Poverty Alleviation via Microfinance using the Concept of Mudharabah

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Abstract

Poverty has been a long outstanding crisis at global scale and poverty alleviation has become one of the primary national developmental agendas. Conventional microfinance programmes have received growing attentions due to its capability to improve standard of living and social inclusiveness. Arguably, however, these conventional microcredit programmes do not effectively alleviate poverty as the borrowers remain into an interest-base debt cycle which may worsen the financial burdens. Meanwhile, Islamic microfinance by way of Mudharabah financing is equity based financing structure which is perceived to have a fair borrower-lender agreement. It promotes an effective wealth redistributive mechanism to reach the poor, to encourage their participation in productive real economic sectors. This not only alleviates poverty, but also enhances standards of living. This research discusses the applications of conventional and Islamic microfinance models currently practiced globally and proposes an enhanced Mudharabah microfinance model to be adopted.

Paper type: Conceptual Paper

Keywords: Poverty, Poverty Alleviation, Mudharabah, Microfinance, Islamic Fiannce, Islamic Microfinance

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1. Introduction

Poverty alleviation and eradication has been at the forefront of many global development agenda such as the Organisation of Islamic Cooperation (OIC), the World Bank as well as United Nations in their Sustainable Development Goals. Despite continuous efforts, a considerable part of the world population remains trapped below poverty line and live in unsatisfactory conditions. Poverty is a multi-dimensional concern, extending beyond monetary aspects per se. It is associated with among others, poor human resources, economics, and provisions for social services. Over 30% (1.6 billion) people worldwide are living in multi-dimensional poverty, of which 29% (465 million) are from OIC member countries (SESRIC, 2015). The CEO of AlHuda Centre of Islamic Banking and Economics also highlighted that Muslim population accounts for 24% of total global population and half of global poverty reside within Muslim countries due to unemployment, lack of education and political instability (Mughal, 2014). If the issues of poverty within the Muslim community are not tackled at its root, we would see such scenario prolonged which will hamper the development of the overall Islamic economic system.

One of the highly looked upon solution to poverty alleviation is Islamic microfinance schemes which could be executed via Mudharabah financing contracts, as it promotes risk sharing while providing necessary funding assistance to poor entrepreneurs who are otherwise excluded from the financial sector. However, at this stage, Islamic microfinance is still nascent, comprising only 1% of total microfinance in the world, corresponding to only USD 1 billion (Mughal, 2014).

The objective of this research is to provide an overview of the conventional and Islamic microfinance schemes which are currently practiced to alleviate poverty and propose an enhanced microfinance model using Mudharabah financing contract.

The authors of this paper use systematic review methodology and analyse a list of relevant literature on best practice models of microfinance for poverty alleviation from both industry reports and academic publications. Based on the microfinance models proposed by Obaidullah (2008) as well as Kabir and Salim (2016), this study scrutinised the current practices in Islamic microfinance and proposed a conceptual framework grounded in the literature review.

The first part of this research paper will provide an overview on various microfinance models currently practiced across the globe. The following section will discuss the applicability of Mudharabah in microfinancing to promote financial inclusiveness and alleviate poverty. The last section will discuss the enhanced Mudharabah microfinance model and its operational challenges to ensure its sustainability. Further research may be required to adopt this model in different countries given the different economic needs of the country as well as its regulatory and legal requirements.

2. Literature Review

Poverty is often defined in absolute terms of monetary value (World Health Organisation, 2017; UNESCO, 2017). The World Bank, for example, defines poverty in absolute terms where extreme poverty refers to living on less than US$1.9 per day (World Bank, 2015). Relative poverty, on the other hand, defines poverty in relation to an individual's socioeconomic position, which means people are considered as poor if they fall below standard of living under given societal context. While both types of poverty have different focus on income and consumption, both absolute and relative poverty signify unmet basic needs of low-income populations. As such, the process of poverty alleviation involves transforming basic capability to function of those low-income populations (Toindepi, 2016). One of the recent developments in poverty alleviation is microfinance, which enables the poor people to take an active role in improving their standard of living.

Segrado (2005) highlights the revolution of microfinance for those who have excluded from formal banking, mainly due to lack of collateral or guarantees to protect the financier against potential financial risk. Abdul Rahman (2007) explains that microfinance refers to programmes which involve extending small financing to the poor for self-employment activities in order to generate income for sustenance. Microfinance programmes have been looked upon for its ability to fill the credit funding gap and it is acknowledged by the World Bank as a tool to address income inequalities and poverty (Abdul Rahhim, 2010). It provides opportunities for more participation among the society, opens new perspectives and empowers people to carry out their own projects and ideas which eventually allow them to free themselves from relying on financial aids, subsidies and assistance.

One exemplary microfinancing institution is Grameen Bank, a Nobel Peace Prize-winning microfinance organisation and community development bank founded by Dr Muhamad Yunus in Bangladesh (Abdul Rahman, 2007; Frasca, 2008). The success of Grameen Bank shows that access to small loans by the poor and those who lack access to mainstream banking services to participate in productive economic activities can be an effective tool to alleviate poverty and raise standards of living. In this model, the prospect borrower is required to participate in a group and given small loans at one time on a short term basis, usually one to two weeks. Upon repayment of loans, new loans may be given. The model is such that there is a social 'guarantee' in which a default or failure of the borrower to repay will render the whole group denied of future access to financing. This control measure mitigates the risk of adverse selection and information asymmetry (Abdul Rahman, 2007). Other models of microfinance currently practiced includes Village Bank used in Latin America and Africa, Credit Union adopted in Asia notably Sri Lanka, as well as Self-Help Groups (Obaidullah and Khan, 2008).

However, the conventional microfinance models are often interest-based and this deviates from the intention to empower the poor because this lead to a debt cycle that the poor may not afford to. Islamic microfinance, on the other hand, provides interest-free loan (qard hasan) or profit-loss sharing system based on Mudharabah (Haneef et al., 2015). In relation to that, Islamic microfinance institutes may have the great potential of reaching the bottom of pyramid due to its interest-free loans. Additionally, profit and loss sharing arrangements were specifically acknowledged as ideal modes of financing in Islamic finance (Abdul Rahman, 2007). At the time of writing, there is a limited shariah compliant microfinance schemes adopted globally. According to Abdul Rahman (2007), there are several Islamic microfinance programmes that are currently being practiced, including the Hodeibah microfinance programme in Yemen, the UNDP Murabahah based microfinance initiatives at Jabal al-Hoss in Syria, Qardhul Hasan based microfinance scheme offered by Yayasan Tekun in Malaysia, as well as schemes offered by Bank Rakyat Indonesia, and Bank Islam Bangladesh.

Nevertheless, the Islamic microfinance sector faces a number of challenges, including: skills deficiencies and shortages (Abbas and Shirazi, 2015; Haneef et al., 2015), lack of fund mobilisation (Kabir and Salim, 2016), and balancing local common pool resources (Hassan, 2014). Abbas and Shirazi (2015) report that Islamic microfinance remains unpopular in Pakistan due to absence of risk management tools to manage the cases of defaulters and in relation to that, moral hazard likewise also poses a constraint.

3. Microfinance via Mudharabah Financing

Islamic microfinance is a process of building social capital and trust (Abdul Rahim, 2010; Hassan, 2014). Unlike conventional banking, microcredit institutions fund their loans to those who are typically perceived as not credit worthy by traditional bankers, without collateral or guarantor (Abdul Rahim, 2010). Based on equity-based financing contracts of Mudharabah and Musharakah, Islamic microfinance have the potential to alleviate poverty by reaching out to the poor, developing a wide range of productive economic sectors as well as sharing of risks and profits generated. The great scholar, Taqi Usmani (1998) recognized that Musharakah and Mudharabah as 'real and ideal instruments of financing' as the money contributed by the financier is to be converted into assets with intrinsic utility and the profits are generated through the sale of these real assets. Table 1 below shows a brief comparison on the features of Mudharabah and Musharakah contracts and the following section discusses why Mudharabah financing contracts are deemed suitable for microfinance programmes.

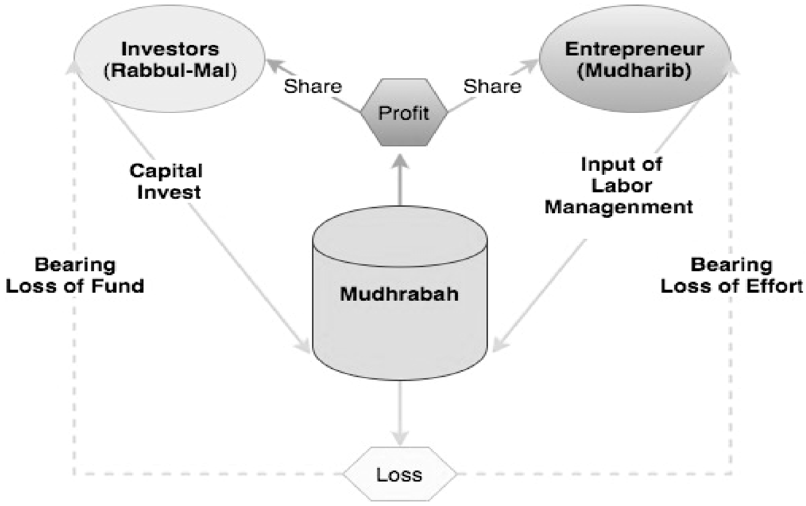
Table 1: Comparison between Mudharabah and Musharakah Contracts

	Mudharabah	**Musharakah**
Capital	The capital is provided by the investors	All partners invest a portion of the capital and assets are jointly owned
Forms of Capital	Cash	Any type of assets (tangible and intangible) which has commercial value
Forms of Investment	Restricted and Unrestricted	Permanent, Temporary and Diminishing
Participation in Business Venture	Only business manager will manage the activities while investor has no right to participate in the management	All partners can participate in the management of business
Distribution of Profit	Shared between the investor and business manager based on agreed profit sharing ratio	Shared between partners based on the agreed profit sharing ratio

Distribution of Loss	Borne solely by the investor unless misconduct or negligence by business manager	Shared among partners based on their proportion of capital provided
Termination	Upon contract expiry or anytime when one or both parties given early notice	Upon contract expiry or anytime when one or both parties given early notice

As depicted in Diagram 1 below, Mudharabah is an equity based contract, involving a partnership where one party provides the capital funds (rab ul mal) to be invested in a commercial enterprise managed by the other party (mudarib) who provides his skills and expertise to carry out a business venture. The Qur'an indeed commends trade (Al-Baqarah, verse 198), and defines the poor (Al-Baqarah, verse 273) as those that need alms.

Diagram 1: Illustration of the Mudharabah Contracts



The Prophet Muhammad (PBUH) was among the poor and later became a successful trader for many years prior to prophecy. This was mainly due to the microfinance capital for his ventures that was provided on a profit sharing basis based on Mudharabah by a wealthy widow, Khadijah (RA), who later became the wife of the Prophet. The arrangement of Mudharabah is highly based on trust which is developed from the rab ul mal's knowledge of the mudarib's honesty and integrity. Mudharabah contracts are deemed suitable for microfinancing programmes as it promotes the circulation of wealth from the surplus party to the deficit party who can generate profits. The funds are channelled towards productive economic sectors and profits generated are shared among investor and entrepreneur based on the profit-sharing ratio agreed upfront. One notable example is Sudanese Islamic Bank which has successfully implemented Musharaka and Mudharabah to the poor families (Abbas and Shirazi, 2015).

In a study of examining the impact of Islamic micro-financing on income and socio-economic status of the borrowers in Indonesia Rulindo (2012) found that Islamic microfinance, depending on the length and size of financing, has a positive impact on income level of the borrowers. His results also indicate that those borrowers who obtain Mudharabah and Musharakah financing have an improved standard of living, in comparison with those who receive Murabahah financing.

Nonetheless, the Mudharabah financing contract is not without challenges. Islamic microfinance institutes (IMFIs) rarely involved in any risky investment or project with the clients based on the mudharabah or *musharakah* principle (Mohamed *et al.*, 2013) due to their operational limitations and for their sustainability (Haneef et al., 2015). These operational obstacles mirror to the challenges faced by the Islamic microfinance sector as discussed in section 2 (see Abbas and Shirazi, 2015; Haneef et al., 2015; Hassan, 2014; Kabir and Salim, 2016).

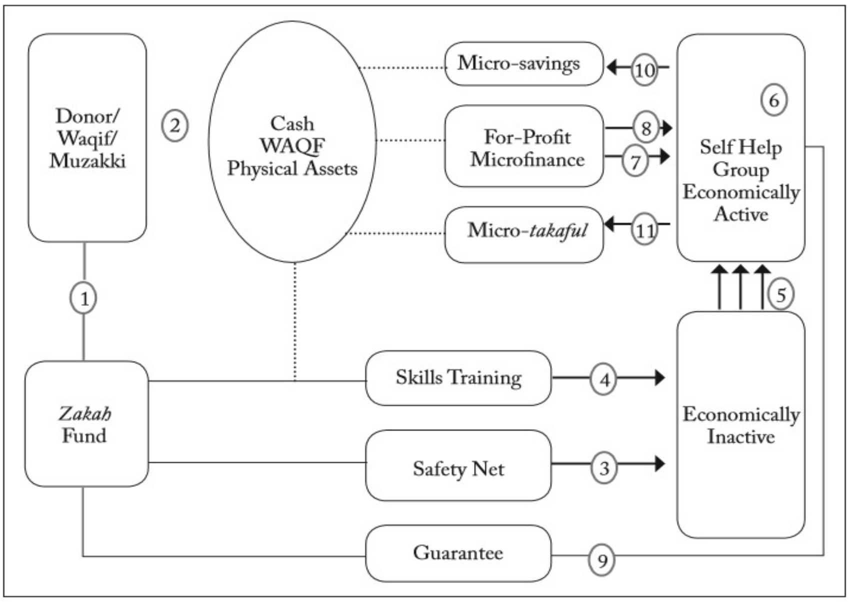
Islamic Welfare Society (IWS) in South Andaman is another good example that successfully implemented Islamic microfinance. To encourage payback, payments were small but frequent; additionally, borrowers formed peer groups that not only gave support but also excreted repayment pressure (Hassan, 2014).

4. Proposed Mudharabah Microfinance Model

The proposed structure is developed based on the initial microfinance models proposed by Kabir and Salim (2016) and Obaidullah (2008). Kabir and Salim (2016) proposed a two-tier capital structure for Islamic microfinance where the first-tier capital, which are in small amounts, are sought from compulsory donation funds. While there is no expectation of return from the borrower, a substantial amount of voluntary repayment will qualify the borrower to a second-tier capital. The second-tier capital is built from the donation fund of the users of the first-tier capital to finance Mudharabah or Musharakah contracts of larger amounts. Kabir and Salim (2016) expect the two-tier capital structure to reduce cost of capital and enhance sustainability of Islamic microfinance programmes thus contributing towards alleviating poverty. Borrowers who fail to repay the second-tier financing will be sent back to first-tier financing and this process will encourage borrowers to build their working capital, hence strengthening the long-term effectiveness and enhancing the stability of Islamic microfinance programmes.

Meanwhile, in the intial model suggested by Obaidullah (2008) as shown in Diagram 2 below, there is a reliance on gratituous funding and it operates based on the following: (i) Donor create zakah fund; (ii) Waqf fund based in physical and cash is build; (iii) The poorest who are economically inactive will get zakah fund as safety net; (iv) Skills training are delivered for the poorest using physical assets from waqf; (v) Skills improvement will encourage the poorest to graduate from poverty and become economically active; (vi) They are formed in self help groups with mutual guarantee; (vii) Allocated fund based on combination for profit debt based and equity based modes; (viii) Loan repayment, with possibilities of higher loan in the future; (ix) zakah fund is used to guarantee against default; (x) Saving is encouraged under micro-savings; (xi) Takaful fund is encouraged to protect against risks and uncertainties.

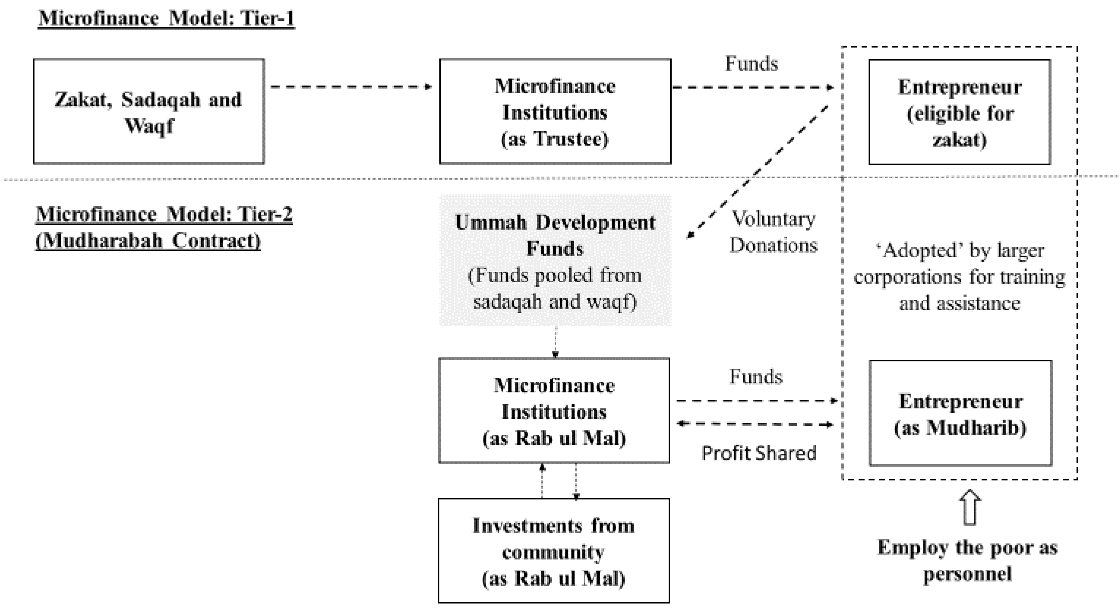
Diagram 2: Composite Model of Islamic Microfinance



Source: Obaidullah (2000: 54)

Both models by Obaidullah (2008) and Kabir and Salim (2016) highlighted a pertinent aspect of Islamic microfinance scheme, that is, the initial funding from Zakat as compulsory almsgiving from the financially capable to the poor and needy. The proposed structure, as illustrated in Diagram 3 below, aims to further develop the ideas by incorporating the Mudharabah financing contract to encourage investments that are in line with the Islamic values.

Diagram 3: Enhanced Mudharabah Microfinance Model



In the first-tier, funds from Zakat, Sadaqah and Waqf are channeled to eligible enterpreneurs who have a viable business proposal and no repayment is required as the source of funds are non refundable donations. Zakah is a compulsory contribution from the rich to the distressed group in a society and this is an ideal way of ensuring the poor Muslim population taken care of. Meanwhile, the cash, land or any asset given in terms of charity in kind as Waqf would be able to generate income to support the Islamic microfinance institution.

The enterpreneur shall be placed under the monitoring and supervision of established corporations to provide technical assistance and training in terms of running the business and other managerial aspects such as accounting book keeping. The Islamic microfinance institution can affiliate with major corporations (e.g. public or listed companies) to provide training for the enterpreneurs as part of their corporate social responsibility initiatives. The training for the enterpreneurs is crucial to develop their expertise and long term viability of the business. At the same time, the enterpreneurs shall employ the poor in society to ensure more employment opportunities and hence, making the poor economically more active in society. At this stage, the amount of contribution to the enterpreneur will be limited just to assist them in kick starting their business venture. After the business is deemed more stable and the enterprenuer has demostrated their skills and expertise to run the business, they could enter into a Mudharabah financing contract to further expand their business.

In the second-tier, the source of funds would be from Sadaqah, Waqf, profits from existing Mudharabah financing contracts as well as from the community who wishes to participate as investors, which is pooled in the ‘Ummah Development Funds’ (managed by the Islamic microfinance institution). The investors (being the Islamic microfinance institution and community investors) and enterpreneurs would enter into a Mudharabah financing contract. The community investors would be able to gain access to pertinent information on the nature of business and enterpreneur prior to investing. In order to make the Mudharabah contract valid, the profit sharing ratio will be determined upfront and a tenure for the financing will be specified.

The Mudharabah contract will be terminated at the end of the financing tenure and the investors who effectively own the business venture may sell their shares to the entrepreneur or any third party. The fund from sale of shares will be reinjected to the microfinance institution to create more opportunities for the economically inactive population to be financially inclusive. Furthermore, the Mudharabah financing schemes have moral and ethical attributes that can effectively motivate the entrepreneurs to thrive.

5. Prospects and Challenges of the Proposed Model

While the models proposed by Obaidullah (2008) and Kabir and Salim (2016) have provided a foundation to a microfinance model, there are several limitations which our proposed model hope to address. The pertinent aspects are highlighted as below:

Table 2: Comparison between the microfinance models proposed by Obaidullah (2008) and Kabir and Salim (2016)

Aspects	Kabir and Salim (2016)	Obaidullah (2008)	Proposed model
Maximum utility and sustainability of funds	Funds based on Zakat, Sadaqah and Waqf	Funds based on on Zakat, Sadaqah and Waqf	Funds based on Zakat, Sadaqah and Waqf. However, additional funds sourced from voluntary donations and the profit share from recipients, as well as investment from community
Enhancing human capabilities and expertise	Not mentioned	Skills training provided using zakat funds	Skills training provided by large corporations as part of their CSR commitment
Participation from community and social impact	Only among the self-help groups providing mutual guarantee	Only among the self-help groups providing mutual guarantee	Involves more members of the community to employing the poor as personnel, investments from public and CSR training from large corporations
Expansion of business	Repayment of the 1st tier funding assistance becomes a qualifying criteria for the 2nd tier financing	Recipient may seek additional funding based on repayment of previous funding	The 2nd tier Mudharabah financing is eligible provided the business has shown potential and viability.
Default risks and dealing with defaults	Potentially less motivation to repay and put continuous effort by recipient as failure to repay will automatically send back the recipient to 1st tier	Default of first financing may pose constraints for recipients to seek additional financing in the future	Default risk is limited as there is no repayment requirement during the 1st tier. Meanwhile, the 2nd tier is based on profit and loss sharing. The business and financial risks are mitigated through stringent selection of business financed and extended to trustworthy recipients.

One of the primary considerations for the proposed model is the sustainability of the structure, particularly the establishment and development of a trusted microfinance institution to spearhead the initiative. Although financial institutions have been recognized as a financial intermediary, the societal expectation of the function of a bank, primarily as a source to borrow funds rather than a business partner and depositors expect to gain returns and shield losses on their deposits. While there has been an increasing demand for halal financial dealings, there was no commensurate increase in the desire to share in profits and losses, particularly with losses (Abdul Rahman, 2007). Additionally, there are hindrances for financial institutions to engage in such activity due to higher capital and solvency requirements by regulatory bodies. Thus, there would need to be a specific not-for-profit microfinance institution mandated and supported by government to undertake this role. In addition, there must be a constant supervision and oversight by a higher independent body to ensure no mismanagement by the Islamic microfinance institution.

Another main concern is the financial sustainability for the Islamic microfinance institutions to carry on its operations as well as the source of funding to be channelled to the entrepreneurs. As Abbas and Shirazi (2015) pointed out, one of the main constraints to Islamic microfinance is lack of adequate loanable funds based on profit and loss sharing. The proposed model aims to gather funds from Zakat, Sadaqah and Waqf investment proceeds to be channelled as capital to the entrepreneurs. This model will need to focus on establishing strategic alliance with Zakat organizations as well as other local organizations to source the funds. The Zakat funds may be channelled to develop projects for educational or health care services as long as the beneficiaries of such projects fulfil the criteria to be recipients of Zakat. Furthermore, additional source of funding for the Mudharabah financing arrangement could be sourced from community investors who wish to partake in developing the *ummah* and earning profits on halal investments. According to Hassan (2014), such collective efforts to promote economic activities and regional development will affect both production and consumption of a community. However, as Haneef et al. (2015) suggested, it is important to provide educational and training programmes to the borrowers so that the borrowers are equipped with necessary know-how to run their businesses or agricultural farms.

Unlike interest-based microfinancing, where borrowers need to pay pre-determined interest rate regardless of the outcome of the business undertaking, both borrower and lenders in Mudharabah microfinance model share the potential risk of making financial losses. In this regard, there is a need for robust screening, strict monitoring and supervision on the entrepreneur by selected larger organisations to minimise asymmetric information problems and transaction costs (Haneef et al., 2015). Islamic bankers and supporting staff also need to be equipped with knowledge of Islamic finance and risk management in order for them to properly and responsibly manage the allocation of funds and distribution of profits to be shared accordingly (Abbas and Shirazi, 2015).

The proposed Mudharabah microfinance model provides a platform for more people to be involved in community and development programmes, in addition to stimulate effective accumulation and distribution of funds to finance productive real economic sectors. An effective implementation of this structure would address issues of lack of financial and human resources, and also inadequate infrastructure and support for the poor to effectively participate and become economically active and independent.

6. Conclusion

In conclusion, the enhanced Mudarabah microfinance model sugggested is capable to adopt microfinance best practices within the context of Islamic law. The conventional microfinancing schemes targeted for the poor are acknowledged to contribute towards alleviating poverty; however, the debt finance grounded on the basis of interest (riba) is prohibited in Islam. The proposed Mudharabah microfinance model, which is enhanced from the initial proposed microfinance model by Obaidullah (2008) and Kabir and Salim (2016) has the potential to provide the necessary funding to develop more productive economic activities as well as encourage more economically active individuals. It promotes financial inclusion while upholding Islamic values of brotherhood, amanah (trusteeship) and shura (mutual consultation) to alleviate poverty, raise standards of living.

In order for the Mudharabah microfinance model to be effective and sustainable, there must be a trusted Islamic microfinance institution specifically mandated and supported by the government to undertake this role. Islamic finance institutions should consider to channelling their funds and also equip their staffs with knowledge of Islamic finance. Additionally, the Islamic banks should make some initiatives to promote microfinance and create awareness among the poor communities. And lastly, the would-be entrepreneurs should be given business supports and training opportunities to enhance their business acumens.

This study draws attention to the challenges to the Islamic microfinance sector and the authors proposed a conceptual framework -- Mudharabah microfinance model -- highlighting the role of islamic finance institutes to serve the interest of the poor with commitment towards Islamic values. Further work and discourse on the operational aspects and legal requirements in different jurisdictions on service delivery to the poor is required.

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