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A Sustainable Islamic Microfinance Model in the True Spirit of Islam

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A Sustainable Islamic Microfinance Model in the True Spirit of Islam

Dr. Talat Hussain[1] Muhammad Nadeem Khalil[2]

Abstract

Microfinance is considered an effective tool in alleviating poverty all over the world. The objective of this paper is to develop a sustainable Islamic Microfinance model in the true spirit of Islam. Despite its importance, the microfinance sector accounts less than 1% of the overall Islamic Finance industry although 1.2 billion of global population is living below poverty line (earning less than $2 per day) and 44% of which are living in Muslim countries. Similarly the current practices of Islamic Banks and Islamic Microfinance Institutions are based on the principles of materialism rather than the concept of *falah* (success in this worldly life and hereafter) due to which they have failed to achieve the objective of fair distribution of wealth in the society and alleviating poverty from the society. Therefore, in this paper an Islamic Microfinance Model based on the moral and ethical values of Islam (Piety, Justice, Benevolence, Cooperation, equality, selflessness avoidance from materialism) is developed. This model proposes Musharakha, Modarabah, Wakalah and Qarz-e-Hasana as the ideal modes of Islamic Microfinance because legitimacy of these modes of financing is beyond any doubt. In this Islamic Microfinance Model various steps are proposed for microfinance institutions, central bank and government. If this model is implemented in true letter and spirit, it can result in balanced growth and bring harmony in the various segments of the society by reducing poverty, increasing employment and fair distribution of wealth among them and thus contribute in the economic development and social well-being of the people.

Keywords: Islamic Microfinance, poverty alleviation, sustainability, materialism, falah.

Introduction

Islamic Finance has made a tremendous growth in the past few years all over the world (Shaikh, 2012). There are more than 300 Islamic Financial Institutions (IFIs) globally and the total assets of Islamic Finance have crossed $1.9 trillion (IFSB, 2016). It is expected that the total assets of Islamic Finance will cross $2.7 trillion by the year 2017. However, if we look at the size of microfinance loans, we come to know that it is very small and the total assets of Islamic Microfinance were only $1.8 billion according to Microfinance Information Exchange (MIX) statistics in year 2014. According to the Oxfam report, 80 richest people in the world own as much wealth as the 3.5 billon poor people and the gap between rich and poor is increasing with the passage of time. So there is a dire need of emphasizing on the microfinance for eradicating poverty and social well-being of the most deprived segment of the society. However, despite the

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importance of microfinance the microfinance sector accounts less than 1% of the overall Islamic Finance industry although 1.2 billion of global population is living below poverty line (earning less than $2 per day) and 44% of which are living in Muslim countries (GIFR, 2016).

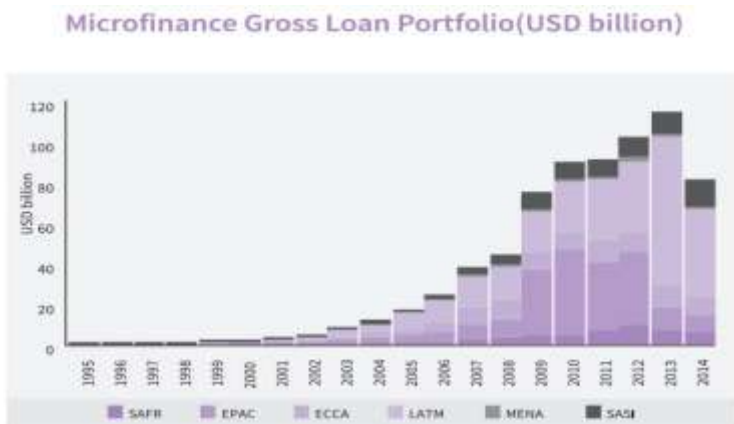

Figure 1. Microfinance Gross Loan Portfolio

Source: Microfinance Information Exchange (MIX) Database 2015, IFSB Secretariat Workings.

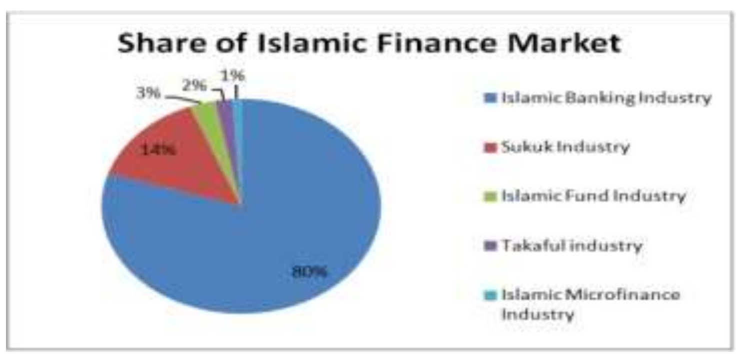

Figure 2. Share of Islamic Finance in the Market
Source: AlHuda Center of Islamic Banking & Economics (CIBE), 2017

Here it should be noted that the contributions of Islamic Banking in overall Islamic Finance industry is about 80% which means that the main focus of Islamic Banks is advancing loans to the corporate sector instead of advancing loans to the poor ones. That's why most of the people are not satisfied with the performance of Islamic banks with respect to their contribution in alleviating poverty and social well-being of poor people (Chaudhry, 2006). Islamic banks have failed to achieve the objective of fair distribution of wealth in the society (Mansoori, 2011). The people argue that the philosophy of Islamic banks is based on materialism rather than on the concept of *falah* (success in this worldly life and hereafter). They believe that the sole motive of Islamic banking is to make profit in the name of Islam. The modes of finance adopted by Islamic banks (such as *Murabaha*, *Ijara*, *Salam*, *Istisna*, *Dimishing Musharakah*, *Bai Musawammah*) are nothing more than legitimizing the interest through various *Hiyals* (plural of term *Hila* which means tricky solutions to difficult problems and clever uses of law to achieve legitimate ends) and *Talfiq* (borrowing between schools of law to reach intended objectives) as they think that various modes of finance introduced by Islamic banks are Shariah compliant with respect to their contract and procedure but they ignore the true spirit of *Shariah* (Mansoori, 2011).

Keeping in view the above mentioned issues in conventional financing as well as overall Islamic banking, there is a need to develop an Islamic Microfinance Model which should be based on the true principles of Islam instead of exploiting the people in the name of Islam. Here it should be noted that there is a sustainability issue for the models being practiced on the basis of Qarz-e-Hasana, like "Akhuwat" in Pakistan. The question arises how we can tackle these problems so that we can develop a sustainable Islamic Microfinance Model in the true spirit of Islam which can contribute to the social well-being of the people by alleviating poverty, keeping in view the true spirit of Islam and Maqasid-e- Shariah. The present study is an attempt to achieve this objective.

2. Problem Statement

Total assets of Islamic Finance have crossed $1.9 trillion but the total assets of Islamic Microfinance are only $1.8 billion which are less than 1% of total Islamic Finance assets. Now the questions arises that "Is Islamic Finance only for rich people or there should be some efforts to finance the poor people for eradicating poverty and balanced growth of various segments of the society? Is Islamic Finance based on the concept of Falah or materialism? Are current practices of Islamic Banks in true spirit of Islam or there is a need to develop a new Islamic Microfinance model keeping in view the true principles of Islam? The present study is an attempt to answer these questions that how we can tackle these problems so that we can develop a sustainable Islamic Microfinance Model which can contribute to the social well-being of the people by alleviating poverty.

2.1. Objectives

The objectives of the paper are:

1. To develop a sustainable Islamic Microfinance Model, which can contribute to the social well-being of the people by alleviating poverty, keeping in view the true spirit of Islam and Maqasid-e-Shariah.

2. To develop an Islamic Microfinance model to enable the poorest of the poor segment of the society in earning their livelihood.

3. To develop an Islamic Microfinance model based on the concept of Falah instead

of materialism.

4. To develop an Islamic Microfinance model in the true spirit of Islam instead of exploiting the people in the name of Islam.

5. To develop a sustainable Islamic Microfinance Model for increasing employment by fair distribution of wealth among various segments of the society.

2.2. Significance

This study helps us in developing a sustainable Islamic Microfinance model in the true spirit of Islam which can contribute to the social well-being of the people by alleviating the poverty, keeping in view of true spirit of Islam and Maqasid-e-Shariah. In this study an Islamic Microfinance model is proposed which is based on the concepts of Musharaka, Modaraba, Wakala and Qarz-e-Hasan embedded with the moral and ethical values of Islam (Piety, Justice, Benevolence, Cooperation, equality, selflessness, avoidance of materialism). So this study helps in reducing poverty and increasing employment by fair distribution of wealth among various segments of the society and thus contributing in the economic development and social well-being of the people. In this model various steps are proposed for banks, central bank and government which help the various stakeholders and policy makers in developing a sustainable Islamic Microfinance model in the true spirit of Islam.

3. Literature Review

Microfinance is defined as: "Small loans that help poor people who wish to start or expand their small business but, are not able to get banks to lend to them" (World Bank Report, 2007). Microfinance Institutions (MFIs) provide loans to the people who don't have access to the commercial banks due to the non-availability of sufficient collateral (Hartarska, Caudill, & Gropper, 2006). The importance of Microfinance Institutions (MFIs) can be understood from the fact that almost 44% of the conventional microfinance client live in the Muslim countries (Mughal, 2011).

There are various microfinance models, the most important among those are Grameen Bank Model, Credit Union or Cooperatives Model, Self Help Group Model and Village Bank Model (Obaidullah, 2008). Graduation Model introduced by BRAC (Bangladesh Rural Advancement Committee), Social Islami Bank Limited (SIBL), Baitul Maal wa Tamweels (BMTs), Community banking model and Grameen La Riba Model are the other important models which are successfully implemented in various countries (Mannan, 2007). In Grameen Bank Model, financing is made to a group of people who provide guarantee of each other. This group usually consist of five people on average who are trained about the basic element and financing requirement of the loan disbursed to them. The repayment of loan is considered the collective responsibility of all group members. Credit Union or Cooperative Model focuses on mutual benefit and is based on non-profit financial cooperative which is owned and controlled by its members. Loans are provided to the members on non-profit basis. In *Baitul Maal wat-Tamweel* (BMT) Model, being operated in Indonesia, Qarz e Hasan and charity based social services are provided to the poor people on non-profit basis. Community Bank Model is based on the concept of local bank in which all the employees working belong to the same geographical area and therefore know the people in the community and can serve them better. In Micro Banking, various banking services to meet the micro financing needs of individuals are provided in rural areas. These facilities include micro lending, micro savings, money transfer, micro insurance etc (Obaidullah, 2008).

The most important questions regarding a successful Islamic Microfinance Model is its sustainability as without the sustainability microfinance model cannot be successfully implemented. Sustainability of microfinance model can be viewed in two perspectives: its economic and social impact. In economic perspective, a microfinance model should contribute in increasing income, poverty alleviation, asset building while its social impact should be viewed with reference to its outreach, skill development, knowledge improvement, family empowerment, religious adherence etc. (Fernandez, 2006). Robbani (2007) argued that Grameen Bank Model cannot be recognized as ideal because it charges higher interest and failed to alleviate poverty. He emphasized on the using of Sharia based models of Islamic Micro financing which are ideal to alleviate poverty from a society. He argued that the collection of Zakat in organized form can help in alleviating poverty. Mannan (2007) compared Microfinance Model of Grameen Bank with Social Islam Bank Ltd. Model and concluded that Grameen Model is not helpful in reducing poverty while the Social Islamic Bank Ltd. Model is helpful in reducing poverty and equitable distribution of wealth in an economy.

Most of the Microfinance Institutions (MFIs) charge huge interest on their loans which put an extra burden on the poor people. Therefore, more attention is needed to devise an Islamic Microfinance Model which is based on the concepts of justice, piety, brotherhood and mutual cooperation instead of exploiting the poor people by charging higher interests. The approach focuses on social benefit rather than profit maximization.

According to Segrodo (2005), Musharrakah, Mudaraba, Murabaha and Qarz e Hasana are the most important methods of interest free financing. In Mudaraba there is no interest rate charged, instead capital provider and the borrower decide a profit and loss sharing basis in which the Mudarib (borrower) carries out the affairs of the business and the financial institution provides capital and the profits are shared as per agreed ratio. However, in case of loss the Mudarib does not share in the loss of the business. On the other hand in Musharakha, two parties provide capital and profits are shared as per agreed ratio and the loss is shared according to the share of capital of each individual investor. In Murabaha, the financial institution first purchases the assets and then sells them to the customer on higher price after adding profit (Habib, 2005). As far as the principle of Qarz e Hasana is concerned, no profit or interest is charged on the loan advanced and the borrower returns the loan on agreed date. Lender does not force him to pay back the loan earlier than the stipulated date (Iqbal & Mirakhor 2007).

4. Role of Islamic Microfinance Institutions under Proposed Islamic Microfinance Model

The main source of revenue for a bank is its deposits. The more deposits the greater the ability of a bank to invest those deposits and generate profits. In a true Islamic Microfinance Bank, there should be only four types of deposits:

Current Account
Investment Account
Donations/Charity Account
Zakat Account

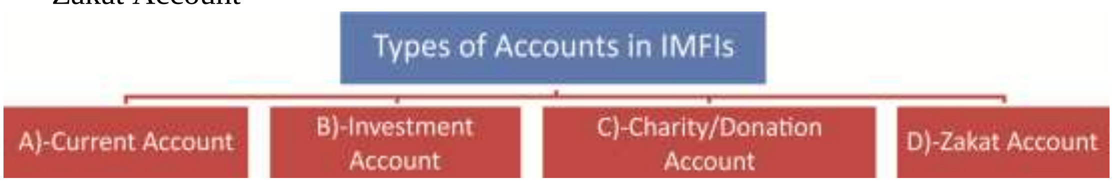

Figure 3. Types of Account in IMFIs

4.1. Current Account

An Islamic Microfinance Bank will receive current deposits on the basis of Qarz- e-Hasan. The bank will receive nominal service charges for providing various facilities to their customers like checking facility, Online Transfer facility, ATM, issuing Demand Drafts and providing locker facilities etc. 80% of the deposits in these accounts will only be used for providing Qarz-e-Hasanah in order to reduce poverty in the country while remaining 20% will be used by the bank for meeting its liquidity requirements. Local community will be given preference in providing Qarz-e-Hasanah. However, after meeting local needs, these funds would be transferred to other areas also. In this regard each bank branch will be responsible for keeping a record of such deposits that will be shared and consolidated at Tehsil level in order to ascertain the total deposits in these accounts and identify people those can be given Qarz-e-Hasanah on need basis. Skilled workers who want to start their own business should be given preference in this regard.Qarz-e- Hasanah can also be provided for skill enhancement and training programs. A special committee comprising honorable persons of the local community can be formed in order to identify the deserving people and check the fair distribution of such funds among deserving people. Serving local community on priority basis will create a sense of satisfaction regarding the fair use of the savings of the people and will encourage them to save more and keep these saving in bank for serving the local community. Government of Pakistan will provide guarantee of such Qarz-e- Hasanah loans to the banks and also to the account holders. However, in order to keep the bank interested a strict penalty should be imposed on banks if non-performing loans in Qarz-e-Hasana category exceed certain limits.

Figure 4. Types of Account in IMFIs

4.2. Investment Account

As far as investment accounts are concerned, the role of Islamic Bank will be that of a Wakeel and Partner (in Musharkah). In this regard, the following banker-customer relationship will be created:

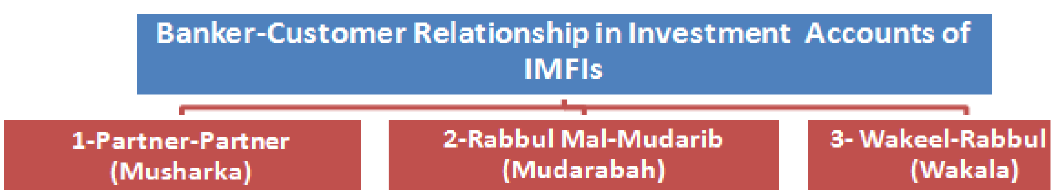

Figure 5. Types of Account in IMFIs

4.2.1. Partner-Partner (Musharkah)

In this case the bank and depositors will finance a project jointly. Both the bank and depositors will be Rabbul Mal and the customer requiring finance will be Mudarib (he may also be partner if he contributes his capital). In this case the bank will contribute from its own profits but not from depositor's fund. Profit and loss will be shared according to their invested capital or agreed formula. As a Mudarib, the customer requiring finance will not be liable to financial loss.

4.2.2. Rabbul Mal-Mudarib (Mudarabah)

In this case the bank will be Rabbul-Mal and provide finance to its customer who will act as Mudarib. Profit will be shared between the bank and customer on agreed ratio. However as Mudarib, customer will not share in the loss of the business. It is to be noted that the bank will provide its own capital or profit instead of using the money of its depositors in the current or investment account. For example, if a customer wants to purchase machinery, the bank will purchase that machinery and then will provide that machinery to the customer and will ask him to start business using that machinery after fixing the profit ratio. In case of malpractices by the customer the bank will cancel the agreement and take back the machinery from the customer.

4.2.3. Wakeel-Rabbul Mal (Wakala)

In this case bank will be Wakeel and customer will be Rabbul Mal. It is to be noted that the bank cannot be the Rabbul Mal of the deposits of the customers as these belong to the customers and not to the bank. Therefore if a person **A** approaches bank for financing a project, then the bank will provide him finance on the behalf of his customer and will charge a fixed fee in return of providing its services and investing on behalf of the customer. If whole amount of the project will be financed from the investment account (No bank's and person **A** contribution), then in this case the relationship between the customer and the person **A** will be that of Rabul Mal-Mudarib (customer being Rabbulmal and Person **A** being Mudarib) where bank will work as Wakeel for a fixed fee. Profit and loss will be distributed as per agreed ratio after deducting wakalah fee of bank. For example Mr. A approaches ABC Bank Limited for purchasing a spinning unit. ABC Bank Limited purchases that machinery worth Rs. 100,000 out of funds from investment account and fixes the profit ratio as 50:50. The business generates Rs.10, 000 as profit. Bank A deducts 1000 as his wakala fee and distributes Rs.4500 to customers and Rs.4500 to Mr. A.

4.3. & 4.4. Donations/Charity Account and Zakat Account

The amount in donation/charity account and Zakat Account will solely be used for providing Qarz-e-Hasanah and Skill Development projects for the poor people of the society in order to enable them to earn their livelihood and thus eradicating poverty from the country. So the funds in Zakat Account, Donation Account and 80% of the Current Account will be used only for providing Qarz-e-Hasanah and skill trainings to the poor people of the society which will help a lot in eradicating poverty in the country and will contribute towards the social well-being of the poor people by enabling them to earn their livelihood and support their families.

5. Trading House

As there are doubts on the legitimacy of various Islamic Banking financing instruments (discussed earlier) like Murabaha, Ijara, Salam, Istisna, Diminishing Musharakah, Bai Musawammah, so instead of using these instruments as a mode of finance, an Islamic Microfinance Bank will work as trading house and will establish linkages with renowned national and international companies. The Islamic Microfinance Bank will make agreements with these companies for supplying various goods from time to time on the demands of the customers of the banks. Whenever a customer will need a particular product, the bank will issue supply order to the concerned company which will supply that particular item to the bank and the bank will sell this item to its customer on market price on deferred payment basis. With the passage of time the customers of the bank will increase as the bank will be supplying goods on market rate but on deferred payment basis. With large number of customers, the bank will be in a position to get more discounts from the companies supplying various products to the bank and hence can increase its profit margin. Trading activities can also be done using the funds in the investment accounts and the profits will be shared with account holders as per agreed ratio.

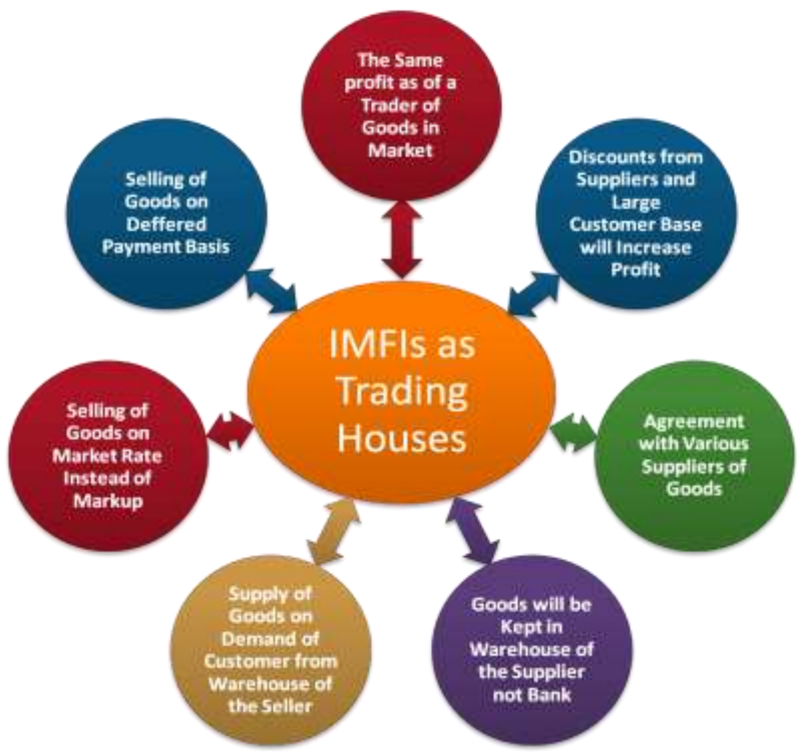

Figure 6. IMFIs as Trading House

6. Role of Central Bank under Proposed Islamic Microfinance Model

The role of central bank in stabilizing the economy is very important. In this regard central bank has to take various measures to control money supply, inflation, overseas banking sector and whole financial system of the country. Under the proposed Islamic Microfinance Model, central bank will fix financing targets for banks and microfinance institutions keeping in view the poverty and unemployment in the country. Central bank of the country as a lender of the last resort will provide funds to the banks on Qarz-e-Hasanah basis in case of liquidity crunch. 20% of the current account balances will also be available for banks to meet liquidity requirements. A penalty will be imposed on the bank not meeting the liquidity requirements and central bank will play an important role in overseeing the performance of various banks in this regard. In Islamic economic system the depositors of the bank agree to share the risk associated with their investments, so there will be no need to fix reserve requirements by the central bank as it will result in making the country's resources idle instead of effectively utilizing them. Additionally, banks will be required to put 5% of their profits as contingency reserve in order to meet liquidity crises so there will also be no need to fix liquidity requirements for the banks.

7. Role of the Government under Proposed Islamic Microfinance Model

Assuming the role of Khalifah, the Government will promote a culture of "*Amr bilmaroofwanahi ani al-munkar*" and will abolish all interest based financial instruments, laws, rules and regulations with immediate effect and introduce new laws keeping in view Shariah principles. Government by leading from the front will put great focus on promoting the moral values of Islam (piety, justice, benevolence, brotherhood, selflessness, cooperation and equality) in the society. Government will allow microfinance institutions to collect Zakat. Zakat, if utilized effectively can reduce poverty in a society to a greater extent. Additionally, current accounts balances and loans provided on Qarz-e-Hasanah basis will be guaranteed by Government in order to boost the confidence of the depositors as well as micro finance institutions.

8. Conclusions and Recommendations

The objective of this paper is to develop a sustainable Islamic Microfinance model in the true spirit of Islam. Various exiting Islamic Microfinance Models all over the world are reviewed and their viability is checked. It is observed that conventional microfinance models charge higher rates of interest from their customers due to increased risk while serving the poor which results in putting more burden on the poor people instead of helping them in coming out of their vicious circle of poverty and earn their livelihood. Similarly the current practices of Islamic Banking are based on the principles of materialism rather than the concept of *falah* (success in this worldly life and hereafter) due to which Islamic banks have failed to achieve the objective of fair distribution of wealth in the society and alleviating poverty from the society (Mansoori, 2011). Additionally, Islamic banks have not emphasized advancing the microfinance loans to the poorest of the poor segment of the society and the microfinance sector accounts less than 1% of the overall Islamic Finance industry although 1.2 billion of global population is living below poverty line (earning less than $2 per day) and 44% of which are living in Muslim countries (GIFR, 2016). Therefore, in this paper an Islamic Microfinance Model based on the moral and ethical values of Islam (Piety, Justice, Benevolence, Cooperation, equality, selflessness and avoidance from materialism) is developed. This model proposes Musharakha, Modarabah, Wakalah and Qarz-e-Hasana as the ideal modes of Islamic Microfinance because legitimacy of these modes of financing is beyond any doubt. In this Islamic Microfinance Model various steps are proposed for microfinance institutions, central bank and government. If this model is implemented in true letter and spirit, it can result in balanced growth and bring harmony in the various segments of the society by reducing poverty, increasing employment and fair distribution of wealth among them, and thus contributes in the economic development and social well-being of the people.

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