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ISLAMIC BANK'S ROLE IN POVERTY ALLEVIATION

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ABSTRACT
This paper discusses poverty alleviation in Islamic banks within the purview of Islamic micro financing. It will touch the on; the prohibition of riba (interest/usury), population and poverty distribution in different regions of the world, Islamic finance's emphasis on welfare maximization as against profit maximization. Specific attention will be placed on Islamic micro finance instruments such as micro credit, micro equity, and charity financing.

Key words: zakat interest, sadaqah, waqf, ijara, murabaha, mudarabah, musharakah, riba, salam, usury

1. Introduction

Islamic Banking and Finance industry has experience rapid expansion mainly because of its emphasis on welfare maximization and other social benefits as against the conventional motive of profit maximization. Islamic banking and finance is a sharia-compliant system of banking devoid of interest (riba) that derives its roots from the holy Qur'an (muslim holy book) and the Hadith or Sunnah (the traditions of the prophet of Islam)

Qur'an says; "o these who believe fear Allah and give up what remains of Usury(interest) if you are believers, but if you do not, then listen to the declaration of war from Allah and his messenger, and if you repent, yours is your principal. Neither you wrong nor be wronged. And if there be one in misery then defer till ease. And that you leave it as alms is far better for you, if you really know. And be fearful of the day when you shall be returned to Allah, then everybody shall be paid, in full what he earned. And they shall not be wronged.

According to the traditions of the prophet (SA) "Riba (interest) has seventy (70) classes in which the least serious being equal to the sin of a man who committed adultery with his mother"

In Islam, the prohibition of interest is the most important step toward socio-economic justice as the only recognized reward for capital in Islam is profit. Islamic banking principles, operations, and policies, lean towards maximization of social benefits rather than profit maximization. This can alleviate poverty, promote social justice and equity, redistribute income, and facilitate financial inclusion among others.

"Islamic micro finance advocates economic empowerment through entrepreneurship, risk sharing and financial inclusion. Hence the nexus between poverty alleviation and Islamic micro finance." (Global Islamic Finance Report GIFR, 2012)

What is Microfinance?

Microfinance is a form of financial services targeted mainly poor individuals and small businesses that lack access to conventional banking and related services. Caramel Sammi (2018). In other words, microfinance is meant to assist individuals and businesses that cannot afford the conditions and requirements (collaterals, guarantors etc.) for obtaining loans/credit from commercial banks. Microfinance are designed to be more affordable to poor and socially marginalized customers and to help them become self sufficient. Caramel Sammi (2018)

History of Micro-Financing

The history of micro-financing can be traced back as far as the middle of the 1800s, when Lysander Spooner was writing about the benefits of small credits to entrepreneurs and farmers as a way of getting the people out of poverty. The first cooperative lending banks to support poor rural farmers in Germany was founded by Friedrich Wilhelm Raiffeisen.

The modern use of the expression "micro-financing" has roots in the 1970s when organizations, such as Grameen Bank of Bangladesh with the microfinance pioneers Muhammad Yunus and Akhtar Hameed Khan, were starting and shaping the modern industry of micro-financing.

Benefits of Micro-Financing

Micro-financing produces many benefits for poverty stricken and low-income households. One of the benefits is that it is very accessible. Banks today simply won't extend loans to those with little to no assets (collateral), and generally don't engage in small size loans typically associated with micro-financing. Through micro-financing small loans are produced and accessible. Micro-financing is based on the philosophy that even small amounts of credit can help end the cycle of poverty.

Another benefit produced from the micro-financing initiative is that it presents opportunities, such as extending education and jobs. Families receiving micro-financing are less likely to pull their children out of school for economic reasons. As well, in relation to employment, people are more likely to open small businesses that will aid the creation of new jobs. Overall, the benefits outline that the micro-financing initiative is set out to improve the standard of living amongst impoverished communities (Rutherford, 2009).

Limitations of Micro-Financing

There are also many social and financial challenges for microfinance initiatives. For example, more articulate and better-off community members may cheat poorer or less-educated neighbors. This may occur intentionally or inadvertently through loosely run organizations. As a result, many microfinance initiatives require a large amount of social capital or trust in order to work effectively. The ability of poorer people to save may also fluctuate over time as unexpected costs may take priority which could result in them being able to save little or nothing some weeks. Rates of inflation may cause funds to lose their value, thus financially harming the saver and not benefiting the collector (Rutherford, 2009).

Population and poverty distribution in different regions of the world

Region	% in USD 1.25 a day poverty	Population (millions)	Population in USD 1 a day Poverty (mils)
East Asia and pacific	16.8	1,884	316
Lat. America and Caribbean	8.2	550	45
South Asia	40.4	1,476	596
Sub-Saharan Africa	50.9	763	388
Total Developing Countries	28.8	4,673	1,345
Europe and Central Asia	0.4	473	17
Middle East and North Africa	0.4	305	11
TOTAL	10,124	2,718	

Source: World Bank (2010)

The table above shows that, the highest in poverty among the regions is Sub-Saharan with 50.9% of its population living by less than one US dollar par day followed by South Asia with 40.4%. Also, 28.8% of the population in developing countries is made up of poor people living by less than one US dollar. This development is a source for concern to everyone especially global bodies, governments, and well meaning individuals, hence the need to employ every available means in order to bring down the prevalent poverty level. One of these means is Islamic micro financing.

It is pertinent to note that the conventional micro finance as it is currently practiced may not be able to address the problem of poverty since is often based on high interest and other charges (which jack up the cost of loan) thus increasing poverty level, many debtors could not pay back what they owed which sometimes even lead to catastrophe such as suicide and social unrest.

Before determining loan price one should take these two costs; Administrative costs by the bank and transaction cost by the client/customer. Customers, on the other hand, may have expenses for travelling to the bank branch, acquiring official documents for the loan application, and loss of time when dealing with the Micro Finance institutions . Hence, from a customer's point of view the cost of a loan is not only the interest and fees she/he has to pay, but also all other transaction costs that she/he has to cover.. "The global average interest and fee rate is estimated at 37%, with rates reaching as high as 70% in some markets". Macfarquhar, Neil. (2010). "the reason for the high interest rates is not primarily cost of capital. Indeed, the local microfinance organizations that receive zero-interest loan capital from the online micro lending platform charge average interest and fee rates of 35.21%. Kiva help (2009). Rather, the main reason for the high cost of microfinance loans is the high transaction cost of traditional microfinance operations relative to loan size". Geoffrey Muzigiti, Oliver Schimidt. (2013)

Conventional microfinance practitioners have long argued that such high interest rates are simply unavoidable, because the cost of making each loan cannot be reduced below a certain level while still allowing the lender to cover costs such as offices and staff salaries. For example, in Sub-Saharan Africa credit risk for microfinance institutes is very high, because customers need years to improve their livelihood and face many challenges during this time. Financial institutes often do not even have a system to check the person's identity. Additionally they are unable to design new products and enlarge their business to reduce the risk. Roodman David (2011) the result is that the traditional approach to microfinance has made only limited progress in resolving the problem it purports to address: that the world's poorest people pay the world's highest cost for small business growth capital. The high costs of traditional microfinance loans limit their effectiveness as a poverty-fighting tool. Offering loans at interest and fee rates of 37% mean that borrowers who do not manage to earn at least a 37% rate of return may actually end up poorer as a result of accepting the loans.

Furthermore, it is suggested that "the duo of Islamic Finance and Islamic micro finance – has the potential of providing financial access to the poor Muslims who currently reject micro finance products that do not comply with Islamic laws. (Global Islamic micro finance Landscape p. 183)

What is Islamic Micro-finance?

Islamic Microfinance is a microfinance system that evolved through Islamic Banking and Finance system to provide financial assistance to people, excluded from the main banking system, in a shariah-compliant way. This assistance is provided without going contrary to the prohibitions stipulated in shariah Islamic law such as; prohibition of interest and others (gambling, betting, alcohol, tobacco, pornography, prostitution etc). Muslims generally would have preferred using shariah-compliant financial products to conventional ones.

Islamic microfinance as a panacea to poverty

Islamic microfinance is an extension of Islamic finance concept of interest-free financing arrangement based on Islamic doctrines of social and economic justice, ethics, wealth distribution and public interest (called masalih almursalah in Arabic). Islamic micro finance also advocates economic empowerment through entrepreneurship, risk sharing and financial inclusion. One of Islam Objectives is to support the most vulnerable in the society, which tally with the micro finance mission.

Most commonly served Islamic microfinance products

Islamic micro finance banks serve customers through three main product structures thus; micro credit, micro equity, and charity financing.

Islamic microfinance product structure

Micro Credit	Micro Equity	Charity
- Qard Hassan	- Mudarabah	- Zakat
- Murabaha	- Musharakah	- Sadaqa
- Ijara		- Waqf
- Salam		

1. Micro Credit

Islamic micro finance institutions offer micro credit using a variety of mechanisms based on shariah principles such as: Qard Hassan, Murabaha, Ijara, and Salam.

a. Qard Hassan

Of all the mechanisms used by Islamic micro finance, Qard Hassan is regarded by many as the purest and most effective way of financing the poor hence best mechanism for alleviating poverty. Borrowers need only repay the principal plus service fee to cover administrative costs incurred in disbursing the loan.

b. Murabaha

Murabaha financing involves the resale of a commodity by the Islamic micro finance institutions at a markup and is commonly used for financing assets or working capital inputs such as raw materials, machinery and equipment. Repayments are made instalmentally while ownership remains with the micro finance institutions until full settlement. Over 70% of Islamic micro finance loan

c. Ijara

Ijara is a form of leasing contract in which Islamic micro finance institutions buy equipments and rent it out to entrepreneurs over a period. Ownership of such equipments resides with the institutions as well as the responsibility of maintaining the equipment so leased.

d. Salam

This product is employed when financing agricultural products. Under Salam contract, agricultural commodities are purchased and paid for in full spot price but delivered at a specified future date by the entrepreneur with a predetermined quality and quantity. The popularity of this mode of finance is still very low because it is the most expensive and it gives room for default and breach by the borrower.

2. Micro Equity

Islamic micro finance institutions can also raised funds through participatory profit or loss sharing models like; Mudarabah and Musharakah.

a. Mudarabah

This is where Islamic micro finance institutions provide capital to a poor entrepreneur who partner with his skill and expertise in a business venture. The profit from such venture is shared according to a predetermined ratio and loss is borne entirely by the Islamic micro finance institutions (capital providers). The said entrepreneurs (borrowers) only lose effort they put into the venture except where the loss is due to negligence or misconduct.

b. Musharakah

This is where both the Islamic micro finance institution and the micro entrepreneur contributed capital to finance and manage a business venture sharing profit and loss in accordance with a pre-agreed ratio. This model of financing is more suitable for an existing business needing more capital for expansion.

3. Charity

Charity financing instruments such as: Zakat, Sadaqa, and Waqf take a central position in poverty alleviation in islam. Unlike the conventional micro finance sector, where institutions give cash directly to a client for financing purpose, Islamic micro finance can maximize social services by using these Islamic charity instruments as sources of funds for micro finance programmers, which fulfils basic needs and increase the participation of the poor.

a. Zakat

Zakat is a form of alms that is given out of cash, gold, grains, domestic animals (like cattle, sheep, goats and camels etc). The alms vary according to items mentioned as prescribed by the holy QUR'AN, for example, 2.5% is given to the poor as alms if cash or Gold reached certain measure and has remained in ownership for a period of one year. Zakat is given mainly to the poor and destitute before others like way farers, captives etc. This is very important in term of income redistribution, social welfare and poverty alleviation. Islamic micro finance can get involved in collection of zakat from the rich muslims and distribute same to the poor and destitute especially the ones interested in micro entrepreneurship.

b. Sadaqa

Sadaqa is a voluntary charity, other than zakat, given out by well-to-do muslims which can be routed through Islamic micro finance bank for efficient distribution to the needy. A pool can be maintained by Islamic micro finance banks in which all funds collected as sadaqa should be kept and be distributed according to priority with poverty alleviation as the main objective.

c. Waqf

Waqf, which like zakat, drives its legitimacy from the Holy Qur'an and Hadith is a form of endowment where a property is made invulnerable to any disposition that leads to transfer of ownership, and donating the usufruct of that property to beneficiaries. In other words waqf means confinement of property from ownership and the dedication of its usufruct to charitable purpose. Charitable waqf, that generates income for distribution to the poor, can play an important role in poverty alleviation by targeting its benefits towards the poor as it has the potential to create and preserve long term assets that generates income flows.

Conclusion

Despite enumerated ways by which the Islamic micro financing instruments can be employed to alleviate poverty yet it may be said to be at infancy stage. Many are of the opinion that Islamic micro finance is yet to demonstrate that it can provide financial services that meet the needs of the poor especially on large scale.

Also, in some developing countries like Nigeria, Islamic Banking and Finance is at an introductory stage. There is a strong demand for sharia-compliant micro finance products and services. Even when these services are provided by the emerging institution, growth may be hampered by lack of awareness as the poor who are supposed to be targeted beneficiaries may not have access to information about Islamic micro finance products hence they resort to conventional micro financing that charge high interest rate. In some cases the poor even patronize individual money lenders who charge even higher interest.

Furthermore, Islamic banks are not always attracted to micro financing because of many reasons such as:

1. Low profitability
2. High risks
3. Dearth of experts
4. Lack of management skills

Moreover, for Islamic micro finance industry to reach its fullest potentials in poverty alleviation, especially in developing countries like Nigeria, government regulators and experts must design policies that can integrate this sector into the mainstream banking and finance system.

In addition, capacity building through training and retraining is very necessary so that requisite skills could be used to operate Islamic micro finance banks, especially in developing countries like Nigeria, where the whole idea of Islamic finance is new.

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