

# Islamic Microfinance: Locomotive In The Service Of Financial Inclusion

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**Abstract**— The exclusion of poor people within the society from the conventional banking system was the starting and focal point for the creation and development of microfinance institutions. The implementation of a new financial inclusion policy has become the priority of several public programs by encouraging microfinance institutions to diversify their products range in order to meet the deprived populations' needs. Emerged as a new market niche, Islamic microfinance represents the confluence of two fast growing sectors: microfinance and Islamic finance. Indeed, it has the potential of not only suggesting financial and non financial services of proximity to individuals operating in the informal sector, but also supporting excluded ones from the banking sector because of their low income and lack of payment guarantees. As mentioned above, due to limited financial resources or an incompliance of conventional products with the ethical financial principles set in Islamic law, excluded individuals and entrepreneurs from conventional microfinance are not taking advantage of their country's economic growth and development. Therefore, the purpose of this paper is to put into perspective the relevance of Islamic microfinance to broadening access of financial services for low-income populations, and also to present the potential barriers that can block the growth and development of Islamic microfinance institutions whether they are economic, social or structural.

**Keywords-component:** *Microfinance; Islamic Finance; industry; Sharia; Financial inclusion;*

## I. INTRODUCTION

Microfinance aims to combat the exclusion of the most deprived from the conventional banking system through the creation and development of microfinance institutions. Indeed, it is an alternative for low - income households to create income - generating activities, to raise assets and to improve their socioeconomic status. In other words, microfinance is designed to combat the different dimensions of poverty. Obviously, the microfinance concept referred to microcredits. Nevertheless, it extends beyond credit to cover financial services adapted to the specific needs of the poor who represent its main target (savings, insurance, money transfer ...).

That said, according to Pierre Forestier [7]:

*" Microfinance is based on motivations such as freeing people from a compulsory informal system (usurers), contributing to the emancipation of a category of population (women, young people, etc.), To provide financial services essential to the success of broader development programs it is*

*then structured and embedded in a broader ambition to be an effective tool in the fight against poverty" .*

As surprising as it may seem, there is a strong correlation between microfinance and Islamic finance.

The Islamic financial system is based on principles of social solidarity and equity that converge towards the objectives of microfinance. Furthermore, many element of microfinance could be considered consistent with the brother goals of Islamic banking. Both system advocate entrepreneurship and risk sharing and believe that poor people should take part in such activities [4].

Moreover, the microfinance sector in the Middle East and North Africa region, with a predominantly Muslim population, still lags behind the lowest rate of access to financial services: % represents the financial inclusion rate in the Middle East and North Africa region compared to 40% of the poorest households. Obviously, this decline may be due not only to the absence of financial services but also to the voluntary obstinacy of the Muslim population to resort to these products if they are incompatible with the « Sharia Law ».

According to the Consultative Group to Assist the Poor (CGAP), the supply of Islamic microfinance is very limited, with a high concentration in East Asia and the Pacific at 92%, the Middle East region at 64% [6]. These institutions allow this category to have access to the various financial services on a micro level by enabling them to improve their living conditions and fight against poverty.

Through this article it is appropriate to understand how Islamic microfinance can overcome the various obstacles faced by the traditional microfinance sector in order to become a more efficient tool contributing to economic development.

## II. EMERGENCE AND DEVELOPMENT OF MICROFINANCE

### A. Birth of microfinance

It is true that economists are unanimous that the microfinance industry experienced a spectacular boom in the early 1980s on a global scale, particularly for the poor in developing countries. However, the history of microfinance did not develop until the 1970s under the impetus of Muhammad YUNUS (Nobel Peace Prize 2006), economist Bengal and founder of the organization Grameen. At that time Bangladesh was experiencing a chaotic situation (a fierce war followed by Pakistan's independence in 1971, two circumstances

precipitating 80% of the population living in poverty and famine) explained the results of the survey of the "Statistical Office of Bangladesh" published in 1992 [1].

The founder of the Grameen organization granted microcredit's to the villagers whose objective was to institutionalize these informal loans to help these people later led to the birth of Grameen Bank, the first modern microfinance bank. However, it seems that microfinance, often referred to as an innovative device, with a logic of substitution for the banking system, is nothing more than a formalization of informal practices when examining the phenomenon of microfinance Collective action of the cooperative or mutualism type. It is a very old and narrowly extended phenomenon [8, 19].

Nowadays, the microfinance institutions' main a central objective was not the achievement of a financial equilibrium since it would seem almost impossible for an MFI to function without receiving financial support from the government or the International financial institutions [3].

In the late 1980s, microfinance activity experienced a period of euphoria. Indeed, BancoSol is an example that would completely change the microfinance industry .Being at the base a Bolivian NGO, nongovernmental organization, created in 1986. BancoSol introduced itself into the microfinance industry; it was successful, reflecting a high reimbursement rate and the emergence of a new social class of entrepreneurs and micro-enterprises.

Nevertheless, since the 2000s, many microfinance organizations have emerged, marking the beginning of a series of persistent challenges in the microfinance industry. Between 1997 and 2006, 121 million people benefited from microcredit's, granted to more than 150 million microfinance clients worldwide in 2006, 84% of whom were women, through 10000 microfinance institutions (IMFs) the world [1].

### B. A more concrete definition

Historically, microfinance has been built as a tool for the inclusion of those excluded from the traditional banking system, providing services to "non-bankable", those who cannot offer physical guarantees or who live in remote, landlocked areas and isolated financial services. In general, this lack of financial services for this unbanked person is due to the immediate risk of profitability that the banks think they risk confronting by managing small deposits and offering loans with low interest rates.

However, the diversity of practices and arrangements put in place about the concept of microfinance do not allow for a definition that can be unanimously agreed on. Besides, if the "finance" aspect presents itself as more or less simple to define, this is not the case for the "micro" aspect. In this context and through the literature review of the concept of microfinance, it appears that the definition of the microfinance phenomenon can be analyzed under three headings: quantitative definitions, institutional definitions and normative definitions [20].

#### i. The quantitative definition

In this definition, microfinance, which is associated with the notion of microcredit, is also a concept that is difficult to define [10]. It is, in fact, a semantic shift in the notion of microfinance usually confused with the concept of microcredit. It is an amount which is lower than that sought by a business or household from a bank often for low-income people. However, what does a lower sum mean? For the World Bank, the amount granted should not exceed a ceiling of 30% of GNP per capital, but the amount may vary from one country to another. For others, the amount of credit is in the range of US \$ 162 to US \$ 768 according to the gender criterion, and US \$ 1014 to US \$ 3410 depending on the chosen intermediary [13].

For the EMN (European Microfinance Network), according to a European-wide survey in 2007, the average value of a microcredit may vary from one country to another, e.g. € 15,941 in Germany to €7,907 €for France depending on the size of the market and the size of microfinance institutions.

#### ii. Institutional definition

Institutional definition of microfinance refers to a particular system of financial intermediation considered to be innovative and providing financial services to populations excluded from the so-called classic financial system. It can take different legal forms such as NGOs, mutual institutions, specific financial institutions or intermediary financial institutions [18]. However, the particularity of this intermediation system is the mobilization of solidarity, proximity and in particular trust in order to reduce the risk of insolvency for poor households.

#### iii. Normative definition

In the search for a so-called normative definition of microfinance, there is a risk of sowing disorder in a way that it is possible to classify the activities of its institutions in the field of "solidarity finance" or "social finance" [17].

However, the financing institutions that grant credits to fight poverty or improve the welfare of a social category living in precariousness are part of the solidarity economy by encompassing an even broader field than the so-called " Social sector, which is based on mutualism and cooperative values while the MFIs must aim, with the exception of social motives and participation in economic development, to realize benefits in order to achieve the effectiveness, efficiency and sustainability of the institution.

### III. ISLAMIC MICROFINANCE: CONFLUENCE OF TWO FAST-GROWING SECTORS

Many economists believe that microfinance and Islamic finance have much in common. Islam insists on ethical, moral, social and religious values in order to promote equality and equity for the good of society as a whole.

The above values seem to correlate with the principles of microfinance that have been developed by CGAP. In this perspective, the financial model of microfinance seems to find new impetus in the emergence of the phenomenon of microfinance [16].

Indeed, in a global economic context, the problems of eliminating extreme poverty, reducing inequalities and accelerating economic growth are major challenges for our



countries. Access to financial services should be seen as a primary objective to be achieved. Since the eradication of poverty and the promotion of income-generating activities are part of the ultimate objectives of microfinance and Islamic finance, microfinance thus seems to be a favorite sector of Islamic finance [16].

After presenting a general overview of the concept of microfinance in the first part of this article, the next section will be devoted to a thorough examination of the merger of these two financial phenomena. This analysis will be carried out in two phases, the first of which deals with the analysis of the Islamic microfinance model and its different aspects with regard to the second one, it aims to study the main obstacles hindering the development of this new growing niche.

It is estimated that the Muslim population in the world is growing by 2.9% per year, a growth rate more significant than that of the world population which grows with an annual rate of 2.3%, in other words 1.57 billion Of Muslims in the world at present, according to the Pew. Nevertheless, by conducting a survey of a sample of 64 countries comprising almost 75% of the adult Muslim population worldwide, researchers noted that the Muslim population is less likely to use financial services in formal institutions [5]. This is not due to the absence of these services or to the existence of a difference between the needs of the poor in Muslim countries and those of their peers in non-Muslim countries, but this obstinacy is sometimes due to the incompatibility of these products with the principles of Sharia.

It is therefore permissible to admit that Islamic microfinance is the confluence of two growing industries, namely microfinance and Islamic finance. These two industries have the potential to respond not only to unsatisfied demand but also to combine the religious principles of Islamic Sharia with the social objectives of microfinance development to provide financial access to the poor. This potential could be the key to providing financial access to millions of poor Muslims who are currently rejecting microfinance products that do not comply with Islamic law.

In a survey published by CGAP in 2007 on the development of Islamic microfinance institutions, based on 125 institutions and a team of financial experts from 19 Muslim countries, it was found that the number of clients Benefited from Islamic microfinance does not exceed 380,000 people, or about 0.5% of total clients of conventional microfinance . It is therefore important to mention that the supply of Islamic microfinance is highly concentrated, 80% of the total supply comes from only three countries: Bangladesh, Afghanistan and Indonesia [14].

#### IV. THE PRODUCTS OF ISLAMIC MICROFINANCE

In his book "Islamic Finance for Micro and Medium Enterprises", economist Mohammed Obeidullah distinguishes two types of instruments that help eradicate poverty in Muslim countries [15]. A first category based on the principle of charity and a second based on the mechanisms of the financial market.

##### A. Category of products based on charity

Zakat and alms are two principles which occupy a central position in the Islamic religion. For Zakat, it is the third pillar of Islam. In fact, the gift of zakat is obligatory on the basis of the wealth of each Muslim, according to clear criteria. For many researchers, Zakat is a tool for income redistribution and public funding; it is one of the most important development mechanisms for poverty reduction [2].

The Sharia imposes clear and detailed rules to determine the nature of the cost and the gift of the beneficiaries of the Zakat. We can also cite in this category the Waqf also called Sadaka Jaria, it is a mode of charity that can be offered for religious purposes such as the establishment of a mosque or for social purposes such as the donation of land, Property or physical assets due to charity. These forms of charity can be used as financing funds for microfinance institutions. However, to ensure the sustainability and vitality of these institutions, they need to shift from a charitable to a more structured system that can cover the costs of financial transactions and provide services with a good price / quality ratio, especially since the lower the loan amounts, the higher the relative operational costs.

Currently, several Islamic microfinance institutions use *Qard Hassan's* contract (benevolent loan) to introduce it to the list of products offered in Islamic microfinance. The *Qard-al-Hassan* contract focuses on the fundamental axiom of Islamic development, namely the fight against poverty [12]. The particular structure of *Qard-al-Hassan* makes use of the distinct characteristic of property rights as prescribed by the Islamic economic system by granting property rights, even to those who do not resort to the principle of Distribution and redistribution [11].

##### B. Category of products based on financial market mechanisms

The Islamic approach to the fight against poverty cannot be based solely on the modeling of charity. Indeed, Islam does not prohibit the creation of wealth on some conditions that are not studied in this article.

It is very easy to notice the existence of a category of poor being able to create wealth for themselves and contribute to the development of their societies just by offering them financing products .Hence, the use of for-profit microfinance products; the remainder of the article will be analyzed.

##### i. The products of micro-savings in the institutions of islamic microfinance

Micro-saving is a crucial financial service for the poor and those excluded from the conventional financial system. Poor people are looking for both secure and convenient deposit services to save small sums and provide easy access to their funds.

However, microfinance institutions around the world tend to neglect this product by placing undue emphasis on microcredit. It is a service that occupies a primordial place in securing the lives of poor households.

In general, it should be noted that several factors encourage micro savers to deposit their savings into microfinance institutions in general. Among these factors, the following examples: safety, comfort, efficiency and personalized services [15]. Various contractual options for the design of savings products exists namely Wadia, Qard hasan and accounts based on the Mudaraba.

## ii. Microcrédits products in islamic microfinance insitutions

Islamic microfinance is an industry in full extension; it is at the same time a niche of innovations of the financial products. This innovation can be designed for religious reasons, specifically to be compatible with Islamic Sharia. These products are at the origin of products of Islamic finance. There are several products developed by traditional Islamic financial institutions involving *Murabaha*, *Bai-muajjal*, *Ijara*, *Bai-salam*, *Bai-istisna*, *Bai-istijrar*, etc.

## V. POTENTIAL BARRIERS TO THE GROWTH OF ISLAMIC MICROFINANCE

In 2011, the Consultative Group to Assist the Poor (CGAP) conducted a global study on the development of Islamic microfinance, gathering information on more than 63 institutions and contacting lawyers from 19 Muslim countries.

This section contains the main findings of this global study on the performance and scope of Islamic microfinance.

According to the CGAP study, MFIs serve nearly 1.28 million customers in 19 countries with a fairly concentrated supply in countries such as Bangladesh (445,000 customers), Sudan (426,000 customers) and Indonesia (181,000 customers), or 82% of the total number of Islamic microfinance customers [6].

According to the study, Bangladesh is the most active in terms of Islamic microcredit with more than 445,153 clients and two dynamic institutions. Indeed, in Islamic countries, the overall supply of Islamic microfinance remains relatively small and represents only a very small part of the entire microfinance sector. e.g., there are approximately 255 financial service providers offering Sharia-compliant microfinance products globally, concentrated in two regions: East Asia and the Pacific with 164 beneficiaries, all providers. The Middle East and North Africa have 72 suppliers, which represents nearly 28% of all suppliers.

For other countries, microfinance is still in its infancy, no major institution offers its services on a regional and national basis. For most countries, the average amount of Islamic microcredit (mainly *Murabaha*) is similar to that of conventional microcredit [9].

Islamic microfinance institutions generally offer only one or two products that are compatible with Sharia .Their activities, which essentially involve the financing of assets limiting the sector and depriving it of sufficient diversity to meet the different financial needs of the poor.

Certainly, thanks to Islamic microfinance, access to finance could be considerably improved and even reach levels

unprecedented in all Muslim countries. However, the sector remains to be demonstrated that it can provide financial services that meet the needs of the poor on a large scale. Despite this potential, several obstacles could hinder the development of Islamic microfinance. Economic models of Islamic microfinance have not yet been developed and no performance benchmarks have been established.

## VI. CONCLUSION

By way of conclusion, Islamic microfinance remains a very wide area, requiring a great deal of research and studies based not only on the economic and financial sciences compatible with Islamic Sharia, but also on the Sociology, psychology, politics and culture.

An effort has been made through the previous pages to present this still growing industry through a definition of the basic concepts for a grouping together of these notions in order to conceive a clearer idea on Islamic microfinance.

It is true that Islamic microfinance suffers from a number of direct and indirect obstacles that block its development, such as the high operating costs and the fragility of the supply, which comes mainly from non-financial agents such as NGOs Or cooperatives. However, it has strengths that can transform its previous threats into assets to add to the already existing opportunities, especially since one of the strengths of Islamic microfinance is its dynamism and its ability to adapt to the surrounding environment whether Muslim or not.

Indeed, it is enough to see the potential and development of Islamic finance in general and competitiveness between European countries to be the center of Islamic finance on a global scale.

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