Microfinance through Islamic Banks & Zakah (A Novel Practice)

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ABSTRACT

The failure of the current microfinance programmes in financing with zero interest and eradicating poverty encouraged the authors to look at a recent practice which can achieve such goals. Hence, the main objective of this paper is to present one of the Islamic approaches of microfinance which is currently practised in Sudan and which succeeded in financing with zero-interest through Islamic banks and zakah. This research used qualitative method in gaining some insight into the problem and to find the alternative solution. To achieve this, secondary data was used by referring to annual reports, World Bank reports from relevant web sites, the central bank's policies, published books, articles and journals. The results present the practical Islamic approach of micro-financing through Islamic banks and zakah, thus nullifying the misconception that banks are institutions which are not set up to provide financial services to the poor and needy.

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Keywords: Islamic Banks, Microfinance, Zakah, Zero-interest

INTRODUCTION

Poverty is no longer viewed as only an economic phenomenon, but is universally recognised as a social as well as political problem. The extent or degree of poverty varies from one community to another and of course from one place or country to another. It does not only depend on resource endowments, population size, economic and social policies, but also on the kinds of economic activities that are being undertaken. What is significant is the sort of policies which are formulated to eradicate poverty and to what extent their implementations are sufficiently successful in meeting the objectives. Since poverty prevails in almost every community, the past decades have witnessed different approaches to poverty eradication which have been adopted by different communities, depending on the extent of poverty, resource endowments, ideology, the level of political commitment, etc., (Alhabshi (1996). One of these approaches is the microfinance approach.

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For the past decades, the World Bank Group has partnered with governments worldwide to reduce poverty by providing financial services through many anti-poverty programmes. Among these anti-poverty programmes is the microfinance programme which has become one of the schemes for poverty reduction and economic redevelopment strategies around the world since the 1970s (Van Saten, 2010). The main objective of this microfinance programme is to provide loans to unemployed or low-income individuals or groups, specifically the moderate poor who are usually outside the formal banking system, to start their small business. Hence, millions of people have been accessing the services of formal and semi-formal microfinance institutions (MFIs). As a result, it has become a vast global industry involving a large number of governments, financial institutions and non-governmental organizations (NGOs) aiming to eradicate global poverty in developing countries including Muslim countries. However, all these programmes lend with interest, a situation which creates persistent poverty especially for those who fail to repay on time. According to World Bank statistics (2014), there are more than 500 million people who have benefited directly or indirectly from microfinance programmes in 100 developing countries, including Muslim countries. And these anti-poverty schemes have succeeded in reducing the poverty of people who lived on less than USD1.25 a day from 1.94 billion people in 1981 to 1.91 billion people in 1990 and to 1.22 billion people in 2010. However, the World Bank predicts that even if the current rate of progress is maintained, some 1 billion people will still live in extreme poverty in 2015 (Investopedia 2014).

Since the main objective of conventional microfinance programmes is to lend with interest, which is not accepted in Islam, then what is the alternative Islamic approach to microfinance?.

Theoretically speaking, according to Abdul Rahman & Dean (2013), the present structure of the banking system is not designed to finance the needs of the poorer segments of Muslim society. As such, they suggested that all central banks in Muslim countries review their policies in order to encourage Islamic banks to be engaged in microfinance. Abdul Rahman (2010) further argued that Islam has the potential to provide various schemes and instruments that can be advanced and adapted for the purpose of microfinance, such as *qard hassan, murabahah* and *ijarah* which are relatively easy to manage and to ensure the capital needs of potential micro-entrepreneurs and the poor.

Since the main objectives of Islam is to finance with zero interest, then Islamic microfinance institutions are one of the most suitable and important tools to combat poverty in Muslim countries. Realizing this fact, Sudanese banks entered the field of microfinance in 1994/1995 with the emergence of full-fledged Islamic microfinance supported by the Central Bank of Sudan. During that time, a new act was issued by the Central Bank which encouraged all banks in Sudan to carry out their social responsibility through providing microfinance to small producers, craftsmen, productive households, professionals and low income people through *Musharakah* and *Murabahah*. Since then, microfinancing has been provided by Islamic banks and other financial institutions in Sudan.

LITERATURE REVIEW

There has been much research in microfinance and poverty eradication from the conventional as well as from the Islamic perspective. This section will highlight the views of some writers in discussing the issue from both perspectives.

Wrenn (2005), in his paper mentioned that microfinance is a relatively new concept which emerged in the 1970s in the field of development. Prior to that, from the 1950s to the 1970s, the provision of financial services by rich people or governments was mainly in the form of subsidized rural credit programmes and which usually resulted in high loan defaults, high losses and the inability to reach poor households.

Otero (1999) defined microfinance as a provision of financial services to low-income poor, and very poor self-employed people. Moreover, she added that since its inception in the 1970s, microfinance has evolved in amazing ways, incorporating into its practice social and economic development concepts, as well as principles that underlie financial and commercial markets, which resulted in an increased number of microfinance institutions around the developing world. However, she declared that it would be successful only if it was able to strike the right balance between the two frameworks - development and finance - that underlie its practice.

Chowdhury (2009), while acknowledging the role of microfinance as an important role in providing a safety net and consumption smoothening since borrowers of microfinance can benefit from learning-by-doing and from self-esteem, argued that its impact on poverty reduction remains in doubt.

Hulme and Mosley (1996), while acknowledging the role of microfinance in helping to reduce poverty, concluded that most contemporary schemes are less effective than they could be. They further stated that microfinance is not a panacea for poverty-alleviation and that in some cases the poorest people have been made worse off because of the interest.

Khavul (2010) acknowledged that microfinance is an emerging phenomenon that opens access to capital for individuals previously shut out from financial services. However, he argued that microfinance is poorly understood, and it remains unclear whether it delivers on its promises.

The weaknesses of conventional microfinance has been examined further by Khabir (2014) who in his paper stated that although the key objective of microfinance is providing credit access to the poor, there has been much debate among development specialists regarding what activities actually constitute a micro business and whether or not microfinance is being used merely for consumption smoothing purpose only. He further realized that in many cases the borrowers start by taking loans for micro-business but end up with fulfilling immediate consumption needs, turning microfinance into merely a consumption-smoothing act.

Islam, Mohajan and Datta (2012) stated in their paper that Grameen bank is the largest microfinance bank in Bangladesh. It provides loans to assetless and landless poor people and even for dowry which they believe is against women's rights. They further stated that the rate of interest charged by Grameen Bank is very high and due to this, the poor women cannot use the loan in a high profitable business to bear this burden, so some of the borrowers lose lands and assets to pay for the loan.

Alhabshi (1996), in his paper provides an example of a modern Islamic microfinance through Amanah Ikhtiar Malaysia (AIM) which provides loans to many women and which has been supported by the Malaysian government by providing more funds to AIM in order to carry on its financial goals.

Habib (2004), highlighted that although various policies have tried in the last few decades to mitigate the menace of poverty, it still continues to plague large segments of humanity in general and IDB member countries in particular. In his paper he tried to solve the problem using the Islamic approach and he explained the role of zakah and waqf as the best components in addressing the problem of poverty which has to be studied carefully.

Overview of The Sudanese Economy

Sudan is an African-Arab country located in North Africa, bordered by Egypt in the north and the Red Sea in the North East. It is considered a junction between the Middle East and sub-Saharan Africa. It is characterized with productive lands, sufficient livestock and industrialized sectors.However, Sudan has been facing internal political and economic problems since its independence which ended in July 2011 with the separation of the southern part of Sudan from the northern part. Moreover, the country is facing many economic problems such as a high rate of unemployment (15.9%) a, high rate of illiteracy (29%), lack of good healthcare and relatively lower than average life expectancy of 57 years and a high 46% rate of poverty (Sudan Overview, 2014). In addition, Sudan is still suffering from huge amount of external debt accumulated due to interest on old borrowing. In 2012, the size of its foreign debt rose to USD42 billion due to non-payment and interest accrued as a result of borrowing in the 1970s (Babiker, 2013). As a result, many national and international anti-poverty programmes emerged in Sudan during the last decade, including microfinance to help in eradicating poverty. Understanding the position of Islam on the prohibition of interest/riba and realizing its harmful impact on the Sudanese economy has encouraged the Sudanese government in 1980s to replace its conventional banking system with the Islamic banking system, thus providing zero-interest financing.

Islamic Microfinance in Sudan

The history of the national and international microfinance programmes in Sudan as a policy targeting the poor with financial services is relatively recent. The first international experience of microfinance was the Faisal Islamic Bank which started at the end of the 1970s to provide microcredit services to skilled workers and craftsperson in urban centres. During that time, Faisal Islamic Bank provided loans for micro-financing and charged conventional interest, which was not accepted by the Central Bank of Sudan in the 1980s. Hence an immediate blocking of such programmes was undertaken during that time. Alternatively, a replacement programme was started by Non-Governmental Organizations (NGOs) in the form of providing microcredit to the same groups which were targeted by Faisal Islamic Bank to help alleviate urban poverty and unemployment. This practice took the form of rotating the same funds; specifically, the same amount of debt recovered was reissued as credit to other applicants (Eissa, 2013). Even though many craftsmen in urban centres benefited from this programme, the services by these NGOs were limited due to limited funds for this programme (UNDP, 2008). This encouraged the Sudanese government to find alternative ways to provide Islamic microfinance through Islamic banks and later through both Islamic banks and zakah.

Microfinance through Islamic Banks

In 2001, the Central bank of Sudan imposed a mandatory policy for all banks, public as well as private banks, to allocate 10% of their investment portfolio for microfinance as a strategy towards poverty alleviation. In 2002, the process for microfinance was divided into direct provisions from the government of SP350 million (USD168 million) and the banks (Al Ebeid, 2012). Since currently all banks in Sudan are operating on the Islamic basis, the approach for microfinance is also through Islamic transactions, namely *Murabahah, Mugawalah, Mudarabah, Musharakah and Salam*. Figure (1) shows the structure of the Islamic microfinance approach through Islamic banks in Sudan.

This microfinance model was practised in 2003 and 2004 by 19 public and private banks. Even though it was realised that some of the contributions of these banks was negligible in comparison to their total resources, nonetheless, it is important to note that four banks showed great concern for this programme with the sole mission of stimulating development in those respective sectors (Al Ebeid, 2012).

As seen in Table (1), Agricultural Bank was originally set up to provide credit for agricultural small-holders. Due to the risks involved in dealing with poor peasants, the bank gradually shifted to rich farmers who can offer collateral as a guarantee of repayment. It is currently financing irrigated agriculture which is even less risky than large rain-fed plantations of the rich farmers. With regard to the Farmer Commercial Bank, this bank provides comprehensive banking services for all segments of society with attention to small-scale producers. The primary mandate of Al Nelain Bank, also known as the Industrial Development Bank, is to provide credit for the small industries sector. Savings Bank was originally set up by the Ministry of Social Affairs as a small savings and microfinance bank. For this reason, it shows substantial commitment to microfinance, amounting to nearly 30% of its outlay, as can be seen in Table (1) (Alshafie, 2012).

The success of these banks in providing microfinance through the Islamic mode of finance encouraged the Central Bank of Sudan to establish an independent Microfinance Unit (MFU) in 2007 to organise the microfinance sector. Additionally, in 2010, the Central Bank of Sudan increased the allocated portion of the investment portfolio from 10% to 12% and project finance of SP20,000 for all banks. A mandatory circular was issued for all banks in Sudan stating the following (Al-Zubair 2012).

"Investing 12% at least, of the investment portfolio for each bank, for the year 2012, in financing the projects and programmes of the small finance, micro finance, mini finance and the small finance with a social dimension and encouraging the banks and micro finance extending institutions to reach the targeted segments."

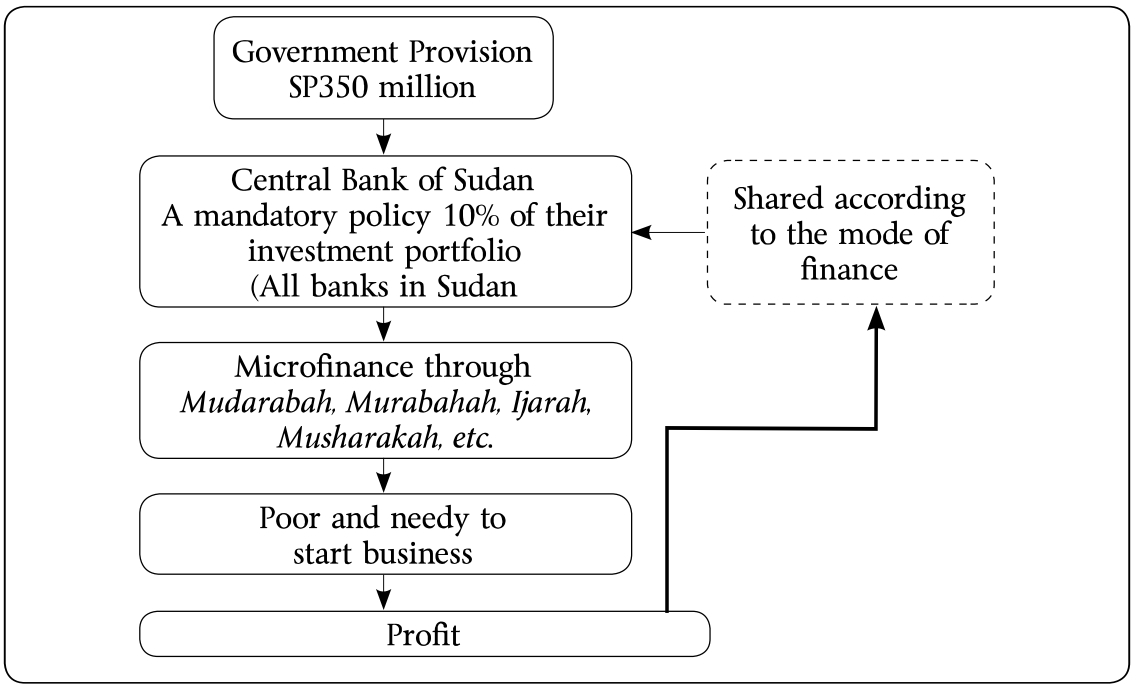


Figure 1: Microfinance through Islamic Banks
Source: Adopted from Abdel Mohsin, (2014)

Table 1: Sudanese Banks and Microfinance (2003-2004)

Banks	No. of Projects		Default Rate %		Microfinance Total Finance %	
Banks	2003	2004	2003	2004	2003	2004
Agricultural Bank	653	864	29	15	0.82	1.14
Bank of Khartoum	15	5	0.03	--	0.02	0.00
Nelain Bank	1,995	1,019	13	17	3.65	2.24
Savings & Soc. Devt. Bank	2,618	5,426	24	18	29.02	29.88
Development Coop. Bank	32	51	--	0.05	0.09	0.13

Continuation of Table 1: Sudanese Banks and Microfinance (2003-2004)

Sudanese French Bank	36	9	.08	54	0.17	0.02
Al Ahli Sudanese Bank	37	46	2	2	0.40	0.60
Tadamon Islamic Bank	23	14	1	1	0.04	0.02
Sudanese Islamic Bank	160	140	5	3	0.65	0.50
Al-Baraka Bank	55	60	--	--	0.08	0.05
Export Development Bank	150	125	5	14	5.36	3.64
Workers Bank	55	33	3	0.35	0.61	0.19
Northern Bank	56	99	--	6	0.47	0.63
Real Estate and Commerce Bank	0	1	--	--	0	0.01
Farmers Commercial Bank	1,547	1,470	3	3	1.00	0.55
Animal Resources Bank	54	24	9	16	0.09	0.05
Omdurman National Bank	140	54	1	--	0.03	0.01
Ivory Bank	--	4	--	--	0	0.12
Gedarif Investment Bank	2	--	--	--	0.01	0
Total	7,628	9,444				

Source: Adopted from the 2006 Annual Report of Central Bank of Sudan

This is followed by the following policies from the Central Bank of Sudan:

- Introducing guarantee services via insurance companies according to the micro-finance insurance policy document in addition to the applicable guarantees.
- Setting up Kafalat Corporation, with a capital of not less than SP200 to render guarantee services to wholesale microfinance for the purpose of encouraging the banks to extend wholesale finance to microfinance institutions in the states and to the targeted sectors.
- Supporting the banks specialized in extending microfinance services and setting up and sponsoring microfinance institutions in all of the states.
- Contribution by the Central Bank to the capacity building and training project for banks and institutions which extend microfinance in addition to provision of training to micro finance recipients (enabling and employing one thousand graduates to work in the banks as microfinance officers).
- Granting the graduates' projects first priority of financing from the resources earmarked to microfinancing from the banks and setting up special windows for financing the graduate projects in all the micro financing institutions in the states.
- Bolstering the graduates' projects portfolio and developing it by extra resources, not exceeding SP50 million.

Moreover, for Micro and Mini Finance Policies, the following polices were issued:

- Encouraging microfinance to contribute to achieving economic and social development by increasing the contribution of the microfinance projects to the gross national income, the provision of employment opportunities, alleviation of poverty acuteness and achievement of social justice.

- Providing finance to women, graduates and youth projects, laying down the principles of social justice, distributing wealth between the population groups and segments and the various geographical areas as a stimulus for encouraging a reverse migration to the rural areas and bringing about stability, integration and settlement.
- Facilitating access of the micro and small finance services to the weak segments incapable of accessing the official financial services, through electronic transfers, mobile branches, rural agencies and intermediaries; working toward building confidence in clients founded on project quality, credit date, salaries and pensions as a guarantee for financing; in addition to reinforcing the role of small savings as a guarantee for granting and recovering the finance.
- Stimulating and supporting the establishment of micro finance institutions in the states, encouraging banks and the microfinance institutions to apply best practices for achieving sustainability of microfinance, and, popularizing the banking culture which enhances the capacities of microfinance and small finance.
- Striving to create an enabling environment for stimulating small savings and promoting the level of savings and investment through mobilization of capital from individuals, societies and non-government organizations and endeavouring to obtain a special exception from the Taxation Department to exempt microfinance projects from all Federal and State taxes throughout the repayment period.

Hence in 2012, this policy was implemented by nine banks, i.e. Agricultural Bank, Savings & Social Development Bank, Islamic Co-operative Development Bank, Workers Bank, Real Estate and Commerce Bank, Farmers Commercial Bank, Animal Resources Bank, Industrial Development Bank and Family Bank which was established by the Central Bank of Sudan in 2008 solely to provide services on microfinance basis and to the targeted category. Foreign and semi-foreign banks are still far from realizing the 12% ratio. It is clear that banks who met, or even exceeded, the ratio are government banks or those with a large component of capital owned by the government (Central Bank of Sudan, 2012).

In general, the modes of finance used by these banks for microfinance are *Murabahah, Mugawalah, Mudarabah, Musharaka* and *Salam* each for a specific purpose as shown in Table 2.

The sectors which have been funded through microfinance through these banks are the agricultural, service, commerce, real-estate, professing and transport sectors as seen in Table 3.

Among the microfinance projects which were provided by the Savings & Social Development Bank in 2013 in the different states are for small producers of Arabic Gum, for working women, and for the Alzahraa project for eggs production as shown in Table 4.

Microfinance through Diwan Al-Zakah

Diwan al-Zakah (Zakah Chamber) was

established by the government in 1990 as a centralized body to collect and to distribute zakah money to the eight recipients of zakah as mentioned in al-Quran in Surah Al-Tauba (9:60). Since then zakah has been compulsory for all eligible Sudanese Muslims working inside as well as outside the country and for all foreign Muslims working in Sudan. The first amount collected in 1990 was SP27.8 million, which increased to SP19.2 billion in 2003 and reached SP232 billion in 2010. Out of this amount, 61% of the collected zakah is allocated to alleviate poverty through paying directly to the poor and the needy in cash. Recently and due to the call for microfinance, 40% of that amount is paid directly to the poor and needy and 21% is given in kind as a means of production and subsistence schemes rather than in the form of handouts to enhance consumption (Awad, 1993). Hence, through this scheme, zakah has become an income-generating instrument for many families as it helps them to come up with their own small business (Nur, 1996). In this case, the poor are given not only what satisfies their immediate basic needs but they are also provided with tools and equipment to start their small business and to earn income rather than rely on charitable handouts.

The success of this scheme encouraged Diwan al-Zakah to be involved in micro financing together with the Islamic banks in Sudan. In 2010, Diwan al-Zakah was involved with 32 banks in providing microfinance to needy families. In total, this scheme allocated SP200 million (USD75 million). SP150 million was provided by the banks and SP50 million was given by Diwan al-Zakah. Through this scheme they managed to finance 83,000 families who have become active members in society. This scheme gives qard-hassan loans or benevolent loans which have to be repaid to Diwan al-Zakah. Although this approach has been criticized by some scholars since zakah should be given as assistance the poor and not

Table 2: Modes of Finance Using Microfinance

MODE OF FINANCE	PURPOSE
Murabahah	Implemented when customers wish to buy new assets, (e.g. machines, equipment and livestock like cows and goats)
Mugawalah	Implemented when customers are in need of money and labour at the same time, (e.g. building of a room or a shop, maintenance of a car digging a well, etc).
Mudarabah	Implemented in the case of financing groups or associations that have had previous successful experiences with the bank in the domain of granting microfinance in murabahah mode
Musharakah	Represents partnership between the bank and its customers in the capital and management of a project
Salam	Implemented in the financing of small farmers in both rain-fed and irrigated sectors

Source: adopted from E-Source, http://198.20.244.191/~ssdbank/sudasiteen/index.php/microfinance/microfinance services/3002-getting_started.html

to be repaid to zakah authorities (Bakheet, 1997), it is realized that this scheme has succeeded in empowering families, nevertheless, this scheme needs further improvement according to the teachings of Islam. Figure 2 shows a combined structure of Microfinance through Diwan al-Zakah and Islamic Banks.

Besides providing funds, Diwan al-Zakah organizes courses and prepares a manual for training in microcredit. In fact, almost all the activities of this institution are directed towards poverty alleviation and through their cooperation, Diwan al-Zakah and the banks have managed to eradicate poverty

Table 3: Sectors Funded though Microfinance Services

SECTORS	SIZE OF FINANCE IN MILLION SUDANESE POUNDS (SP)	%
Agricultural	26.2	20
Services	68	52
Commerce	16	12
Real-Estate	9	7
Professing	7.8	6
Transport	3.9	3
Total	**130.9**	**100**

Source: adopted from E-Source, http://198.20.244.192/~ssdbank/sudasiteen/index.php?news=3017

Table 4: Microfinance Projects provided by Savings & Social Development Bank

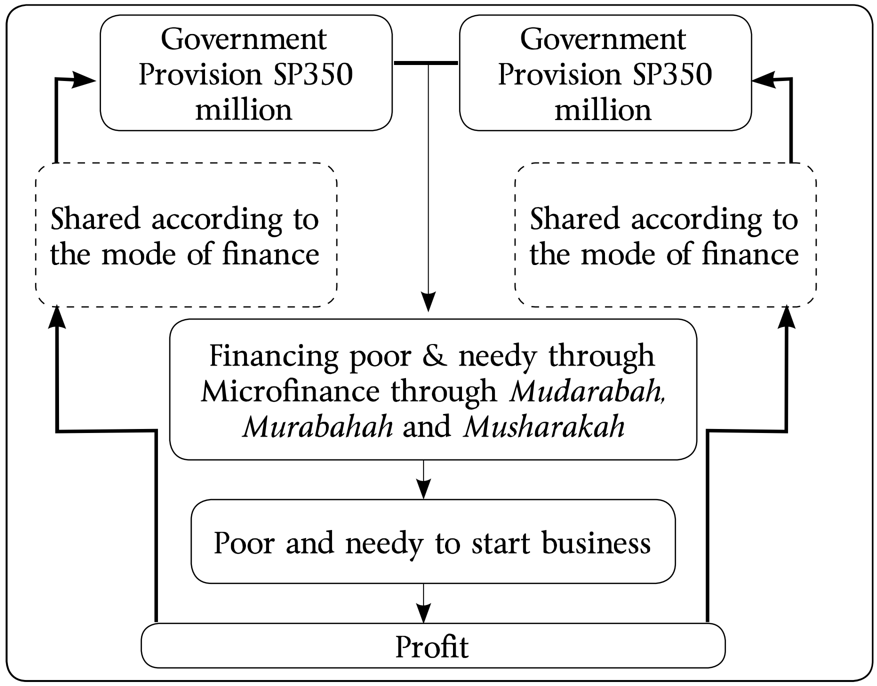
MICROFINANCE PROJECTS	SIZE OF FINANCE SUDANESE POUNDS IN MILLIONS	MEDIUM OF SIZE OF FINANCE SUDANESE POUNDS (SP)	BENEFICIARIES INDIVIDUALS/ HOUSEHOLDS
Arabic Gum Small Producers (States: South & North Kordofan, Sinnar, North Darfur)	5.0	500	3358
Womens Associations (States: North Kordofan and Kassala)	4.7	3117	1479
General Union For Sudanese Women (All states)	5.4	1226	4402
Alzahraa egg production (Shendi and River Nitle)	5.0	7000	600

Source: adopted from E-Source, http://198.20.244.192/~ssdbank/sudasiteen/index.php/microfinance/index.1.html

among 120,000 families with microfinance services (Alshafie, 2012).

In general it has been estimated that the number of beneficiaries that benefited from microfinance in 2013 reached more than 7 million in the different states (SDB, 2015).

Figure 2: Microfinance through Diwan al-Zakah and Islamic Banks



Source: Adopted from Abdel Mohsin (2014)

CONCLUSION AND POLICY IMPLICATIONS

The paper highlights the fact that even though conventional microfinance schemes have succeeded to some extent in financing "unbankable" people, yet they fail to alleviate the poverty of the poor and the needy. Besides, they burden these people with interest which is not only prohibited in Islam but will also ensure persistent poverty of those who fail to repay their due amount. Looking at the alternative Islamic approach in solving such issues, the paper provides the current practice of microfinance through Islamic banks and zakah in Sudan. This Islamic microfinance approach uses almost all types of Islamic transactions, such as *Murabahah, Mugawalah, Mudarabah, Musharakah and Salam,* and hence, succeeds not only in financing the poor and the needy with interest-free microfinance but also in helping many families to start their own small business and come out of poverty. Besides, the new strategy of zakah distribution of using a portion of its fund in the form of financing productive projects through qard-hassan loans or benevolent loan for the poor and needy instead of giving it all in the form of consumption handouts will open the door for more in-depth research to study this approach for the benefit of the poor and needy. We hope that the current practice of microfinance through Islamic banks in Sudan will change the misconception of the relevant features of today's banks and financial institutions to provide financial services to the poor and the needy. ■

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