

# The Potential of Islamic Microfinance in Uplifting B20 Communities in Malaysia: A Review of Literature

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## ABSTRACT

The purpose of this study is to review the Islamic microfinance model that best suit the bottom of the wealth pyramid (B20) communities. Islamic microfinance products and services that are friendly to the B20 communities are crucial to ensure they are not lacking behind from the current development where everybody has access to financial services. Most current Islamic microfinance products use debt-based financing that similar to banking products. These products not suitable to the B20 communities because it creates debt and burdens them to pay back the financing. This paper reviews past literature to determine the Islamic microfinance model through Scopus, Google Scholar, and ResearchGate platform. The search criteria are confined to English documents that are within the period of 2000-2020. Articles that did not score or did not convince that the subject of Islamic microfinance has been applied in the Islamic economy, Islamic finance, Islamic financing products, and economic development are excluded. Appropriate search keys are used to get better results. The findings inform that contemporary scholars show a robust commitment to the themes of the result during the stated period. Equity-based financing via *musharakah mutanaqisah* is seen as the innovative Islamic microfinance model that suits the B20 communities compare to debt-based financing.

**Keywords:** *Islamic Microfinance, B20 Communities, Malaysia*

## 1.0 INTRODUCTION

In Malaysia, distribution of wealth is a sensitive issue due to the socio-economic-political structures of the country where the majority ethnic group, the Bumiputera 66.4% (of which 82.2% are Malays), who relatively hold the political power, still lower average income compared to the minority ethnic Chinese (25%) who dominate the economy. In 2014, 60% of the adults in the top 1% income group are Chinese, while 33% Bumiputera, and 6% Indians (Khalid & Yang, 2019). The income gaps between the racial groups, between urban and rural areas and between regions were still wide. Based on the Household Income and Basic Amenities Survey 2016 (Department of Statistics, 2017), shows that there is a gap

between states, rural and urban, and between racial groups. The result shows that Kelantan, Kedah and Perlis are far behind the other states in Malaysia in terms of mean monthly household income. Mean monthly household income for B40 is only RM2848 compared to M40 RM6502, and T20 RM16088 (Department of Statistics, 2017). The gap between the B40 and T20 is huge, approximately 82% difference. It shows that there is still a gap in wealth circulation in the society. A study found that the gross wealth per capita of bottom 20 percent is 0.2 percent of the total household wealth, this figure for bottom 40 percent is 7 percent while the top 10 percent hold 40 percent of the wealth distribution (Khalid, 2014; Salih, 2014). Nevertheless, mean income for B20 at national level is yet to be researched due to scarcity of data and difficulty to reach

the community. This issue is important to be investigated to provide us with clear information related to poverty in Malaysia, particularly around Kelantan, Kedah, and Perlis as well as to guide financial and social organizations to develop specific social-economic programs to free the targeted community from poverty.

There are a lot of initiatives done by the government to reduce the gap. One of it is through micro financing. The term refers to the providing small financial services in order to help low-income communities. The aim of microfinance is to help hardcore and low-income communities to get out from the poverty trap and help them improve their standard of living. The micro financing is offered by government sponsored institutions such as Amanah Ikhtiar Malaysia (AIM) and TEKUN Nasional, banking institutions such as Bank Simpanan Nasional (BSN), Maybank, Bank Rakyat and CIMB Bank under the micro financing scheme introduced by Bank Negara Malaysia. Most of the Micro Finance Institutions (MFIs) charge quite high for their clients around 4% to 20% because of the high cost of running a microfinance program. In addition, Ar Rahnū scheme is also one of the micro finance products, for instance, ar rahnū provided by Yayasan Pembangunan Ekonomi Islam Malaysia (YaPIEM). However, ar rahnū is less accessible because they need to mortgage the jewelries such as gold and silver.

Islamic microfinance products and services that are friendly to the B20 communities are crucial to ensure they are not lacking behind from the current development where everybody has access to the financial services. The current Islamic microfinance products offered in the market are based on replication from Islamic banking products that need the borrowers to pay back their loans on time based on the table of repayment. However, microfinance clients especially the B20 are different where most of them are self-employed who don't have a fixed monthly income, and the incomes are mostly seasonal depending on the sector of economics available within their contexts. For example, microfinance clients in agricultural activities received their income when they sell the crops

and it depends on the quality, quantity, and economic seasons of the crops. Islamic microfinance needs to treat their clients based on their income sector.

Islamic microfinance is a new sector in Islamic finance. It has great potential to expand where it is estimated that 72% of the population living in predominantly Muslim countries do not use financial services, because they do not follow the precepts of Islam. As at 2015, Islam has about 1.8 billion adherents, making up about 24.1% of the world population (Lipka & Hackett, 2017). Islamic microfinance is an Islamic financial service based on shariah-compliant to the poor and needy people who are left behind from the normal banking sector because they are lack collateral. Islamic microfinance is an important tool for poverty eradication and improving economic growth and development of the needy people. Islamic microfinance is free from *riba* (interest) and use Islamic contract such as profit and loss sharing contract (*mudarabah* and *musharakah*), leasing (*ijarah*), interest-free contract (*qardhul hassan*) and mark-up price contract (*murabahah*) (Obaidullah, 2008). It different to the conventional microfinance that charge high interest rate to their clients. Thus, Islamic microfinance is a credible alternative which allows hardcore poor populations to have access to basic financial services at low cost. Therefore, this study tries to review Islamic microfinance model, which is suitable, affordable and accessible to the hardcore poor (B20). Limited studies have investigated the Islamic microfinance model as compared to the conventional microfinance model (Fianto et al., 2018; Norma & Dzuljastri, 2013).

This paper is divided into 5 sections. Section 1 discusses the introduction followed by the history of microfinance in section 2. Section 3 explains the Islamic microfinance and the potential of Islamic microfinance products for B20 communities in section 4. This paper ends with conclusion in section 5.

## 2.0 THE HISTORY OF MICROFINANCE

Microfinance has been started in the 1980's when the establishment of Grameen Bank by Professor Muhammad Yunus in Bangladesh. It then spread to other countries including Malaysia as an efficient strategy to reduce poverty. Microfinance has been recognized as an essential socio-economic and financial mechanism for poverty alleviation, promoting entrepreneurial development and increasing the profile of disadvantaged people in numerous countries throughout the world (Hossain, Rees & Millar, 2012). Microfinance serves to promote rural livelihoods and urban poor by the creation of entrepreneurship opportunities that encourage the reduction of unemployment through creating potential business based on their interest and skills. Microfinance is targeted to poor people because these people usually lack collateral, no steady employment and a verifiable credit history, which therefore, cannot even meet the most minimal qualifications to gain access to normal banking. Besides, it can avoid poor people from illegal lending sources such as moneylender and loan shark that charge exorbitant/excessive interest rate (Norhaziah & Mohd Noor, 2012). Microfinance is one of the important components required to get sustainable micro enterprise besides technical support, training, technology, input supplies and market access.

Microfinance is offered by different types of institutions namely formal financial institutions such as commercial banks, savings bank and insurance companies, semi-formal financial institutions such as credit unions, village banks, and cooperative banks and informal financial institutions such as local moneylenders, pawnbrokers, Self-Help Groups and NGOs. In 2018, 139.9 million borrowers benefited from the services of MFIs, compared to just 98 million in 2009. Of these 139.9 million borrowers, 80% are women and 65% are rural borrowers. The proportions remained stable over the past ten years, despite the increase in the number of borrowers. The global market for Microfinance is projected to reach US\$313.7 billion by 2025, driven by the

rising inequality in wealth distribution and the resulting increase in the number of unbanked people (Global Microfinance Industry, 2020). Many research studies proved that microfinance can improve the standard of living of the poor and get them out of the poverty trap (Ariful, Atanu & Ashiqur, 2017; Norhaziah & Mohd Nor Shariff, 2012; Suraya Hanim Mokhtar, 2011; Khandker, 2005; Mainsah, Heuer, Kalra & Zhang, 2004; Matin, Hulme & Rutherford, 2002). Ariful et., (2017) found that microfinance program has a significant positive impact on household income, expenditures and savings. They revealed that the level of education plays an important and statistically significant role in increasing the household income, expenditure and savings.

Many studies prove the positive impact of microfinance programs in both economic and social impact. However, a significant portion of past literature also shows that microfinance has met with limited success in bringing sustainability in the social uplift of its clients. The major failure of conventional microfinance is inability to ensure the end use of microfinance loans and target the abject poor. Ensuring the end use in microfinance becomes critically important, as any consumption use versus the intended productive use of microfinance loans has great potential to take the poor into a debt spiral instead of uplifting them from poverty (GIFR, 2013). It has been proven that it is not only the financing gap but the lack of social intermediation which is a major hurdle towards improving the social status of those below the poverty line (GIFR, 2013). Social intermediation is the process in which investments are made in the development of both human resources and institutional capital with the aim of increasing self-reliance of marginalised groups, preparing them to engage in formal financial intermediation (Dusuki, 2008).

In addition, the misuse of loans leads to indebtedness instead of uplifting them from the poverty trap. Whereas, to maintain the sustainability of the MFIs, usually they will charge high administration costs up to 30% (Fersi & Boujelbéne, 2016). Charging high and

fixed interest on loan is prohibited in Islam. It has suppressed the poor to pay back their loans. Besides, MFIs must maintain the repayment rate to secure the funds because most of them are NGOs that received funds from government and donors. It drags them to give loans to not very poor to ensure they can pay back the loans. There is a major debate on the issue between financial sustainability and poverty reduction. Some scholars opined that microfinance should be financially sustainable while others argue that the objective of microfinance is not profit-oriented but rather poverty reduction (Regassa & Negash, 2014; Ayayi & Sene, 2010; Mersland & Strom, 2009). Besides, conventional microfinance offer microcredit based on *riba* which is *riba* is prohibited in Islam cause many Muslims denied conventional microfinance. Even if the finance is made available, some poor folks are voluntarily excluded because of the nature of the product (Adewale & M. Daud, 2010).

### 3.0 ISLAMIC MICROFINANCE

Islamic microfinance is based on profit and risk sharing, fixed prepayment rates, and transparency to safeguard social welfare and justice. The aims of Islamic microfinance are to help the poor and ensure equitable distribution of wealth and enhance social welfare. The application of Islamic microfinance is still lacking where majority of the microfinance institutions offer microfinance based on interest charge (*riba*). Abdul Rahim (2007) suggested equity financing via *mudarabah* and *musharakah*, savings schemes via *wadiah* and *mudarabah* deposits, money transfers such as through *zakat* and *sadaqah*, and insurance via *takaful* concept should be apply in designing Islamic microfinance. Meanwhile Ahmad Kaleem and Saima Ahmed (2010) proposed charity-based Islamic microfinance institutions where it will be financially and socially sustainable as these are to be based on the concepts of brotherhood, local philanthropy, and volunteer services. Salwana et al., (2013) proposed a shariah compliant microfinance product for Islamic banking in Malaysia. They

propose *ijarah*, *musharakah* *mutanaqisah*, *murabahah* and *mudarabah* financing. It states that many Islamic financial institutions prefer to use *murabahah* because it requires no credit record of the clients, there is existence of well-defined contracts and lower administrative cost (Salwana et al., 2013). This leaves the application of other contracts to fully utilize such as the potential of *musyarakah* and *ijarah* financing. Norma Md Saad and Jarita Duasa (2010) found that there is a great demand for Islamic microfinance products in Malaysia. The need for developing Islamic microfinance products is also stressed by Hassan, Mahknecht and Michal (2011). Islamic microfinance providers should develop new Islamic microfinance products to solve a variety of financial problems in conventional microfinance.

BMT (Baitul Maal Wa Tamweel/ Islamic Financial Cooperative) and BPRS (Shariah People Credit Bank) are the main players of the shariah microfinance institution in Indonesia. BPRS is a bank which receives sufficient support, regulation, and monitoring from the Central Bank. It is a micro-banking who operates in specific local districts providing micro-financing, savings and other related financial products to local communities under Bank Indonesia's supervision and regulation. Whereas, BMT has a unique character: this community-based organisation has a cooperative legal base and providing financing services to the low-level society with more flexibility and faster than banks. Usually the establishment of BMT is initiated by the local community leaders, who are concerned with the development of local communities through providing financial access to the poor and to micro- and small enterprises (Ascarya et al. 2007). BMT also helps promote Islamic values in economic activities in their financing products. Previous studies show that BMT has contributes to the development of the microenterprises (Chokro & Ismail, 2008; Sakai, 2010; Nur Indah Riwayatanti, 2014; Muhammad Akhyar Adnan & Shochrul Rohmatul Ajija, 2015). Their findings reveal that BMT financing is effective in reducing poverty. Most of the respondents can increase their income after receiving BMT financing.



Products of BMT, especially *bay bithaman ajil* and *mudarabah* have empowered the poor in various productive businesses and have been able to reduce the extent and severity of poverty.

#### 4.0 THE POTENTIAL OF ISLAMIC MICROFINANCE PRODUCTS TO B20 COMMUNITIES

The concept of Islamic microfinance that based on Shariah is not questionable since it in line with the Islamic religion where Islam prohibits *riba* in any transactions. Islamic microfinance can mobilize various forms of deposits such as *wadiah* (safekeeping), *qard al-hassan* (benevolence loan) and *mudarabah* (profit sharing) (Siddiqui, 2001). Under *wadiah* mechanism, the deposits are held as *amanah* (trust) and utilized by the Islamic microfinance institution (Islamic MFI) at its own risk. The depositors are not entitled to any return since the profit or loss resulting from the investment of these funds is entirely belonged to the Islamic MFI. Another model is using *qard al-hassan* mechanism, whereby the funds deposited in the Islamic MFI is treated as a loan by the depositor (Siddiqui, 2001). Here, Islamic MFIs shall have to guarantee the principal amount, but is not allowed to offer any return to depositors. Besides, Islamic MFIs can offer a wide-array of Shariah-compliant financing instruments addressing various needs and demands of the client especially among the poor entrepreneur. These instruments can be broadly divided into: participatory profit loss-sharing modes like *mudarabah* and *musharakah*; sales-based modes like *murabahah* (cost plus sale), lease-based modes like *Ijarah* and benevolence loan (Siddiqui, 2001).

*Murabahah* is the most popular and widely used Islamic financing technique (Asutay, 2007; Dusuki & Abdullah, 2006) perhaps because it is relatively simple to apply, certainly when compared to other Islamic financing techniques. *Murabahah* is not based on a profit-loss sharing scheme. It is based on cost plus markup pricing. In *murabahah*, the financier buys the product on behalf of a client

and then adds a percentage to the cost and resells it to the client. The client then promises to pay it back in a pre-specified time period or in instalments. The financier acts like an intermediary between buyer and seller and does not share in profits or losses (Ajaz Ahmad Khan, 2008). However, there is some skepticism towards this particular mode of financing and indeed it has been argued that a fixed mark-up it is similar to interest (Ahmed et al., 2016; Zandi et al., 2012). To ensure this contract is shariah compliant, the financier must own physically the tangible asset before reselling to the buyer and the buyer must know and then agree to the purchase and resale prices. The financier owns the asset purchased until the last instalment is repaid, whereupon ownership is transferred to the buyer. The concept is much similar to the Islamic banking products (Fianto et al., 2018). According to Obaidullah (2008), Islamic MFIs across the globe utilize a variety of Shariah-compliant mechanisms, such as *murabahah*, *bay bithaman ajil* (BBA), *bay al mu'ajal*, and *bay al salam*. All these modes of financing create debt among the entrepreneurs and burden them to repay the financing on time. Whereas, Haron and Shanmugam (2001) mentioned debt-based financing such as *murabahah* and BBA is not sufficient to reflect Islamic business philosophy.

*Qardhul Hasan* or benevolent loans are interest-free loans that are very encouraging in Islam. The Quran clearly encourages Muslims to provide *qardhul hasan* to "those who need them" as mention in the Surah Al-Hadid, Ayah 11.

*"Who is he that will give Allah qard al hasan? For Allah will increase it manifold to his credit"*

In *qardhul hasan*, the borrower only repays the principal however Islamic MFIs are allowed to charge a service charge for administration of the loan. The service charges are not profit, they are actual costs in respect of such items as office rent, salaries, stationary, etc. Islamic law allows a lender to recover from the borrower the costs of the operation over and above the principal. The borrower usually has to repay the loan within a certain time period.

The financier of the *qardhul hasan* not only gives financial support to the borrower but also provides moral support. These loans are often given to charitable organizations or people with sudden or unexpected need for funds (death, natural disaster, new child). Microfinance institutions can provide this scheme to the entrepreneurs who need small start-up capital and have no business experience. The scheme is also relevant for micro entrepreneurs who need immediate cash and has good potential to make full settlement. Here, the Islamic MFI will bear the credit risk and they need to choose the right technique to ensure repayments will be received as agreed (Shahinpoor, 2009).

*Ijarah* by definition is a long-term contract of rental subject to specified conditions as prescribed by the Shariah. *Ijarah* or leasing is when the Islamic MFI buys the product and leases it to the entrepreneur for a certain number of months or years (Shahinpoor, 2009). The lease arrangements, their terms and conditions, are agreed to by both parties. The *ijarah* contract is terminated as soon as the asset ceases to give the service for which it was rented, or the leasing period comes to an end and the physical possession of the asset and the right of use reverts to the financier. In some *ijarah* cases, the customer has an option to buy the product from the bank (Norma, 2012). In this case, the lease payments could apply to the purchase of the product. Unlike conventional finance lease, the Islamic MFI not only owned the asset but takes the responsibility of monitoring the used of asset and discharges its responsibility to maintain and repair the asset in case of mechanical default that are not due to wear and tear. The Islamic MFI should first purchase the asset prior to execution of an *ijarah* contract. The institution takes possession of the assets and subsequently offers the asset for lease to customer. The institution then is responsible for the risks associated with the asset. For *ijarah*, the Islamic MFI may be exposed to settlement risk where the entrepreneur as a lessee is unable to service the rental as and when it falls due.

Islamic microfinance initiative may also mobilize funds through participatory

models such as *musharakah* and *mudarabah*. There is a great potential to attract depositors amongst the rich who intend to do charity via Islamic participatory approach of risk and profit sharing. In *musharakah* model of fund-raising, public can buy shares and become owners of the whole microfinance program initiated by Islamic MFIs or choose specific financing project of their choice. Islam offers mechanisms for redistribution of income and wealth and enhancement of social inclusion, so that every Muslim is guaranteed a fair standard of living. *Musharakah* can also be used for assets or working capital purpose. At the end of the production cycle, or season, the costs of production are deducted from the revenue, and a certain percentage is earmarked for management fees, while the rest is divided between the partners according to their percentage investment in the share capital or other agreed division. If the entrepreneur wholly manages the project, the management fees go to him or her, in addition to his or her profit share. If the financier is involved in management, part of the fees is paid to the financier (Ajaz Ahmad Khan, 2008). The main challenge of *musharakah* is many micro entrepreneurs do not have proper accounting in recording their profit and loss that may they record less profit than actual or report greater losses than actual. It became a burden for the Islamic MFI to monitor and following up the micro entrepreneurs' transaction.

Meanwhile, in *mudarabah*, the financier does not participate in the management of the enterprise nor are they allowed to request collateral to reduce credit risk. The financier is entitled to a percentage of the profit or loss outcomes of the enterprise. Profit has to be shared in a proportional basis and not a lump-sum amount and there is no guaranteed rate of return. The financier is not liable for losses beyond the capital that he has contributed to the enterprise. The entrepreneur is not liable for losses beyond the loss of time and effort used in running and managing the enterprise unless it is proven that the loss is as a result of the negligence or mismanagement of the entrepreneur (Shahinpoor, 2009). The main difference between *mudarabah* and *musharakah* is under

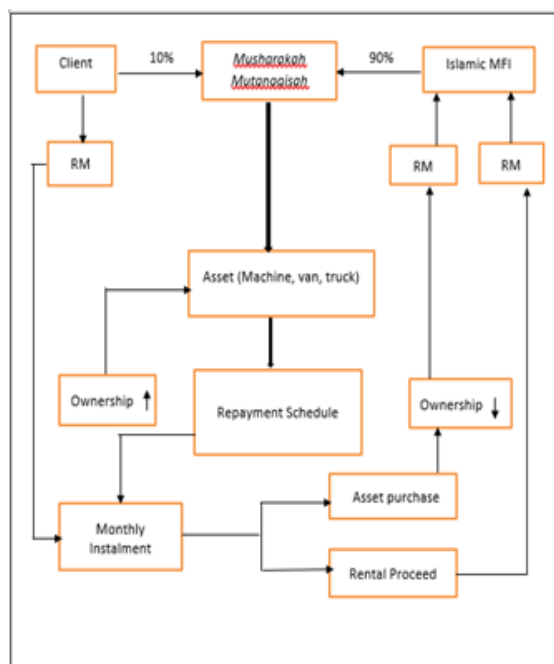
*musharakah*, the entrepreneur adds some of his own capital to what is provided by the financier. The two sides of the transition are partners and both risks losing their capital. In the case of *musharakah*, the profit shared is based on an agreement between the two parties and any gain or loss is divided based on the proportion of each party's capital contribution (Shahinpoor, 2009). Whereas in *mudarabah*, the entrepreneur offers his or her labour and skills only, without any contribution in cash or kind, and any losses are borne entirely by the financier. However, in a *musharakah* can be continuous until the end of a project's life span or it can be a diminishing partnership (*musharakah mutanaqisah*), in which a case the entrepreneur is allowed to buy out the financier's share gradually. For example, where the financier provides the land and the farmer takes care of planting and harvesting the fruit trees. The output of the fruit trees is divided between the two parties based on their contributions. Fianto et al., (2018) reveal that equity financing performed better than debt-based financing. They investigate the impact of Islamic microfinance on rural households' welfare in Indonesia.

The most suitable technique of *musharakah* for microfinance especially to the B20 could be the concept of diminishing partnership or *musharakah mutanaqisah* (Ariff et al., 2012; Norma & Dzuljastri, 2013). In the case of *musharakah mutanaqisah*, capital is not permanent and every repayment of capital by the entrepreneur will diminish the total capital ratio for the capital provider. This will increase the total capital ratio for the entrepreneur until the entrepreneur becomes the sole proprietor for the business. The repayment period is dependent upon the pre-agreed period. This scheme is more suitable for the existing business that needs new or additional capital for expansion (Shahinpoor, 2009). Many scholars suggest *musharakah mutanaqisah* is an innovative model of financing and should be a preferred instrument of financing in Islamic microfinance such as Zuhaira and Ab Mumin (2015); Norma and Dzuljastri (2013); Muhammad Abdurrahman Sidique (2008) and Gaffar Abdalla Ahmed

(2008). In both methods (*musharakah* and *musharakah mutanaqisah*), the risk is shared by both sides of the transaction and the participants must follow all Islamic rules and restrictions. The parties involved, therefore, could not invest in any good or service that is contrary to Islamic ethical standards and values. Table 1 shows the proposed model of *musharakah mutanaqisah* that could be implemented to the B20 communities.

The proposed model is not based on debt like current implementation in microfinance. The *musharakah mutanaqisah* contract consists of two separate contracts. First, a client enters into an agreement with Islamic MFI under the concept of joint ownership (*Shirkat-al-Mulk*). Under this part of the agreement, the customer pays the initial share (for example, 10% of the price of an asset) to co-own the asset, and at the same time, Islamic MFI provides funds for the remaining 90% of the share. The client will then gradually buy back the financier's 90% share at an agreed portion periodically until the asset is fully owned by the client. Second, Islamic MFI leases its share (90%) in the asset ownership to the client under *ijarah*, i.e. by charging rent. The client agrees to pay the rental to the Islamic MFI for using its share of the asset. The periodic rental amounts are jointly shared between the client and the Islamic MFI according to the percentage of shareholding at the particular times which continues to change as the client redeems the financier's share. The client's share ratio would increase after each rental payment due to the periodic redemption until he/she eventually fully owned the asset as shown in the table 1. The portion of percentage between entrepreneur and Islamic microfinance institution is based on how much the entrepreneur able to contribute for early funding. The fund may also come from zakat or waqf fund.

TABLE I  
*Musharakah Mutanaqisah Model (diminishing partnership contract)*



Source: Adapted from Norma & Dzuljastri (2013); Muhammad Abdurrahman Sadique (2008)

## 5.0 CONCLUSION

Microfinance has been recognized as an effective development and poverty alleviation tool that can help the hardcore poor to get financing from the formal financial provider and get them out from the poverty trap. However, most of the microfinance programs that been offered in the market are based on *riba*. It is prohibited in Islam and makes the hardcore Muslim poor left behind from this service. Islamic microfinance is seen as a substitute for conventional microfinance. There are a few models that suitable for the hardcore poor such as *qardhul hasan*, *musharakah*, and *mudarabah*. These models based on equity-based financing where financier and entrepreneurs share the profit and loss (PLS) of the project. However, *musharakah mutanaqisah* is

seen as a suitable model that can be implemented as an Islamic microfinance model especially to the hardcore poor. *Musharakah mutanaqisah* may help hardcore poor to get microfinancing to start a business and own the asset at the end of the financing period. No empirical research has been done on the implementation of *musharakah mutanaqisah* in microfinance. Thus, this paper is useful to develop hypotheses for future research.

## 6.0 ACKNOWLEDGEMENT

The author wants to thanks to Albukhary International University (AIU) for the research grant granted for this project.

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