

# The Role of Islamic Microfinance in Poverty Reduction

**Tursunov Anvar Sultonovich**

PhD., Dean of Extramural education faculty of  
The Banking and Finance Academy of Uzbekistan

Email: a.tursunov@bfa.uz

ORCID: 0000-0001-9556-4332

## 1.1. Topic annotation and keywords.

**Abstract.** Poverty is one of the biggest problems of the 20th century. More than three billion people live in poverty in this world. Muslim societies lag far behind the rest of the world in addressing poverty. According to database of the World Bank (2021), approximately 698 million people, or 9 percent of the world's population, live in extreme poverty. They have an income of less than 1.90 US dollars a day. One of the main causes of poverty is limited access to financial services. Unlike commercial banks, microfinance organizations were established and are developing as a financial mechanism that serves the population with low income. This article mainly covers the types of Islamic microfinance and its role in reducing poverty. Scientifically based proposals and recommendations on the establishment of an Islamic microfinance organization in Uzbekistan have been developed.

**Key words:** Islamic microfinance institution, poverty alleviation, Islamic financial services, zakat, waqf, murabaha, musharaka, mudaraba.

## 1.2. Relevance of the research topic

Microfinance is a powerful tool in the fight against poverty around the world and is making great strides. The origin of microfinance was based on the eradication of poverty, but later it was redirected as a profit-making mechanism and used for various purposes. Nowadays, it is widely used not to alleviate poverty, but to make financial services available to the general public. Islamic microfinance has proven to be of particular importance in reducing poverty. As a result of the introduction of this financial mechanism, it is possible to reduce poverty in Uzbekistan by creating job vacancies and increasing the financial literacy of the population.

## 1.3. Review of literature on the subject

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 the underprivileged, as well as other forms of service provision such as insurance, social mediation, financial literacy and entrepreneurship training. It is an effective tool to combat poverty, especially in developing countries.

Brandsma and Bourjorji (2004) describe microfinance as follows:<sup>1</sup>

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.

Microfinance is divided into three types from the point of view of state regulation:<sup>2</sup>

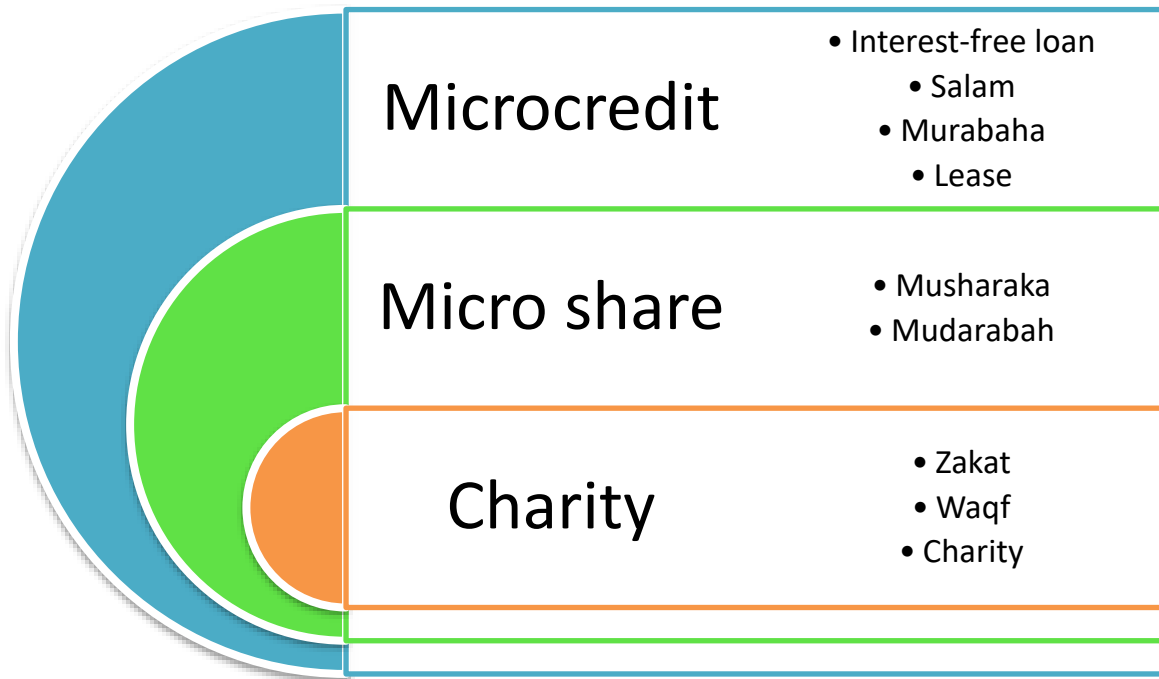
1. Informal. Not regulated or controlled by a regional authority. Institutions include self-help groups, credit unions, families (relatives), and personal lenders.

<sup>1</sup> Brandsma, Judith, and Deena Burjorjee. 2004. *Microfinance in the Arab States: Building Inclusive Financial Sectors*. New York: United Nations Capital Development Fund.

<sup>2</sup> ADB (Asian Development Bank). 2000. *Finance for the Poor: Microfinance Development Strategy*. Mandaluyong City: Asian Development Bank.

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. 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 partnerships between institutions and clients.<sup>3</sup>



**Figure 1 Structure of Islamic Microfinance.<sup>4</sup>**

The main types of Islamic microfinance services include mudarabah (partial partnership), musharaka (full partnership), murabaha (financing for the purchase of goods), deferred payments on products, presale contracts, exception (production contract system), ijara (lease financing) and qard al hasan (interest-free loan).<sup>5</sup>

In 2008, the "Finance for everyone" program published by the World Bank focused on access to financial services.<sup>6</sup> Many studies have shown that access to financial services can be a part of poverty alleviation and can be used as a tool to fight poverty.<sup>7</sup>

#### **1.4. Ways to solve the problem.**

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

<sup>3</sup> Seibel, Hans Dieter, Wahyu Dwi Agung. 2006. "Islamic Microfinance in Indonesia." *Working Paper* 2006 (2). Development Research Center, University of Cologne. <http://hdl.handle.net/10419/23656>.

<sup>4</sup> Muallif ishlanmasi

<sup>5</sup> Gait, Alsadek H., and Andrew C. Worthington. 2009. "A Primer on Islamic Finance: Definitions, Sources, Principles, and Methods." *Discussion Paper Finance* 2009 (09). Griffith Business School.

<sup>6</sup> World Bank (2008). *Finance for All?: Policies and Pitfalls in Expanding Access*. Washington DC, The World Bank.

<sup>7</sup> Kiran Siddiqi (2008). *Potential of Islamic Microfinance in Pakistan*. Dissertation submitted in partial fulfilment of the requirements for the degree of M.A. in MA Islamic Banking, Finance & Management (In association with Loughborough University).

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.

Poor people also want to save and save money. But because of their low income, they save little money for their daily needs and are forced to keep it with themselves due to the lack of available deposit services to match their savings. People on low incomes also want safe, convenient deposit services that offer short-term savings and easy access. Depositors, whether they are poor or rich, are always looking for high returns. It is also important that their deposits are safe and highly liquid. However, another most important aspect is to be Shariah-compliant when using financial services such as deposits, loans, etc.

By establishing Islamic microfinance organizations, poverty in the country can be reduced.

First, the prohibition of Riba. That is, if the borrower makes a late payment, no extra payment (penalty) will be charged, or if the borrower incurs a loss, it will be divided between the parties.

Secondly, there is a level of poverty, that is, the poor and needy who have almost no income are given financial support through zakat, almsgiving and waqf. Zakat is one of the pillars of Islam and it is obligatory to give 2.5% or 1/40 of the total property once a year (according to the Hijri year) to Muslims who have reached Nisab. If this is systematized, the collected funds will help reduce poverty.

Thirdly, the possibility of effective use of frozen assets will be opened by establishing Islamic microfinance. Islamic microfinance is very important for a country where 88% of the population is Muslim. A large part of the population, even if they need financial services, try not to use them for religious reasons.

Fourthly, insufficient availability of microloans by commercial banks does not ensure an increase in the level of microloans, and 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 Islamic microfinance loans, profit-or-loss financing provides consumers with a wide range of options.

### **1.5. Science-based suggestions and recommendations.**

1. Establishing Islamic microfinance services, creating financial products that meet the needs and solvency of the population in need of social protection and small businesses, using information and communication technologies and social financing methods to overcome mass poverty observed in many countries and provide financial and economic support to a large segment of the population. able to involve in the process and thereby accelerate economic activity and create the necessary conditions for healthy economic growth. In order to establish Islamic microfinance, it is necessary to solve the following obstacles.

2. The Central Bank should develop a separate law or regulation on the organization of Islamic microfinance. In this case, Islamic microfinance should include rules on the formation of authorized capital, types of Islamic services, risk assessment, monitoring, accounting and reporting. It should be noted that Islamic microfinance must be given the right to receive a deposit. In this way, a large amount of religiously frozen assets can be used.

3. Development of proposals on the procedure for taxation of Islamic microfinance activities. Because, in order to sell, Islamic microfinance must first buy the asset, take ownership, and then sell it. This can lead to double taxation.

4. Information-explanatory work on Islamic microfinance should be carried out: preparation and implementation of a program on explaining Islamic services through mass media; also consider the possibility of creating a special internet portal;

5. Sharia council should be established under Islamic microfinance. This board ensures that Islamic microfinance activities and services are based on Sharia rules, and provides training to employees and clients on Islamic financial services and performs other duties.

6. Development of a road map for public and private sector support in establishing and increasing the number of Islamic microfinance organisations in poverty reduction. For example, it is possible to direct zakat and alms to those included in the "iron book" that is currently in practice. It is appropriate to take the Akhuwat Islamic microfinance model in Pakistan.

7. Waqf charitable public fund is a non-profit form of Islamic microfinance institution. Based on this, it is necessary to improve the activity of this organization, that is, the main income should not be from zakat or donation money, but from self-financing, like the modern endowment funds.

### 1.6. Expected economic impact.

In summary, microfinance refers to the provision of financial services to poor and disadvantaged people whose low economic status limits their access to existing financial systems. It provides micro-scale financial services that enable the participation of those with limited access to services such as credit, venture capital, savings, insurance, and remittances. Providing financial services to the poor can help increase household income and economic security, build assets, and reduce poverty.

Comprehensive implementation of Islamic microfinance will provide the following opportunities for the country:

1. to ensure the maximum participation of free funds available to the population and business representatives in the development of the economy; (If deposit option is given)
2. development and diversification of the capital market in the country;
3. create many new jobs;
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.

In conclusion, it can be said that the establishment of the Islamic microfinance sector will be an important factor for the bright future of Uzbekistan, as well as a foundation and development perspective for the establishment of Islamic windows and Islamic banks, as a result of which the country, which reflects the deep roots of Islam in its culture, will achieve the full use of the available opportunities for the well-being of the people and the sustainable development of the country.

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