



Islamic Microfinance for Alleviating Poverty and Sustaining Peace

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Abstract

Peace is humanity's highest values, its prized possession, the most sought after and yet the most elusive. Peace encompasses a broad array of social, political and economic aspects. Peace is threatened by unjust economic, social and political order, absence of democracy, environmental degradation and absence of human rights. Every single individual has the potential and the right to live a decent life.

Peace is interlinked with poverty. Poverty can unsettle peace. The root causes of poverty cannot be solved by a short-term infusion. It requires the building of systems, structures, capacity. A Vatican communique states "The scandal of poverty reveals the inadequacy of current systems of human coexistence in promoting the realization of the common good. This imposes the need for reflection on the deep roots of material poverty and, consequently, also on spiritual poverty that makes man indifferent to the suffering of others". In fact the frustrations, hostility and anger spawned by poverty cannot sustain peace in any society. For building stable peace, society must find ways to provide opportunities for people to live with dignity. The society must ensure the fulfillment of basic needs.

The world is slowly recovering from the worst financial crisis ever. The crisis has undone major strides in the millennium development goals. Analyst believe the world's pledge to achieve the MDGs by 2014 may not be achievable. People round the world are poorer and hungrier than in the recent past. This undoubtedly calls for new ways of thinking. The institution of microfinance was developed to create access to funds for the poor and unbanked population. It is time to examine new microfinance products and solutions to tackle the challenges of growing poverty.

Our Creator Allah states in the Holy Quran that **a society where there is no justice will ultimately head towards decline and destruction** (Al-Qur'an 57:25). This implies that the most important objective of Islam is to realize greater justice in human society. Justice requires a set of rules or moral values, which everyone accepts and faithfully complies with.

The financial system will promote justice when risks are shared between the financier and entrepreneur and the system mobilizes resources and make them available for the poor through expansion of opportunities for investments, generation of employments and production to fulfill basic needs thereby contributing towards reduction in inequalities in income and wealth.

Traditional microfinance institutions based on compounding interest causes serious hardship on the borrowers in servicing their debt. It is, therefore, important that access to credit is provided to the poor on more humane, interest-free basis. This may be possible if the microfinance system is integrated with zakat and waqf institutions. For those who can afford to bear the cost of microfinance, it would be better to popularize the Islamic modes of profit and loss systems and sales- and lease-based modes of finance, not only to avoid interest but also to prevent the misuse of credit for personal consumption. It is worth noting that zakat is a cornerstone of the values that govern Islamic economics. Being directional and normative, zakat defines the norms of economic activity and, through its effects on economic variables, determines the direction along which the economy should move. On the revenue side, it specifies the manner in which revenue is to be raised and who pays it, and on the expenditure side, it sets forth the uses of the revenue. Like any modern budget, it describes the economic order that it attempts to establish and express the ideals and aspirations of society.



This study will examine Islamic Microfinance in light of growing global poverty and its potential to create opportunities for the poor. Today when we find Muslim countries caught up in vicious shackles of poverty, we are faced with the question- 'whether this is the failure of Islamic financial system or whether it is our own failure to adopt the guidance provided in the Holy Quran and the knowledge left to us by our beloved Prophet Mohammad SAW?'. Perhaps, the reason lies in our failure to utilize the knowledge of the Islamic Financial System which is grounded on the principles of risk-sharing, opportunities for all, socio-economic justice and sustainable peace.

Keywords: Islamic Microfinance, poverty, zakat, poor, peace

Introduction

Peace is humanity's highest values, its prized possession, the most sought after and yet the most elusive. Peace encompasses a broad array of social, political and economic aspects. Peace is threatened by unjust economic, social and political order, absence of democracy, environmental degradation and absence of human rights. Every single individual has the potential and the right to live a decent life.

Peace is interlinked with poverty. Poverty can unsettle peace. Poverty is a concept with many facets. It is the individuals' lack of freedom and ability to meet daily needs for themselves and their dependents. Poverty encompasses failure to attain minimum living levels, welfare attributes as well as the resources that may enable people to improve their conditions. The root causes of poverty cannot be solved by a short-term infusion. It requires the building of systems, structures, capacity. A Vatican communique states "The scandal of poverty reveals the inadequacy of current systems of human coexistence in promoting the realization of the common good. This imposes the need for reflection on the deep roots of material poverty and, consequently, also on spiritual poverty that makes man indifferent to the suffering of others". In fact the frustrations, hostility and anger spawned by poverty cannot sustain peace in any society. For building stable peace, society must find ways to provide opportunities for people to live with dignity. The society must ensure the fulfillment of basic needs.

More than a billion people live on less than a dollar a day. The moral test of a society is how it treats its most vulnerable members. The poor have the most urgent moral claim on the conscience of the nation and it should look at its policies that affect the poor. Deprivation and powerlessness of the poor wounds the whole community. On the other hand, a healthy community can be achieved only the able members of society accords proper addresses the needs of the poor. This includes proving the poor the opportunity and tools too work their way out of poverty. People have a right to economic initiative and private property, but these rights have limits. No one is allowed to amass excessive wealth when others lack the basic necessities of life. Peace is the fruit of justice and is dependent upon right order among human beings. Peace is more than end of violence. Peace is unity and harmony. Peace upholding the rights of others and fulfillment of basic human needs.

A Crisis that Disrupted Economic Wellbeing

The world is slowly recovering from the worst financial crisis ever. The crisis has undone major strides in the millennium development goals. Analyst believe the world's pledge to achieve the MDGs by 2014 may not be achievable. People round the world are poorer and hungrier than in the recent past. The socio-economic problems facing people today have emanated from the unbridled creation of fictitious assets, particularly reserve currencies, and the unhindered forces of demand and supply with exploitative tools in the financial system.



John Perkins, in the preface to his book, *Confessions of an Economic Hitman*, while analysing the dangerous world situation, writes: “The idea that all economic growth benefits humankind and that the greater the growth, the more widespread the benefits, _ _ _ is of course erroneous _ _ _ It benefits only a small portion of the population _ _ _ may result in increasingly desperate circumstances for the majority _ _ _ When men and women are rewarded for greed, greed becomes a corrupting motivator.”

Islamic economists(eg, Siddiqui, 2009; Chapra, 2009, Bagsiraj, 2009) continually refer to the global economic crisis as a result of interest rates(Riba) from the great depression to the crisis in the western countries . Huge budgetary imbalances, excessive monetary expansion, large balance of payments deficits, insufficient foreign aid, and inadequate international cooperation can all be related to flaws in the theory of interest - the root of the crisis. If the value of an Islamic bank’s liabilities were determined by the performance of its assets, there would be no sub-prime crisis. Unfortunately, risk-sharing techniques do not predominate in the world of modern finance.

Economic well being is the primary goal of development. It is one thing to be a wealthy nation but unless that wealth is spread medium/ long term stability cannot be guaranteed. A modern welfare state performs four economic functions, viz. establishing the legal framework for the economy; directing allocation of resources to improve economic efficiency; establishing programmes to improve distribution of income and stabilizing the economy through macroeconomic policies. Goals of macroeconomic policy are full employment, price stability, economic growth and comfortable Balance of Payment situation. Money, credit & finance are the life blood of the economic system. Wealth creation involves using goods and services (wealth) already available in the economy. Money or finance makes it possible to cycle existing wealth to create further wealth.

The global financial may have been avoided had the use of fictitious monetary assets not been so easy and widespread. The solution lies in disciplining the creation of money, limiting self-interest with social interest and business ethics, and transforming the corrupt financial system to make it free from exploitation and games of chance, thus enabling mankind to optimally use the resources for benefits on a larger scale. Islamic finance provides a solid basis for these reformatory measures; it is up to human beings how they realize the potential.

In the midst of such an unprecedented crisis, Islamic banking and finance is witnessing phenomenal growth, with the global value of Islamic finance approaching \$1 trillion. According to an estimate by the Asian Development Bank, the average annual growth of the Islamic banking and financial sector is more than 15 percent. Islamic banking and finance is now among the fastest-growing financial segments in the international financial system. This has lead to much research and interest.

Characteristics of Islamic Finance and Islamic Microfinance

The Islamic economics system is based on justice, equity and welfare. Islamic economics seeks to establish a broad-based economic well-being with full employment and optimum rate of economic growth. It will bring socio-economic justice and equitable distribution of income and wealth. Islamic economics will also ensure the stability in the value of money to enable the medium of exchange to be a reliable unit of account and a stable store of value.

The system strikes a balance between flexibility and oversight. The proponent of Islamic banking system expect that credit crunch could not happen in the Islamic financial institutions, because this system operates based on partnership between the client and the banks. There is a social commitment within the Islamic banking and finance. This crisis has stunned both the left and the right of the political spectrum and the different economic schools of thought. Many economists and policy makers have suggested more regulation and transparency, with only a few highlighting the role greed and speculation played. Islamic finance provides moral injunctions on accountability to



the Creator to check human vices such as greed. It also enforces market discipline through limits on leverage, excessive lending and derivatives.

The Islamic economic system is based on the Shariah Law. The Shariah is derived from two primary Sources of Islamic law, namely the divine revelations set forth in the Qur'an, and the sayings and example set by the Islamic Prophet Muhammad in the Sunnah. Islamic Jurisprudence interprets and extends the application of Sharia to questions not directly addressed in the primary sources by including secondary sources. These secondary sources usually include the consensus of the religious scholars embodied in ijma, and analogy from the Qur'an and Sunnah through qiyas.

Islamic economics, in fact, can promote a balance between the social and economic aspects of human society, the self and social interests and between the individual, family, society and the State. It can effectively address issues like income distribution and poverty alleviation, which capitalism has not been able to address. At the global level, it may be helpful in eliminating the sources of instability, thus making the world a happier place with harmony among followers of various religions. In the words of Dr Zeti Akhtar Aziz, ex Governor of Bank Negara Malaysia, 'Islamic finance is a corporate, social responsibility movement of the educated, enlightened Muslim middle classes'.

Traditional vs. Islamic Microfinance

In traditional bank loans secured by collateral substantially detaches bankers from the risks faced by their clients. In fact it even creates conflicts of interest. Traditional banks are also biased towards the rich. Poor people with good ideas but no collateral often fail to attract finance under this system, with the result that wealth inequality increases from one generation to the next. The risk-sharing financing of Islamic Banks has the potential to do away with conflicts of interest and usher in greater economic stability.

Entrepreneurs and conventional bankers like to increase excessive risk, and then insulate themselves from it, in order to increase their return on capital. In this way, an entrepreneur can borrow from a bank at fixed interest and then invest in a business that makes profit. The entrepreneur retains profit out of the borrowed money. Such incentive encourages entrepreneurs to borrow heavily and grow their business operations. One consequence of this approach is that a few large organizations have come to dominate the business landscape. The heavy indebtedness of such corporations means that a moderate rise in interest rates combined with a moderate fall in revenues can quickly erode an entire profit margin. This is one reason that share prices can change so dramatically over relatively short periods. Furthermore, interest charges on bank finance are a cost item in the production process and, therefore, act to increase the price of goods and services. The interest payments that society receives from the conventional banking system are funded by society itself.

Islam has a completely different philosophy for the economy that results in a very different society from a capitalist one. The overall direction of the Islamic economic system is to secure the satisfaction of all basic needs for every individual completely, and to enable them to satisfy their needs as much as possible. From this perspective, Islam looks at people individually rather than the whole of society. This means economic policies will look to cater for all rather than just leaving satisfaction to the market. This may be achieved by a host of rules Islam has to ensure wealth distribution and by government involvement in the economy to ensure that it moves in the direction Islam has designated.

While both systems accept money to be a store of value and a medium of exchange, the financial market-based economic system permits money to be treated like any other commodity which can be traded for a profit/interest. In contrast, most Islamic scholars enjoin that money should be fully backed by real assets. It is not permissible for money to be traded for money except at par. From



the Islamic perspective, a key consequence of permitting both creation of credit money and interest-based lending is to allow banks and other financial institutions to generate massive amounts of wealth at the expense of the rest of society, especially the poor, resulting in the inevitable charge that the economic system persistently favours the rich over the poor.

Inequity has become the hallmark and the most serious problem facing mankind in all societies. Masses of people in almost all emerging/developing, Islamic and non-Islamic, and even developed and industrialized economies are facing the same fate. The interest-based financial system is a major hurdle in achieving distributive justice. It is creating unrepayable debt – making a class of people richer and leaving others poorer and oppressed. Excessive debt and its servicing are the striking features of the interest-based mechanism: yesterday's debt can be repaid by taking out more debt today. The economic problems of developing countries are the result of excessive debt accumulation. The cost incurred in the form of interest has to be paid by successive governments through increasing rates, taxes and charges on consumption goods and utilities. For servicing the debts, governments raise taxes without providing any socioeconomic amenities. Their foreign exchange earnings, including export proceeds and remittances of expatriates, are also consumed by debt servicing.

Leaving aside the poor and developing countries, even the developed countries have become accustomed to the bane of debt. The real story of modern empire, writes John Perkins, is that it "exploits desperate people and is executing history's most brutal, selfish and ultimately self-destructive resource-grab."

Experience has shown that micro-enterprises have generally proved to be viable institutions with respectable rates of return and low default rates. They have also proved to be a successful tool in the fight against poverty and unemployment. The experience of the International Fund for Agricultural Development (IFAD) is that credit provided to the most enterprising of the poor is quickly repaid by them from their higher earnings.

A number of countries have, accordingly, established special institutions to grant credit to the poor and lower middle class entrepreneurs. Even though these have been extremely useful, there are two major problems that need to be resolved. One of these is the high cost of finance in the interest-oriented microfinance system. A timely study by Dr. Qazi Kholiuzzaman Ahmed, President of the Bangladesh Economic Association, has revealed that the effective rate of interest charged by microfinance institutions, including the Grameen Bank, turns out to be as high as 30 to 45 percent. This causes serious hardship to the borrowers in servicing their debt. They are often constrained to not only sacrifice essential consumption but also borrow from money-lenders. This engulfs them unwittingly into an unending debt cycle which will not only perpetuate poverty but also ultimately lead to a rise in unrest and social tensions.

It is, therefore, important that, while the group lending method adopted by the Grameen bank and other microfinance institutions for ensuring repayment is retained, microcredit is provided to the very poor on a humane interest-free basis. This may be possible if the microfinance system is integrated with zakah and awaqf institutions. For those who can afford to bear the cost of microfinance, it would be better to popularize the Islamic modes of profit-and-loss sharing and sales- and lease-based modes of finance in Muslim countries not only to avoid interest but also to prevent the misuse of credit for personal consumption. Moreover, availability of resources at the disposal is an issue faced by of microfinance institutions. This problem may be difficult to solve unless the microfinance sector is scaled up by integrating it with the commercial banks in order to enable the use of a significant proportion of their vast financial resources for actualizing a crucial socio-economic goal.

The risk arises from the inability of micro-enterprises to provide acceptable collateral. One way of reducing the risk is to use the group lending method which has already proved its effectiveness. Another way is to establish the now-familiar loan guarantee scheme which has been introduced in



a number of countries. To reduce the burden on the loan guarantee scheme it may be possible to cover the losses arising from the default of very small micro-enterprises from the zakah fund provided that the loan has been granted on the basis of Islamic modes of finance and does not involve interest. A third way is to minimize the use of credit for personal consumption by providing credit in the form of tools and equipment through the ijara (lease) mode of Islamic finance rather than in the form of cash. The raw materials and merchandise needed by them may be provided on the basis of murabahah, salam and istisna' modes. If they also need some working capital, it may be provided as qard hasan (interest-free loan) from the zakah fund.

Poverty Alleviation through Zakat and Waqf

The institution of microfinance was developed to create access to funds for the poor and unbanked population. However, Conventional microfinance is not for the poorest of the poor. There is a sizeable substratum within the rural poor whose lives are unlikely to be touched, let alone improved by financial services. They are not "bankable" in their own or their neighbour's eyes, even when the bank is exclusively for poor people. Yet they desperately need some sort of assistance. In addition, traditional microfinance institutions based on compounding interest causes serious hardship on the borrowers in servicing their debt. It is, therefore, important that access to credit is provided to the poor on more humane, interest-free basis. This may be possible if the microfinance system is integrated with zakat and waqf institutions.

An Islamic microfinance system, on the other hand, identifies being the poorest of the poor as the primary criterion of eligibility for receiving zakah. It is geared towards eliminating abject poverty through its institutions based on zakah and sadaqah. Zakah and sadaqah as instruments of charity occupy a central position in the Islamic scheme of poverty alleviation. Zakah is the third among five pillars of Islam and payment of zakah is an obligation on the wealth of every Muslim based on clear-cut criteria. Zakah has been variously described by scholars as a tool of redistribution of income, a tool of public finance, and of course, as a mechanism of development and poverty alleviation. Rules of Shari'ah are fairly clear and elaborate in defining the nature of who are liable to pay zakah and who can benefit from zakah. The first and foremost category of potential beneficiaries is the poor and the destitute. A greater degree of flexibility exists with respect to beneficiaries of sadaqah. The primary issue with zakah and sadaqah-dependent institutions is the issue of sustainability as they are essentially rooted in voluntarism. Funds mobilized through charity could fluctuate from time to time and may not lend themselves to careful planning and implementation.

The issue of sustainability is addressed in the institution of awqaf through creation of permanent and income-generating physical assets. Awqaf has historically been the major vehicle for creating community assets. On the flip side, the restrictions on development and use of assets under waqf for pre-specified purposes introduce rigidity into the system. Undoubtedly, it is important to preserve and develop assets under waqf to add to productive capacity and create capabilities for wealth creation. Awqaf may also be created specifically to impart knowledge and skills in entrepreneurship development among the poor as microfinance alone cannot create wealth unless combined with entrepreneurial skills. Indeed all technical assistance programs can be organized as awqaf.

While zakah funds must be distributed to the destitute and poorest of poor, this institution could be integrated with microfinance. This may be attempted by seeking to push such individuals through zakah distribution out of dire poverty to levels, where they are no longer regarded as "unbankable" by MFIs. A linkage if established between the MFIs and zakah funds would enhance the effectiveness of microfinance towards achieving poverty alleviation.

Zakat is a cornerstone of the values that govern Islamic economics. It created the first universal welfare system in human history. It specifies the manner in which zakat revenue is to be raised



and who pays it. On the expenditure side it set forth the uses of zakat revenue. Like a modern budget it describes the economic order that it attempts to establish and express the ideals and aspirations of society. As a fiscal mechanism zakat performs some of the major functions of public finance which deals with social security entitlement system like food subsidy, education, health care etc. Thus Islam discourages accumulation of personal assets and encouraging eradication of poverty.

Zakat is Free Money. It is a grant for the poor It may be reiterated that zakat is an Islamic charitable fund and therefore, no form of interest or profit can be made from it. It is free money and it a right of the poor and hence may be used in Islamic microfinance. Although traditional interest – based microcredit has evolved as an important tool for poverty alleviation, it is failing to attain desired effects for many reasons:

- A major portion of loan disbursed to the poor is diverted to fulfill their basic consumption needs that leaves them with smaller investable fund and hampers business profitability.
- Traditional microfinance institutions (MFIs) charge higher interest rate than banks that may lead to credit rationing problem as only higher return projects being selected and overall social welfare not being maximized.
- Similar projects in different locations may differ in their profitability. But MFIs usually charge standard fixed interest rates for similar projects.

Because of these three reasons, non-graduation from poverty for conventional MFIs is falling. In addition to zakat funds in Islamic Microfinance – Shairah based and profit and loss sharing or equity participation modes may also be utilized to give the poor access to funds. The bank's sharing of risk and the return is undoubtedly more beneficial for the poor.

Recommendations from the Institute of Hazrat Mohammad SAW

One of the most important objectives of Islam is to realise greater justice in human society. The Holy Quran states the following.

“Where there is no justice will ultimately head towards decline and destruction”
 (Quran, 57:25).

Justice requires a set of rules or moral values, which everyone accepts and faithfully complies with. The financial system may be able to promote justice if, in addition to being strong and stable, it satisfies at least two conditions based on moral values. One of these is that the financier share in the risk so as not to shift the entire burden of losses to the entrepreneur, and the other is that an equitable share of financial resources mobilised by financial institutions should become available to the poor to help eliminate poverty, expand employment and self-employment opportunities and, thus, help reduce inequalities of income and wealth.

The Holy Quran States ***“Deal not unjustly, And ye shall not be dealt with unjustly”*** (Holy Quran 2:279)

Islamic Finance was established by the Beloved Prophet of Islam, Prophet Hazrat Mohammad SAW. He urged his followers to struggle against riba (interest) stating that **Allah and His Rasool (The Prophet) has declared a war on riba.**

The noble teachings of Islam are shining examples for all ages and time. It is the curse of the interest that is the biggest vice of today's economic system that concentrates wealth among few, making the rich richer and the poor poorer. Economic justice can only be achieved through an



economic system based on fulfillment of basic human needs for all. Interest is prohibited and access to funds are made available through other modes of financing based on principles of sharing of risks and return. A system grounded on the principle of welfare for all has the necessary ingredients for promoting peace through economic well-being.

The Institute of Hazrat Mohammad SAW is a research and advocacy think tank committed to promoting and upholding the teachings of Prophet Hazrat Mohammad SAW for peace and human development through research, discourse and advocacy programs. It is committed to mainstreaming Islamic Microfinance for establishment of socio-economic justice and peace. The Institute makes the following recommendations for promoting Islamic Microfinance for poverty alleviation and lasting peace.

- Promote the availability of skilled personnel to handle the diverse & innovative transactions possible within the framework of the Shariah through training.
- Advocate for the development of Sound Legal and Regulatory Framework to address current and forthcoming innovations and challenges in Islamic Microfinance.
- The need for advocacy programs to highlight the sound moral principles of Islamic Microfinance which is fair on the poor and geared towards equitable economic development.

Conclusion

The major objective of economic policy has been to promote growth in the overall pursuit of development and happiness of the population. However, it has been observed that because of rising inequality, growth alone is not a reliable indicator of socio-economic development. Despite growth in many parts of the world, a large number of people are unemployed, half-fed and ill-treated as a result of unhindered market forces. A growing population who are marginalized in terms of economic opportunities due to the omnipresence of interest and an economic system that does fulfill their basic needs poses a threat to peace. To quote the words on ILO headquarter "If you want peace, cultivate justice". Socio-economic justice is essential for lasting peace and harmony in any and all nations.

In the aftermath of the global financial crisis, rising inequality and an ever growing population under the poverty line, it is imperative for adopting an economic system concerned with fulfilling basic human needs and creating opportunities for the poor. The Islamic economic system is essentially such a system with a fine blend of community welfare, ethics and morality and investments in the real economy.

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