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   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

   RECOMMENDATIONS/SUGGESTIONS

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BANKING FOR THE POOR IN THE CONTEXT OF ISLAMIC FINANCE

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ABSTRACT

This paper tries to show that it is possible to use the micro finance, as an internationally accepted way for poverty eradication, in the context of Islamic banking and finance. It sheds lights on the meaning of the Islamic micro finance and the similarities and dissimilarities it has with that of conventional micro credit. The results of this theoretical research shows that the goals of micro-financing movement in the conventional financial system is in harmony with the goals of the Islamic finance system and hence Islamic micro finance institutes, if established and well managed, can strengthen the level of the Islamization of the banking system. Further research is needed about the conceptual analysis provided in this article and this will smoothen the way for establishment and expansion of Islamic micro finance institutes as complements of Islamic banks.

JEL CODES
O12, O15, O50.

KEYWORDS
Islamic micro finance, conventional micro credit, Islamic banking system, Islam, financial system.

1. INTRODUCTION

One of the most important challenges that most of the current Islamic countries are facing is the problem of poverty and financial exclusion of the many people from the banking system. It means that although the banking system has grown drastically over time, but the access of the poor to the finance is not yet satisfactory at all. Consequently, the issue of financial inclusion has emerged as a policy concern, primarily to ensure provision of credit to small and medium enterprises that are not considered bankable in the conventional financial system. The emerging microfinance revolution, in the recent decades, with appropriate designed financial products and services enable the poor to expand and diversify their economic activities, increase their incomes and improve their social wellbeing (Bennett & Cuevas, 1996; Ledgerwood, 1999).

Paying attention to poverty reduction via microfinance initiatives is also of relevance to Islamic banks and financial institutions. These kinds of institutes are business entities established within the ambit of Shari`ah and in the context of Islamic economic worldview. Hence, they are expected to be guided by the Islamic economic objectives, among others, to ensure poverty alleviation and the fact that wealth is fairly circulated among as many hands as possible without causing any harm to those who acquired it lawfully (Ibn Ashur, 2006).

It seems more important if we note that Islamic banking industry is one of the fastest growing industries, having posted double-digit annual growth rates for almost 30 years. What started as a small rural banking experiment in some Islamic countries many years ago, has now reached a level where many mega-international banks worldwide are offering Islamic banking products. While the estimates about the exact magnitude of the Islamic banking market vary, one can safely assume that it presently exceeds 200 billion USD and is poised for further growth. However, with the passage of time, the orientation of Islamic banking and finance has somehow dominated by profit-maximization doctrine. As a result, most of the financial engineered instruments are designed favorably catering the needs of the well-off clients while the poor left unbankable due to the inherent impediments (Iqbal & Molyneux, 2011).

With such an impressive growth of Islamic banking over the last 30 years and the exclusion of the poor from Islamic banks services, it seems that it is time for the industry to be reoriented to emphasize on issues relating to social and economic goals of Islamic economics, rather than overemphasizing on just Fighi issues or making profits. Islamic banks should endeavor to be the pioneer in using community banking and microfinance programs to provide financial services to the poor.

To put it in nutshell, one could believe that Islamic banking is concerned with much more than just refraining from charging interest. It is a system that aims at making a positive contribution to the fulfillment of the socioeconomic objectives of Islamic society inscribed in Maqasid as Shari`ah (the objectives of Shari`ah). Considering this, it seems that microfinance, which is an internationally accepted strategy for poverty alleviation that has been used by many developing, and even developed, countries to help the poor, can be considered as another level of Islamic finance that will complete the shortcomings of current Islamic banks.

After providing the definition of Islamic micro finance, this paper tries to go over the experience of microfinance in some Islamic countries and to show that this poverty alleviation strategy has the potentials to be used within the context of Islamic economics and finance. However, this experience cannot be adopted in Islamic world exactly as it is practiced in non-Islamic countries. In other words, there should be some modifications in different aspects of microfinance to make it suitable for Islamic countries. In addition, this research, which has a theoretical conceptual nature, tries to shed lights on the principals of Islamic microfinance and the way they differ from the conventional ones.

2. LITERATURE REVIEW

The review of available literature shows that although there are several studies about Islamic micro finance in recent years (Toghiani, 2006; Kahf, 2004; Habib, 2007; Mannan, 2007), but usually these studies are concerned with elimination of interest by Islamic contracts such as “installment sale”; therefore, the concept of the using Islamic micro finance as a tool for poverty alleviation and emphasizing its differences with that of conventional one is not discussed enough. Here are some of these studies:

Arab Mazar and Motamed Farzin (2003) have put forward the new methods of micro-finance in enabling low-income group, especially women. While comparing the characteristics of micro-finance methods of Bank Keshavarzi, this study has analyzed these credits in the framework of four plans implemented in this bank.

Motamed Farzin and Nematian (2004) have shown in their paper that although micro-finance is extended as a service by financial institutes, but also can provide gains for the institutes.

Hassanzadeh Et al (2006) have studied the effectiveness of micro-finance on alleviation of poverty and in-equality in different provinces of Iran by panel data method. The results which use interest-free loans as a substitute for total extended micro-finance variable, shows that micro-finance can only alleviate poverty if the lower income group is well distinguished, and the credit is spent for job creation.

After discussing economic, accounting and risk management challenges in his study, Habib (2007) shows that if micro finance institute is established by money Islamic and Qharz-al-hassan financing, it wouldn’t face challenges facing traditional micro finance institutes (including credit risk, moral hazard, and economic viability).

Hassan and Ashraf (2010) presented a model in their study in which Zakat and Islamic are mentioned as sources for micro finance. After explaining the characteristics of Zakat and Islamic and presenting a model, they show that the application of their model will reduce the challenges faced by interest bearing micro finance institutes (including viability of the micro finance institute).

Many other writers such as Al-Harran (1999), Akhtar (1996, 1998), Dhumale and Sapcanin (1998), Ashkevary (1998), and others, believe in the great potential of Islamic banking to be involved in microfinance programs to cater for the needs of the poor who usually fall outside the formal banking sector.

3. DEFINITION OF MICROFINANCE AND ISLAMIC MICROFINANCE

Although there is not only one definition about the term micro finance and micro credit, but totally, Microfinance can be defined as provision of financial services such as deposits, loans, payment services, and so on to low-income people and to the underprivileged. In other words, microfinance is a financial activity that tries to provide financial services to those sections of the society such as artisans, farmers, and small proprietors and entrepreneurs. These people are generally left out by the traditional banks and other financial institutions as they are considered less credit worthy and risky. Financial institutions are also reluctant to advance small loans due to the high processing and monitoring cost involved (Kaleem and Ahmed, 2009, p. 3).

Microfinance has proved to be a useful and effective poverty eradication strategy in the international scene and has grown dramatically. As data shows, Since Professor Muhammad Yunus (from Grameen Bank) received the Nobel Peace Prize for his work in microfinance, the industry has been receiving much press, most of it positive. In means that, microfinance has developed rapidly, particularly in the last five years. For example, as one of the best known microfinance institutions (MFIs), the Grameen Bank in Bangladesh, saw growth in loans from $229.14 million in 2001 to $488.41 million in 2006, an increase of 113.15% (14.4% annually) (Grameen Bank, 2006). Despite this growth, most banks (including Islamic banks) in developed, developing, and especially, less developed countries still ignore poor clients because their lack of collateral makes them more risky, and the lenders fear the poor clients will feel little obligation to repay loans.

Most of the micro credit institutes function under the theory of group lending and peer pressure and many papers have shown that this characteristic have helped them most to be successful in reaching their goals. For example, Besley and Coate (1995) believe that group loans are a powerful device to yield higher repayment rates than individual loans. The self-selected group shares the common interest of gaining access to credit at low information cost and applying sanctions to those who do not comply with the rules.

Considering some questionable characteristics of the conventional micro finance institutes, specifically the interest-based financial activities, Islamic scholars and researchers have tried to define and emphasize Islamic microfinance. Going through the available literature on Islamic microfinance, one can clearly come to the point that most of the writers on the topic, have taken it for granted that Islamic microfinance is nothing more than the conventional microfinance less than interest (Imboden, 2005). Unlike previous literature that confines Islamic microfinance to the abolition of interest, in this paper, it is claimed that there are other areas and dimensions that are different between Islamic and conventional microfinance.

4- WORLDWIDE EXPERIENCE OF ISLAMIC MICRO FINANCE

Considering the fact that it is important to go briefly over the available Islamic micro finance institutes experience, in this part, some experiences are mentioned. This review tries to show that there is not only one best practice in Islamic micro finance and each country should pursue its own model.

A. YEMEN

Banking products have been available in Yemen for many years, however, many people, and the poor in specific, shied away from banking credit, mainly due to religious beliefs. In reaction to this, the Hodeibah Microfinance program (HMFP) was established in 1997, Hodeibah is a port city, characterized by having an active economy based on trading, fishing, food production, small industries handcraft and transportation. The program was the first of its kind in Yemen. By June 2000, it had 1770 active clients, 23% of whom are women, and US $ 350,000 in outstanding debts. The average disbursement size was US $ 240 (Imboden, 2005, p. 24).

The clients went through a cycle of disbursement levels and each level had a wide scope, based on group approach, where group members are not confined to the same disbursement amounts or same activities. One of the main achievements of the program during its first phase was to develop a microfinance methodology closely tailored to local circumstances and based on Islamic banking principles. However, the program uses Murabaha as the tool which appears to be more expensive to the clients. There is limited application of Musharaka and Mudharaba in Yemen though it is preferred by the clients (Imboden, 2005, p. 26).

B. SUDAN

Sudanese Islamic bank (SIB) established special micro-credit windows called “productive family branches” in the year 1992. These branches mostly adopted partnership financing, among other Islamic methods of finance. In the SIB experience, the user of funds does not have to contribute in cash to the proposed investment, rather, his share might be in kind (input), labor, or rent of machines or equipment. The SIB however, did not pursue the experiment to the end due to the central bank regulations on one hand and the change in the management of the SIB on the other hand (Kaleem and Ahmed, 2011, p. 17).

The experience of providing Islamic microfinance has been extended to other banks in Sudan, including Nile Bank, SSDB, ICDB, Agriculture Bank and Al-Baraka bank. Murabaha is the dominant contract used with few exceptions where benevolent loans were provided in addition to finance using Murabaha.

Sudan has faced many macroeconomic problems that have created a difficult business environment for small firms and micro enterprises. However, in a study conducted by Habib shows that these businesses have nevertheless played a major role in generating employment opportunities and increasing the family income of people of modest means. He evaluates the contribution of the informal sector, craft workshops and productive families, all of which have benefited from Islamic financing, especially since the 1990s. This has helped significantly with poverty alleviation, and there is much potential for this type of small and micro business support to be extended in the Sudan as well as elsewhere in Africa and the developing world more widely. Indeed, Habib suggests that the profit and loss sharing techniques used for Islamic financing can be extended to interest-free micro financing (Habib, 2002, p. 18).

C. MALAYSIA

The Malaysians developed a system known as “Ar-Rahnu”. The system was simply based on the way widely accepted notion: gold is women‘s best friend. Malaysians made use of the simple facts all agree on, gold adorns a woman‘s looks, it enhances status as it implies wealth, it is a saving mechanism as its price is stable and it normally appreciates, and it can serve as collateral whenever cash is needed. Micro financiers found out that Malaysians were reluctant to engage in banking activities that are un-Islamic. Therefore, they devised a system whereby gold was used as collateral while the lender charges a fee for keeping the gold safe. Hence, the system was based on the following principles of Islamic microfinance; it is interest free, transparent and customer friendly; it follows clear record keeping of all transaction, and secures safekeeping. Ar-Rahnu, received wide acceptance in Malaysia by poor families and is considered a very useful tool in encouraging savings and investments (Ahmed, 2002, P. 29).

It is based on benevolent loan (*Qardhul Hasan*) an agreement between a lender and a borrower whereby the lender is forbidden to ask for extra payment but the borrower is encouraged to give a token of appreciation. *Ar-Rahnu* is seen as an economic tool to improve the socio-economic development of the lower and middle-income society, because of its flexibility and co-operative principles.

5- SIMILARITIES AND DISSIMILARITIES OF ISLAMIC AND CAPITALIST MICRO FINANCING

Having gone over the definition of the Islamic micro finance and reviewing some international experiences of it, in this part we try to make a theoretical comparison between the Islamic MFIs and conventional MFIs. Conventional MFIs follow the well-known example of the Grameen Bank of Bangladesh, which is considered a pioneer of microfinance. This model is interest-based model. The proposed and currently used models for Islamic MFIs is also based on Grameen model, but in these models interest is eliminated and Islamic instruments or modes of financing like Mudārabah, Mushārakah, Bay Bithaman Ajil, etc., are used. However, it seems that Islamic MFIs are different from conventional MFIs at least in the following areas:

A. PROVISION OF FINANCE TO THE POOREST OF THE POOR

Although the microfinance movement is meant to help the poor out of poverty, still the poorest population is left out by conventional MFIs (Choudhury, 2002). However, this is not (or should not be) the case within Islamic MFIs. IMFIs can integrate the poverty eradication institutions of Islamic economic system like Zakat, Qard-Alhasan and other voluntary charities (Sadaqat) to provide the poorest people with financial services.

B. USING ISLAMIC WAYS AND MEANS TO FINANCE ITSELF

Conventional MFIs usually get the funds from foreign donors. They also finance themselves from the savings of the clients and external funds (Habib, 2002, p. 12). Islamic MFIs, however, apart from these sources of funds, can get the funds from religious institutions such as Waqf, Zakat, Anfal etc., which are prevailing in most of the Islamic countries.

C. USING ISLAMIC MUSHARAKAH AND TRADE-BASED WAYS TO FINANCE THE NEEDY

Conventional MFIs are interest-based while Islamic MFIs are interest free. Islamic MFIs operate through several Islamic modes of financing such as Ijārah, Murābaha, Istisna, Mudārabah, Mushārakah, Bay Bithaman Ajil, etc.

D. AMOUNT AND DEVIATION OF THE FUNDS

It is a practice of conventional MFIs to deduct an amount from the loan before disbursement. This deduction is for different reasons such as group and emergency funds. However, the interest paid by a beneficiary is calculated on total amount. Under these conditions, the effective interest rate paid by beneficiary to the MFI increases. Furthermore, there is a risk that the funds, once transferred to the poor, might be diverted to non-productive uses. Under the IMFIs, there is no such deduction. Here, usually the total amount is used to purchase the good and that good is transferred directly to the beneficiary. By doing so, the risk that the funds will be used for non-productive uses is minimized (Habib, 2002).

E. TARGET GROUP

While conventional MFIs mostly target women, Islamic MFIs are targeting family as whole. The objective of targeting women in conventional MFIs is to empower them. It is believed that women use funds more productively and this increases their incomes (Imboden, 2005). However, in Islam, family is the cornerstone of the social system. Family is not a casual or spontaneous organization of people, but it is a divinely ordained institution. Family and marriage are regarded as noble and sacred. As a result, the IMFIs should focus on the family as whole and not only women. Consequently, unlike conventional microfinance, in case of IMFIs, both recipient and spouse are responsible for the loan since IMFIs are targeting the family as a whole.

F. INCENTIVES OF STAFF

In the case of conventional MFIs, usually, the main motives of employees are monetary, while the work incentives of employees of IMFIs are first of all, religious and after that monetary. It means that In IMFIs, the work is seen as a part of religious duty (i.e. to help those in need).

6- CONCLUSION

Poverty is a real problem in most of the Islamic world (specifically the OIC member countries). It necessitates finding ways and solutions to solve this problem. One of these solutions is microfinance, an internationally successful experience for poverty eradication which has the same goals as the Islamic finance system. However, this experience cannot be adopted in Islamic world exactly as it is practiced in non-Islamic countries. In other words, there should be some modifications in different aspects of microfinance to get suitable for Islamic countries. This theoretical article, has tried to briefly shed lights on the idea of considering micro finance in the context of the Islamic banking and finance system. It tried to provide a complete definition of Islamic micro finance and examine its differences from that of conventional microfinance. Understanding these differences will help policy makers in Islamic countries to be able to design the best microfinance models that is both Islamic and suitable for their needs. Future research can be based on this theoretical paper and try to use Islamic instruments and institutions to make conventional microfiche suitable for the need of different Islamic countries.

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