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Islamic Micro Finance

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ABSTRACT
The objective of this paper is to relate the practices of microfinancing with the practices of Islamic financing. It discusses the main concepts and underlying assumption behind both thesystems. It further explains the different practices of Islamic financing. Also finds out the link between conventional microfinancing and Islamic financing practices i.e. how Islamfinancing can be merged with the conventional financing.

Introduction

Banking sector plays vital role in the development of economy of a country. Commercial banks provide loan with certain conditions i.e. they require collateral and also charge interest. But they only cater the specific segment of society who can provide collateral and ignore major segment of the country that are poor and can't afford to provide any collateral. Microfinance institutions were established to fill this gap. Major objective of microfinance institutions is to improve their livelihood by giving them collateral free loans.

This paper is written to assess how Islamic financing can contribute to existing microfinancing schemes to make it according to the "Shariah" principles. It discusses that both conventional and Islamic microfinancing are established for the welfare of society i.e. work for common goal. The main objective of this paper is to create a link between Islamic financing and microfinancing.

Microfinancing

Microfinance means the programme that facilitates poor people by extending them small loans for self employment to generate income. It's not only helpful in improving the living standard of just one family. Rather it has a multiplier effect in generating economic activity. A successful entrepreneur can contribute for the development of economy by extending his business and providing employment to others. Thus microfinance plays a powerful role in empowering poor entrepreneur and considered as a useful step towards poverty alleviation.

There are several features of microfinance schemes. It provides collateral free loans to the poor entrepreneurs on easy and flexible terms and conditions. Microfinance is very beneficial for micro-entrepreneurs who are usually not eligible for loans from conventional banks. Conventional banks don't cater these people as they consider them high risk customers and deny loans to them. Moreover, terms and conditions of conventional banks are not easy to meet. They require collateral and poor entrepreneurs don't have any tangible asset. Microfinance acts as an alternative to conventional banks for icro-entrepreneurs. It has a positive impact on the economy of developing countries. It has increased financial independence of poor people. Now they don't need to wait for employment opportunities, instead they can start their own small enterprise. They not only get benefit from their enterprise themselves but they can also become source of employment for others. Thus generating an economic activity and play their part for the welfare of society. (Shahinpoor 2009)

The concept of microfinance was first implemented by Muhammad Yunus, when he started Grameen Bank in Bangladesh. The primary objective of Grameen Bank was to eradicate poverty and making poor people financially independent to utilize their skills. It was believed that supporting people by charity is to make them dependent on others and eventually they don't contribute in generating any economic activity (Rahman 2010). Instead of making them burden for society. It is better to empower them by giving small collateral free loans. The collateral in these small loans is not based on any tangible asset rather group peer pressure served as the purpose of collateral in this case. People work in a group and they encourage each other to pay back the loan timely. If the loan is not paid, it will make it impossible for the other members to get the loan in future (Yunus, 1997).

Another feature of microfinance is its high recovery rate. Because of group lending, it's become easy to get information about the borrowers. Villagers know each others' closely, so the chances of defaults are rare. This results in cost reduction for lenders. Group lending also plays vital role in dealing with moral hazard problems. This problem arises when lender can't monitor their borrowers effectively. But group lending solves this problem, as group members get incentive for monitoring their fellow members and encourage them to start less risky projects (Stiglitz 1990). Accessibility of loans through microfinance institution is very easy. People don't need to go to the bank rather bank comes to the people (Goldberg 1997). Microfinance institutions charge higher than market interest rates to cover their transaction costs. It is necessary for microfinance institutions to charge high interest in order to sustain in the market (Yunus, 1997)

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Islamic Financing

Islamic finance is based on the prohibition of interest (riba). In Islam, riba is strictly prohibited in its all forms and in all transactions. Islamic finance gives an alternative to the conventional banking to the Muslim society (Ziauddin 1991). The main sources of ban on interest are “Quran” and “Sunnah”

“And for their taking interest even though it was forbidden for them, and their wrongful appropriation of other peoples' property. We have prepared for those among them who reject faith a grievous punishment (4: 161)” (Surah al-Nisa', verse 161)

From Jabir (R.A.): The Prophet (SAWW), may cursed the receiver and the payer of interest, the one who records it and the two witnesses to the transaction and said: "They are all alike [in guilt]." (Muslim, Kitab al-Musaqat, Bab la'ni akili al-riba wa mu'kilihi; also in Tirmidhi and Musnad Ahmad)

Charging of interest in Islam is considered as exploitation of poor and needy borrowers. “Unlawfulness of interest” in Islam has several reasons. One of the major reasons is that it is the main source of creating unjust environment in the society. Borrowers pay interest as an excessive amount to the principal and lenders get predetermined interest and live their lives comfortably at the expense of needy borrower. This leads to accumulation of money in few hands and creates unequal distribution of money in the society. Eventually concern of people for others decreases (Qureshi 1991). It also plays its part in increasing unemployment rate because it increases the cost of production and in order to control costs producers avoid to hire new workers (Mannan 1986). It hinders the progression of economic activity because lender gets fixed amount of interest. He doesn’t make any effort to utilize his abilities towards the progression of economic affairs (Qureshi 1991). The international financial crises are mainly due to the institution of interest. Countries in need of credit borrow money from other countries or international organization and because of high interests it’s become difficult for them to pay back the loans. As a result these countries default on their loans and this eventually gives rise to international financial crisis (Venardos 2005)

Islamic solution to conventional banking is the profit-loss sharing arrangements. Ethics, social justice and equality are the main features of Islamic society and the concept of profit-loss sharing is considered to be closer to the sense of ethics, equality and social justice. In these profit-loss sharing arrangements, both the parties i.e. lender and the borrower share profit and risk of the investment (Shahinpoor 2009)

Basically there are mainly two risk sharing techniques in Islam. Both the techniques are based on sharing profit and risk on joint participation basis. These techniques are Mudarabah and Musharkah. Mudarabah is most commonly used risk-sharing technique in Islamic banking and finance (Lewis and Algaoud, 2001).

Mudarabah

It is a contract between two parties, in which one party provides funds or capital while the other party provides entrepreneurial skills and labour. In Mudaraba lender can’t request for collateral from the entrepreneur and he has no control over the management of the enterprise. Profit or loss is shared on the proportionate basis between lender and entrepreneur. Lender is not responsible for the losses beyond his capital contribution and in the same way entrepreneur is not liable for any loss beyond his efforts in managing the enterprise unless it is proved that the loss is only due to the negligence of the entrepreneur (Shahinpoor 2009)

Muzara’ah: It is a form of mudarabah contract and applicable in farming. In muzara’ah microfinance institution contribute land or monetary capital for farming and get share of harvest according to the pre-decided profit sharing ratio in return (Mirakhor and Iqbal, 2007)

Musharakah

It is another risk sharing method, in which lender enters into a partnership with the entrepreneur. Profit is shared on pre-decided ratio while the loss sharing is according to proportion of their capital contribution (Rahman 2010)

Musaqat : It is a form of musharakah contract for orchard financing. In this type of contract harvest is shared among the equity partners according to their capital contributions.

Mudarabah and Musharakah are considered as the basic elements of Islamic banking and finance (Ariff 1982). In these types of contracts, both the parties share risk and they could not invest in any good or service which is against Islamic values.

Methods Alternative to Mudarabah and Musharakah

There are many alternative methods to Mudarabah and Musharakah which are considered to be less risky. Some of them will be discussed in this paper (Shahinpoor 2009).

Murabaha

This type of mode of financing is not based on profit-loss sharing rather it is based on the cost plus mark-up basis. In case of murabaha, the lender or the bank purchases a product on behalf of the client and resells it to the client after adding some percentage to the cost. The client is required to pay back the selling price in pre-agreed installments. In murabaha transactions the lender or the bank acts as an intermediary between the buyer and the seller. In murabaha lender or the bank bears less risk whereas client or entrepreneur has to bear high risk as compared to the mudarabah or musharakah (Shahinpoor 2009).

Qard al-hasaneh

These are simply known as interest free loan. It is an Arabic term, which means “beautiful loans”. Quran states that these loans are made to Allah rather to the borrower. The word hasan is used in the context of ihsan which means that the loan is made only to please Allah without expecting any return from the borrower. (Mirakhor and Iqbal, 2007). There is a difference between qard al-hasaneh and the charity. Qard al-hasaneh has to be repaid while the charity or sadaqah is given to the needy just for the sake of his help (Rahman 2010).

Ijarah

It is defined as “the long term contract of rental subject to specified conditions as prescribed by the Shari’ah”. In case of ijarah, the bank or the lender buys the product and leases it to the customer for some specified number o f months or years. In some Ijarah cases, customer has the right to buy the product from the bank. In this case, lease paymeny would be applied to the purchase of the product (Lewis and Algaound, 2001).

Conclusion

The paper argues that both microfinancing and Islamic financing are based on the same principle i.e. welfare of society. In many aspects microfinancing is considered to be consistent with the main objective of Islamic financing. Both the systems believe that poor entrepreneurs should be financially empowered so that they can take part in generating economic activity. Provision of collateral free loans shows how microfinancing relates to the Islamic financing. Major difference between microfinancing and Islamic financing is interest. However, current practices of Islamic financing can be combined with the conventional practices of microfinancing in order to provide maximum benefits to poor people of Islamic countries. Both the systems work towards the eradication of poverty. This can only be eliminated if poor entrepreneurs are considered creditworthy. Financial support will not only improve their living standard but also contribute in the economy of the country. Conventional microfinancing can easily be converted into Islamic microfinancing by eliminating interest factor. It is evident from “Quran” and “Sunnah” that interest is strictly forbidden in Islam. Interest or riba not only exploit poor entrepreneurs but it has also been proved from various studies that it is the major reason behind destruction of many financial institutions; this eventually results in destruction of whole economy. So combing Islamic practices, like Mudarabah, Musharakah and Murabaha etc., with the conventional microfinancing might result in improved living standard of poor people and as a result whole economy will flourish.

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