Islamic microfinance: Solution to poverty alleviation?

Microfinance could be one of the ideal approaches to alleviate poverty in the Islamic world. MOINUDDIN MALIM questions why there have as yet been no significant attempts or successful implementations in the sector.

Modern day microfinance goes back to 1960s, when a few dominant donors developed programs which were focused on a particular aspect of assisting selective segments of the economy. Microfinance gave individuals and families the financial fuel they needed to stand on their own feet without the repressive burden of repaying moneylenders beyond their means. Borrowers use loan proceeds to buy raw materials to manufacture products for sale in the market; purchase livestock to sell milk/eggs; or open small shops.

However, most conventional microfinance providers charge high interest rates compared to mainstream banking. The main reason for this can be attributed to the miniscule size of investments compared to the earning numbers, and higher administrative and monitoring costs associated with microfinance.

This has raised an interesting debate. Should this method of financing remain interest-based? And ensuing from this debate comes the concept of riba-free financing — or to be more precise, Islamic investment and financing. As the world has seen during last few years, interest-related liabilities have accentuated the financial dismay or even failure of not only giant banking institutions but also some sovereign entities. Can non-compounding of debt in the case of possible default come to the aid of the borrower? If so then how can this be effectively used to alleviate the level of poverty that the world faces today, through the means of Islamic microfinance?

Some facts

Prior to embarking on a discussion on microfinance and how Islamic finance can take a bite of this segment of the industry, it is crucial to understand some facts about what drives microfinance.

The world population crossed the 7 billion mark in October 2011.

- The World Bank defines extreme poverty as living on less than US$1.25 (purchasing power parity) per day, and moderate poverty as less than US$2 or US$5 a day. It estimates that in 2001, 1.1 billion people had consumption levels below US$1 a day and 2.7 billion lived on less than US$2 a day.
- Poverty is the biggest moral challenge of this century. One in every fifth person on earth survives on less than US$1 a day.
- An estimated 2.7 billion people or 38% of the world population have no access to formal financial services.
- Fewer than 18% of the world's poorest households have access to any financial services.
- Poverty levels have also been associated with high inequality alongside low productivity. It is estimated that the 10 most populous Islamic countries account for more than 600 million of the world's poor.
- There are incredibly high degrees of financial exclusion of Muslims in OIC countries and India (67-80% of Muslims have minimal or no contact with the formal banking sector).
- Muslim societies fare far worse than the rest of the world in the matter of addressing the problem of poverty.

A Consultative Group to Assist the Poor (CGAP) study by Karim, Tarazi and Reille (2008) reported that large numbers of poor Muslims in various countries reject all forms of loans, including Grameen-style microfinancing, on religious grounds.

The World Bank estimates that there are over 7,000 microfinance institutions, serving some 16 million poor people in developing countries.

The Microcredit Summit in 2009 estimated that US$21.6 billion is needed to provide microfinance to 100 million of the world's poorest families.

According to the Grameen Foundation USA, there are 13 million microcredit borrowers, with US$7 billion in outstanding loans, generating repayment rates of 97% and growing at a rate of 30% annual growth.

Purpose of microfinance

Why is it that most economic development projects focus on large infrastructure or industrial projects? While these projects do create jobs, their ultimate target is not to empower the local population to become economically self-sufficient.

There is no argument that such projects do uplift the economic fabric of that location and they may serve the bigger interest of the country, but these projects do also dispel the local population and push them further back into rural areas. Take any example and one can see that any such project requires more skilled labor and thus will only hire workers that have experience or that have the capacity to be trained for work for such a project.

The segment of population that generally gets precluded is the poor class who are living well below the poverty line.

This is where microfinance enters. Microfinance is a channel to reach those segments of society whose low economic standing excludes them from conventional financial institutions. Microfinance generally includes microcredit, savings, micro insurance and to certain extent small-scale venture capital.

The key difference between microfinance and regular conventional or Islamic finance system is the concept of joint responsibility and liability. Under microfinance the financing or investment is not given to one individual but is extended to a group of individuals who

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form an association to apply for financing or investment.

A microfinance provider trains the group regarding the basic elements of the financing or investment and the requirements they will have to abide by as a group in order to continue to have access to funding or investment. The basic concept is risk sharing by each individual with the group. Funding or investment is disbursed to individuals within the group after they are approved by other members in the group. Repayment of the financing or investment then becomes a joint responsibility of the group's members.

Hence, if one defaults, the entire group's members share the risk or even suffer together. This is the basic concept of microfinance which has laid the foundation of an effective credit scoring mechanism that may translate into a temporary suspension of the group from the program and therefore no access to financing for the group or other penalties.

Another feature of microfinance is the cap on maximum amounts of financing or investment and a short time period that generally does not cross a few months. The basic emphasis here is to cap the tenor and amount based on the product life cycle. This limits microfinance to focusing on the cash-generating capability of the underlying financing or investment.

Islam and microfinance

The principles of Islamic microfinance are as follows:

1. **Convert charity into productivity**: Economic empowerment is the basic rationale and the need to rule out dependence on charity by seeking any means to make one productive and income-generating is the ultimate goal of Islamic microfinance.

2. **Basic needs**: Under Islamic microfinance, if the basic needs of the needy are satisfied, they can then focus all their energies onto the productivity which they are then capable of delivering. Linking a social safety-net to microfinance is a crucial element for success.

3. **Accessibility**: The poor and deserving segments of the population need to have access to economic and financial assistance at all times.

4. **Assessment**: The financier or the investor in microfinance should be able to assess the financial health of the poor to ascertain what their skill set is and what they can do with their time. A basic evaluation matrix needs to be in place and understood by the assessor.

5. **Unity in community**: Islamic microfinance encourages unit-building within the community. Until the larger communities are involved in such initiatives, poverty alleviation programs under microfinance will not be as successful as they should be.

6. **Transformation**: Post-evaluation of the situation of the poor, Islamic microfinance should be able to transform the unproductive assets or skill sets of the beneficiaries into income-generation. This is where group assessment plays a vital role.

7. **Technical assistance**: Islamic microfinance is not simply about extending microcredit to the needy but also involves technical and professional assistance to guide them in the right direction.

The lack of proper documentation and accounting by beneficiaries is a major challenge confronting microfinance. However, Islamic teaching requires proper accounting and accurate measurement of results of operations or profits, which is also a pre-requisite for profit sharing-based mechanisms. The Islamic approach puts overwhelming emphasis on micro-enterprise development through financial and non-financial assistance and adherence to principles of transparency, empathy and cooperation.

Please note that Islamic microfinance cannot be mixed with or made synonymous to the zakat or sadaq or awqaf systems, which are not supposed to eradicate poverty but to provide social safety-nets to the extremely poor and destitute. While there have been attempts to organize collection and distribution of zakat, this has yet to be successfully institutionalized as a part of the finance industry.

Having demonstrated the potential of Islamic guidelines for microfinance, the question that remains is what the contribution of Islamic microfinance in alleviating poverty in Muslim countries actually is? Why is it that we do not hear of contributions from Islamic banking and finance toward microfinance?

On the other hand, why are Islamic finance principles not being adapted by conventional microfinance? Is it because Islamic finance principles are difficult to implement, especially in rural settings? Or is it the uncertainty that microfinance institutions may find when they try to understand Islamic modes of finance, which are based on profit and loss sharing.

Whatever the case may be, the contribution of Islamic finance in the area of microfinance is very minimal while its scope has the potential to be one of the greatest, based on the facts (stated above). Why is it that most Islamic banking and financial services activities are merely trying to replicate others rather than thinking out of the box to become real value-added partners to their communities?

Conclusion

While Islamic microfinance may be one of the ideal approaches to alleviate poverty, there have been no significant attempts made in this sector or any truly successful implementation. Islamic microfinance can be used as a tool both to target wealth creation and to provide solutions for raising the living standards of the poor.

Islamic modes of finance are available to encourage equity and partnership-based financing which are unfortunately utilized more in debt-based funding structures. It is also commonly known that while Shariah compliant debt-based modes are permissible, equity-based modes of financing are clearly preferred. The basic concept of group-based financing and mutual guarantee within the group are norms in microfinance, and these concepts are ideal for Islamic microfinance.

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