A new paradigm of Microfinance

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Abstract

One of the most challenging targets set out by the World Bank is poverty alleviation. The most substantial instrument to eradicate poverty is a microloan to those who are not entertain by commercial banks. Microloans are small unsecured loans that promotes entrepreneurial activity among poor's and push them out of vicious circle of poverty. This is the conceptual paper, that provides an investment/return model that will help the poor to get out from the vicious circle of poverty.

Keywords: Poverty, investment, return, microfinance, credit.

Introduction

On April 20, 2013, one of the most challenging targets set out by the World Bank is poverty alleviation. The target is to reduce the poverty headcount ratio from 10.7 percent globally in 2013 to 3.0 percent by 2030. The statistics yielded by the World Bank in 2013 stated that, 10.7 percent of the world population lived on less than $1.90 a day and the poverty profile circumscribe within rural, larger household with more children, employed in agriculture sector, poorly educated, and young population. However, the most substantial instrument to eradicate poverty is a microloan to those who are not entertain by commercial banks. Microloans are small unsecured loans that promotes entrepreneurial activity among poor's and push them out of vicious circle of poverty. Firstly, propounded by Mohammad Yunus a noble peace prize winner for introducing the concept of Microcredit. It involves making small collateral-free loans to poor people who have a strong desire to start a business and make a good living for themselves and their families. These people are usually denied loans by conventional banks because they have no valuable tangible assets that could be used as collateral. Conventional banks usually consider these people as high-risk customers and deny them credit. Yunus believes that the poor are bankable and making credit available to the poor not only improves their livelihood, but it also could increase the welfare of the community. However, this system of microfinancing charges high interest for loans. Demand for micro credit decreases as MFI charges high interest rates on microloans (Robert Cull, Asli Demirgüç-Kunt, Jonathan Morduch 2007). Due to high interest rates factor, poor people face difficulty to repay loan. So that's why an alternative measure can also be taken forward and that is the principle of Islamic banking for helping poor peoples.

Islamic banking was virtually unknown 30 years ago. Recently, Islamic banks operate in 55 countries with estimated deposits of over $100 billion. There are more than 200 Islamic banking institutions in operation around the world and they are one of the fastest growing financial services markets in the Islamic world (Venardos, 2005). What makes Islamic banking distinctive is its adherence to the basic Islamic principle that money should only be used to exchange goods and services and nothing else. Thus, both receipt and payment of interest for using money is prohibited by Islamic law, sharia. Sharia promotes equality and fairness for all members of the society by emphasizing ethical, social, and religious factors. Muslims have special responsibilities toward the poor and are appointed by God to be God's stewards to maintain balance in the universe. As the Prophet Mohammad said, "He who sleeps on a full stomach whilst his neighbour goes hungry is not one of us." Debt is usually central to the difficulties faced by the poor. The Islamic response to eliminating this difficulty is to make loans available to the poor free of interest and collateral. Since Islam requires borrowers and lenders to share the risk of success or failure equitably, loans are made on a profit/loss sharing basis. Islamic banks, which are the major source of loans, have an important responsibility in meeting the credit needs of the poor and in promoting their welfare. Unfortunately, Islamic banks are often not meeting these obligations.

In this paper, the issue of higher interest rate is a key concern of such marginalized, especially when they are learning to stand on their feet. The financial institutions believed that due to higher risk factor, higher interest rate is justified. Yet,

the experience shows that collective and group responsibility towards repayment of loan is an effective tool to ensure higher recovery rate. If the recovery rate improves there shall not be a need for charging higher interest rate. It is against this backdrop that this paper conceptualizes the possibility of Islamic banking profit sharing model to replace the interest charging strategy of micro-financial institutions

Islamic banking

Islamic Banking is based on the principle of profit and loss sharing and forbids Riba (Interest). Islamic bank follows the rules and principles of Islam in all their transactions (Henry and Wilson 2004; Iqbal and Mirakhor 2007).

According to Quran Riba (Interest) is prohibited in all transactions. Dictionary meaning of Interest is money earned on money lent. Quran mentioned Riba in no less than eight different places, Surah Al-Imran chapter number 3 verse number 130, Surah Al-Nisa chapter number 4 verse number 161, Surah Al Baqarah chapter 2 verse number 275 three times, Surah Al-Baqarah chapter number 2 verse number 276, Surah Al-Baqarah chapter number 2 verse number 278, Surah Al-Baqarah chapter number 2 verse number 279. According to Surah Al-Baqarah chapter number 2 verse number 278, Surah Al-Baqarah chapter number 2 verse number 279, if anybody involved in payment and receipt of Riba (Interest), then it is just like waging a war with almighty Allah and with Prophet Mohammad. Riba (Interest) is considered exploitative in Islam because its makes a rich person richer and a poor person poorer (El Gamal 2006).

Some scholars define the detrimental effects of Riba(Interest) in terms of economics. For example, interest rate promotes unemployment in an economy by adding higher cost to the producer of goods and services, higher cost will attract lesser number of workers (Mannan 1986). Further, (Venardos, 2005) argues that international monetary crisis is caused by non-repayment of loans due to high interest rates.

Microfinance

In the early 1970s when social innovators began to offer financial services to the working poor. Microfinance institutions started interventions with those who were previously considered un-bankable with no collateral to offer or with no credit record. Microfinance took birth. It was experienced that given a chance to develop their credit record, not only did clients of MFIs established their credit records but also expanded their businesses and increased their incomes. Microfinance soars income levels of poor's and lift families out of poverty (Nathanael Goldberg 2005). Microfinance not only supports poor families but also capable of nurturing the economy in the aggregate (Shahidur R, Khandker 2005). There is also some evidence on the positive impact of microfinance in Ghana (and generally) on the empowerment of women, increase in respect and decision rights within the family, and increased self-esteem (Cheston and Kuhn, 2002). This financial model has effectively dislodged all conventional thinking and ethos in this regard. Their high repayment rates demonstrated that the poor are equally capable to transform the lives, given the opportunity. (Marc J. Epstein and Christopher A. Crane 2005) presented a model, how many dollars were loaned and whether the borrowers were satisfied with the service of MFI's and finds out that microfinance ensures a good return to society and reduction of poverty. Since then, microfinance has become one of the most sustainable tools in the fight against poverty and deprivation.

In the words of Sinclair (2001), one of the most obvious reason for economic inequality is financial exclusion. Poor and disadvantaged people have no access to capital and financial services, especially affordable credit (Whyley and Brooker, 2004). As a result, poor people could stay in the cycle of poverty for a long time, if not forever. One of the solutions to this problem is microfinancing, first introduced by Muhammad Yunus, an economist in Bangladesh, in the early 1970s. Yunus started a bank called the Grameen (village) Bank of Microcredit. The bank was started based on Yunus' belief that credit is a powerful weapon and poor people's access to credit is crucial for building a just and ethical society where people live with dignity and hope for their future. Yunus (1997) argues that credit unlocks the door to all other important human rights: food, shelter, education, and health care. The transaction costs are high for maintaining credit discipline among borrowers through group pressure and monitoring of borrowers' behaviour, and programs have relied on donors to sustain their operations.

Microfinance: A profit sharing model

With all the appreciation, the world has taken microfinance as a proven powerful poverty alleviation tool. It is one of the important development tools having the potential to be financially self-sustaining when compared to subsidies. However, even after more than 45 years of industry effort, 72 percent, i.e., more than 395 million families, are still without access to microfinance services. however, the given graph will not be covered for current growth rates and miniscule gap covering, the gap will not be covered for decades. The policy makers will have to intervene and for microfinance to achieve its potential as a global poverty alleviation tool, the industry will have to grow to scale.

A hypothetical illustration of permutation/combination of investment and returns stated below: -

Table 1: Hypothetical Illustration of Investment/Return

Number of years	Initial Investment	Interest Charged	Expected Return		Bank share of 20% of profit	
			Case 1	Case 2	Case 1	Case 2
			10% with growth of 5%	20% with growth of 10%		
1	10000 Saving	1300	2000	4000	Grace Period	
2	10000 Credit	1300	3000	6000		
3	20000 Total Investment	1300	4000	8000		
4		1300	5000	10000	1000	2000
5		1300	6000	10000	1200	2000
6		1300	7000	10000	1400	2000
7		1300	8000	10000	1600	2000
8		1300	9000	10000	1800	2000
9		1300	10000	10000	2000	2000
10		1300	10000	10000	2000	2000
Sub Total at 10 years of interval		13000				14000
11		1300	10000	10000	2000	2000
12		1300	10000	10000	2000	2000
13		1300	10000	10000	2000	2000
14		1300	10000	10000	2000	2000
Total at 14 years interval		18200			19000	22000

The table reveals that a fix rate of interest charged in the initial stage of project will lead to outflow of funds. It is not desirable from a point of view of a small business. It may hamper the group spirit and enthusiasm. Consistent outflow of interest will negatively influence redeployment of funds for the growth of business in the initial stage. The earning capacity of the said business may not multiply over the coming years. In fifteen years' time, the financial institution will get a maximum return of Rs 18200/- only charging interest rate at 13 percent on a credit of Rs.10000.

However, taking clue from the principles of profit sharing, the financial institution may decide to enter into a partnership with SHG. In the first instance, this will immensely enhance the confidence level of the SHG. With their small savings of Rs 10000 and an additional credit of Rs.10000/- they may start a business with initial capital of 20000/-.

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