its capital and that

of its members, and continuously serve its intended customers (Said et al., 2019). Another definition by Bayai and Ikhide (2016) is the ability of an institution to “capitalize on (economies of) scales, exercise cost-conscious(ness), and promote innovation, as well as advancing its outreach, whilst minimizing its losses.” Financial sustainability is determined by how efficiently MFIs utilize their resources into services, thereby fulfilling their financial and social responsibilities to the poor and underprivileged (Olasupo et al., 2014).

The recent COVID-19 pandemic, however, poses a major challenge to the global economy in general and financial institutions in particular, which threatens their operational and financial sustainability. Since its outbreak in December 2019, the COVID-19 pandemic had spread to all corners of the world, paralyzing global economic activities. In terms of economic and financial costs, the impact had been devastating. The World Bank Group (2020) stated that the COVID-19 pandemic is leading the world to the deepest global recession since the second world war, with output contractions across some developed and majority of emerging market and developing economies (EMDEs). In line with this, the International Monetary Fund (IMF) projected that global output would contract by 4.9 percent at the end of 2020 (IMF, 2020). The effect is more serious on the most vulnerable segment of the society - those without safety nest and access to financial services. This is exacerbated by the lock-downs and movement restrictions throughout the world. For EMDEs with weak health care systems, the impact is more severe. As a result, global financial markets experienced a massive flight to safety while equities plunged.

In Nigeria, gross domestic product (GDP) is forecast to shrink by 3.2 percent in 2020 due to the collapse of crude oil price, as well as measures taken to slow down the spread of the disease (World Bank Group, 2020b). Given that the informal sector is estimated to contribute 65 percent of Nigeria’s GDP, and a significant number of its participants depend on day-to-day economic survival, it will be a choice between observance of social distancing or survival (United Nations Development Program, 2020).

In response to the pandemic, a number of fiscal and monetary policy measures were implemented by the Federal Government of Nigeria (FGN) and the Central Bank of Nigeria (CBN). These, according to (PwC, 2020) include a three-month repayment moratorium for soft loans to the informal sector and other FGN-funded loans issued by the Bank of Industry, Bank of Agriculture, and the Nigerian Export-Import Bank. Others include conditional cash transfers to the vulnerable segment of the society, reduction in interest rates on all CBN intervention facilities, creation of an NGN50 billion (US\$139 million) targeted credit facility, an NGN3.6

trillion stimulus package in the form of loans to the banking system. There is also the NGN50 billion targeted credit facility through the FGN-owned NIRSAL Microfinance Bank to households and Micro, Small and Medium Enterprises (MSMEs). Most of these initiatives will be carried out by or transacted through financial institutions, among which are Islamic MFIs.

To perform these and other duties effectively, these institutions must be sustainable. Studies, however, have shown that MFIs in Nigeria have been facing a lot of challenges that threaten their sustainability. A World Bank Group (2017) Report on Nigeria's microfinance sector described the MFBs as weak, insolvent, and undercapitalized. MFIs in Nigeria face other challenges such as high set-up and administrative costs, poor business model, insufficient financial resources, poor regulatory and supervisory framework (World Bank Group, 2017); inadequate donor funding, insufficient or low equity capital, less attention on financial sustainability, communication gap and inadequate awareness (Kanayo, Jumare & Nancy, 2013). All these affect their operational and financial sustainability.

The objective of this conceptual paper is, therefore, to review the determinants of financial sustainability of MFIs around the world, with a view to drawing lessons for Islamic MFIs in Nigeria. The paper reviewed conceptual and empirical papers to synthesize major findings in the study area. The paper is structured into six sections. Section two reviewed the conceptual and theoretical issues around microfinance and its funding, as well as the concept and theories of financial sustainability. Section three discussed the evolution of MFIs in Nigeria, while section four reviewed empirical studies on the determinants of and factors affecting the financial sustainability of MFIs. Section five summarized the lessons learnt, while section six concluded the paper and provided policy recommendations.

Conceptual and Theoretical Issues

Conventional Microfinance

Microfinance is the advancement of "small loans to destitute people for self-employment projects that generate income in allowing them to take care of themselves and their families" (Rahim Abdul Rahman, 2010, p. 284). Given that the poor and under-privileged seldom have access to financial services from the commercial and conventional financial institutions due to lack of collateral, they resort to microfinance institutions and self-help groups for loans. Hence, "the terms and conditions of the loan are normally easy to understand and flexible." This is due to the fact that most of the clients are rural-based with little education and low

or irregular income. According to the (World Bank, 2007, p. 3), “many programs offer stand-alone savings products, and remittances and insurance are becoming popular innovations in the suite of services offered by financial institutions for the poor.” This makes microfinance institutions ready-made tools in developing economies where governments strive to enhance access to financial services in order to achieve their financial inclusion objectives and targets.

According to Ferdousi (2015), the withdrawal of support by national and regional governments and donors in the 1980s from “programs for the SME sector” led to the development of microfinance “when microcredit evolved into microfinance, and when group-based lending evolved into individual lending while developing new products and services.” This period thus witnessed the transformation of microcredit to microfinance and the individualization of group financing.

Consequently, Hinrichsen (2018) described microfinance as “the provision of small (micro) loans and other financial services to people for whom traditional banking services are mostly unattainable.” Lately, however, the concept had transformed from exclusively offering microcredit to other financial services such as “savings, insurance, and money transfer.” Thus, it caters for the social and economic needs of the poor, which includes “housing, water or consumption (Mader, 2018, p. 3). Accordingly, Samad (2014, p. 202) “considers it as a powerful tool for poverty alleviation.” Thus, it will be instrumental in carrying out government programmes aimed at tackling poverty and income inequality in emerging and developing countries where conventional financial services are costly and inaccessible.

Islamic Microfinance

Islamic finance is founded on the prohibition of *riba*. “*Riba*’ was prohibited in all forms and intentions” (Rahim Abdul Rahman, 2010, p. 286). Defining *Riba*, Rahim Abdul Rahman (2010) divided it into two classes: stated that *riba* could be divided into two categories – “credit *riba*’ (*riba*’ al-nasi’ah) and surplus *riba*’ (*riba*’ al-fadl)”. Accordingly, any loan that brings ‘additional benefit’ (with the exception of reward from Allah) to the lender, over and above the principal, is prohibited. Islamic microfinance, therefore, is “the Shariah-compliant way of providing financing to those rejected by the mainstream financial services, to help them start-up microenterprises or maintain their existing business” (Hassan, 2015, p. 360). Islamic microfinance thus, “operates based on Islamic jurisprudence which prohibits dealing in interest, the avoidance of *gharar* (ambiguity), participating in risk-sharing activities and ensuring the welfare of all members of the society” (Nabi et al., 2017; Rhule, 2016).

Nabi et al. (2017, p. 32) defined Islamic microfinance as “financial services delivered among low income/destitute people based on Islamic Shariah”. This means that it is devoid of interest rate charges. In addition to providing commercial, but affordable services, Islamic microfinance also provide social financing by sourcing funds through Islamic social instruments of Zakat and Sadaqah (Ali, 2015; Hassan, 2015). In terms of financing activities, it utilizes asset-based financing tools such as Musharakah, Mudarabah, Salam, among others (Said et al., 2019).

These asset-based, risk-sharing financing tools are supplemented by Islam’s social financing and income re-distributive tools of Zakat, Sadaqat, and Waqf. These are extended to the poor and needy in society (MIFC, 2014). The importance of risk-sharing to financial stability and shared prosperity was succinctly presented by Maghrebi and Mirakhor (2015, p. 107) when they argued that “financial inclusion and financial stability have little significance for the poor households, however, in the absence of risk-sharing mechanisms with tangible and observable effects that provide the basis for shared prosperity”. In addition, Rhule (2016) maintained that by combining risk-sharing contracts and the instruments of Islamic wealth redistribution (Sadaqat, Zakat, and Waqf), Islamic MF can help reduce poverty. It will also promote social justice, mobilize resources to the poor, and improve the productive capacity of society as a whole (Zulkuhibri, 2016).

Another peculiarity of Islamic MFIs is that in addition to normal governance and regulatory issues, they must also adhere to the provisions of Shariah in the conduct of their operations. According to Kassim, Hassan and Nadhirah (2018), IFIs must uphold the Shariah principles that promote ethical behavior and the fulfilment of social obligations. In addition, Islamic MFIs face the challenge of high transaction costs compared to their conventional counterparts. According to Kassim et al. (2018), being profit and loss sharing ventures, these institutions face high monitoring and enforcement costs due to the problem of information asymmetry, especially in rural financial markets, which is their mainstay. The study recommended that Islamic MFIs must innovate to reduce transaction cost, while government should provide the requisite infrastructure such as roads, power and communication to help reduce information asymmetry and adverse selection. In spite of these issues, however, Islamic financial institutions generally have an edge over their conventional counterpart due to their financing modes. These provides a tremendous help in reducing vulnerabilities during financial crisis.

Financial Sustainability

Financial Sustainability is a term widely adopted by different sectors of the economy. Al-dirawi and Dahash (2018) defined financial sustainability 'as the consistency of firms in generating the positive outcomes that not only cover cost but also accelerate the firm growth.' For Bayai and Ikhide (2016), it entails 'capitalizing on (economies of) scales, exercising cost-consciousness, promoting innovation, reducing information and asymmetry costs, lower adverse selection and moral hazard, advance(d) outreach, whilst suffering least losses'. According to Said et al. (2019), financial sustainability is the ability of a MFI to survive on its cashflow, grow its capital and that of its members, and continuously serve its intended customers. The quest to move to more sustainable alternatives of financing forced MFIs to move from donor to commercial financing.

Financial Sustainability and MFIs

Similar to any other institution or organization, financial sustainability is crucial. MFIs attain financial sustainability by generating sufficient income from their activities that will enable them to meet their operational and financial expenses without seeking external finances through grants or donations (Chikalipah, 2017; Fersi & Boujelbéne, 2016). The blended value theory is used to explain the position of financial sustainability in MFIs. According to Vacklen 2010, cited by Bayai and Ikhide (2016), the theory, though unpopular in microfinance, stated that social, financial, and environmental objectives are integrated and inseparable. As a result, while trying to achieve one, others are achieved simultaneously. As a result, financial sustainability is used to bolster social objectives through the adoption of a commercial scope in running microfinance. This allows investors with commercial orientation and those with social orientation to invest in one MFI.

One way in which MFIs attain and maintain financial sustainability is through financial innovation. The World Economic Forum (2012), in its Report on *Rethinking Financial Innovation*, defined financial innovation as 'the act of creating and then popularizing new financial instruments, technologies, institutions, markets, processes, and business models – including the new application of existing ideas in a different market context.' Accordingly, financial innovation is limitless and timeless as far as opportunities that will address new problems and market imperfections are present. From this perspective, financial innovation improves the viability in serving the poor and underprivileged through the reduction of operational cost using technology.' When attained, financial sustainability helps MFIs attract investor funds, which leads to viability and overall sustainability (Said et

al., 2019). Another way is to have a sound financial infrastructure that will reduce information asymmetry, credit risk, as well as improve the supply of funds to MFIs (Bayai & Ikhide 2016).

According to Fersi and Boujelbéne (2016), financial performance, which culminates in sustainability, is the achievement of profitability by maximizing efficiency and productivity, resulting in higher return on equity and assets. This is invariably both financial and operational sustainability. Financial sustainability is very important in avoiding and managing financial crises (Al-dirawi & Dahash, 2018), and also ensures improved efficiency, transparency, discipline, and longevity of MFIs, and a prerequisite for industrial sustainability (Chikalipah, 2017).

Microfinance Financing Theories

The financing options explored by financial institutions are determined by the financial services they offer and the cost associated with the provision of those services. Given that donors and governments are weaning MFIs, coupled with the fact that they are being regulated for financial system stability, their source of funding needs to be diversified. For Islamic MFIs, there is another layer of scrutiny. Given that they offer non-interest services, they do not take up funds that bear interest elements. In general, the manner in which MFIs finance their operations varies across regions. According to Bayai and Ikhide (2016), while they rely more on deposits in Africa, their main source of financing in the Middle East and North Africa (MENA) region is through equity. In South Asia, MFIs rely more on debt financing. Thus, in analyzing financing options, other factors to consider include the study area, the period, and the level of financial development.

According to Bogan (2012), while there are various theories explaining MFIs' funding, they could be categorized into two main frameworks: the life cycle theory (LCT) and the profit-incentive theory (PIT). Bayai and Ikhide (2016), however, added the agency theory (AT) to arrive at three. The LCT explains the evolution of MFIs based on their financing structure. According to the theory, most MFIs start as non-governmental organizations (NGOs) with a social vision, thereby obtaining funding from grants and donations (Bogan, 2012). Bayai and Ikhide (2016) described the growth stages as: start-up, expansion, consolidation, and integration. The *start-up stage* is when MFIs are financed through donations and concessionary funding by NGOs and governments. The *expansion stage* is when equity is brought in by NGOs and public investors, while International Finance Institutions provides seed capital. Subsidies are still available in the form of soft loans and grants. The *consolidation stage* commercializes the operations of MFIs through the

observance of regulations that introduce commercial debt in their funding structure, while the *integration phase* is when the MFI turns into a microfinance bank. This is the stage when they become financially sustainable and profitable, while subsidies and grants are no longer part of their funding structure.

In contrast to the LCT, the PIT posits that the use of commercial funding enables the MFIs to meet their microfinance promise by raising cost consciousness, efficiency, and outreach (Bayai & Ikhide, 2016; Bogan, 2012). The theory holds that MFIs that are commercially funded respond more to profit incentives, where they increase their revenues and decrease expenses in order to generate sufficient funds to sustain their operations. This is in contrast to donor-fund financed MFIs that may choose outreach over efficiency by serving clients with a higher delivery cost. MFIs pursue revenue maximization and operational cost minimization in order to cover expenses and reduce costs, which helps in building surpluses. Finally, the AT highlights the role of debt in aligning the performance of the management to that of capital providers. Accordingly, higher leverage serves as a useful mechanism in reducing wasteful cash flow and the threat of liquidation. This will, however, increase the pressure on management to generate sufficient cash flow to service their debt obligations.

Other financing determinants include a regulatory provision in climes where MFIs fall under the regulation of monetary authorities. Therefore, in countries where deposit collection by MFIs is outlawed, they tend to rely more on debt and equity financing. While deposits serve as a means of cheap financing, regulation serves as an additional cost, which limits outreach, especially to women and rural areas, by forcing them to cut smaller loans in favor of larger ones. In conclusion, however, Bayai and Ikhide (2016) posited that sources of funding largely depends on local conditions, which are subject to the development of institutions. This hinges more on the culture of savings and lending, as well as the legal environment.

Sources of Financing MFIs

The major sources of funding for profit-oriented MFIs are grants, debt, equity, and savings/deposits (Bayai & Ikhide, 2016; Bogan, 2012). While debt comes from private investors, commercial banks, and multilateral organizations, while equity comes from national and international nonprofit institutions and development banks.

Subsidies/grants Vs Financial Sustainability

The flow of financing through grants and subsidies had eased up in recent times, leading MFIs to look for other sustainable sources of funding in order to guarantee

their operational and financial sustainability. According to Bayai and Ikhide (2016), at their formation stage, MFIs rely more on government subsidies and grants from NGOs. However, as they grow and expand their outreach, these sources start to undo the FS of MFIs. Thus, there is a positive relationship between subsidies and FS to a certain level of their development, beyond which donations start to undo sustainability. According to Bogan (2012), Funding MFIs through subsidies and grants is beneficial, especially to start-ups that do not have any source of commercial funding. However, the challenge is that being easy money, does not encourage efficiency. This gave birth to the idea of ‘smart subsidies,’ where subsidies are designed to minimize distortions and inefficiencies, while they are used to promote innovations and the financing of establishment costs. In addition, Bayai and Ikhide (2016) cited De Aghion and Murdich (2005), who identified three ways of making subsidies smart. These are by: ‘subsidizing the program, not the customer’; ‘strategic short-term subsidization on the very poor clients’ in the short-run; and ‘strategic subsidization over long periods’.

Debts Vs Financial Sustainability

Studies have shown that debt has both positive and negative effects on the financial sustainability of MFIs. Bogan (2012) argued that while commercial debt is a good source of low-cost funding to MFIs as it encourages efficiency, it could, however, distort domestic markets if it is concessionary. Summarizing the main arguments on the effects of debt on financial sustainability, Bayai and Ikhide (2016) noted that highly leveraged MFIs are forced to become more efficient due to the threat of loss of personal benefits. The benefit of which is increased profitability and efficiency. However, the cost of monitoring may lessen these gains, especially in the MF industry that is “informationally opaque.” As a result, they try to control moral hazards and adverse selection while reaching out to more clients. However, other studies showed that debt has a significant negative effect on financial sustainability, as it results in a high service fee, which ultimately leads to bankruptcy and financial unsustainability.

Deposits/savings Vs Financial Sustainability

Deposits are a major source of financing for MFIs worldwide, and especially in Africa, where deposits have grown more than the loan portfolios of MFIs (Bayai & Ikhide, 2016). Savings, therefore, are a source of loan expansion, and a way of improving sustainability. High savings mobilization indicates the ability to self-finance, thereby attaining independence and permanence. It is more important because deposits are attracted at a lower cost, allowing MFIs to enjoy higher profit-

ability. The challenge, however, is that only regulated institutions are allowed to take deposits (Bogan, 2012). The fact that most MFIs that are allowed to collect deposits are regulated imposes additional costs on them due to capital provision requirements and licensing costs. This limits outreach depth due to the imposition of higher interest rates.

Equity Vs Financial Sustainability

Equity has been found to be positively related to the FS of MFIs. It had thus been recommended (equity-financing of MFIs) for sustainability and greater outreach due to the low cost of obtaining equity compared to other sources of financing (Tehulu, 2013, cited by Bayai & Ikhide, 2016). The major benefit of equity financing is it comes at a low cost. However, it only comes to mainly mature organizations or licensed financial institutions (Bayai & Ikhide, 2016; Bogan, 2012). While equity financing of MFIs is encouraged, it remains rare and scarce. Other studies have shown that financial sustainability explains the level of equity assumed by MFIs. According to the *franchise-value hypothesis*, there is a positive relationship between equity financing and financial sustainability, while the *efficiency-risk hypothesis* argued that equity financing has a negative relationship with financial sustainability. The *franchise-value hypothesis* posits that MFIs achieve high level of equity financing ‘in order to guard against loss of economic rent or value of the franchise from probable liquidation. The *efficiency-risk hypothesis* on the other hand explains that if the chances of liquidation are low, MFIs employ more debt-based financing while cutting back equity levels. In the same vein, Long and Marwa (2015) posits that literature had indicated that MFIs are therefore encouraged to hold higher levels of equity in their capital structure to attain longevity and sustainability.

Microfinance in Nigeria

Conventional Microfinance

The origin of microfinance in Nigeria dates back centuries ago. According to Seibal (1984, p. 2), “the earliest evidence of financial institutions in Africa dates back to the 16th Century to ‘*esusu*’, a rotating savings and credit association among the Yoruba” in Southern Nigeria. There were pieces of evidence of similar efforts in Eastern Nigeria. These were later upgraded and modernized, which enabled them to link up with formal financial institutions in order to access loans. A major shift was, however recorded when the Central Bank of Nigeria issued the “Microfinance Policy, Regulatory and Supervisory Framework” in December 2005. The purpose of the policy document was to “enhance the provision of diversified microfinance

services on a long-term, sustainable basis for the poor and low-income groups” (Central Bank of Nigeria, 2005, p. 6). The aim is to “enhance the productivity and entrepreneurship” of the poor and low-income through the provision of accessible financial services.

The policy categorized licensed MFBs into two with different capital requirements based on geographical coverage. These are the unit and state MFBs. “Unit MFBs were required to maintain a minimum capital requirement of Twenty Million Naira (N20,000,000) and shall operate within a specified local government area, while state MFBs have a minimum capital requirement of Two Hundred Million Naira (N200,000,000), and operate within a state of the federation” (Central Bank of Nigeria, 2005, p. 17). The Policy stipulated the role of each stakeholder in the microfinance sub-sector. These include “that of the government as a law-giver and supporter, the Central Bank of Nigeria (CBN) as a regulator and supervisor, the MFIs as operators, public sector poverty alleviation agencies as collaborators and partners as well as donor agencies that provide subsidized funds and technical assistance.”

In 2011, the “Regulatory Framework” for microfinance banks was revised by the Central Bank of Nigeria. The “National Microfinance Bank” category was created. “The minimum paid-up capital of Unit and State MFBs were retained at Twenty Million and Two Hundred Million,” respectively, while “the minimum paid-up capital of a National MFB was set at Two Billion Naira.” The Unit microfinance bank was “to operate only one branch,” while the “State MFB is allowed to open its branches within the same state, as well as the Federal Capital Territory (FCT), subject to prior approval of the CBN, for each new branch or cash center.” The new national microfinance bank was “authorized to operate in more than one state, including the FCT, subject to the prior approval of the CBN for each new branch or cash center.” Unit or State microfinance banks that plan to move to a higher category were required to secure new licenses (Central Bank of Nigeria, 2011).

Islamic Microfinance

In 2017, the CBN released the “Guidelines on the Regulation and Supervision of Non-interest (Islamic) Microfinance Banks (NIMFBs).” The aim is to provide a level playing field between conventional and NIMFBs. Furthermore, it was envisioned to provide an alternative mode of microfinance operating based on profit-sharing and loss-bearing principles. This is in line with the National Financial Inclusion Strategy that intends to take financial services to “individuals, communities, and corporations that may not be captured by conventional MFBs.” The target clients of these banks are the poor and low-income, unbanked and the under-served, as well as other microenterprises (Central Bank of Nigeria, 2017).

Islamic microfinance banks were, under the new policy, authorized to conduct their activities based on Islamic financial jurisprudence. They were also to comply with “the established non-interest deposit insurance scheme and anti-money laundering / combating the financing of terrorism (AML/CFT) laws and regulations” (Central Bank of Nigeria, 2017, p. 14,20). The minimum capital requirements for Unit and State Non-interest microfinance banks were “Twenty Million and One Hundred Million Naira,” respectively, while that of a National NIMFB was set at “Two Billion Naira.” The scope of operation is similar to those of conventional MFBs. Currently, there are three Islamic Microfinance Banks in Nigeria. These are Tijarah MFB, I-Care MFB, and Halal Credit Microfinance Bank.

Review of Literature

MF Financing and Financial Sustainability

Bogan (2012) examined the link between capital structure and sustainability of MFIs. The paper empirically studied MFIs to determine the best mix of debt, equity, and grant funding that will improve efficiency and ensure solvency and financial sustainability. The study found that grants as a percentage of assets and share capital as a percentage of assets are negatively and significantly related to self-sufficiency. The negative relationship between grants and sustainability supports the profit-incentive theory, which posits that MFIs should depend less on donations and subsidies. In addition, results showed that for most MFIs, the size of their assets affects their sustainability and outreach. The author concluded that in order to address the capital challenges of MFIs, ‘smart subsidies’ and innovative financing instruments may be required. Also, during times of financial crisis, when grants in the form of bailout funds increase, the paper suggested that this should be for a short period, as (sustained) grants decrease operational sustainability.

Tehulu (2013) empirically investigated the determinants of financial sustainability among MFIs in East Africa between 2004 and 2009. Using binary probit and ordered probit regression to study 23 MFIs in East Africa, the study found that loan intensity and size are positively and significantly related to financial sustainability of MFIs, while management inefficiency (ratio of operating expenses to total assets) and portfolio at risk are negatively related to financial sustainability. Outreach and deposit mobilization were found to be insignificant in determining the sustainability of MFIs in East Africa. This shows that MFIs with a bigger pool of assets have a higher probability of sustainability. Also, cost of operations plays an important role in ensuring that MFIs sustain their future operations, and inef-

iciencies hinder sustainability, which tends to support the profit incentive theory of funding MFIs.

Kosgei (2014) empirically analyzed the role of corporate governance on the financial sustainability of MFIs in Kenya between 2000 and 2011. The study examined 42 MFIs using both primary and secondary data. It specifically measured the role of board size, board diversity, and CEO duality¹, among others. Overall, the study found that corporate governance plays a significant role in ensuring the financial sustainability of MFIs. Specifically, results showed that a Board of Directors of moderate size, which is diverse, is in a better place to ensure Board independence, thereby boosting financial sustainability. A Board that consists of diverse members with different skills and expertise ensures better decision making and have a better relationship with other stakeholders. In addition, the separation of the offices of the Chairman and CEO helps in reducing conflict of interest and the tension between the CEO and other Board members.

Long and Marwa (2015) used quantitative techniques to determine the factors driving the financial sustainability of MFIs in Ghana. The authors analyzed data from 25 MFIs in Ghana over six years period from 2006 to 2011. The study found that yield on gross portfolio and administrative efficiency positively and significantly affects financial sustainability. Gross yield, which reflects the revenue generated from assets under management and loans extended to borrowers, increases the ability of MFIs to attain financial sustainability. This shows that the more profitable an institution is, the higher the probability it will sustain its activities for a longer time. In addition, low-level operating expenditure, which is used as a proxy for efficiency, helps MFIs achieve and sustain financial sustainability. In addition, portfolios at risk, which is an indication of the quality of loans in the MFIs' portfolio, was found to be negatively related to financial sustainability. Finally, administrative efficiency (cost per borrower) and outreach were also found to be positively and significantly related to sustainability. However, greater outreach should be balanced with administrative efficiency. The study advised that MFIs should hold higher levels of equity in their capital structure in order to attain sustainability.

Ngoc (2016) empirically examined the effect of capital structure and the legal status of MFIs' sustainability. The study used multiple regression analysis to analyze data from a sample of 434 MFIs in developing countries. The study found that the capital structure of MFIs, in terms of debt to equity ratio, negatively and

1 CEO Duality is where the CEO doubles as the Chairman of the Board

significantly affects their sustainability. This is because equity is cheaper and thus more sustainable for the long-term sustainability of MFIs. This, according to the author, is the finding of many studies on the relationship between capital structure and financial sustainability of MFIs.

Using a generalized method of moments (GMM) method estimation technique, Chikalipah (2017) examined the determinants of financial sustainability of 324 MFIs in 33 sub-Saharan African countries. Results indicated that return on assets (ROA) is the major determinant of financial sustainability among the MFIs studied. This showed that to achieve financial sustainability, MFIs must be able to generate higher net income from their credit portfolio. Given the high level of information asymmetry in the MF industry, there is, therefore, the need to vigorously screen beneficiaries in to ascertain their credit worthiness, thereby reducing the possibility of loan defaults. The study identified the operational cost per borrower as a significant factor affecting the financial sustainability of MFIs in SSA, where an increase in the cost per borrower reduces the level of financial sustainability. In addition, the cost of mobilizing deposits negatively affects financial sustainability, given that it is cheaper to raise funds through equity, grants, or loans. However, outreach (number of borrowers) is positively and significantly correlated with financial sustainability. In addition, higher interest rate charges generate more revenues to the MFIs and improves financial sustainability. The paper suggested that MFIs should implement robust screening plans to assess the credit worthiness of their clients in order to enhance financial sustainability.

Examining the role of financial innovation on the financial sustainability of MFIs in Kenya, Kibelioni and Ayuma (2019) studied 15 MFIs in Kenya using the innovation diffusion theory. The study found that MFIs in Kenya have adopted several technology-based financial services in order to boost their financial sustainability. These services include mobile banking, agency banking, internet banking, and the use of automated teller machines (ATMs). These had enabled them to expand their services, acquire more customers, and serve their customers easily. Results from econometric analysis also indicated a positive and significant relationship between financial innovations and financial sustainability. It thus recommended that MFIs should imbibe new technological innovations in their operations in order to compete favorably and attain financial sustainability.

Rahman and Dean (2013), in a conceptual paper, discussed the challenges faced by Islamic MFIs and made a suggestion on the way forward. The paper identified four major challenges facing Islamic MFIs. These are low market penetration, sustainability, high transaction costs, and ineffectiveness in alleviating

poverty as the major challenges. Market penetration challenges arose due to low branch networks and the absence of capacity of managers and staff. Low level of funds mobilization, high administrative costs, and lack of product diversification were identified as the major causes of unsustainability. Another challenge identified by the authors that cut across all MFIs is high transaction costs arising from information asymmetry. This translates to high searching and enforcement costs, as a result of which the interest charged by these institutions becomes usually exorbitant. To make Islamic MFIs more sustainable, the authors recommended that banks should increase their participation in microfinance activities as a way of raising more funds. In addition, MFIs should diversify their portfolios while providing more education and training, better coordination, and networking. More importantly, Zakat and Waqf funds should be utilized as providers of funds to Islamic MFIs, while donor funds, where available, should be used to complement rather than compete with MFIs.

Siti and Hakimi (2015) used primary data to quantitatively examined the risk management practices of Islamic MFIs in Malaysia. This is with a view to analyzing the risk management practices of their products in order to address issues and challenges that will potentially affect their sustainability. This is due to the realization that it is only when these institutions are sustainable that they will be able to deliver their financial and social objectives of financial inclusion and poverty reduction. Also, poor risk management practices lead to unsustainability, especially in microfinance practices, due to several default risk factors. These include misuse of funds, health conditions of borrowers, unfavorable turn-over of business ventures, moral hazards, and adverse selection, among others. Data was collected from MFIs' officers in charge of risk management, and the results showed that MFIs had taken necessary steps to ensure good risk management practices that will ensure their sustainability. Risk management practices employed by the Islamic MFIs included imposing a limit to loan size, provision for loan loss reserves, developing expertise for character assessment, and the practice of peer lending, among others.

Fersi and Boujelbéne (2016) studied factors determining the organizational, social and financial performance of conventional and Islamic MFIs using panel data spanning 1996 – 2012 from 333 conventional and 49 Islamic MFIs. The study found a positive relationship between capital structure and financial performance. The authors argued that an increased or higher level of capital helps in reducing external borrowing, which ultimately increases the performance of MFIs. This is because a good capital structure helps the MFIs to absorb losses. The study also found that the sustainability of Islamic MFIs (measured by operational autono-

my) is influenced by their social performance, while that of conventional MFIs is influenced by their financial performance. In terms of financial sustainability, that of conventional institutions is affected by their quality of credit portfolios. That of Islamic institutions, on the other hand, is influenced by their capital structure. Organizational performance, however, affects the sustainability of both categories of MFIs. Finally, the study revealed that conventional MFIs outperform their Islamic counterparts financially due to their reliance on organizational and financial performance. This enables them to be more sustainable and gives them the ability to continue serving their clients.

Said et al. (2019) analyzed Islamic MFIs in Tanzania, and especially Savings Credit Cooperative Societies (SACCOS), in order to understand the factors that contribute to their financial sustainability, which is the bedrock of all other forms of sustainability. The study found that there are five main factors that lead to the attainment of FS of SACCOS in Tanzania. These are: responsible staff, regular review of the financial guidelines of these institutions, financial literacy among members, cooperation between employees and management, as well as staff training. The regular review of financial guides helps staff in dealing specifically with financial duties and robust internal financial procedures, while staff training improves staff capabilities and helps in attaining efficiency. This is more so in Islamic FIs that aims to achieve the double bottom line. One of the major challenges of conventional MFIs is high-interest charges. This usually makes their operations unsustainable. Given their mode of financing and transparency requirements, Islamic MFIs possess an edge over their conventional counterparts.

Summary and Lessons for Islamic MFIs in Nigeria

While there are limited studies on the financial sustainability of Islamic MFBs in Nigeria because they are in their infancy, studies from other climes could be used to draw lessons and make recommendations that will ensure their financial sustainability. From the review of empirical studies in the previous section, the following were identified as the determinants of financial sustainability:

- Capital structure (Bogan, 2012; Fersi & Boujelbéne, 2016; Ngoc, 2016). A capital structure with a higher equity level reduces the possibility of borrowing for operational activities of MFIs. In addition, it is cheaper and also helps absorb losses during a financial crisis. This also supports the profit-incentive theory. Some authors (Rahman & Dean, 2013) support the idea of using Zakat and Waqf funds to fund activities of Islamic MFIs.

- Operational efficiency (Chikalipah, 2017; Long & Marwa, 2015; Tehulu, 2013). Low cost of operation, especially in deposit mobilization and loan recovery, plays an important role in financial sustainability.
- Asset size (Bogan, 2012; Tehulu, 2013). The larger the asset size of an MFI, the better its outreach and sustainability. However, outreach should be balanced with operational efficiency.
- Gross yield on asset/return on asset (Chikalipah, 2017; Long & Marwa, 2015). This ensures financial sustainability by helping MFIs generate higher income from their credit or financing activities.
- Financial innovation (Kibelioni & Ayuma, 2019). Studies have found that the use of technology-based financial services such as mobile banking, online banking, ATMs help expand the services provided by MFIs at a relatively cheaper cost. This reduces operational costs and improves efficiency.
- Good risk management framework (Siti & Hakimi, 2015). This helps in reducing default risk and operational losses. This is very important for Islamic MFIs whose operations are equity- rather than debt-based.
- Good corporate governance framework (Kosgei, 2014). Maintaining a moderate-sized, diversified Board and the separation of the offices of the Board Chairman and CEO help improve transparency, reduce administrative costs, and manage conflict of interest in MFIs. This affects financial sustainability.
- Grants during a financial crisis in the form of bailout funds should be for a short period, as (sustained) grants decrease operational sustainability (Bogan, 2012).

Conclusion and Recommendations

This paper reviewed the role of MFIs in promoting financial inclusion and the reduction of poverty and income inequality and highlighted the sources of funding for MFIs. The role of Islamic MFIs in promoting social finance was also reviewed. The paper also reviewed empirical studies on the determinants of financial sustainability of MFIs with the objective of drawing lessons for Islamic MFBs in Nigeria. Most of the results obtained support the role of capital structure, operational efficiency, and asset size in promoting the financial sustainability of MFIs. Their paper also found evidence that financial innovation, good corporate governance, and risk management framework play significant roles in achieving financial sustainability.

For the attainment and maintenance of financial sustainability by Islamic MFBs in Nigeria, the paper recommends that they have a robust capital structure that relies more on equity. They should also maintain a lean but diversified Board to ensure cost reduction and improved transparency. Islamic MFBs should also utilize technology-based services in order to reach out to more clients at a lower cost. They should also emphasize the profit and loss sharing principles of Islamic finance that usually stand the test of time during financial crises.

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