Maqrizi: Journal of Economics and Islamic Economics
Vol. 4, No. 2 (2024): 104-116
Website: http://ejournal.iain-manado.ac.id/index.php/maqrizi

THE ROLE OF INFORMAL LENDING PRACTICES IN SUPPORTING MICROENTERPRISE DEVELOPMENT: A CASE STUDY OF MOLOMPAR VILLAGE, SOUTHEAST MINAHASA

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ABSTRACT

This study explores the dynamics of informal lending practices in Molompar Village, Southeast Minahasa, Indonesia, and their role in supporting microenterprise development. Informal lending has become a lifeline for microentrepreneurs who face barriers such as limited access to formal financial institutions due to stringent requirements, including collateral and complex documentation. Through qualitative methods, including observations, interviews with three informal lenders and five borrowers, and document analysis, the study identifies key drivers behind the reliance on informal loans, including their accessibility and flexibility. The findings reveal that while informal lending enables microentrepreneurs to expand their operations, increase inventory, and stabilize income, it also imposes significant challenges. High interest rates, the absence of legal protections, and the social stigma associated with delayed repayments create financial and social vulnerabilities for borrowers. Despite these drawbacks, informal lending plays a critical role in filling the financial gap left by formal institutions and fostering entrepreneurship and local economic growth. The study highlights the need for integrating informal lending into formal financial systems to ensure equitable access and borrower protection. Recommendations include adopting microfinance models that retain the flexibility of informal lending while reducing risks for borrowers. Limitations of the study include its focus on a single village, suggesting the need for broader regional research.

Keywords: informal lending, microenterprise development, financial access, Southeast Minahasa, rural economy.

INTRODUCTION

Molompar Village, situated in the picturesque landscape of Southeast Minahasa, Indonesia, serves as a quintessential example of a rural community where traditional livelihoods intertwine with the growing influence of microenterprises. As a small, close-knit community, Molompar consists predominantly of agricultural and small-scale business endeavors, reflecting the common economic fabric of many Indonesian villages. The village's geographical isolation coupled with its limited infrastructure poses unique challenges but also presents distinctive opportunities for examining the dynamics of informal lending. In Molompar, where formal financial services are scarce and often inaccessible to the local populace, microentrepreneurs have developed a reliance on informal credit systems. These systems are deeply embedded within the community's social and economic interactions, providing a critical lifeline for business operations and growth. This setting makes Molompar an ideal case study for exploring how informal lending influences microenterprise development in rural areas, offering valuable lessons on both the potentials and pitfalls of such financial practices outside the formal banking sector.

Microenterprises have long been recognized as critical drivers of economic growth, particularly in developing countries. They contribute significantly to job creation, poverty alleviation, and community development (Yunus, 2007). Despite their importance, microenterprises often face substantial barriers to accessing financial resources, which limits their ability to expand and sustain operations (Gherhes et al., 2016). These barriers are particularly acute in rural areas where formal financial institutions are either absent or impose stringent requirements that many microentrepreneurs cannot meet (Beck & Demirguc-Kunt, 2006).

The literature on financial inclusion underscores the role of credit access in fostering entrepreneurial activities. Formal lending institutions, such as banks, are typically viewed as the primary channels for providing capital to businesses. However, studies have shown that microenterprises in rural contexts are often excluded from these channels due to lack of collateral, poor credit histories, and bureaucratic hurdles (Akahome & Ogodo, 2024; Islam, 2024). Consequently, informal lending practices have emerged as a viable alternative, offering more flexible and accessible financing options (Manzilati & Prestianawati, 2022; Mpofu & Sibindi, 2022).

While informal lending has been studied in various contexts, much of the existing research focuses on its negative aspects, such as high interest rates and exploitative practices (Bu et al., 2022). Less attention has been given to understanding how informal lending can positively influence microenterprise development and contribute to local economic growth. This gap in the literature highlights the need for research that examines the dynamics of informal lending in specific rural settings and its implications for microenterprise performance.

Molompar Village, located in Southeast Minahasa, Indonesia, provides a unique context for exploring these issues. The village's microentrepreneurs rely heavily on informal lending to finance their businesses due to limited access to formal financial institutions. Despite its prevalence, there is little empirical research on how informal lending operates in Molompar and its impact on microenterprise growth. Addressing this gap is essential for developing a nuanced understanding of the role of informal credit in rural economies.

This study aims to contribute to the literature by investigating the factors that drive informal lending practices in Molompar Village, the mechanisms through which these practices are implemented, and their implications for microenterprise development. By focusing on this under-researched context, the study seeks to provide insights that can inform policy interventions and support strategies for microenterprise growth in similar rural settings.

The key contributions of this research are twofold. First, it provides a detailed analysis of the informal lending ecosystem in a rural Indonesian village, highlighting its role as a critical enabler of financial access for microenterprises. Second, it examines the tangible benefits and challenges associated with informal lending, offering practical recommendations for stakeholders seeking to enhance financial inclusion and support rural entrepreneurship.

METHODS

This study employs a qualitative research design to explore the dynamics of informal lending practices and their impact on microenterprise development in Molompar Village. A case study approach was selected to allow an in-depth understanding of the phenomenon within its real-life context (Jemna, 2016). This design is suitable for capturing the perspectives of multiple stakeholders and identifying the nuanced mechanisms underlying informal lending practices.

The population of this study includes informal lenders and microenterprise borrowers in Molompar Village. A purposive sampling technique was employed to select key informants who are directly involved in informal lending activities. The sample consists of three informal lenders and five microenterprise borrowers. This selection ensures diverse perspectives and comprehensive insights into the research problem (Lenger, 2019).

Data were collected from October 9 to October 11, 2023, using the following methods:

1. Field observations were conducted to understand the environment and interactions between lenders and borrowers.
2. Semi-structured interviews were carried out with the three lenders and five borrowers to gather detailed accounts of their experiences and practices.

Questions were designed to elicit information about the conditions, procedures, and outcomes of lending activities.

3. Supporting documents, including loan records and photographs of lending activities, were collected to triangulate and validate the data obtained from interviews and observations.

The collected data were analyzed using thematic analysis to identify recurring patterns and themes. The analysis involved the following steps (Vaismoradi et al., 2013):

1. Transcripts and notes were reviewed multiple times to gain a comprehensive understanding of the content.
2. Key phrases and concepts were coded and categorized into themes, such as "factors driving informal lending," "lending conditions," and "impact on microenterprise development."
3. Codes were grouped into broader themes that address the research questions.
4. Triangulation of data sources was conducted to ensure the reliability and validity of the findings.

By employing these methods, the study provides a robust framework for understanding the role of informal lending in supporting microenterprise development in Molompar Village.

RESULT AND DISCUSSION

Informal Lending Practices and Microenterprise Development

The role of informal lending in microenterprise development has garnered significant attention in both academic and policy-making circles, particularly in contexts where formal financial systems fail to provide adequate support to small-scale entrepreneurs (Bateman, 2014). This literature review synthesizes key insights from existing studies, focusing on the benefits, challenges, and policy implications of informal lending.

One of the most critical theoretical underpinnings of informal lending is its emergence as a response to financial exclusion. Formal financial systems, characterized by stringent requirements such as collateral, credit history, and lengthy approval processes, often exclude microentrepreneurs, particularly in rural areas (Beck & Demirguc-Kunt, 2006). Informal lending fills this gap by offering accessible and flexible credit options that cater to the unique needs of small-scale businesses. Omeihe (2023) emphasize that informal lenders capitalize on trust-based relationships and social networks to mitigate risks, thereby providing credit where formal institutions are unable or unwilling to do so.

Empirical studies highlight the significant benefits of informal lending for microenterprise development. Johnson & Arnold (2012) found that informal loans serve as a crucial source of startup capital for small businesses, enabling entrepreneurs to launch and sustain operations. Unlike formal loans, which are often rigid and bureaucratic, informal loans are highly adaptable to the borrower's needs, with flexible repayment schedules and minimal documentation requirements. This flexibility is particularly important in rural contexts, where income streams are often irregular and dependent on seasonal factors (Yunus, 2007). Informal credit also acts as a buffer during economic downturns, allowing entrepreneurs to maintain liquidity and avoid business closures.

Despite its advantages, informal lending is not without its challenges. A significant concern is the high cost of borrowing. Informal lenders often charge exorbitant interest rates to compensate for the lack of collateral and the higher perceived risk of default (Charles & Mori, 2016). Collins (2009) note that these high rates can erode the profitability of microenterprises, limiting their ability to reinvest in growth. Additionally, the reliance on social mechanisms for enforcing repayment—such as public shaming or leveraging community ties—can lead to psychological stress and social fragmentation, particularly in tight-knit communities.

Another critical issue is the lack of legal protections for borrowers in informal lending arrangements. Without formal contracts, disputes are often resolved through informal arbitration, which tends to favor the lender. Beck & Demirguc-Kunt (2006) argue that this imbalance leaves borrowers vulnerable to exploitative practices, such as arbitrary changes in loan terms or excessive penalties for late payments. Furthermore, the cyclical nature of dependency on informal loans, where borrowers take on new loans to repay existing ones, creates a debt trap that can undermine long-term financial stability.

The intersection of informal lending and financial inclusion is a topic of growing interest. While informal lending addresses immediate credit needs, its long-term sustainability and equity remain contentious. Scholars such as Ismail et al. (2020) advocate for the integration of informal lending into formal financial ecosystems through microfinance initiatives. By retaining the flexibility of informal practices while incorporating regulatory oversight and borrower protections, such models could offer a more sustainable solution to the credit needs of microentrepreneurs.

Policy interventions play a critical role in addressing the challenges of informal lending while maximizing its benefits. Key recommendations include the development of financial literacy programs to empower borrowers with the knowledge and skills to manage their finances effectively and avoid predatory lending practices (Kabeer, 2002). Additionally, regulatory frameworks that formalize informal lending practices through licensing and oversight can enhance transparency and accountability. Ojo (2024) underscores the potential of innovative microfinance models to bridge the gap between formal and informal financial systems, offering products that are both accessible and equitable.

In conclusion, informal lending is a double-edged sword in microenterprise development. While it provides essential financial support to underserved entrepreneurs, its challenges highlight the need for systemic reforms. By integrating informal lending into broader financial inclusion strategies and addressing its inherent risks, policymakers can create a more sustainable and equitable financial environment that supports the growth and resilience of microenterprises. Future research should focus on longitudinal studies and cross-regional comparisons to deepen our understanding of the dynamics of informal lending and its impact on entrepreneurial ecosystems.

Factors Leading to Informal Borrowing

The key factor driving informal borrowing in Molompar Village is the lack of access to formal financial institutions, which stems from the stringent requirements imposed by these institutions. Formal banks often demand extensive documentation, such as proof of income, valid collateral, and a good credit history. These requirements are unattainable for most microentrepreneurs in rural areas, whose incomes are irregular, and whose assets, if any, are not readily acceptable as collateral. This financial exclusion forces microentrepreneurs to rely on informal lenders, who offer loans with minimal requirements.

Informal lenders in Molompar Village provide flexible terms that cater to the unique needs of borrowers. Unlike formal banks, they do not require extensive documentation or fixed-income proof. Instead, they often rely on personal identification documents, such as the national ID (KTP), and verbal agreements to facilitate the loan process. This simplified procedure significantly reduces the barriers to obtaining credit, making it a preferred option for many.

The prevalence of informal lending reflects systemic gaps in rural financial ecosystems. Studies Beck & Demirguc-Kunt (2006) and Bu et al. (2022) indicate that such exclusion is common in rural economies across developing countries. The informal credit market thrives as an adaptive response to these gaps, offering accessibility at the cost of higher risks and interest rates.

Empirical evidence from this study highlights the dual role of informal borrowing. On the one hand, it enables microentrepreneurs to overcome immediate financial constraints, allowing them to sustain and expand their businesses. On the other hand, the reliance on informal lenders perpetuates a cycle of dependency, as borrowers often face high repayment obligations and limited legal protection. This dynamic underscore the critical need for financial reforms that integrate informal lending practices into the formal financial ecosystem without compromising their accessibility.

The implications of these findings are profound. Policymakers must address the root causes of financial exclusion by simplifying access to formal credit and supporting the development of microfinance institutions tailored to rural contexts. By doing so, they can reduce the dependency on informal credit and create a more equitable and sustainable financial system for microentrepreneurs in villages like Molompar.

Informal Lending Practices

Informal lending practices in Molompar Village are shaped by personalized agreements and localized norms that emphasize mutual trust and flexibility. The agreements between lenders and borrowers are largely informal, relying on verbal commitments and basic documentation. Borrowers are generally required to present their national identification card (KTP) as a standard requirement. In some cases, collateral such as property certificates is requested to secure larger loans. According to one lender, Nida Lasabuda, "We only need the KTP to ensure the borrower’s identity, and for larger amounts, we ask for land certificates as a safeguard. It’s all about mutual trust."

Borrowers often appreciate the simplicity and speed of the informal lending process compared to formal banking procedures. A borrower, Sukma Dapat, shared, "When I needed money urgently to restock my inventory, I couldn’t wait weeks for a bank to approve my loan. Here, I got the money on the same day by just showing my KTP." This expedited process makes informal lending an attractive option, especially for microentrepreneurs with immediate financial needs.

However, these informal practices are not without risks. The terms of the agreement, particularly the interest rates and penalties, are often communicated verbally and are subject to interpretation. One lender, Karim Rajamuda, explained, "We always discuss the repayment terms clearly, but since there’s no written contract, misunderstandings can occur, especially if payments are late." Borrowers also reported that late repayments could result in penalties, including social embarrassment through public exposure of their defaults. Another borrower remarked, "If you miss a payment, the lender might announce your name to the community as a defaulter, which is very humiliating."

The absence of formal contracts also poses challenges in dispute resolution. Borrowers have limited legal recourse if disagreements arise, as the agreements are not legally binding. Despite these shortcomings, the informal lending system thrives due to its adaptability to local needs and the trust-based relationships between parties.

These findings reveal the complex dynamics of informal lending in rural contexts, where flexibility and accessibility are prioritized over legal formalities. While this system provides critical financial support to microentrepreneurs, it also exposes them to vulnerabilities that formal financial systems aim to mitigate. The duality of informal lending underscores the need for interventions that balance its strengths with protections against its risks.

Loan Types and Repayment Structures

Informal lending practices in Molompar Village involve three primary loan types: daily, weekly, and term-based loans. These loans are tailored to suit the repayment capacities of borrowers, with amounts and schedules varying based on negotiated terms.

Table 1. Illustrates the typical repayment structures

Loan Amount (IDR)	Duration	Repayment Amount (IDR)	Frequency
1,500,000	30 days	60,000	Daily
2,500,000	30 days	100,000	Daily
1,000,000	4 weeks	310,000	Weekly
3,500,000	4 weeks	925,000	Weekly

Source: observation dan interview (2023)

Borrowers and lenders mutually agree upon the repayment terms during the loan initiation process. These agreements are informed by the borrower's income patterns, with some borrowers opting for daily repayments to align with daily revenue flows, while others prefer weekly schedules to match periodic income cycles. Despite this flexibility, the evidence highlights significant financial burdens imposed by these repayment structures. Daily loans, for instance, require consistent cash flows, which may be challenging during periods of low business activity.

The interview data provide further insight into the experiences of borrowers. Deelisa Sangko, a borrower, stated, "The daily repayment schedule helps me stay disciplined, but on slow days, I sometimes have to borrow from others just to meet the installment." This sentiment underscores the precarious balance many borrowers face between managing business operations and meeting repayment obligations.

High interest rates are another feature of these informal loans, often justified by lenders as compensation for the risk and immediacy of the loans. One lender, Selomita Nola Solangka, explained, "We take a higher rate because we don't have the guarantees that banks have, and we provide the money on the same day." While borrowers generally accept these terms as a trade-off for accessibility, the financial strain is evident in cases of delayed repayments, which can trigger penalties or social repercussions.

Despite these challenges, informal loans have proven to be instrumental in supporting microenterprise development. Borrowers reported that access to capital allowed them to invest in inventory, expand operations, and stabilize income streams. However, the financial burden of high-interest loans often limits the net benefits, suggesting a need for structured interventions to optimize the balance between accessibility and affordability.

Impact on Microenterprise Development

The findings of this study underscore the significant impact of informal lending on the growth and sustainability of microenterprises in Molompar Village. Borrowers consistently reported that the loans enabled them to address critical financial gaps, particularly in the areas of inventory procurement, operational expansion, and income stabilization.

Table 2. illustrates the progressive increase in profits observed among borrowers over an eight-week period.

Borrower Name	Profit (Week 1)	Profit (Week 8)
Sukma Dapat	750,000	950,000
Deelisa Sangko	1,400,000	1,900,000
Rusmiati Baso	2,100,000	3,050,000
Lisda Dauda	850,000	1,100,000
Tarmi Adam	1,050,000	1,250,000

Source: observation and interview (2023)

Borrowers such as Rusmiati Baso credited the loans for enabling a significant increase in their business scale. "I was able to buy additional raw materials in bulk, which reduced costs and allowed me to serve more customers," she explained. Similarly, Deelisa Sangko noted that the borrowed capital helped her diversify her inventory, attracting a broader customer base and increasing her revenue streams. These examples highlight how informal lending serves as a catalyst for entrepreneurial innovation and growth, even in resource-constrained environments.

Despite these positive outcomes, the challenges associated with repayment obligations remain a critical concern (Heyl et al., 2021). Borrowers often face difficulties maintaining consistent cash flows, particularly during periods of low market demand. Sukma Dapat reflected, "While the loan helped me stock my shop, the daily repayment schedule was tough during slow weeks. I had to borrow from friends just to make the payment on time." Such experiences emphasize the precarious nature of microenterprise operations, where financial gains can be offset by repayment pressures.

The study further reveals that while the loans facilitated business growth, they did not always translate into proportional increases in net income. The high interest rates attached to informal loans often absorbed a significant portion of the profits. Lisda Dauda, for example, stated, "The loan gave me the push I needed to expand, but the repayments took away most of the extra income I earned." This indicates that while informal loans address immediate financial needs, their long-term sustainability and equitable benefits remain limited by the cost structures imposed by lenders.

These findings highlight the dual role of informal lending in fostering growth while simultaneously creating financial vulnerabilities. Policymakers and stakeholders must recognize the value of informal lending as a financial lifeline for underserved communities. However, efforts to regulate interest rates, introduce repayment flexibility, and integrate informal lending practices into formal financial frameworks are crucial for ensuring that these benefits are equitably distributed and sustainable in the long run.

Challenges in Informal Lending

Informal lending practices, while addressing critical financial gaps for microentrepreneurs in Molompar Village, present significant challenges that can undermine the long-term sustainability of these enterprises. One major issue is the high repayment burden associated with informal loans. Unlike formal lending institutions, which offer structured repayment options with lower interest rates, informal lenders often charge exorbitant interest as compensation for the risk they assume (Schäfer & Wulf, 2022). Borrowers reported that this high cost of borrowing frequently cuts into their profits, limiting their ability to reinvest in their businesses. As one borrower explained, "The loan helped me start my business, but every month, I find myself struggling to meet the high repayments. I feel like I'm working just to pay back the lender."

Another critical challenge is the social stigma attached to late payments. In the tight-knit community of Molompar Village, informal lenders often use social pressures to ensure timely repayments. Borrowers who fail to meet repayment deadlines risk being publicly shamed, a practice that can have devastating consequences for their social standing and psychological well-being. One borrower recounted, "When I missed a payment, the lender announced my name in the community meeting. It was humiliating, and now everyone knows about my financial troubles." This method of enforcement, while effective in ensuring compliance, raises ethical concerns about the emotional toll on borrowers and the fairness of such practices.

The lack of legal protections for borrowers in informal lending agreements further exacerbates these challenges. Without formal contracts, disputes between lenders and borrowers are often resolved based on verbal agreements or community arbitration, both of which heavily favor the lender (Baradaran, 2020). This imbalance leaves borrowers vulnerable to exploitative practices, including arbitrary increases in interest rates or additional penalties for late payments. According to one lender, "We decide the terms based on the situation. If a borrower delays, we may charge extra as a penalty. It's only fair since we're taking the risk." Such practices underscore the precarious nature of informal lending and the urgent need for regulatory oversight.

Additionally, the cyclical nature of dependency on informal loans poses a long-term risk to borrowers. Many microentrepreneurs reported that they had to take new loans to repay existing ones, creating a debt cycle that is difficult to break. This issue is particularly pronounced during periods of low business activity or economic downturns, when revenues are insufficient to cover both operational costs and loan repayments. As one borrower lamented, "I had to borrow again just to pay off my previous loan. It feels like I'm trapped in a cycle that I can't escape."

Addressing these challenges requires a multi-stakeholder approach that balances the accessibility of informal lending with safeguards to protect vulnerable borrowers. Policymakers should consider integrating informal lending practices into the formal financial ecosystem through microfinance programs that retain the flexibility and accessibility of informal loans while offering lower interest rates and legal protections. Financial literacy programs can also play a crucial role in equipping borrowers with the knowledge and skills to manage their finances effectively and avoid predatory lending practices.

In conclusion, while informal lending serves as a vital financial lifeline for microentrepreneurs in Molompar Village, its challenges highlight the need for systemic reforms. By addressing the high repayment burdens, social stigma, lack of legal protections, and cyclical dependency, stakeholders can create a more equitable and sustainable financial landscape that supports the growth and resilience of microenterprises.

CONCLUSION

This study has highlighted the dual role of informal lending practices in Molompar Village as both an enabler of microenterprise growth and a source of significant challenges. The findings reveal that informal loans provide crucial financial support for entrepreneurs who lack access to formal credit systems. Borrowers have used these loans to expand their businesses, purchase inventory, and stabilize their income streams. However, the study also uncovers critical issues such as high interest rates, social stigma, lack of legal protections, and the risk of cyclical debt dependency, which undermine the long-term sustainability of these practices.

To address these issues, this research recommends the integration of informal lending practices into formal financial ecosystems through microfinance programs that retain the flexibility of informal loans while offering lower interest rates and enhanced borrower protections. Policymakers should also focus on implementing financial literacy programs to empower borrowers with the skills necessary to manage their finances effectively and mitigate the risks of over-indebtedness.

Despite its contributions, this study is not without limitations. The sample size was relatively small, focusing on a single village, which may limit the generalizability of the findings. Future research should consider a larger sample across multiple regions to validate and expand upon these findings. Additionally, longitudinal studies could provide deeper insights into the long-term impacts of informal lending on microenterprise development.

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