



Economic Essentials of Islamic Microfinance and Importance in Poverty Reduction

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ABSTRACT

Poverty is one of the biggest challenges of the 21st century. More than three billion people in the world live in poverty. Muslim societies are far behind the rest of the world in tackling poverty. In Indonesia, which has the largest Muslim population in the world, more than half of the national population - about 129 million people - is poor or earns less than \$ 2 a day. One of the main reasons for this is the limited access to financial services. In fact, the poor will not only need loans, but will also need a variety of banking services such as loans, savings, money transfers and insurance. As commercial banks specialize mainly in megacities, microfinance institutions come to the rescue. Microcredit organizations are also divided into two groups in terms of formation and operation. These are Traditional and Islamic microcredit organizations.

The microcredit offered by traditional microfinance institutions contains an element of usury that is prohibited by Islamic Sharia, which prevents it from being used by the Muslim population and businesses in the country. This means that the establishment of Islamic microfinance institutions will play an important role in eradicating poverty in the country.

Microfinance can be viewed in a narrow and broad sense. In the narrow sense, microfinance refers to the provision of small loans and leasing services. In a broad sense, microfinance includes a wide range of financial services, in addition to microcredit and microleasing, such as microfinance, microinsurance, money transfers, and consulting services. The provision of these services in accordance with the rules of Islamic Sharia is called Islamic microfinance. Unlike commercial banks, microfinance institutions have been established and are developing as a financial mechanism to serve low-income people. This article presents the economic necessity and importance of Islamic microfinance, as well as scientifically based proposals and recommendations for the establishment of the Islamic Microfinance Organization in Uzbekistan.

ARTICLE INFO

Received: 8th November 2022

Revised: 8th December 2022

Accepted: 11th January 2023

KEY WORDS: Islamic Microfinance Organization, usury, Islamic financial services, zakat, waqf, murabaha, musharaka, mudaraba.

600 million people worldwide live in extreme poverty. Under the United Nations definition of poverty indicators, extreme poverty is defined as including hunger, health, shelter and other basic human needs for survival. Unfortunately, 50% of the world's poorest people are Muslims.[12] That is, 1 out of every 5 Muslims lives in extreme poverty. So we can see that the demand for Islamic microfinance is very high. Muslim countries have 70% of the world's natural resources, including oil, natural gas, gold, copper, and more. Most of the Islamic countries have agriculture. Nevertheless, the large number of poor people among Muslims can indicate that the zakat system does not work well, and the share of Islamic microfinance in the total capital of Islamic finance is still 1%.

The main reason for the emergence of microfinance was to reduce the level of poverty, to create an opportunity for the population with low income to use financial services, but it was later redirected as a mechanism aimed at making a profit and was used for various purposes [2]. Until now, it is actively used not to reduce poverty, but to make financial services available to the general public. It has been recognized internationally that Islamic microfinance is more effective in reducing poverty than traditional microfinance.

In 2020, the assets of Islamic microfinance institutions were estimated at USD 156.7 billion and this figure is projected to reach USD 304.3 billion by 2026, with an annual growth rate of 11.9% during the analysis period[3]. As a result of the introduction of this financial mechanism, it is possible to reduce poverty by creating job vacancies and increasing the financial literacy of the population, and the use of financial services by the low-income population.

Research method

This article is written on the basis of available secondary data scientific articles, studies, websites of Islamic microfinance organizations. Grouping, comparison, scientific abstraction methods were used in writing the article.

Microfinance institutions have been proposed as a way to provide financial services to low-income households that do not have access to commercial banks. Microfinance is primarily the provision of financial services in the form of savings and loans to low-income people, as well as other forms of service provision such as insurance, social mediation, financial literacy, and entrepreneurship training.[8] It is an effective tool to combat poverty, especially in developing countries.

Brandsma and Bourgeoisie (2004) describe microfinance as:[9]

1. Focusing on low-income entrepreneurs who do not have access to commercial banks;
2. Creating simple and convenient access to small, short-term and recurring loans to borrowers using informal assessment that replaces collateral and investments;
3. Provides voluntary savings services that facilitate small deposits, convenient deposit and quick liquidation.

From the point of view of state regulation, microfinance is divided into three types:[10]

1. Informal. Not regulated or controlled by a regional authority. Institutions include self-help groups, credit unions, families (relatives), and personal lenders.
2. Partially formal. Includes registered individuals and certain financial institutions. Although they provide several financial services, these institutions do not accept deposits and do not make loans. Hence, they act as financial intermediaries but are not regulated like commercial banks.
3. Formal. These include microfinance units of commercial banks, rural banks and cooperatives. Institutions are regulated as commercial banks.

The poor also need financial services because things happen to them that require them to spend more money than they have available. Experts usually divide such events into three main groups: regular life events, extraordinary events and investment opportunities. Every household faces either once-in-a-lifetime events (birth, marriage, death, building a house, old age) or recurring events (education, holidays, tea party). Emergencies include personal illness or injury, death or unemployment of a breadwinner (father), and natural disasters such as earthquakes, floods, and famine. Third, you can invest in business, land or housing. Low-income people need a microcredit for the situations listed above. In fact, the poor may not only need credit, but it is natural that they need various banking services such as credit, savings, remittances and insurance.

Results.

Microfinance organizations operating on the basis of Islamic Sharia rules are called Islamic microfinance organizations. Islamic Microfinance involves providing financial services to clients using Islamic principles such as brotherhood, solidarity and partnership. In addition, business is financed on the basis of partnership between institutions and clients [6].

Microcredit offered by traditional microfinance organizations contains an element of riba, which is forbidden by Islamic Sharia, which prevents Muslim entrepreneurs from using it. To answer the question of what is the demand for Islamic microfinance, below are the 20 countries with the largest Muslim population.

Table 1. 20 countries with a large Muslim population.¹

No	Countries	2022 Population	Muslim population	Share of Muslim population	Percentage of Muslim population in share of world population
1	Indonesia	279,134,505	229,000,000	87.20%	12.70%
2	Pakistan	229,488,994	200,400,000	96.50%	11.10%
3	India	1,406,631,776	195,000,000	14.20%	10.90%
4	Bangladesh	167,885,689	153,700,000	90.40%	9.20%
5	Nigeria	216,746,934	99,000,000	49.60%	5.30%
6	Egypt	106,156,692	87,500,000	92.35%	4.90%
7	Iran	86,022,837	82,500,000	99.40%	4.60%
8	Turkey	85,561,976	79,850,000	99.20%	4.60%
9	Algeria	45,350,148	41,240,913	99.00%	2.70%
10	Sudan	45,992,020	39,585,777	97.00%	1.90%
11	Iraq	42,164,965	38,465,864	95.70%	1.90%
12	Morocco	37,772,756	37,930,989	99.00%	2.00%
13	Ethiopia	120,812,698	35,600,000	33.90%	1.80%
14	Afghanistan	40,754,388	34,836,014	99.60%	1.80%
15	Saudi Arabia	35,844,909	31,878,000	97.10%	1.60%
16	China	1,448,471,400	28,127,500	1.73%	1.60%
17	Yemen	31,154,867	27,784,498	99.10%	1.50%
18	Uzbekistan	35,382,084	26,550,000	96.50%	1.70%
19	Niger	26,083,660	21,101,926	98.30%	1.00%
20	Russia	145,805,947	20,000,000	13.50%	1.00%

It can be seen from this table that more than 1.5 billion Muslims live in 20 countries. The number of Muslims in the whole world is more than 1.9 billion, that is, 24.7% of the world's population.[16]

Islamic microfinance organizations are divided into two groups: commercial and non-commercial. The business form includes microcredit and microshare (business based on partnership). Non-commercial forms include Waqf funds. All types of microfinance organizations must strictly adhere to the following 3 main principles. These are the following:

- ❖ Riba (interest) in any form is prohibited. In simple terms, it means to borrow money with interest without doing any work. Any kind of credit are an example of this.
- ❖ Gharar -uncertainty, deception, and risk. It has been described as "the sale of what is not yet present," such as crops not yet harvested or fish not yet netted. In this case, the seller and the buyer must have equal

¹ <http://wdi.worldbank.org/table/2.1> website ma'lumotlari asosida muallif tomonidan mustaqil tuzildi.

information about the goods. The main purpose of prohibiting this by the Shari'ah is to prevent one party from gaining an unfair advantage over the other. Ghorar doesn't generate anything extra at all, but earns money by losing or hurting someone. For example, selling a damaged car as if it was not damaged, selling a bag of potatoes with damaged potatoes after picking good ones on top, and selling the product to a buyer who does not know the price in the market.

❖ **Maisir-** Unfounded entrepreneurial luck is understood as profit or loss without any action. An example of this is gambling, which is the accidental acquisition of wealth without hard work at the expense of someone else. Catalyst in a football match.

The introduction and development of Islamic financial services remains an urgent issue for Uzbekistan, where the majority of the population is made up of Muslims [7]. In our country, only non-commercial form of Islamic microfinance organization "Waqf Charitable Public Fund" operates. In the future, it will be important to develop commercial forms.

Akhuwat Islamic microfinance organization was founded in Pakistan in 2001. By now, this organization has 800 branches, 301 educational institutions, and 4.8 million users.[14]

Widespread introduction of Islamic microfinance organizations provides the following opportunities for the country:

1. Increasing the welfare of the society by providing financial services to the population with low income;
3. to reduce poverty by providing financial services to people who do not have a source of income; (at the expense of waqf, zakat funds)
2. development and diversification of financial services for the low-income population in the country;
3. create many new jobs. That is, financing for self-employment
4. increase the activity of the population in the financial market by increasing the financial literacy of the population;
5. Coordinate and upgrade infrastructure in the country by establishing a new microfinance industry providing Islamic financial services;
6. contribute to the implementation of the state program to combat poverty;
7. creating a personnel training program in a new direction.

Discussion.

Islamic microfinance provides services based on Sharia rules and shares profits and losses with the entrepreneur. The question arises, why does Uzbekistan need Islamic microfinance?

❖ Islamic microfinance has the ability to attract more funds, that is, to collect deposits, from the majority of the population, which is Muslim. It is this factor that can attract free money of the population in our country and invest it in production. The entrepreneur, the bank and the customer will be equally interested in this. It also prevents cash from being left in the hands of the population and ensures its circulation in the economy. This, in turn, serves to reduce inflation. We do not have the right to receive deposits to non-banking organizations, this right should be reconsidered. The law "On non-bank credit organizations and microfinance activities" (ORQ-765, 20.04.2022) was adopted.[1] The signing of this law is considered one of the major steps taken for the development of the sector. Under this law, commercial banks organize Islamic microfinance. can provide Islamic banking services.

❖ Inadequate availability of microloans by commercial banks does not ensure an increase in the level of microloans, high interest rates on the services of microcredit organizations and pawnshops in most cases lead to the deterioration of the financial situation of consumers. Unlike interest-bearing loans, Islamic microfinance offers a wide range of opportunities for consumers through profit- or loss-sharing financing. That is, the entrepreneur and the microfinance organization operate on the basis of partnership. If the business makes a profit, in accordance with the agreement, if it makes a loss, it bears the loss in the amount of the share it invested in the business.

❖ Sharing of profits and losses between partners provides additional opportunities for persons engaged in business activities with little or no income. It also plays an important role for the economic and social development of the society and serves to reduce poverty.

Islamic microfinance is one of the important and effective ways to create hope among not only the poor people of the society, but also among the people who are above the poverty line like traditional microfinance[11]. Summarizing the data collected during the scientific research, microfinance refers to the provision of financial services to poor and disadvantaged people, whose economic status due to low income limits their access to existing financial systems. Provides micro-scale financial services for people with limited access to services such as credit, venture capital, savings, insurance, money transfers. Providing financial services to the poor can help reduce poverty by increasing household income and assets and economic security.

Islamic microfinance provides financial services based on Sharia principles. Its superiority over traditional microfinance is characterized by the prohibition of *riba* and *gharar*, as well as the inclusion of services such as *zakat* and *sadaqah*, which are given to the extremely poor population on the condition of non-repayment. The conducted studies show that Islamic microfinance is more effective in reducing poverty and increases the welfare of the society than the traditional one. In the development of this system, the government needs to make a special decision and implement a plan. The reason that the share of Islamic microfinance in the total Islamic finance is 1% is that the income of the system is low. That is, it can be explained by the fact that the profit for shareholders is low. That is why the private sector is not interested in it.

Summary. Islamic microfinance organization has passed the stage of establishment and formation and proved to be more effective in fighting against poverty than traditional organizations. The introduction of Islamic microfinance organizations primarily serves to combat poverty and create jobs. The establishment of an Islamic microfinance institution will be an important factor for the bright future of Uzbekistan, as well as a foundation for the establishment of an Islamic window and Islamic banks. This mechanism helps in the implementation of the social protection function of the state.

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