Enhancing the Islamic Microfinance to Overcome *Biba* based Economy

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Abstract

In order to have the success of economic policies to develop microenterprises and alleviate the problems of poverty in Indonesia over the past two decades, financing microenterprises was considered as a new paradigm in the grass root economic sector and became the popular subject of study by a number of researchers in the past, particularly, after the proclamation of the year 2005 as the microfinance year by the United Nations (NU) and labeling Mohammed Yunus - founder of Grameen Bank of Bangladesh- as the pioneer of microfinance. Moreover, the innovative poverty eradication and economic development policies of Grameen Bank focused on solidarity group-based financing scheme was considered as a new concept and has burgeoned in both developing and industrialized countries, including Muslim countries. However, this success has been criticized by some Muslim researchers; they said that financing and services offered by microfinance institutions are based on interest *(riba)* and some other prohibited elements. Most of their social development programs are secular in nature. Therefore, the discussion begins with the characteristics and structure of microfinance, historical development of microfinance followed by the discussion on inclusiveness of Islamic microfinance. Some important issues closely related to the subject are also discussed. These issues include the foundations of Islamic microfinance, *Shariah* compliance of contract and comparative analysis of the conventional microfinance system from the *Shariah* perspective.

Keywords: Enhancing, Islamic Microfinance, Riba, Economy

Introduction

The establishment of microfinance institutions that can serve the needs of micro entrepreneurs in obtaining fund actually is necessary. This fund is required to give micro entrepreneurs an opportunity to develop their business and enhance their quality of life. Professor Mohammed Yunus in Bangladesh has become a leading figure in microfinance today. He successfully established the "Grameen Bank" or "Village Bank" which he has been striving to establish since 1976. The Grameen bank was founded on the principles of trust and solidarity to help the rural poor and lower income groups in running micro-businesses by offering them small loans, especially to poor women. This success has attracted the attention of the world to follow in his steps and he earned a Nobel Peace Prize on 13 October 2006 as a result of his commitment and struggle. Moreover, the United Nations (UN) determined that the year 2005 should be the "International Year of Microfinance" (M. A. Mannan, 2007).

Objective

The objectives of this article are to show the way in having the success and enhancing of economic policies to develop microenterprises and alleviate.

Materials and Methods

This paper uses the library-based research method by analyzing relevant materials such as the Holy Quran, the Hadith, the traditional Islamic books and literatures, journals, academic textual materials as well as internet sources.

Results and Discussion

1- Characteristics and structure of microfinance

In this section, we discuss the characteristics and structure of microfinance from the conventional microfinance point of view as well as the Islamic microfinance point of view as both share common basic principles and structures but sometimes differ in objectives. In regard to this discussion (al-Baltaji, 2005), has broadly identified five characteristics of microfinance system. They are as follows:

i. The standard numbers of workers. Many countries have agreed on the identification of microfinance in accordance with the number of employees in each country. For example, Indonesia has identified small enterprises which do not exceed 20 workers. Japan and Korea set the number as 30 workers. Sudan has set the number of workers as 25 or less. Saudi Arabia set the number of workers less than 25. However, Western countries have set large numbers of maximum workers, such as 250 workers in United States of America (USA), 50 workers in Belgium and 200 workers in United Kingdom (UK).

ii. The standard capital size of microfinance. The size of capital invested for quantitative criteria used in the identification of microfinance or small-sized enterprises, in addition to the value of fixed assets of the debtors, differs from one state to another, according to the economic development policies of each state. For example, in Egypt, the limit for microenterprises (without land and building) approximately is L.E. 700 thousands. This was classified by the General Authority for Industrialization in Egypt. As for Indonesia, the standard capital size of microfinance or small-sized enterprises is IDR 5 million (not including land and building) (Ahmed Habib and Mashita Dian, 2011).

iii. The standard value of annual sales. Microfinance institutions use some criteria of the sales' value of enterprises with low volume of their production in terms of quantity and value, linked to local markets and their inability to market their products to international markets. Each country is different in estimating the volume of sales which are classified as small businesses. In Saudi Arabia for example, the annual sales of less than 3 million Riyals are classified as micro. In America, the figure is less than USD 1 million. Therefore, the identification of this standard depends on the circumstances of each country.

iv. The quality of the technology used. In most cases, the use of advanced technology may lead to a reduction in employment and invested capital values, in the sense that small enterprises generally use modest technology in accordance with the investor.

v. The legality standard of microfinance. The legal standard of microfinance depends on the legal nature of an enterprise such as the nature and magnitude of the capital invested in it and mode of their funding. According to this criterion, microfinance institutions are often founded with small installations according to the scope of individual business, family and solidarity with a simple recommendation.

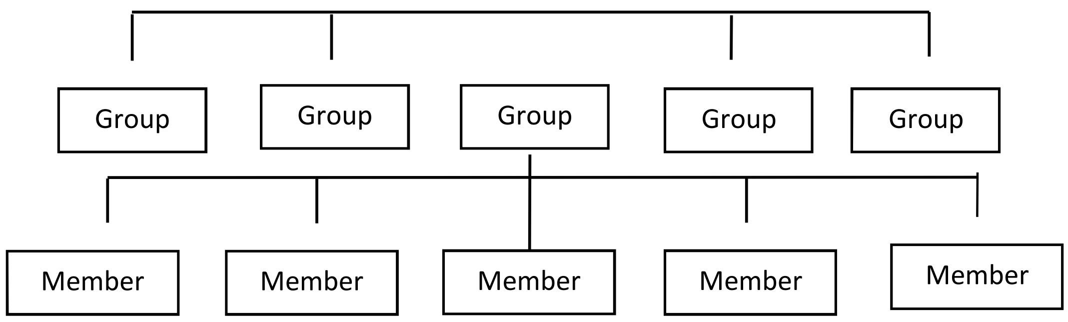
One of the distinct characteristics of microfinance that makes it more specialized components in economics and financial system today is the alternative approach to collateral that comes from the concept of joint liability or solidarity based on lending group scheme. Says: (Mohammed Obaidullah: 2008).

> Good microfinance programs are characterized by small, usually short-term loans; streamlined, simplified borrower and investment appraisal; quick disbursement of repeat loans after timely repayment; and convenient location and timing of services. Microfinance institutions thus have distinct characteristics that make them specialized components of the financial system. The main point of departure of microfinance from mainstream finance systems is its alternative approach to collateral that comes from the concept of joint liability. In this concept, individuals come together to form small groups and apply for financing. Members of these small groups are trained regarding the basic elements of the financing and the requirements they will have to fulfill in order to continue to have access to funding. Funds are disbursed to individuals within the group after they are approved by other members in the group. Repayment of the financing is a shared responsibility of all of the group's members. In other words they share the risk. If one defaults, the entire group's members face a setback. This is a basic but effectual credit scoring mechanism that may mean a provisional suspension from the programed and therefore no access to financing for the group or other penalties. In most cases, microfinance programs are structured to give credit in small amounts and require repayment at weekly intervals and within a short time period- usually a month or a few months. The beneficiary looks forward to repetitive financing in a graduated manner and this also helps mitigate risk of default and delinquency.

The model that has popularized the above methodology and has been replicated in many countries in a wide variety of settings is the Grameen Bank model. The model requires careful targeting of the poor through means tests comprising mostly of women group. The model requires intensive fieldwork by staff to motivate and supervise the borrower groups. Groups normally consist of five members, who guarantee each other's loans. A number of variants of the model exist, but the key feature of the model is group-based and graduated financing that substitute collateral as a tool to mitigate default and delinquency risk (Mohammed Obaidullah, 2008).

Figure 1 below describes the structure of group lending scheme of joint liability or solidarity formed by the Grameen Bank of Bangladesh since it is successful foundation in 1976, and today it is adopted by many microfinance institutions and Islamic microfinance institutions across the world.

Figure 1 Grameen Bank's Structure of Solidarity Group Lending Scheme



In implementing the above scheme, clarify:

In this concept, individuals come together to form small groups and apply for financing. Members of these small groups are trained regarding the basic elements of the financing and the requirements they will have to fulfill in order to continue to have access to funding. Funds are disbursed to individuals within the group after they are approved by other members in the group. Repayment of the financing is a shared responsibility of all of the group's members. In other words, they share the risk. If one defaults, the entire group's members face a setback. This is a basic but effectual credit scoring mechanism that may mean a provisional suspension from the program and therefore no access to financing for the group or other penalties (Mohammed Obaidullah , 2009).

Furthermore, asserts that the above concept of lending scheme solidarity structure formed by Grameen Bank in Bangladesh has widely adopted by many microfinance institutions throughout the world, such as Asia, Africa and Latin America, with several following reasons :(Ahmed Khan, 2008)

i. Peer monitoring: The ability of borrowers to monitor the investment behavior of one another during the course of a loan makes sure that each borrower only undertakes safe investment projects with the borrowed money.

ii. Social ties: The social cohesion that exists in some communities means that the sanctions that a borrower would receive from the group for defaulting results in each member wanting to repay faithfully.

iii. Group pressure: The group pressure between borrowers to repay means that group can be expelled as non-members if they default, thus, excluding them from continued access to credit.

However, a critique of group lending scheme mentioned above was raised by scholar. He claims that perhaps it is difficult to promote group lending scheme in regions where social ties are not necessarily high because many entrepreneurs are individualistic. He also doubts that they like working in groups and they may also compete with each other and be unwilling to share confidential information with potential competitors.

Asserts that the Grameen Bank has charged the borrowers a high interest rate of up to 54.95 percent per annum, if the hidden cost for documentation of membership fees and obligatory provision for blocked amounts are taken into consideration. Since non-reducing method of accounting is applied in case of the repayment of loan installments, this raises the interest rate by an additional 31.46 percent, pushing the total interest rate to a whopping 86.41 percent (M.A. Mannan, 2007).

2- Historical development of microfinance

No one knows for sure when the microfinance concept of business in the world began. However, some economists said that the philosophy or concept of microfinance is not new. Micro savings, credit groups and micro insurance activities have been operating for centuries in several countries under many different terms, such as *"Koperasi"* in Indonesia, Malaysia and Brunei Darussalam; *"Tontines"* in the West of Africa and "*Pasanaku"* in Bolivia as well as numerous micro savings groups, entrepreneurs and burial societies all over the world.

According to Islamic historical civilization *(tarikh al-hadarah al-Islamiyyah),* Islamic civilization dealt with the financial practices including micro credit (lending and borrowing of money), money exchange and such, had been actually practiced in early era of Islam. It is claimed that, because usury *(riba)* had been widely practiced among business people who were borrowing and or lending money at the time before Islam, the Islamic tenet then came to state clearly that usury *(riba)* is prohibited as it is said in the Qur'an as follows: (Muhammad Akhyar Adnan, 1996).

Those who devor usury *(riba)* will not stand except as stands one whom The Satan by his touch Hat driven to madness. That is because they say: "Trade is like usury", but Allah hath permitted trade and forbidden usury (Al-Baqarah: 275).

The origin and the development of microfinance concept in the world have essentially driven by the issues of poverty based on the capitalistic economic system. The existence of microfinance system in a country is very important tool to break the wall of poverty as a result of the capitalistic economic system. Therefore, the first microfinance organization which was born in England (1844) to solve the problem of daily needs of its members by way of togetherness based on the basic principles of justice, trust, unity and responsibility, known as "Rochdale Principles". Within a short time, in France some microfinance institutions have also been established, which engaged in the productions

According to another historian, the birth of microfinance in Europe dates back to tremendous increase in poverty since the 16th century. One of the earlier and classic longer lived microcredit organization has provided small amounts of loan for the rural poor and privileged with no collateral security, using peer monitoring to enforce the repayment, weekly installments, initially interest free loans and donated resources. This concept called "Kreditkassen" or "Irish loan funds", was initiated in the early 1720s by Jonathan Swift. Swift's concept then grew slowly until he died, but by the 1840s this concept had become widespread where there were about 300 funds all over Ireland providing small loans or credits.

In Europe, furthermore, various types of larger, formal and non-formal savings and credit institutions were organized primarily among the rural and urban poor in the 1847s. These institutions, then, were known as "Darlehnsvereine" or "Credit Associations", created rural savings and credit cooperatives with the help of contributions of some wealthy people. This concept was developed by *Friedrich Wilhelm Raiffeisen* and his followers in Germany. Their altruistic action was motivated by the concern to assist the rural population, to break out of their dependence on money lenders besides improving their social and economic welfare. Beginning from 1870, this concept has expanded rapidly over a large sector in German States and spread to other countries in Europe, North America and Asia, including Indonesia (Masngudi, 1990).

3- Inclusiveness through Islamic microfinance

The previous section has shown that microfinance and Islamic microfinance, in their short history, seen a tremendous growth and development, besides the market for Islamic microfinance is large enough to be attractive. This reflects the strong demand of Muslims to uphold and include the Islamic microfinance system as one of the important structures of the Islamic nation. This section highlights the inclusiveness through the Islamic microfinance.

A study conducted by Honohan found that it is very significant to build inclusive Islamic financial system in the microfinance scale as an alternative to conventional system because it is estimated that 72 percent of people today living in Muslim-majority countries do not use formal financial services. Even when financial services are available, some people view conventional products as incompatible with the financial principles set forth in Islamic law *(Shariah al-Islamiyyah)* (Honohan, 2007).

In conjunction with the above study, Obaidullah has clarified that in recent years some microfinance institutions have stepped in low-income Muslim clients who demand products consistent with Islamic financial principles leading to the emergence of Islamic microfinance as a new market niche. Therefore, Islamic microfinance represents the confluence of two rapidly growing industries, i.e. conventional microfinance and Islamic finance. It has the potential to not only respond to unmet demand but also to combine the Islamic social principles of caring for the less fortunate with microfinance's power to provide financial access to the poor. Unlocking this potential could be the key to providing financial access to millions of Muslim poor who currently reject microfinance products that do not comply with Islamic law (Mohammed Obaidullah, 2008).

A global survey on Islamic microfinance was conducted in the year 2007 by the Consultative Group to Assist the Poor (CGAP) has collected information on over 125 institutions and contacted experts from 19 Muslim countries. The survey and a synthesis of other available data revealed that Islamic microfinance has a total estimated global outreach of only 380,000 customers and accounts for only an estimated one-half of one percent of total microfinance outreach. The supply of Islamic microfinance is very concentrated in a few Islamic countries, with the top three countries Indonesia, Bangladesh and Afghanistan accounting for 80 percent of global outreach. Based on the above survey, CGAP asserted that there is a need to build inclusive micro financial system to bring the over one billion Muslims into the fold of formal Islamic micro financial institutions for different reasons, as it said:

Micro finance is a very flexible tool, models of which can be replicated but required to be tailored to the local socio-economic and cultural characteristics. The potential demand for tailored microfinance services is still largely unmet, also in countries where the majority of the populations are Muslims.

a. Some surveys proved that there is a high demand for Islamic banking especially in low and middle income predominantly Muslim societies.
b. Commercial banks could be interested in this issue as a tool to reach interesting market niches, create loyalty in their clients and accomplish their client satisfaction strategies.
c. Islamic microfinance institutions have to share most of their principles, such as: application of trade *(al-bay')*; prohibition of all forms of economic activity which are morally or socially injurious, egalitarian approach (no restriction to any category of clientele); focusing on the well-being of the community as a whole; concentrating on the poor, destitute or deprived sections of the society; aiming at social justice; advocacy of entrepreneurship; advocacy for financial inclusion through partnership finance; participatory approach and risk sharing.

4- Foundation of Islamic microfinance

All Islamic financial systems including Islamic micro financial system was founded on the religious philosophy, i.e. achievement of *al-falah* (success) in the worldly life and more importantly, in the Hereafter. Therefore, Islamic commercial law strongly promotes the principles of cooperation *(al-musharakah),* justice *(al-^{c}adl)*, benevolence *(al-ihsan)* and trust *(al-amanah)* to ensure the property will not be placed in jeopardy through unfair dealings and totally disallows usury *(riba),* gambling *(maysir)*, hoarding *(ihtikar),* ambiguity to one party or both parties *(gharar)* and other forms of exploitation that will make financial transactions invalid and prohibited

With respect to the foundation of Islamic microfinanceclarified that:

> Islamic microfinance was founded on principles of the Islamic law of financial transactions *(fiqh al-mu^{c}amalat al-maliyyah)*. The basic sources of these principles are the Qur'an and *Sunnah*, which are followed by the consensus of the Muslim jurists *(Ijma^c al-^{c}ulama').* The central characteristic or feature of Islamic microfinance and all Islamic financial systems is the prohibition of the payment and receipt of interest (*riba*). The strong disapproval of interest by Islam and its vital role in modern financial markets, such as microfinancial institutions and banking system have led Muslim thinkers to explore many ways and means to gain the goal of interest-free bases of economy and financial systems.

Regarding the prohibition of the payment and receipt of interest (*riba*) as the vital prohibition in Islamic microfinance and all Islamic financial systems, Archer and Ahmed stated:

> The Interest *(riba)* is banned in Islam because a pure return of rent on money is considered to be immoral. To be entitled for a return, a provider of finance must either undertake business risk or provide some other services, such as supplying an asset; otherwise, the financier is, from *Shariah* point of view, not only an economic parasite but a sinner.

In addition, Akhyar Adnan argued that prohibition of interest *(riba)* is simply, because it unjust *(zulm)*. In the last part of the Qur'an (al-Baqarah: 279), Allah s.w.t says: "Deal not unjustly (by asking more than your capital sums), and (you) shall not be dealt with unjustly (by receiving less than your capital sums)." Likewise, Rosly (Saiful Azhar Rosly, 2005: 54). Emphasis added, that *riba* is condemned in Islam because it constitutes wealth created at the expense of other people's wealth. Doing so is unjust *(zulm)* (Akhyar Adnan, 1996).

The above arguments would seem to be an adequate overview of Islamic principle in the prohibition of interest *(riba).* The appearence of this prohibition in the Qur'an is also relatively frequent. There are four verses relating to usury or *riba* (interest) in the Qur'an. This indicates how important, clear and final prohibition of usury or *riba* in the Qur'anic view.

Besides prohibition of interest *(riba),* as mentioned earlier, Islam strongly emphasis the efficient manner to produce maximum output and to fulfill Allah's plan of establishing prosperity in this world and achieving of *al-falah* (success) in the Hereafter. In this aspect, Siddiqi stated that Islamic law of financial transactions *(fiqh al-muᶜamalat al-maliyyah)* emphasizes the Islamic attitude to achieve the objectives of wealth creations and economic activities among Muslims, especially to those who are involved in economic activities. Therefore, the Holy Qur'an and *Sunnah* have given specific guidelines as follows:

Islam looks first at the wealth as a life sustaining vehicle, to be used efficiently and gained from *halal* (pure) sources (al-Baqarah: 168; and 267).

a. Private ownership is affirmed but viewed as a trust *(amanah)* (al-Hadid: 7).

Islam encourages enterprises, efforts to create wealth, which have been characterized as Allah (S.W.T.)'s bounty (al-Jumuah: 10).

b. All Muslims are obligated to fulfill contracts and keep their promises (al-Isra': 34).
c. All exchanges should be with willing consent of the parties' concerned (al-Nisa': 29).
d. The use of wealth and exercise of freedom of enterprise are constrained by the obligation not to harm others.

Furthermore, the use of wealth and exercise of freedom of enterprise has to be seen in the perspective of the positive obligation to care for others and share with them. This is symbolized by the well-known duty of paying alms (z*akah)*. But that is not for all, the important thing is the spirit of a cooperative on helpful behavior as mandated by Islamic view on life as being a test (Siddiqi, 1998). These are the clear textual guidelines of the holy Qur'an and the *Sunnah,* which are revealed to provide sound for Islamic attitude or norms towards wealth creation and economic activity. Clear and secure individual ownership rights, one's right to the fruits of one's efforts and contracts enforceable through social authority strengthen that attitude and provide a wide arena for it.

Based on the previous points of view, it has been shown that Islam consists not only of ritual activities, but contains a comprehensive guide for life. It is a total way of life. It provides all kinds of norms and philosophical religious that might be applied by people wishing to achieve *al-falah* (success), in the world and more importantly in the Hereafter. The concept of secularism and socialism has no place in Islam. That is way, any activities included in the microfinance activities must be founded on divine revelations.

5- *Shariah* Compliant and *Shariah* supervision

The foregoing section have discussed the foundation of Islamic microfinance, which showed that Islamic micro financial system definitely was founded on the religious philosophy and Islamic attitudes to insure that the property will not be placed in jeopardy through unfair dealing but to utilize it in the most efficient manner and to fulfill Allah's plan of establishing prosperity in this world. Therefore, this section will discuss about the most important aspect of Islamic financing methodologies in Islamic micro financial institutions that more precisely termed as the *Sharah* guidelines or *Sharah* compliant instruments.

According to Dawabih Islamic microfinance has the unique characteristics and features that do not exist in conventional system or any other system, because its method of funding is based on donations *(al-tabarru^{c}at),* such as *qard hasan* (benevolent loan), charities *(sadaqat),* alms *(zakah)* and *awqaf* (endowments). Likewise, it is based on participatory modes, such as, *al-musharakah al-mutanaqisah* (diminishing partnership), *al-mudarabah* (profit and risk sharing), *al-muzara^{c}ah* (sharecropping partnership), etc. Other methods are based on micro credit financing, such as, *bay^c bi thaman al-ajil* (deferred payment sale), *bay^c al-salam* (advance payment sale) *bay^c al-istisna ^{c}* (sale by order) and *al-ijarah* (leasing). All these modes of funding and financing provide more opportunities and areas for small entrepreneurs, especially if they are Muslims (Ashraf Muhammad, 2006).

Obaidullah and Thariqullah Khan clarified that the prohibition of usury (*riba)*, uncertainty (*gharar)*, hoarding *(ihtikar*), gambling *(maysir)* and other constraining norms in Islamic microfinance definitely, constitute an obstacle in building sound microfinance products or services. Therefore, the need for *Sharah* compliance has led to considerable research into products or services' development. While the conventional microfinance system provides interest-based deposits, donations and loans, Islamic microfinance system comprises of an array of instruments for mobilization of funds, financing and risk management to ensure their products and services in accordance of the *Sharah al-Islamiyyah* (Obaidullah and Thariqullah Khan, 2008).

Furthermore, another important issues and main aspects that must exist in any Islamic banking and finance institution, including Islamic microfinance institutions is the *Sharah* supervision aspect. This aspect has been seriously taken into consideration, as there is a special body to oversee and ensure the Islam city of a particular product or service to be examined and endorsed before promoting it to the public or customers. The *Sharah* supervision aspect can be considered as the backbone of Islamic financial industry. Without it, the compliance aspects might be at stake (Daud Bakar: 2008).

It is the duty of the Islamic financial institutions to ensure that all activities and products are *Sharah* compliant. The body that is specifically responsible for the supervision towards such compliance is the *Sharah* Advisory Council (SAC) or *Sharah* Supervisory Board (SSB) of the financial institutions. The SAC or SSB is an independent body of specialized in *fiqh al-mu^{c}amalat al-maliyyah* (Islamic law of financial transactions) entrusted with the duty of directing, reviewing, supervision and/or approving the activities of Islamic financial institutions in order to ensure compliance with *Sharah* rules and principles. Corresponding to the faith based nature of the Islamic financial institutions business, the task of the SAC or SSB in the Islamic financial institutions is much wider and more comprehensive as compared to SAC or SSB in conventional financial institutions. They are required to possess significant understanding on *Sharah* principles not only in the product development, but also in Islamic financial operations and activities.

Conclusion

Interest *(riba)* the most important concept in conventional microfinance is totally avoided by Islamic microfinance besides other prohibited elements. Islamic microfinance institutions adopt the Islamic economic values or ethics. This particular difference has led to many other differences in products and services, organizational structure and management of the microfinance institutions, the customer groups and even to some extent in microfinance theory and practices. In respect to the foundation of Islamic economics and financial theory, it seems that different authors set different formula because this system is strongly based on the basic principles of *tawhid* (God's unity and sovereignty), *rabbaniyyat al-masdar wa al-hadf* (divine source and objective), *tazkiyyah* (purification), *ukhuwwah* (brotherhood) and accountability *(mas'uliyyah)*. Accordingly, these two types of microfinance institutions must be seen as different industries with different objectives. A question that has not been answered through this part is whether the Western concept of microfinance which have been adopted and practiced by Muslims in Muslim countries at present, should be rejected and avoided, or not?

However, a strong financial system needs to be supported by a strong regulatory and legal framework that can effectively discourage undue risk-taking behavior, particularly in the Islamic microfinance to prevent it from being harmful or disobeying *Sharah* commercial law. It must also have adequate standards for effective risk management, financial disclosure standards and governance. These are areas for development to bring Islamic microfinance to the next level of exponential growth. Despite these challenges, the Islamic microfinance industry has grown to become available alternative for many, whether for reasons of personal faith or on economic grounds.

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