Innovate and Modern Modeling in Micro-Finance Structure in Compatible with Islamic Shariah Rules

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Abstract

Micro financing is providing financial services and resources for low-income people to improve their financial situation. In many less developed countries, providing these services for low-income classes was next to impossible due to high interest rates and heavy collaterals and guarantees that banks and other credit institutions demand. Micro financing was used since 1960s as a fundamental approach to eliminate these barriers and could relatively provide credit and financial services to lower income and poorer populations. However, large groups of Muslim population, who prefer Islamic based financing for themselves and their families, do not have access to such financing. Considering this issue and the limitations in Islamic societies face in using financial services, this paper tries to propose a model of Islamic Shariah-based model of Islamic micro financing, suitable with the financial and credit needs of lower income Muslim societies.

Keywords: Micro-Finance, Shariah Rules Financial Services, Low income Muslims

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Introduction

Social justice is achievable through reduction of financial inequality and a balanced income distribution. This can be achieved better at the macro economic and social levels through use of appropriate policies of social justice and through a trend, which brings together all issues and related factors. An issue in social justice is equality in opportunities, which has an important role in reduction of unjust distribution of facilities. A way to achieve this objective for poorer and lower income people, a target of all governments, is micro financing. These programs are drafted to improve the economic conditions, reduce unemployment, create job opportunities in self-employment programs, entrepreneurship, the elimination of social inequality, poverty reduction and more participation of women in the labor market. Experiences in the past three decades have shown that micro financing is a suitable approach to create new job opportunities, poverty reduction, and enabling people in less income regions.

The point to be considered is that all the successful experiences were based on the usual financing, that is, usury-based financing. This is while all Muslim populations, including those in Iran, prefer Shariah-based financing and avoid payment of usury. Micro financing lower income people using financial instruments compatible with Shariah, coupled with technical and educational aids through proper institutions can set the ground for more participation of Muslims in social and economic fields. Therefore, the search for, and the introduction of, proper micro financing instruments, as well as introduction of proper institutions in Islamic countries can be a priority in credit and fiscal policies in the state economic plans, with emphasis on poverty reduction and providing social justice.

Micro Financing Models

Micro financing preceded modern banking in the sense that it was done through unofficial financial providers, financial enterprises, friends, family members, and markets. Most these were done against a debit for the receivers of loans, most of which were expensive due to lack of any collaterals or other guarantees. These methods of financing have usually resulted in exploitation of people in dire needs by opportunist financiers and have seldom led to expansion of poverty in society and even its generational carry-over among low-income societies. These can still be witnessed in many societies, despite presence of modern banking because groups that do not have access to banking services are forced to use unofficial financing. Therefore, considering the failure and the inability of banking systems in providing financial services to the poor, formation of a new organization in the context of non-government credit institutions for providing micro financing to the poor, aiding them in line with civil society economic growth and their participation in economic activities is of utmost importance.

To this end, many countries across the world, in developing countries, national governments have established micro financing institutions to improve the economic situation of lower income people in their poverty elimination programs. This paper will briefly review some successful and unsuccessful examples.

Bangladesh, the Model of Grameen Bank

Bangladesh can be considered the birthplace of micro financing. Its experience of providing micro financing to small businesses, the poor and the special groups, like women, attracted the attention of many countries to the Bangladesh experience, especially the Grameen Bank. To evaluate the quality and performance of micro financing institutions in Bangladesh, one can refer to the practices in Grameen Bank, Bangladesh rural

development committee (BRAC), Rural Development Plan-12 (RDP-12), Bangladesh Renovation Organization {BURO), the Shakti Foundation, the Rajpur Donyajpur Rural Services (RDRS} and the Marginal and small farms system development plan (MSFSCIP).

Although these institutions have been set up with different objectives in mind, their main approach and idea behind their formation is providing support to the poor, enabling them for economic activities and providing a minimum income for them. These institutions, especially Grameen Bank, focus on lower income strata and lower classes of the society. Because of the lower income of customers and their inability to provide heavy collaterals, loans are granted only against an obligatory saving. Payments are based on group mechanisms in order for branches to ascertain settlement of the loans.

Malaysia, Non-Government Micro Financing Institutions

With implementation of new economic plans in Malaysia in 1985-95period, despite the extent of the poor population in rural areas, the ratio of poorer population fell from 45%to 15%. Two major factors in expansion of financial services to the poor in the plan were extensive government supports and the use of Grameen Bank experiences. The experience of micro financing by NGOs in Malaysia shows that, similar to Grameen Bank experience, lower income people are grouped and that each group supervises over its own loan, its spending, other issues and the welfare of others. It is interesting that loans are granted without collateral, without guarantor, at no interest and with no legal penalties.

Jamaica, Failure of Micro Financing

In 1985, Jamaica drafted a joint plan for granting small amount loans for e\self-employment group projects and joint group responsibility for settlement of loans. The objective was employment by small entrepreneurs with a joint approach of moving toward suitable jobs in the official economy, especially in the developed sectors. The loan performance of the plan shows that the youth and the women were the main recipients of loans for development of their businesses. However, evaluations show that the plan failed due to lack of supervision over loans granted, lack of business abilities that require skilled human resources, failure to identify target people and inability to settle the loans.

India, Self-Assisted Groups

Before the outset of financial reform program in 1990s, providing financial services and loans to the poorer population in India was possible only in the state program of subsidies. This was the prevalent view among top policymaker and bankers but the de-regulation of the financial sector could gradually change this view. For example, as the result of interest rate liberalization, many banks, with the support of Koopervasi Kredit Rakyat, the national rural and agricultural development bank, started their ties with the unofficial self-Assisted poorer population to mobilize their saving and grant loans at appropriate interest rates.

One of the biggest poverty eradication programs in the world was the one planned by International Rural Development Program (IRDP), which included over 45 million people. This program, in addition to providing cheap loans by the National Bank for Agricultural and Rural Development (NABARD) caused the formation of self-assisted groups in these regions. This is crucial in reduction of operational costs, sustaining level and

sufficiency of macro financial institutions, including attraction and absorption of savings.

Nepal, the program to improve the condition of small farmers

Nepal is a poor country and in dire need of land reforms. Given the failure of micro financing institutions in Nepal, the ground is set for flourishing of unofficial institutes. Among the most important poverty eradication programs in that country are the program to develop and improve small farmers' conditions, the centralized banking plan with 85'000 loan recipients and production loans to rural women. Most financing institutes in Nepal are not self-sufficient. Therefore, their ability to grant loans to the poorer population is limited and falling because the average ration of loans in these institutes is less than 18%. Among their problems are two factors. Firstly, the Nepalese central bank regulations limit the spread between interest rate on loans and to savings to 6% only. Secondly, obligatory loans are \frequent in that country and commercial banks are obliged to grant 12%of their loan portfolios to priority sectors of agriculture, industry, rural housing and services.

Micro Financing and Its Compatibility with Shariah Laws

Although most countries and models cited above are Muslim or have a substantial Muslim population, the institutes and models of micro financing are not Shariah based. These institutions, like the Grameen Bank, receive interest on loans granted to their customers and in return, pay interest on the deposits. In Islamic viewpoint, these constitute usury and are, therefore, forbidden. The question is whether these poverty eradication models and programs can be used on sustainable basis, given the inconsistency of these methods of saving attraction and financing with

beliefs and values of Islamic societies. In addition, will they not lead to higher rates of economic crimes, expansion of materialistic and consumer mentality among low-income groups in both rural and urban regions and ultimately to more poverty and deprivation of society of society of its ethic values?

Using Islamic instruments and contracts instead of usury-based mechanisms of receiving and payment of interests in financing low-income groups will not only provide financial services to the target groups, but also it can avoid the aforementioned negative consequences. As was indicated in the review of previous models, most micro financing institutes have been forced to undergo losses due to subsidies given to loan recipients, and this has undermined their long-term operations. Substitution of these instruments with Islamic ones can both resolve the issue of limitations and losses and can facilitate their widespread use and consequently, quantitative and qualitative improvement of the living standards of Muslim populations. This method of micro financing can be done based on usual instruments of non-interest loans – the only permissible type of loan in Shariah – as well as term sales, future sales credits, project financing, lending facilities in SMEs, etc. Muslims can use one or a combination of these instruments to finance their needs. They can, for example, use term sales for purchase of machinery, ownership rents for their properties, buildings, etc.

Potential Instruments of Islamic Micro Financing

Islamic micro financing is usually done using Shariah-compatible instruments. Yet, these should be also compatible with necessities of the modern world and with competing instruments and products. Most these instruments are designed to perform the same task as the usury-based instruments because services and financing needs of Muslim customers are not different from those desired by non-Muslims. The fundamental difference is in the type of legal contract between the customer and the

financier, especially about issues like rights and responsibilities of the sides concerning fines and penalties, products and real assets. However, these can also include other goods and services. This issue is one of the benefits of the Islamic micro financing, compared with the unofficial and the traditional methods, because the previous methods can have certain degrees of risks involved due to its unofficial and unregistered nature, which may lead to misunderstandings or which may cause exploitation of customers. Of course, drafting a legal contract necessitates additional costs but when there is a standard form and framework for contracts, these costs are considerably reduced. Standard contracts not only make them formal and official, they ascertain that contracts are free from any ambiguities, are clear and will not cause legal arguments and quarrels. These legal cases can have considerable costs for both sides, both in financial aspect and mentally.

Islamic financial contracts are designed for special purposes relative to real businesses. For example, term sales contracts are used for purchase of goods while rental contracts are for rents of assets or capital goods. A production contract finances constructions and other development projects. All these instruments can be used in micro financing but in addition to these uses, many customers demand cash financing (working capital) for their businesses. Two instruments of non-interest lending can also be used for these types of micro financing.

Theoretically, non-interest lending is more suitable to micro finance customers' needs. The problem is it does not have any kind of benefit for financier. Although certain sums of money can be given as management charges, fees or other costs, if these costs are higher than the real costs of financing they will be considered as usury and are, therefore, forbidden.

The basic problem here is that small personal loans and micro financing small businesses are not usually differentiated. In other words, it is difficult to decide which instrument should be used for which purpose. In Shariah, non-interest loans are considered the best option, with its own

complications. In the following part of this paper, tow models of Islamic-based micro financing models are introduced.

Organizational Structure and Management Models for Islamic Micro Financing

Now, with respect to Islamic models of micro financing for low-income Muslim population, we can introduce two different effective organizational structures to micro finance these groups.

Group Participation and Power of Attorney Based Model

A large part of micro financing requires good will of financiers in granting non-interest loans or constant supply of subsidies to loan beneficiaries. Therefore, access to cheap capital for financing institutes to low income people is of utmost importance.

Setting a credit institute based on group participation models, with a professional financial management, can guarantee this objective. In this structure, all group members, under the management of partners of the credit institute, provide the necessary financing for the operations of the institute. All partners are eligible to receive financing from the available funds at any given time, conditional on the ratio of their shares, but cannot receive more at the same time, due to shortage of available funds. This mechanism means that a rationing system or a pricing system for available funds should become operational. Yet, using market mechanisms and the usual procedures for such pricing translates into another form of usury, which contradicts Islamic principles. Nevertheless, good will can substitute rationing as an instrument or as a mechanism so that partners can ignore their own rights in favor of the needs of others. This priority-mechanism is suitable for prioritizing financing applications or prioritizing projects in need of financing. People that cannot have feasible

projects but show their management skills or prove their ability to settle the loans can be given priority in receiving these loans. The technical management of the credit institute is responsible to reject or to approve these applications. Yet, an objective should be providing training for applicants whose projects have been turned down, in order to enable them to come up with better, more feasible projects, suitable for market necessities. The objective of the management is merely risk estimation and reduction and not risk evaluation since there is not any interest cost on the provided funds in such projects. This financing structure brings into account justice in financial deals.

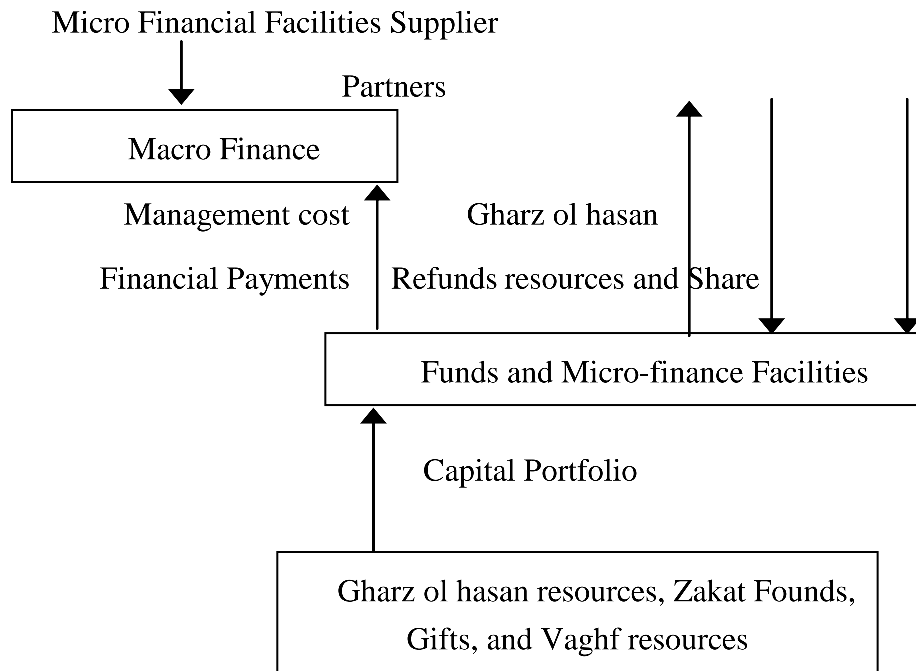
The resources of such micro financier institutes are provided through five sources. The first and foremost part is donations, contributions, or endowments of the partners or fund members, with no need to return them. This is a very cheap source of funds for these types of institutes for providing cheap products and services to their low income customers.

The second part of financial resources is the charges levied against customers for their applications, feasibility studies, etc. These are usually used to cover administrative costs, organization and management of funds, drafting and sending bills to customers, partners, etc.

The third source is from re-settlement of loans received by partners. Re-settlement guarantees that the nominal value of the fund resources will never reduce, although inflation and possible breaches of partners in settlement of their loans will leave such effect.

The fourth resource is the subsidies received from charity organizations, endowments or religious funds like Zakat. To use this latter fund, it must be proven that the funds are used to aid the needy and the poor, and not for setting up businesses.

Graph (1): A Group Participation-Based Model



The fifth resource is the revenues from financial assets kept in the fund. This lies within the responsibility of the management of the financial institute because these responsibilities are more than merely balancing costs and incomes. Because there is always a time gap between receivables and payments of the institute, the management can utilize part of the funds and turn them into financial assets in capital markets with interest, instead of keeping them idle with no interest. Yet, these should not be considered long-term assets and should be able to be liquidated fast and prone to minimum amount of risks. In this regard, Islamic Participation bonds can be the best option for these assets.

A Limited Partnership Model of Micro Financing

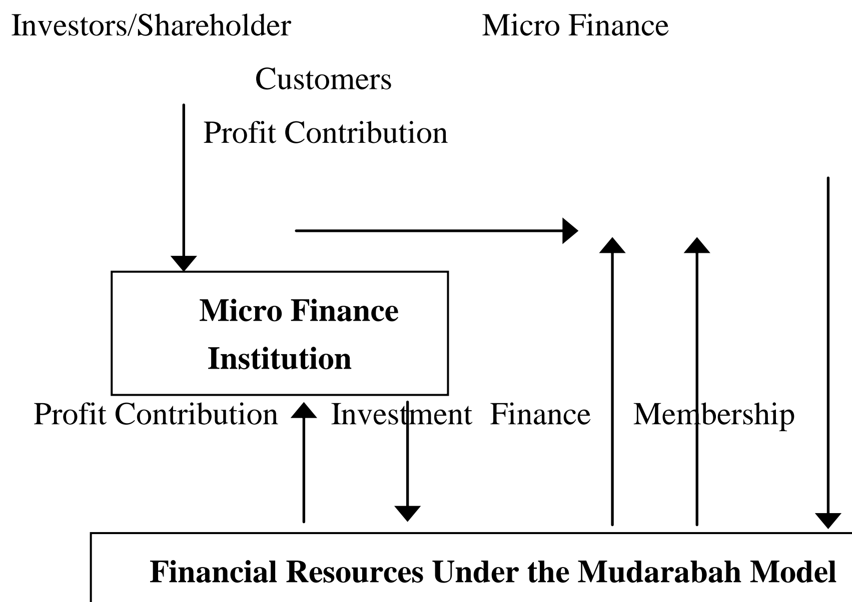
Although a group participation-based model of micro financing has many advantages, another model can be used more effectively in business financing. This is the limited partnership model. This model has three major differences with the previous model. Firstly, since limited partnership contracts are based on partnership and participation in both losses and benefits, in this model, the micro financier acts as a direct investor and earns its share from this type of financial investment. This interest/benefit is a good incentive, coupled with other costs and charges of financial services levied against the loan recipients, for the institute and a guarantee that its activities will always be profit-making.

The second difference lies is the organizational structure and the ownership of these institutes. Here, institute members do not provide the funds from endowments, donations or contributions but act as members of the institute in providing financial resources from others through their participation in economic activities. In addition, they earn the right to use institute funds for the members. In this framework, the dividends can be pre-determined between the institute and the financiers, based on a pre-determined contract, acceptable to both parties while the manner of dividend distribution does not change. Although the interest is pre-determined, because there is no similar determination of the period of interest and the real interest can change from one period to another or from one project to another, it cannot be considered a form of usury and thus, not inclusive in its ban.

In the model of limited partnership, contrary to participation models, investment projects are treated differently. Here, identification of the owner of the material capital and the partner is of importance since the owner of material capital is held accountable and responsible to any losses incurred to the capital principle. For this reason, in this model, there is added incentive for the micro financing institute as the owner of the capital to ascertain the correct performance of the resources in economic

activities. In addition, because customers of the micro financing institute are considered limited partners, their demands for financing are for their own economic activities. Therefore, reduction of risks of the limited partners will encourage economic activities in general.

Graph (2): Limited Partnership-Based Model of Micro Financing



The third difference between participation-based and limited partnership-based models is that in the participation-based model, part of the resources comes from religious duties like Zakat or other endowments, but this is not the case in limited partnership model. The logic of exempting this model from religious duties is that these contracts are generally commercial and business in nature and the religious duties like contributions, endowments, etc, had better be used in ways that

support the needy with the objective of social benefits and the poorer population of the society.

Conclusion and Propositions

Although this paper dealt with the theoretical and conceptual aspects of compatibility of micro financing instruments for lower income population with Islamic laws and principles, given the two models discussed in the paper, and their compatibility with the existing micro financing institutes in both rural and urban regions, their activities should be supported and expanded. This can done by re-organizing their structures, drafting fresh regulations and laws for them to utilize potential resources like endowments, Zakat, charities, etc. In addition, formation of a policy making council at the macro level, composed of ministers, monetary officials, ministers of welfare and labor and the organization of endowments and charities can be fruitful in increasing the capabilities of this sector and in improving the quality and quantity of its services.

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