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Microcredit Management Model: An Islamic Perspective

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Abstract:

Microcredit is a widely acclaimed development intervention to extinguish social exclusion, crude poverty, unemployment, hunger and above all social deprivation. Unfortunately, it has un-succeeded to uphold its generic legacy under the contemporary microcredit mechanism being pursued in the third world countries including India. The approach adopted is lopsided and calls for replacement. Therefore, to innovate a viable Microcredit Management approach that could address the crux of the subject matter is a serious challenge. Accordingly, this paper makes a humble attempt to propose an elusive model for microcredit management using the tenets of Islamic Economics to arrest the unmanageable magnitude of economic poverty, unemployment and social deprivation in all situations and regions. The model brings about a comprehensive discourse for microcredit generation, disbursement, deployment, reimbursement, risk aversion, financial support, security and importantly phenomenal reduction of poverty, unemployment and income generation to the *economic vulnerable sections of society.*

Key words: Islamic banking, Musharaka, Murabaha, Islamic Sharia, Ribba, Wadiah, Quard al Hassan, Zakat.

Introduction:

The United Nations Economic and Social Council named the year 2005 the 'Year of Microcredit'. Microcredit refers to disbursement of credit exclusively for the benefit of poor and underprivileged classes of society for generating their income, employment and standard of living. Farooq (2004) says that microcredit is one of the most powerful tools employed for poverty eradication. Habib (2004) and Mehraj (2001) view that financing microcredit for specific groups of people is a "new paradigm" for bringing about development and eradicating absolute poverty. UNICEF (1998) hails that access to microcredit and basic social service is effective and cost efficient approach which enable the poor to pull themselves out of poverty. Globally, an overwhelming amount of microcredit is being disbursed under the conventional banking mechanism to downsize the level of poverty and unemployment. Micro summit 1997 envisages that 100 million poor would have access to microfinance by 2005. Parker (1998) opines that a total of USD 7 billion has been disbursed to over 13 million people worldwide by microfinance institutions. In India, about 25 million have been disbursed as microcredit for the benefit of extreme poor under an organized and structured government programmes over the last more than five decades, but the research has shown that microcredit have not brought any fundamental change in the panorama of poverty in India including in the state of Jammu and Kashmir (Mehraj :2004). Ratifying the fact, Tendulkar Report (2010) hints that poverty in India has accentuated in both absolute count and relative magnitude. This seems predominantly due to operation of conventional banking mechanism which lend only against collateral security at an exorbitant rate of interest to barrower, who lacks loan repaying ability, risk management and above all exposure for availing credit. It is in this backdrop, that the present study is a humble attempt primarily to gauge the forces that led the collapse of existing microcredit management system and thereafter to propose a microcredit model that accords to tenets of *Islamic Sharia* under the contemporary domain of Islamic Economics.

The Objectives:

The study has been undertaken to attain the following objectives

- To study the bottlenecks in the conventional microcredit system;
- To examine the need of Islamic microcredit system; and
- To offer a model for execution of Islamic microcredit mechanism.

Study Design:

Given the reinforcing character of microcredit to alleviate poverty and unemployment, it sounds imperative to examine the broad contours of microcredit though it's varied manifestations to accomplish the objectives of the study. Accordingly, this paper is organized into three parts. The first part delineates with performance of microcredit panorama in the existing conventional banking system, while the second part of the study would throw light on the relevance of Islamic Economics vis-à-vis microcredit mechanism. In the third part of the study, microcredit management model would be presented under the tenants of Islamic Economics to offer a viable approach for microcredit management.

Literature Review:

Microcredit, a buzzword of contemporary times, is viewed with mixed reaction vis-a-vis poverty alleviation and employment generation. Arun, Imai and Sinha (2006) opine that microfinance has brought significant welfare gains in terms of income, household assets creation and fulfillment of other basic needs (e.g. food security, sanitation, and access to healthcare). Somewhat similar findings were noted by Bali, Swain, and Floro (2007) who on the basis of data furnished by NABARD found that being a member of Self Help Group (SHG), the incidence of poverty with respect to food insecurity and welfare could be minimized at much lesser degree. Similarly, the research findings of Khandker (2003) unfold that microcredit do produce additions in financial gains and assets creation provided credit is drawn and used by females. According to the World Bank, "[micro] credit increases womens' options for optimizing the use of available resources." Women's loan repayment rates within the Grameen Bank in particular, were 99.4% successful in 1994. Research has recently concluded that women are much more responsible when it comes to handling micro-loans, thus microcredit lenders are targeting mostly women. Microcredit has also been shown to effect the educational development of families when women borrow (Mehraj 2002). According to the World Bank, child school enrollment increased from 0.68% to 0.77% when women were in charge of micro-loans, as opposed to men. Microcredit loans to the women are also benefiting the labour force. When a ten percent increase in women borrowings is evident, there is also a one percent increase in women's participation in the labour force. Schurmann and Johnston (2009) view that microcredit is a development intervention that converts social exclusion aspects in developmental instruments. While Mehraj (1998, 2003) opines, that microcredit brings only a marginal improvements in the income position of beneficiaries. Further, research of Mehraj (2001), Mainder et al (2007) held that institutional microcredit seldom the "principle of justice ". Although, it enables poor individuals to start businesses, it can also carry a very high interest rate if compared to average interest rates in developed countries. Loans and credit cards in the U.S.have an annual interest rate of 5 – 20%. Interest rates on micro-loans are often upwards of 35 – 40% of the total amount of the loan. That means that a loan of $30 with a 40% interest rate may accrue $12 a week in interest if it is to be paid in weekly installations. Individuals starting with micro-loans may not have the capital or business expertise that other experienced business owners have acquired. Therefore, they may not be able to pay off the initial weekly installation payments.

Islamic Credit Management System:

Islamic Economic system is somewhat distinct from the conventional economic system. This system is divine and free of economic exploitation and social deprivation. It is more related to true human development and optimal utilization of resources (Khursheed 1996). It forbids hoading of wealth, favors for productive investment and directs a systematic distribution of resources towards the needy and deserving to empower them economically and socially.

Islamic finance is predicated upon changing the inherently asymmetrical contractual relationship between borrowers and lenders to reduce inequity between the provider and recipient of capital in terms of risks and returns. A riba-based financial system, which is at the core of the current global financial crisis (Feroz, 2009), places disproportionate risks of repayment upon the borrower, who is obligated to repay the principal plus compounded interest, whether the business for which the funds were borrowed is successful or not. This phenomenon calls for prudent financing system that could nullify or cease the moments of economic/ financial crises that world is still caught in across the Europe etc. and empower the poor and deserving . On the forefront, Islamic economic system holds the merit to safeguard the financial downfall and bring phenomenal reduction in poverty. In this context, it is well conceived that ***musharaka*** and ***murabaha*** could act as means to transfer the means of wealth propagation in favor of poor. The Islamic scholars view *musharaka* a more appropriate Islamic form of financing than *murabaha* because it relies upon risks and profit-and-loss sharing (Feroz, 2009),. However, *murabaha* can play a transitional role in providing Shari"ah-based financial services to the poor. The use of *murabaha*, which shares many of the same procedures with conventional microfinance, can provide an avenue by which microfinance „best practices" are integrated into a Shari"ah-based microfinance model. Our financing model is based on both the *murabaha* and *musharaka* contracts frequently used by Islamic banks. In the former, the MFI purchases goods requested by the client from vendors and resells them to the client with a pre-agreed upon markup and receives payments spread over an agreed-upon time (usually 52 weeks or less). In the latter, the MFI and client sign an agreement specifying the business conducted by the client, the profit-sharing ratios, and the buy-out schedule. Upon signing, the MFI provides the client with money to expand the client's business and they share profits and losses until the agreement ends with the client gradually buying the MFI"s share of the business. The use of *murabaha*, which has equal repayments like conventional microloans, allow initial focus on emphasizing that financing does indeed need to be repaid if future financing is to be available. Incorporating microfinance best practices into a *murabaha* product allows the MFI to focus on the know your customer approach familiar to many MFIs and also allows training to be easily incorporated. This training component is vital for the success of the *musharaka* product. Consistent to the fact, the research has shown that Islamic banks operating in few countries of the world provide microcredit overwhelmingly in a fragmented form rather in group based mechanism. This ultimately is not rightly channelized to the purpose for which it is used. Moreover, it is also argued that some Islamic banks do not follow the true principles of Islamic sharia in the process of fund generation and disbursement. Their products are combination of Islamic and conventional banking products. In the backdrop of these facts and the other issues that revolve around the subject matter, the author attempts to offer a viable discourse of Islamic banking system that could be used as a role model by nations for planning, executing and harvesting the benefits of Islamic banking system.

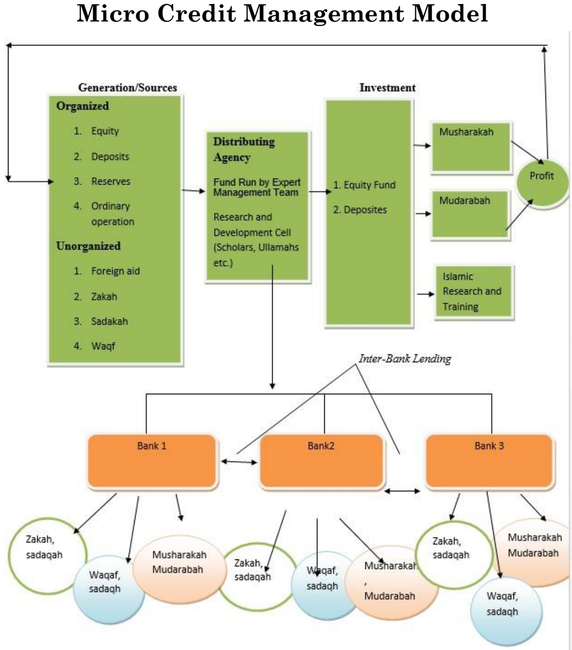
Model building brings forth a scientific justification and mechanism for resolution of any problem provided the elements of problem are operationally quantified (Mehraj 2006). Understandably, development of Microcredit management is a complex phenomenon and demands a careful investigation of whole gamut of subject matter. As expected, a Microcredit Management model must present a detailed mechanism to manage microcredit for achieving the desired goal of social justices and economic well-being. Although various models to this effect have been propounded under both the existing conventional and the Islamic banking system, yet most of them have failed on ground to achieve the desired results. Anwar (1991) views that islamization requires models that connect Islamic norms with modern science and are free from all unIslamic elements whether they be assumptions, hypotheses, postulates and /or theorms. Therefore, the present study makes a humble attempt to offer a viable 'Microcredit Management Model' specifically based on the valid tenants of Islamic Economics (*Ribba Free Economy*) that could go in a long way to fight and eliminate the extreme plight of poverty and social deprivation.

The Assumptions:

The Model rests on the under mentioned assumptions:

- A large section of the society have strong inclination towards the Islamic banking system and as such, they deliberately endeavor to stay away from conventional banking system;
- Depositors, barrowers and lenders significantly dislike interest or Riba. It raises cost of capital, debt burden, chance of risk and default i.e a proportionate relation persists between interest, cost of capital, debt burden, chance of risk and default;
- The penetration of organized Islamic institutional arrangement for generation and disbursement of finance is strongly felt; and
- Developmental programme of Islamic banking system should focus both on economic and social developmental aspects.

Micro Credit Management Model



Elements of the Model

The model proposed is built upon certain valid elements discussed hereunder.

Creation of Central Islamic Bank:

At the very outset, the model proposes to create a structural and cultural Islamic banking panorama in the state. For this purposes, the model primarily suggests to create an Islamic Central Bank in India under which a spiral of Islamic Banking System or network should be established to lay an edifice for spurting culture of Islamic banking in the state. The Islamic central bank would function as an apex banking institution for all the other Islamic banks in the region. The job of the central Islamic bank would be to arrange and allocate resources for the microcredit amongst its member state banks. And accordingly, the central bank would function as an advisor, financer and regulator for the other Islamic banks in the state through a *Sharaih Board*. Strictly, each Islamic bank would deal with the banking products ratified and permitted by the *Sharaih Board* which would comprise the ulamas and scholars of the Holly Quran and the Hadith alongwith the contemporary knowledge of trade and commerce. The Islamic central bank would act as custodian of all the resources and it shall be prudently put to use for microcredit disbursement. For this purposes, the Islamic central bank would devise distinctive microcredit policies for different sources of receipts of which some would be based on *murabaha* , *musharaka etc*

Microcredit Generation:

Microcredit generation refers to identifying the sources through which the finances are arranged to provide the microcredit to the deserving individuals or groups of people. For this purposes, the model suggests that the finances should be generated both from the organized and unorganized sources i.e. its resources base shall constitute the receipts from both organized and unorganized sector. The former entails the receipts from equity, public deposits, while the latter includes the receipts from foreign Islamic countries in the form **of grants, aid, sadqat and Zakat, Waqaf Funds and other voluntary donations**. To raise the finances from formal source, the model proposes that an Islamic central bank should be floated as a public sector undertaking (with major holdings with the government) through a contemporary company formation procedure exercised under the conventional banking mechanism. The funds raised should be disbursed as loans under the murabaha trade agreements.

Microcredit Disbursement:

Microcredit disbursement refers to allocating credit for microfinance to entire Islamic banking spiral operating in the country. The primary job of the Islamic central bank would be to distribute the credit among various banks according to the incidence of poverty in jurisprudence of their operation. Moreover, it incorporates the disbursement of credit among the underprivileged and poor classes of people by the respective Islamic banking institutions in the country according to the principles of *Shariah*. For this purpose, this study proposes a scheme of credit disbursement for different types of receipts/incomes for the poor.

Equity Capital:

Equity refers to an amount contributed by the owners for undertaking business ventures without expecting any prefixed amount of return. The equity holders are the real owners and get dividends only out of profits and cannot claim any return in the event of loss. Such shareholders purely fall under the principle domain of Islamic business and trade. The Quran refers to the money invested in a business enterprise from the stand point of investee as capital (Moustafa, 1991). The authors view that the equity capital of the Islamic central bank should be given as loan (*without Riba*) under profit sharing contours, wherein the bank should receive varying share of profit from the business of the barrower and bear the whole loss in case the entrepreneur fails to earn any profit. The entrepreneur should not be a party to bear the burden of loss for the failed business as he already incurs loss in the form of time and effort (Zaidi: 1991). It is more or less a kind of Murabah agreement for borrower and ***Musharaka*** for the investor. This mechanism or framework is somewhat similar to one propounded by Gafoor (2006). However, it (the mechanism) does not ratify the other varied costs propounded by Gafoor (2006) that lending agency must unnecessarily charge to the barrower.

Deposits:

In the proposed system, the depositors are considered as the lenders to the bank and since Islam does not permit us to take interest therefore they lend without interest but with the assurance that there capital will be returned in full. All Islamic Banks primarily maintain three kinds of accounts

1. The Saving Account/Safekeeping/ *Wadiah*- in this account Principle amount is guaranteed. Since depositors allow the banks to utilize their money at their own risk, no return is promised to depositors since entire risk is born by the bank;
2. The Current Account/ benevolence loan/ *Quard al Hassan*- here the principle amount is guaranteed. However, the banks are not allowed to offer any return to depositors; and
3. The Investment Account/ Profit sharing/*Mudarabah*- here the principle amount is not guaranteed. Investment deposits are accepted for a fixed period or unlimited period of time and the investors agree in advance to share the profits or loss in a given proportion with the bank.

Foreign Aid:

Foreign aid, that more often pours into different under privileged economies, is a very important source of receipt to rehabilitate the poor and deprived class of the society. Under the present microcredit management model, the author views that it is not effectively used for micro credit disbursement and deployment. Alexnder (2008) views these funds arrive in a fragmented form and are being disbursed accordingly. Moreover, the transfer of foreign funds to Islamic states is always looked with doubtful eyes. Many a time these funds are daubed as *Hawala transfers* by some elements. It comes from different channels and reaches to different individuals or groups of people/NGOs who use it according to their own wishes and whims. Therefore, it does not reach the real deserving poor. For this purposes, the study views that these funds must be directly sent to Islamic central bank by foreign donors, where these funds would be pooled and ultimately disbursed through a network of Islamic banks among the poor in a more systematic form. In this context, the study views that the entire foreign aid can become a predominant source to ameloreiate poverty and unemployment, provided these funds are facilitated as soft loans for the purposes of purchasing income generating assets *without Ribba*. The study proposes that funds from this pool of money should be given as loan *free of interest* and the beneficiary should not be asked to return the amount for at least first three years. And only when his position of income has improved, the beneficiary should be called to repay the soft loan in smaller distant time interval installments. Moreover, the individuals who have not progressed should be given second doze of soft loan enabling them to cross the ultimate benchmark of poverty. The foreign aid could also be conveniently used for undertaking social development programmes depending upon the requirements of situation.

Zakat:

Zakat is one among the main five pillars of Islam. It is viewed a vital element of Islamic Economics (Siddqi 1987). Zakat refers to transfer of some excess part of wealth from Sahhbi Nisab (capable of paying) to those who are worth to receive it. The basic philosophy of Zakat is to empower the deserving to consume their basic necessary essentials or give philip to any reasonable small venture. The Quran has specified clearly the categories of people and the avenues entitled to benefit from Zakat. They include the poor, the pauper, the indebted, the wayfarer, the new converts and the avenues have been enumerated as the liberation of slaves, maintenance of Zakat administration and last but not the least "in the path of Allah"(Faridi 1987). The economics of Zakat unfolds that it leads to an upward shift in the aggregate demand function and raises the marginal propensity to consume for those who receive it. While Siddqui (1987) holds that it brings demand function for foreign goods downwards and thereby reinforcing balance of payment stability. Nasir (154:90) and Mahmad Ahmad (188:124) view that Zakat releases the unproductive wealth for productive use. **The true effect of Zakat is that it nullifies the Keynesian Liquidity Preference Doctrine and makes the rate of interest a meaningless instrument of monetary policy.** Here, it is pertinent to mention that Zakat is not a tax only but more an Ibadah. Its dividends are larger than any existing high rate of investment. Zakat is more often viewed an inflexible fixed rate that goes against the existing trends of progressive or regressive taxation system. From Islamic economics point of view Zakat deflates expected rate of return on investment thereby pushes investment from capitalistic ideology to social and economic development of the vulnerable class of society.

Understandably, the Zakat is not prudently utilized to support the poor and the other sections of people for whom it is meant for. Accordingly, Zakat management deserves a careful attention. The model proposes that Zakat needs to be managed in such a manner as to produce cumulative effect on poverty and instantly become an effective instrument of active fiscal policy designated to promote welfare function of public expenditure . In this context, the model views that all Zakat funds must be deposited by a Muslim Umaha of state in the Zakat account of the Islamic central bank through network of Islamic banking institutions in the state. This is because, Zakat in most parts of the Muslims states in India is not collected collectively but is disbursed in a more fragmented form leaving only a negligible impact on poverty alleviation. Therefore, the model views that Zakat funds need to pooled at one place to disburse them among the relevant classes in a more systematic form which would act an means for poverty reduction and fiscal stability.

Social Development:

Social development is a process to improve the intellectual and physical well being of society by inculcating among masses ethical standards, human values, living standards, etc. It is overwhelmingly viewed as a sign of all advanced human civilizations. Therefore, the model focuses to work inclusively both on economic and social front. The model proposes that the Islamic central bank (ISCB) should act as a custodian of social change. In this context, it is suggested that ISCB undertake the following activities for social development:-

- ISCB must establish a network of educational institution and health centers on the pattern of IRF (Islamic Research Foundation) across the state to offer standard and subsidized education and health care facilities to people especially the poor;
- ISCB should establish various training centers to provide training in different areas of engineering disciplines and other allied trades to enable the trained trainees to establish their self employment ventures by

offering them interest free capital, plant , expert advice, etc.; and

- ISCB should constantly work through an organized Islamic group of scholars to eliminate the prevalent social evils to sensitize the Islamic culture and way of living.

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