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Islamic Microfinance in Indian Perspective

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Abstract

In India, the population of Muslims is about 180 million and the majority of them live below poverty line and if non-Muslims are taken together this number reaches to about 77% of total Indian population, Micro-finance is providing financial services to poor people, who traditionally lack access to banking and related services. The disaster of conventional microfinance in India in the state of Andhra Pradesh where hundreds of people committed suicide due to stress of non- payment of loans motivated the authors to study the Islamic microfinance model to eradicate poverty. Study on interest-free (Islamic) micro-finance for implementation in a country like India can be very helpful in eradicating poverty and developing micro-enterprises together with sustainable development of poor and country as a whole. While conventional microfinance institutions (MFIs) have expanded their operations in the last two decades, Islamic microfinance products are still quite small relative to the conventional microfinance sector. In this respect, the aim of this paper is to shed light on Islamic microfinance in Indian perpective.

Introduction

The Indian economy was able to witness high levels of economic growth following the economic reforms that were introduced in the 1990s. The GDP grew at the rate of 8.45 % per annum between the years 2004 till 2011 [1]. Despite this, India continued to see high degree of poverty and low human development. While growth did create zones of prosperity, and reduce poverty and hunger, the residue was still very large – 37.2 % of the Indian population continued to be poor[2] , while 77 % of the population remained vulnerable to income shocks[3]. This proportion was even higher for the socially disadvantaged groups such as the Scheduled Castes, the Scheduled Tribes and Minorities. India continued to occupy a low rank – 134 – in the UNDP Human Development Index which takes into account health, education, income, inequality, poverty, gender, sustainability and demographic indicators[4].

In India, the population of Muslims is about 180 million and the majority of them live below poverty line. The regions where poor Muslims are in majority are marked as negative for providing loans by the banks. Study on interest-free (Islamic) micro-finance for implementation in a country like India can be very helpful in eradicating poverty and developing micro-enterprises together with sustainable development of poor and country as a whole.[6]

Another report tells us that SKS Micro-finance is charging approximately 24 per cent rate of interest in Orissa, Karnataka and Andhra Pradesh; in southern India, Equitas Micro-finance is seeking 21-28 per cent interest rate and Basix Microfinance is providing small loans at 18-24 per cent interest rate. There are numerous other players, and they all rake in money. Sewa in Gujarat and the Grameen Bank in Bangladesh too thrive on a similarly high rate of interest. It shocking that a poorest of the poor in a village, who may be only surviving on the NREGA promise of 100 days assured employment has to pay a 24 per cent rate of interest if he borrows money to buy a goat, and we in the cities can get interest-free loans or loans with a minimum rate of interest for buying a car.[12]

The unique model adopted by Anjuman Islahul Muslemeen(AIM) of Islamic micro-financing in which the organization has not received any foreign aid or financial support from Government of India since its inception in 1918, i.e., about 98 years have passed but growth of AIM has been sustained. When this institution started, the members used to give loans as Qarz-e-Hasna from their savings. The organization started opening Accounts of Muslims called Amanat accounts who deposit their money in the account with the motive to help the poor. The account holders can withdraw their money at any time. The people know that they will not get any interest on their deposited money and the money would be used for giving Qarz-e-Hasna to the poor. Every month, INR 4,500,000 (Rs. 4.5 million) is distributed as loans among the clients. The institutions' annual turnover has reached up to approximately Indian Rupees 50,000,000 (Rs. 50 million). The loans are given from Rs. 1,000 to 20,000. Collaterals in the form of gold are asked from the borrowers borrowing from 4,000 to 20,000 plus 4% administrative charges. The people who need loansfrom INR 1,000 to 3,000 are not asked for any collaterals and also administrative charges are waived off.[6]

The Andhra Pradesh Crisis Conventional Microfinance in India :

Indian MFIs, particularly the four in AP – SKS, Spandana, SHARE and Asmitha – witnessed high levels of growth from 2006 onwards and could not manage that process well. A vast majority, with the exception of SEWA and BASIX, were following the Grameen Bank, Bangladesh model, offering a single product – a yearlong loan repayable in 50 equated weekly instalments. They recruited a large number of people, but did not train them or monitor them adequately. The only parameters to which the MFI managements and Boards seemed to pay attention to were growth in and health of the loan portfolio, and reduction in operating costs. The field staff quickly learnt to respond to that which was being monitored and incentivised and ignored all the rest, including, going to remote villages, searching for the really poor clients, handholding and training of client groups before giving them the powers to approve each other's loans, and ensuring client education, or even adequate disclosure about interest rates and other terms. 200 borrowers into committing suicide. Repayment rates went down to between 10% and 20% for several months in the district (Ghate, 2006, pp. 61–66, 2007a; Sharma, 2006)[7].

In the state of Andhra Pradesh microfinance was characterized by the charging of exorbitant rates of interest, resorting to unethical ways of recovering loans by confiscating title deeds, using abusive language, combining multiple products like savings, insurance and loans to ensure prompt recovery and aggressively poaching from government and banks to capture their borrowers. This in turn negated the main motive of poverty reduction and led to a number of suicides among rural borrowers who could not pay their insurmountable debts and faced forceful collection methods by the lenders. There has also been a situation in Maharashtra where some large microfinance institutions (and many smaller ones) were increasing client numbers at 5-10% per month in some districts in 2009, as newly recruited staff aggressively sought to achieve their financial targets and the credit bubble burst. In short, it can be said that the microfinance lost its motive and this resulted in the exploitation of the poor through high interest rates, excessive debt burdens and coercive recovery practices.[11]

Emerging Scenario – Responsible Finance :

The AP crisis led to several regulatory reforms and operational improvements. The larger MFOIs, which are NBFCs, formed as self-regulatory organisation – the Microfinance Institutions network (MFIN) and all of them joined the RBI approved credit bureaus, contributing over 70 million loan records and following a code of conduct, which prevented over and multiple lending. MFIN also systematically started interacting with political and administrative leaders to obviate crises before those arose. 4.1 RBI Upgraded the Regulatory Framework for MFIs Following the AP Microfinance crises, the RBI appointed the Malegam Committee to study the MFI regulatory environment in India. The Malegam Committee after a consultative process with all stakeholders, including the Government of India, select State Governments, major NBFCs working as MFIs, industry associations of MFIs working in the country, other smaller MFIs, and major banks etc., recommended (i) defining microfinance loans as up to Rs 50,000 per household, of which no more than 25 % could be for consumption purposes and placed an income limit of the clients (Rs. 50,000 pa); (ii) imposed a margin cap and an interest rate cap on individual loans; (iii) transparency in interest charges; (iv) lending by not more than two MFIs to individual borrowers; (v) creation of one or more credit information bureaus; (vi) establishment of a proper system of grievance redressal procedure by MFIs; (vii) creation of one or more “social capital funds”; and (viii) continuation of categorisation of bank loans to MFIs, complying with the regulation laid down for NBFC-MFIs, under the priority sector. The Committee also made a number of recommendations regarding MFI supervision, corporate governance etc.30 The RBI accepted the broad framework of regulations. Loans to MFIs will remain under the classification of priority sector lending provided they fulfil the Malegaon conditions. Besides a limit has been placed on the maximum income of the clients (Rs. 60,000 for rural and Rs. 1,20,000 for urban), size of indebtedness (not to exceed Rs. 50,000), extent of loan that can be used for consumption (maximum 25 %), etc. The RBI also imposed both a cap on interest rate (max 26 %), as well on the net interest margin (12 %). The acceptance of the framework of Malegam Committee by the RBI provided much needed orderliness to the sector.

Microfinance Institutions (Development and Regulation) Bill 2012 :

The GoI introduced the Microfinance Institutions (Development and Regulation) Bill 2012 in the Parliament to further strengthen the regulatory framework in the microfinance industry. Drafted with extensive inputs from MFIs, SIDBI and NABARD, features of the Bill include: (i) defining microfinance broadly – beyond just lending, to include savings, insurance, money transfers, etc.; (ii) inclusion of NBFC MFIs in its purview, in addition to NGO-MFIs; (iii) recognition of the RBI as the sole regulatory of NBFC MFIs and exclusion of MFIs from the purview of Money Lender Act; and (iv) Strengthened client protection norms – establishment of advisory councils at the central, state and district levels and restrictions on pricing and profitability; and an Ombudsman system. Greater insistence of transparency in pricing and fees.

The AP crisis was not caused either by the reckless actions of a few MFI promoters not by over-zealous bureaucrats out to protect SHG women from coercion. It was the failure of the complete eco-system – from the rich investor in Europe to the poor borrowers in AP villages. All played their part in the unfolding of this tragedy. The investors saw microfinance as a way of doing good while doing well, expecting high returns when this was unrealistic. The MFI promoters, CEOs and managements, desperate for capital to grow, fell in line to fulfil these expectations. Banks fuelled this growth with a lot of leveraged loan funds, as they found this to be an easy way to meet their priority sector lending obligation, with a high margin. MFI field staff were incentivised to lend more and recover tightly. Borrowers could not resist the temptation of easy loans till they realised that repaying one loan by taking another gets them into more and more indebtedness. The regulator, RBI, followed a policy of benign neglect.

Islamic Microfinance

Islamic Microfinance emphasis on risk sharing for certain products and collateral-free loans, is compatible with the needs of some micro-entrepreneurs. Islamic Microfinance is very effective and essential for creating hope for the poor and those above the poverty line as shown by the traditional microfinance, but also for the extremely poor in the community the Islamic microfinance, based on a partnership mode, is fair and does not require poor clients’ payment, or lead to a loss of the livelihood of the poor in the case of project failure beyond the client's control. It also does not require strong guarantees. Viable projects that are rejected by conventional lending institutions because of insufficient collateral might prove to be acceptable to Islamic banks on a profit-sharing basis. Poor Muslims remained excluded from traditional microfinance for several reasons, voluntarily due to the practices of the interest rate by conventional lending institutions which considered riba, can be excluded nonvoluntarily due to inability to repay back the loan plus the interest rate accrued to it. Hence, Islamic microfinance can easily overcome these challenges due to its wide scope to cover various diversity of customer whether based on their expertise or sectorial dimension.[13]

On the funding side, Islamic microfinance services providers can mobilize additional resources through Zakat (Zakah is instruments of charity occupy a central position in the Islamic scheme of poverty alleviation) , Imdad, Sadaqa and waqf (Waqf is a trust or pious foundation), and on the lending side they mainly use financial instruments that are based on Profit and Loss Sharing (PLS) schemes such as mudarabah and musharaka (Musharaka and mudaraba are contracts which share risks and benefits) rather than loans. Qard-al-Hassan (Qard-al-Hassan is an interest-free loan that the Qur'an encourages Muslims to make to the needy) resources should be made available to Islamic microfinance.

Aslam[9] stated that a micro-finance institution is an organization that provides financial resources to the needy and poor people and covers a wide area to cover its legal structure, mission, vision, methodology, and sustainability that are all attributed to provide the financial resources to the clients of poor and those who have no approach to the financial banks.

Islamic microfinance in India :

Microfinance existed in India for about 100 years as an informal economic activity. Traditionally, poor people borrowed from local merchants in cash or in-kind consumption or emergency loans and paid back the loan when their anticipated funds become available. According to the authors the Islamic Microfinance started in about 1918 in Bhopal Madhya Pradesh India. Anjuman Islahul Muslemeen (AIM) was set up by a group of Muslims of Bhopal state in 1918.[6]. Later on many Islamic Microfinance Institutions were set up various states of India like Kerala, Bihar, New Delhi Andaman Island etc.

The Government policies to set up Islamic banking and Islamic Micro Finance Institutions in India are not favourable. Various committees were set by Government since the start of 21st century but no concrete guidelines by Reserve Bank of India are laid down to open Islamic windows in conventional banks.

The various institutions set are the personal efforts of people working in different parts of country to help the poor and the needy. The outreach of the institution is slow but steady as the organization has neither government support nor extra fund to organize fund-raising events. The only way out for publicity is the word of mouth but is very effective. Secondly, the laws are not favourable in India as stated by Chakrabarty[10] that financial regulatory authority of India has still not adopted Islamic micro-finance as an alternative way of financial inclusion while interest-free micro-finance is working in some parts of the country. Due to stringent laws for registration of interest-free financial institution, both of these organizations face serious hurdles in expansion of its services. The demand is really big and they have the "product" (service) in hand, but could not supply it due to legal restrictions.[10]

Outreach :

Outreach is an important aspect of Islamic microfinance in view of the fact that the fundamental aim of microfinance is to reach the largest number of unnerved poor people who do not have access to financial services. Limited outreach can impact on the sustainability in terms of benefits linked to economies of scale. The capacity of providers is very far from meeting the demand for this service. Potential microfinance customers in the country should be millions of families, while coverage as shown by the number of clients of the microfinance services providers by this study hardly exceeds a million. Even discrepancies exist in the distribution between the state and between urban and rural. Most of the service providers are concentrated in the states with the lower poverty rates and are less in poverty stricken states, contrary to the policy and rationale that was behind the support for micro financing. Most windows are not in rural areas.

Challenges of Islamic microfinance in India :

However, in spite of its successes, Islamic microfinance in India has not even scratched the surface of need. Yet at the same time, 72% of the micro entrepreneurs surveyed said they had no access to formal or informal credit services.

The vast majority of the Muslim population in India is chronically poor and destitute and cannot avail the welfare schemes of the government meant for them through the formal financial institutions.

The financial exclusion of the community is further proved with the recent reports that 50,000 Muslim students in Bihar and 90,000 in Andhra Pradesh could not open the bank accounts to deposit their scholarship cheques. The complaints were received by the State Minorities Commission which, in turn, referred them to the National Commission for Minorities in Delhi. The Ministry of Minority Affairs (MMA) took up the matter and wrote to all States' Chief Secretaries directing them to facilitate the opening of "no frills, nil balance" accounts by minority students. Though there is a long standing RBI circular in this direction.

In the case of loan, the Sachar committee's finding is that Muslims did not easily get loans. The committee further says that the Muslim community's share of outstanding Priority Sector Advances (PSAs) was pathetic — only 4.6 per cent as against a population share of 13.4 per cent. In 44 districts, where the Muslim share of the population was 33 per cent, their share of PSAs was an abysmal 7.9 per cent. The share of other minorities, who together constituted two per cent of the population, was 3.7 per cent. In 11 of these districts, where the Muslim share of the population was 51.4 per cent, their share of PSAs was 12.9 per cent. But the financial problem of the community would not be solved even by the spread of the commercial banks with proper services in Muslim concentration areas as we all know the commercial banks are based on the minimization of risks and maximization of profits and unfortunately cannot reach the masses. Almost 75% of Muslims in the country don't get benefit from the formal financial services extended by the government due to unable in providing the required collaterals against the borrowings and finding no guarantor standing for them. This problem is furthered because of the ruling of the Supreme Court that "the principal debtor and the guarantor are equally liable to be proceeded at the same time against for recovery of a loan by the creditor." The legal position is clear that "liability of the guarantor and principal debtor are co-extensive and not in alternative'' said a Bench of justices Dalveer Bhandari and H L Dattu.

Thus the big challenge India is facing now is the financial inclusion of a large segment of the population. And this challenge could only be met through the proper application of microfinance.[13]

Conventional Micro-finance movement in India can be traced back in 1992 when NABARD linked SHG with banks. The working definition of micro-finance is given by NABARD in 1998 which states: "Provision of thrift (saving), credit, and other financial services and products of very small amount to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve living standards." It is a paradigm shift from class banking to mass banking growing at the rate of 60% and covers the population earning more than $2 a day. Out of 9 crore clients or customers of MFIs in India, 80% are women and 90% have Sc/ST and minority background.

It is all in the name of empowering the poor. One can ask the practitioners of microfinance, who charges 24% rate of interest, how you justify the exorbitant rate of interest. At 24 per cent rate of interest the micro-finance institutions (MFIs) are empowering the poorest of the poor where as the rate of interest for the urbanites, whether it is for housing, for car, or for any other business activity, as low as 6 to 8 per cent. If the poor can be empowered with a 24 per cent rate of interest, how the resourceful persons need a much lower interest rate to get empowered? If the poor in the villages can make a business enterprise even after paying a 20-24 per cent rate of interest, why do people in the cities find it difficult to do so? Or is it that we need a different yardstick to empower the poor and the not-so-poor? In other words, since the poor have no voice, the MF practitioners have joined hands to exploit the poor in the name of poverty alleviation.

Micro-finance provides financial services to poor and low income people whose low income standing excludes them from formal banking systems. Now-a-days financial credit is treated as a human right. They need financial services to meet their life-cycle events such as birth, marriage, old age and in emergencies. In India 40% of Muslim population and about 32 % non-Muslims are not included in financial services. Actually Islamic microfinance is a confluence of Microfinance and Islamic banking. Islamic (Interest free) Microfinance is one of the better option for inclusion of poor and poorest in India, but the challenges are no Government financial support and adverse financial regulatory policies.

Conclusion and Implications

It can be concluded that the prospects of Islamic Microfinance are very great and can be very useful in eradication of poverty not only in Muslims but non-Muslims as well. The population that would benefit from this is about 77% of the total Indian population. Secondly, the poor and the poorest can be protected from the clutches of "Sahukars" (money lenders) asking high rate of interests on borrowed money as high as 60% of the principle amount and conventional microfinance institutions charging 20-28% rate of interest. Thirdly, India has seen the disaster of conventional microfinance in Andhra Pradesh and other states of India whereas Islamic Microfinance has shown sustainability and growth as evident from the Islamic Microfinance Institution Anjuman Islahul Muslemeen. The success of the organization can be evaluated from the fact that all its expenditure is compensated from the 4% administrative charges and still some money is left over which is added to the principal amount of organization. The loan recovery rate is as high as 99.8%. [6]

This study demonstrated India's experience in implementing Islamic principles in developing Islamic microfinance. It has shown the Islamic microfinance models practiced in India compared with the conventional microfinance models in India The paper also, highlighted the Islamic microfinance implementation in India and showed the shortcomings in these projects to be solved by taking the experiences of other countries into consideration. Based on the aforementioned studies, this study concludes that there are a lot of opportunities for Islamic microfinance in India for both Muslims and non-Muslims in the whole world, if Government and Finacial Regulatory Bodies pay attention to the business model for poverty eradication and financial inclusion of poor and poorest.

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