

# IISS INTERNATIONAL ILEM SUMMER SCHOOL 3



## SOCIAL JUSTICE AND POVERTY IN MUSLIM WORLD PROCEEDINGS

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# Impact of Microfinance for Poverty Alleviation in Bangladesh: From an Islamic Point of View

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**Abstract:** Despite being heralded as an acclaimed method for poverty reduction worldwide, the key aspects of traditional microfinance have created a sociological as well as psychological barrier in the Muslim social and intellectual hegemony in Bangladesh. The high interest-based loans, encouraging the poorest population for a shortcut but unstable route for development and the overwhelming focus on women as the beneficiaries of microfinance are few of the many aspects of the problem. The question regarding the effectiveness of microfinance as a tool for social justice is also under serious scrutiny worldwide. At the same time, the concept of Islamic microfinance is slowly taking shape in some Muslim countries including Bangladesh, aiming to solve the strategic problems with microfinance. By rectifying the ideas of microfinance with the general tools of Islamic financial mechanisms in the grassroot level with a proper management of the Zakat can accelerate the process of poverty alleviation in Muslim countries. Finding Shariah accepted solutions for the shortcomings of mainstream microfinance and effective implementation of those approaches will be an effective tool for ensuring sustainable development as well as establishing social justice in Muslim world.

**Keywords:** Microfinance, Islamic Microfinance, Poverty alleviation, Social Justice, Zakat, Bangladesh.

## Introduction

Being a developing nation in South Asia, Bangladesh has shown an apparently significant progress in poverty alleviation through microcredit. The terminal populations living at the bottom level of the production chain are being empowered by this economic tool, and it has been globally acclaimed and adopted for its effectiveness. By providing financial services to the people excluded from general banking system that was not interested in providing funds for their income generating microenterprises, Grameen Bank of Bangladesh and many other Microfinance institutions (MFIs) are marching forward to economically empower the ultra-poor populations, thereby achieving the sustainable development goals.

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The question regarding the effectiveness of microfinance as a tool for social justice is also under serious scrutiny worldwide, as the recent insights showed significant negative impacts of the system, portraying it as an impediment for sustainable development and poverty alleviation. Financers in some countries are now leaving the bloated microfinance sector, as it stands on the verge of a self orchestrated collapse. Targeting the poorest versus the issue of achieving sustainability has become a major question as well.

This paper will show how the developing concept of Islamic microfinance which is slowly taking shape in Bangladesh and a few other Muslim countries can reach out to solve the strategic problems with microfinance. By rectifying the ideas of traditional microfinance and loan system by implementing Shariah accepted solutions for the shortcomings of mainstream microfinance could be a viable tool for ensuring sustainable development as well as social justice in Muslim world.

### **Bangladesh and the Evolution of Microfinance**

Bangladesh, the third largest Muslim country of the world is one of the developing countries with a huge burden of population. In 2010, it was estimated that 43.3 percent of the people living in Bangladesh live below the poverty line and more than 11 percent live in absolute poverty. The number of poor was 78.2 million in 1970 but by 2009 the number increased to 80.46 million. (World Bank, 2009) They suffer from acute rural-urban economic disparity coupled with lack of education and lack of proper health and sanitation facilities.

Traditionally, the ultra poor people in Bangladesh developing countries were not able to get financial support from conventional Banks and other institutions, because of low income or collateral. Microfinance is a basic financial service consisting of credit, savings and insurance. It empowers the most underprivileged section of the society with the opportunity to borrow, save and invest money to enhance their living standard, thus paving the way if sustainable development.

Institutionalized and popularized by the Bangladeshi economist *Muhammad Yunus*, The key concept of Microcredit has evolved over the years and does not only provide credit to the poor, but also provides a bundle of financial services including savings, insurance, remittances and non-financial services such as financial literacy training and skill developing programs; microcredit is now referred to as microfinance. (Armendariazde Aghion and Morduch 2005) And now, the first MFI of the modern world Grameen Bank boast of 8.1 million borrowers, 97 percent of whom are women.

## **Social Impact of Microfinance and the Poverty Alleviation Scenario**

Primary goal of development by alleviating poverty is to ensure economic stability and continuous growth. The key economic functions of a modern welfare state includes establishment of a legal framework for economic development, direction for allocating resources to improve economic efficiency, establishment of programs to improve distribution of income and stabilizing the economy through different sets of policies. The focus of these actions mostly stays upon the major institutions and stakeholders. In general, the poorest corner of the society stays out of the consideration and gets trapped into the vicious circle of poverty. So when the concept of microfinance came into prominence, it was globally acclaimed as the key instrument for fighting poverty.

Despite the apparent success and popularity of microfinance, no clear evidence yet exists that microfinance programs have positive impacts. (Armendariazde Aghion and Morduch 2005) It turns out that Microfinance usually ends up making poverty worse. Though the money was lent with an intention to generate income, in most of the cases it is used to fund consumption i.e. buying the basic necessities for survival or smoothing up family needs. For example, In South Africa consumption accounts for 94% of the microfinance use (Hickel, 2015). As seen in a number of cases around the world, the consistent winners in the Microfinance 'game' are the lenders who charges exorbitant interest rates that sometimes reach up to 200% per annum. (Roodman, 2011) Gradually, this has become a socially accepted tool for extracting wealth and resources from the poor in some countries.

In most of the cases, the over indebtedness becomes the main hurdle of Microfinance, as the borrowers take further loans to repay the old ones. Failure to generate any income from the funds of Microcredit subsequently wraps themselves in layers of debt, and it has been the center of concern for MFI thinktanks over the years. (Lascelles, Mendelson, Rozas, 2014) Interestingly, no robust evidence of positive impacts on the most highlighted clients of MFI, women' status or girl's enrolments were found in researches, partially for lack of data and partially for the failure of the system. (Duvendack, Palmer-Jones, Copstake, 2011) Some of the most harsh critics also argue that the MFI is a very effective tool of political control, which has its' roots in the 'Containment strategy' of the US Government in Latin America, where the idea was to prevent people from subscribing to leftist movements by reframing poverty not as a political problem, but as a private problem. (Bateman, 2010). A comprehensive research of extant data reveals that the 'Microfinance craze' has been built on foundations of sand because no clear evidence yet exists that microfinance programs have positive impacts. (Duvendack et al, 2011)

Notable Islamic economists (Siddiqui, 2009; Chapra, 2009, Bagsiraj, 2009) continuously referred to the global economic crisis as a result of high interest rates (*Riba*) from the great depression to the crisis in western countries, as it does the same for microfinance as well.

## Islamic Norms for Microfinance Initiatives As a Tool for Development

Traditional microfinance institutions based on compounding interest causes serious hardship on the borrowers in servicing their debt. In this regard, access to credit should be provided to the poor on more humane, interest-free basis. This is only possible if microfinance system is integrated with Shariah accepted financial mechanisms i.e. *Zakat* or *Waqf*. (Laila, 2010) The major difference between conventional economics i.e. Microfinance and Islamic Microfinance is the application of *Riba* or interest, and in most of the times, compounding interest. *Zakat* distributes wealth from riches to the poor, where interest takes away the wealth from poor to riches.

Quran prohibits the usage of interest or *Riba* in any transaction whatsoever –

‘Allah has permitted you to trade and prohibited interest.’ (Quran 2:275)

It also prohibits the compounding effect of interest,

‘do not take interest, doubling or multiplying. And keep your duty to Allah, so that you may prosper.’ (Quran 3:130).

Sharia does not recognize the time value of money and it is therefore, not permissible to make money by lending it. To mitigate the problems of conventional MFIs with the Sharia, the concept of Islamic microfinance has started to take root, albeit mostly in three countries: Indonesia, Bangladesh and Afghanistan. (Honohan, 2007) The key products that are generally offered by Islamic MFIs are below (CGAP, 2008) –

### 1. *Murabaha* (Cost plus markup sale contract)

*Murabaha* is an asset based sale transaction used to finance goods needed as working capital. Typically, the client requests a specific commodity (tangible good) for purchase, which the financier procures directly from the market and subsequently resells to the client, after adding a ‘mark-up’ for the service provided.

### 2. *Musharaka* and *Mudaraba* (Profit and Loss sharing)

*Musharaka* is equity participation in a business venture, in which the parties share the profits or losses according to a predetermined ratio. *Musharaka* can be used for assets or for working capital.

*Mudaraba* denotes trustee financing, in which one party acts as financier by providing the funds, while the other party provides the managerial expertise in executing the project. In this scheme, profits are shared by the both parties in a predetermined ratio, but the losses are borne entirely by the financier.

### **3. *Ijarah* (Leasing contract)**

*Ijarah* is a leasing contract typically used to finance equipments, such as small machinery for factories. Duration of the lease and related payments must be determined in advance in order to avoid any speculation. The contract must specify that the ownership of the asset and responsibility of its maintenance remain with the financier. This type of *Ijarah* may be followed by a contract for sale, through which the ownership of the commodity will be transferred to the lessee.

### **4. *Takaful* (Mutual insurance)**

*Takaful* is the equivalent of Islamic insurance. The word originates from the Arabic word *kafala*, which means guaranteeing each other or joint guarantee. Each participant contributes to a fund that is used support the group in times of need, such as death, crop loss, or accidents. Paid premiums are invested in a Sharia-complaint manner to avoid interest.

Apart from microfinance, the most significant tool for poverty reduction could be the process of direct cash transfer with no strings attached. It delivered success where traditional microfinance fails as experiments have been conducted in countries like Namibia, Mexico and South Africa where participants were provided with financial grants, and the result was surprising. (Hanlon, Berrientos, Hulme, 2010). Consumption deficits were smoothed out, health indicators were improved and people successfully started small enterprises which dragged them out of the poverty line.

For Islamic Microfinance, the profit and loss sharing models are the preferred forms of microfinance contracts among Sharia scholars, where the *Murabaha* model is most widely used. According to Islamic MFIs, the profit and loss sharing models has more drawbacks than the *Murabaha* model, since the other models require careful monitoring of the projects of the clients. *Murabaha* model requires less time and moderation, and has a lower margin of error and provides immediate collateral for the MFI, which owns the goods until the last installment is paid. (Khaled, 2011) However, determining the appropriate financial model for Islamic MFIs is a more complex process than that used with conventional MFIs, since the Islami microfinance adheres to the same principles as Islamic finance; financial principles must emphasize the process and structure of human interaction and its impact on society as a whole. These principles are based on the idea that welfare should be provided to people by prohibiting practices that seem unfair or exploitative. (Rahman, 2007) Nevertheless, a study revealed that there is a strong demand of Islamic MFI initiatives especially in Muslim countries. (Karim et al, 2008)

**Table 1.***Demand of Islamic MFI initiatives in Muslim countries*

<b>Country</b>	<b>Percentage of people for Islamic MFI products</b>
Palestine	%60
Yemen	%40
Syria	%43
Java, Indonesia	%49

A glaring example of success of Islamic MFIs would be Indonesia, where its microfinance initiatives have played a vital role in reducing the poverty rate in the country from 40 percent in 1970 to 12.4 percent in 2011. This success has been attributed to Indonesia's national development strategy which was introduced in the 1980s and later on in 1994 when the Govt. placed microfinance as an important component in its poverty reduction strategies and programs. (UNDP, 2012)

### **Scopes of Intervention and Application of Islamic Microfinance in Bangladesh: The Rural Development Scheme of IBBL**

The Govt. of Bangladesh has placed a number of policies to encourage the private sector for implementing initiatives for poverty reduction. In accordance to that plan, Islami Bangla Bangladesh Limited (IBBL), the country's first and the largest private Bank launched a project called 'Rural Development Scheme' (RDS) in 1995. The main goal of the RDS is to create employment opportunities for the poor by providing small and micro investments and to alleviate poverty through income generating activities.

The RDS program follows the format of Grameen Bank, except the scheme uses the Islamic modes of investment based on profit and loss sharing methods (*Musharaka* and *Mudaraba*). In this system, the bank doesn't issue the agreed upon loan amounts to customers in cash, rather deliver goods to the customers ensuring that the funding is invested into income generating activities. Study says, there are more than one million small businesses in Bangladesh as potential clients, but only 7 percent of them have access to formal financial institutions. (Parveen, 2009). This RDS project of IBBL was created to capture the market and to address the gap between clients below the poverty line and government, conventional MFIs and other NGOs. It follows a very comprehensive operational mechanism which has been proved to be very successful in benefitting the rural poor and ultra-poor community. The current repayment rate of RDS is at 99 percent, making this one of the most successful MFI schemes in Bangladesh.

## **Methodology**

RDS follows a distinct methodology which is loosely similar to that of Grameen and other conventional MFIs. The loan is given to a group of five members living in a same village. A leader and a deputy are appointed to manage and coordinate the total process. In order to qualify for the loan, all the members are obliged to attend the weekly meetings at local office premises. They are precisely informed about the moral values, social rights and responsibilities of investment payment, collection of investment installments, personal savings and centre funds.

After eight weeks of observation period, IBBL starts the finance. Members are offered support services such as skill training, environment awareness and entrepreneurship development to ensure the success of the potential small and medium entrepreneurs. This step ensures and enhances the success rate of the potential beneficiaries to manage their investments. Upon approval of the application from the small groups, investment products (not cash) are handed over to the clients. The rate of return in this profit and loss sharing model is 12.5 percent; however, proper repayment in time wins a rebate of 2.5 percent. It means, a successful client will have to pay only 10 percent of his/her profit to the bank; making this the lowest rate offered by any conventional MFIs in Bangladesh. (UNDP, 2012)

An important aspect of this model is that it requires every member to open a Mudaraba account with a deposit of TK 20 per week. This saving can be withdrawn once members have fulfilled their liability towards the Bank. It encourages the habit of savings and ensures the sustainability of the fund. Besides, members are encouraged to deposit an amount of BDT 5 each week to a fund called *Qard-e-Hasana*, which is an interest free fund given to the ultra-poor people. The receiver of the *Qard-e-Hasana* is only liable for repayment of the principle.

## **Other Dimensions**

Apart from providing loans and other financial support in the conventional process, another significant development in Islamic MFI sectors is the evolvement of branch-less banking i.e. Mobile banking. With the established conventional financial systems of Bkash and DBBL, introduced by two major conventional banks, the Islamic Mobile banking scheme named MCash has also poised a deep impact in the market. (Chen, 2013) Islamic MFIs and their clients are ready to use this new dimension in order to ensure smoother management of their investments. It also started to show positive impact upon the socio-economic scenario of ultra-poor community especially the women. (Nugroho, Chowdhury 2014)

### **Challenges and Impacts**

A key concern regarding the success of Islamic MFIs is the sustainability. Since most of the initial funding at the start-up level of an MFI comes from voluntary contribution or donations, their economic viability is fragile, mostly because of lack of fund mobilization and high management costs. Over time, as the Islamic MFI grows, savings and profits are accumulated which can be recycled into new loans. However, Islamic MFIs have not yet tapped the sources of funds from Islamic institutions of *Zakat*, charity and *Waqf*. (Rahman, Dean, 2013). The Islamic MFIs along with mainstream Islamic financial institutions must come forward to institutionalize the *Zakat* and *Awkaf* mechanism to ensure fund mobilization.

As the effectiveness of microfinance depends on how sensitive the MFIs are to client demand, the scope of financial services offered to the poor needs to be more than for income generating activities, but must extend to consumption needs, such as health, education and social obligations. (Farooq, 2009), A number of researches conducted in Bangladesh have reflected that the positive impact of Islamic MFIs, most notably the RDS was significant in achieving the Millennium Development Goals of poverty alleviation, Gender equality and women empowerment, Access to healthcare services, safe drinking water and sanitary latrines. (UNDP, 2012). The changes in income can be shown in a chart (Rahman, 2010) –

**Table 2.**

*Impact of RDS in income of rural people*

Source of Income	Household Income per year (In Taka)		Change in Income (In Taka)	
	Before Joining	After Joining	Amount	(%) Percent
Agriculture	17,470	22,595	5,125	29.3
Business	46,513	60,505	13,992	30.1
Total	63,983	83,100	19,117	29.9

Two different studies from Habib (2003) and Badiuzzaman (2006) clearly portrayed the positive impact of RDS in poverty alleviation mechanism. What makes this scheme different from any other mechanism is that it offers the clients, who successfully graduated the RDS, to commercial products of the Bank. This partnership between the Bank and the beneficiaries has been proved to be a win-win partnership, and it helped the bank to make this program a self-reliant sustainable one across the country.

## **Conclusion**

At this moment, Islamic microfinance accounts for less than 1 percent of the global microfinance outreach which are mainly concentrated in a number of countries. Bangladesh has the largest outreach of Islamic MFIs, yet the percentage accounts for less than 1 percent in total microfinance market share. The estimation of global population living below the poverty line is approximately 1.2 Billion, 44 percent of which live in Muslim countries and are potential clients of Islamic MFIs.

Conventional MFIs have been successful in some extent to reduce poverty, but the problems of moral hazard and economic viability are not resolved. The Islamic based methodologies, in particular the waqf-based microfinance schemes have been proved to mitigate the problem. There is also a need to develop a welfare-based partnership model for Islamic MFIs which will focus on equity financing, which will promote profit and loss sharing unlike the conventional systems which distributes risk and return unevenly between rich and poor. Furthermore, the question of meeting the growing demand of Islamic MFI products within a cost-effective and sustainable process requires further research.

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