

The Role of Islamic Microfinance in Uplifting B20 Communities in Malaysia in The Covid-19 Pandemic

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Abstract

The purpose of this study is to review the Islamic microfinance model that best suited the bottom of the wealth pyramid (B20) communities in Malaysia. 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. Most current Islamic microfinance products use debt-based financing that similar to the banking products. These products are not suitable to the B20 communities because it creates debt and burdens them to pay back the financing. Therefore, this paper reviews the potential of equity-based financing models that suit to the B20 communities. The study reviews past literature obtained from scholarly databases including Web of Sciences, Scopus, and Google Scholar. In addition, data from microfinance providers are also collected through their website, news published, and bulletin. The findings reveal that equity-based financing via musharakah mutanaqisah seeing as the innovative Islamic microfinance model that suit to the B20 communities compares to debt-based financing.

Keywords: *Islamic Microfinance, B20 Communities, Malaysia*

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1.0 Introduction

World Health Organization (WHO) has declared COVID-19 as a pandemic on 11 March 2020. The disease has been detected in Wuhan city in Hubei province, China on 31 December 2019. As of 3 January 2020, a total of 44 patients with pneumonia of unknown cause have been reported to WHO by the national authorities in China. Of the 44 cases reported, 11 are severely ill, while the remaining 33 patients are in stable condition. According to the authorities, some patients were operating dealers or vendors in the Huanan Seafood market. Therefore, the concerned market was closed on 1 January 2020 for environmental sanitation and disinfection. The virus rapidly spread to other provinces in China such as Beijing, Shanghai, and Shenzhen that caused 83004 peoples to be hospitalized. Chinese scientists have identified a novel coronavirus as the main causative agent. The disease is referred to as coronavirus disease 2019 or COVID-19, and the causative virus is called severe acute respiratory syndrome coronavirus 2 (SARS-CoV-2) by WHO on 11 February 2020 (WHO, 2020). It is a new strain of coronavirus that has not been previously identified in humans. The outbreak was declared a Public Health Emergency of International Concern on 30 January 2020. The COVID-19 is affecting 222 countries and territories around the world including Malaysia as of July 2021 (WHO, 2021).

In Malaysia, the virus starts spread since 25 January 2020 that brought by the Chinese tourists who came to Johor Bahru from Singapore for holidays. It is increasing day by day until the government decided to lock down the country to prevent it from spreading worse starting from 18 March 2020. All businesses and offices were closed as well as schools and universities and everybody needs to stay at home. The government only allowed for essential services to operate their business such as supermarkets, gas stations, pharmacies, and clinics and hospitals. This pandemic virus has affected all business operations including the manufacturing, construction, and services sector. They had to close their business in accordance with the movement control orders enforced by the government. The unexpected crisis gives a big challenge to the people especially to the bottom 40 (B40). It is because most of them are self-employed that receive daily income from their business activities or work to support daily life. If they don't work or close the business, they will lose their source of income. The pandemic also affected other categories of income status where the Economic Action Council (EAC) reported that 600,000 M40 households or at least 8% of Malaysian households have slipped into the B40 category due to the pandemic (iMoney, 2021). The government has introduced a lot of financial assistances to help all affected people such as Household Living Aid, the i-Sinar Program, and the moratorium scheme.

In Malaysia, the 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, constitute the poorest segment with the lowest average income compared to the minority ethnic Chinese (25%) who dominate the economy. The average household income gap between Malays and Chinese are RM2,802 and between Indians and Chinese are only RM1,679 in 2019 (Department of Statistics, 2020). 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 2019 (Department of Statistics, 2020), 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. The mean monthly household income for B40 is only RM3,152 compared to M40 RM7,348, and T20 RM18,506 (Department of Statistics, 2020). The gap between the B40 and T20 is huge, approximately 83% difference where 30% of the household in Malaysia receive income below RM4,000 per month. It shows that there is still a gap in wealth circulation in society. A study found that the gross wealth per capita of the bottom 20 percent (B20) is 0.2 percent of the total household wealth, this figure for the bottom 40 percent (B40) is 7 percent while the top 10 percent (T10) hold 40 percent of the wealth distribution (Khalid, 2014; Salih, 2014). Nevertheless, mean income for the 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 providing a small financial service in order to help low-income communities. The aim of microfinance is to help hardcore and low-income communities to get out of 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), TEKUN Nasional, and Majlis Amanah Rakyat (MARA). Besides, it also offered by the banking institutions under the micro-financing scheme introduced by Bank Negara Malaysia such as, Maybank, Alliance Bank and CIMB Bank, and the development financial institutions namely Bank Simpanan Nasional (BSN), Bank Rakyat, and Agro Bank. In addition, the Ar Rahnu scheme is also one of the microfinance products, for instance, Ar Rahnu provided by Yayasan Pembangunan Ekonomi Islam Malaysia (YaPIEM). However, Ar Rahnu is less accessible because they need to mortgage the jewelry such as gold and silver. Therefore, this study tries to review the Islamic microfinance model, which is suitable, affordable, and accessible to the hardcore poor (B20).

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 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, borrowers 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 its 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 (Lipka & Hackett, 2017). As of 2021, Islam has about 1.9 billion adherents, making Islam the second largest religion in the world behind Christianity (World Population Review, 2021). 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 the economic growth and development of the needy people.

2.0 The History of Microfinance

Microfinance was invented in Bangladesh by Professor Muhammad Yunus. He founded Grameen Bank which means village bank in 1983, the first microfinance institution in the world. The basic idea of Grameen model is to uplift the economic condition of the rural poor through lending money to women without financial collateral, thereby raising self-reliance and encouraging them to play a key role in their own life or family (Yunus & Weber, 2010). The Grameen Bank's activities has attracted the attention of other countries to follow, including the Bank Rakyat Indonesia (BRI) in Indonesia, BancoSol in Bolivia, K-REP in Kenya, ADEMI in the Dominican Republic, and Amanah Ikhtiar Malaysia (AIM) in Malaysia. The 1990s saw increased growth in the number of microfinance institutions throughout the world where Dichter (1999) refers to the 1990s as the microfinance decade. Along with the growth in microcredit institutions, attention changed from just giving credit to the poor to the provision of other financial services such as savings and insurance (Microcredit Summit, 2005). 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 by creating potential businesses based on their interest and skill. 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 moneylenders and loan shark that charge exorbitant/excessive interest rates. Microfinance is one of the important components required to get a 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. Many research studies proved that microfinance could improve the standard of living of the poor and get them out of the poverty trap (Ariful, Atanu & Ashiqur, 2017; Al-Shami et al., 2018; Samer et al., 2015; Norhaziah & Mohd Nor Shariff, 2013; Khandker, 2005; Mainsah, Heuer, Kalra & Zhang, 2004; Matin, Hulme & Rutherford,

2002). Ariful et al., (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. Although many studies prove the positive impact of microfinance programs on 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. 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 the self-reliance of marginalised groups, preparing them to engage in formal financial intermediation (Dusuki, 2008).

The major failure of conventional microfinance is the inability to ensure the end use of microfinance loans, and target to abject poor. 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 20% (Murdoch, 2000; Rosenberg, 2002; Obaidullah, 2008). Charging high and fixed interest on the loan is prohibited in Islam. It has suppressed the poor to pay back their loans. Besides, microfinance institutions have to maintain the repayment rate to secure the funds because most of them are NGOs that received funds from the 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. In addition, conventional microfinance offers microcredit based on interest (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. One of Islam objectives is to support the most vulnerable, which tally with the microfinance mission. However, the application of Islamic microfinance is still lacking among Muslim countries. According to the CGAP study, only 300,000 customers were concerned by the Islamic microfinance through 126 institutions operating in 14 countries, and approximately 80,000 customers are linked to a network of Indonesian cooperatives (El-Zoghbi & Tarazi, 2013). The Islamic microfinance continues to struggle to find sustainable business models with a broad array of products that can meet the diverse financial needs of religiously observant poor Muslims. Most of the microfinance providers rely primarily on two products namely murabahah and qardhul hassan (El-Zoghbi & Tarazi, 2013). Murabahah is the most popular and widely used Islamic financing technique (Ahmad, 1993) 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 reselling it to the client. The client then promises to pay it back in a pre-specified period or in installments. The financier acts like an intermediary between buyer and seller and does not share in profits or losses (Khan, 2008). However, there is some skepticism towards this particular mode of financing and indeed it has been argued that a fixed mark-up is similar to interest. 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 used in Islamic banking products. According to Obaidullah (2008), Islamic microfinance institutions 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.

While 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 mentioned 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, and they are also typically forgiven in the event of default (even though the taking of collateral is permitted). Islamic microfinance institutions however are allowed to charge a service charge for the administration of the loan. The service charges are not profit, they are actual costs in respect of such items as office rent, salaries, stationery, 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. This financing is often given by charitable organizations such as zakah, sadaqah, and waqf institutions.

In Malaysia, all banking institutions that offer Islamic microfinancing are based on tawarruq contracts except for Bank Islam Malaysia Berhad (BIMB). BIMB has offer two types of products namely i-TEKAD microfinancing that based on tawarruq and MikroBangkit that based on qard through Bank Islam Sadaqah House where the funds come from public donations. It opens to unbankable people who want to start a business or to expand their business. The purpose of financing is for working capital and capital expenditure. Bank Islam works with appointed Implementing Partners to identify potential micro-entrepreneurs among members, beneficiaries, or stakeholders. The microentrepreneurs are compulsory to attend business training and coaching program organized by the Implementing Partner before disbursement. It used a qard contract with a

0% financing rate. The financing amount as low as RM500 to RM3,000 for start-up a new business and RM3,000 to RM20,000 for business expansion. The tenure period between 6 months to 3 years.

Similar to banking institutions, most of the non-banking institutions also use tawarruq contracts in offering Islamic microfinancing. It shows that non-banking institutions follow the banking institutions in delivering microfinancing services. Tawarruq or commonly known as commodity murabahah consists of two sale and purchase contracts. The first involves the sale of an asset by a seller to a purchaser on a deferred basis. Subsequently, the purchaser of the first sale will sell the same asset to a third party on a cash and spot basis (BNM, 2018). Tawarruq is being extensively practiced by Malaysian Islamic financial system (Zukri, 2009) especially in deposit products, financing, asset, and liability management. Salwana et al., (2013) revealed that many Islamic financial institutions prefer to use murabahah because it requires no credit record of the clients, there is the existence of well-defined contracts, and lower administrative costs. However, tawarruq is one of the most controversial Islamic financial products as it is believed by some of the scholars that it contains elements of usury and hilah (legal stratagem) (Ahmad et al., 2017; Yusuf & Ndiaye, 2017)). Ibn Qayyim is of the view that tawarruq is impermissible, and he strongly believes that it is as a fraudulent practice against Allah (SWT) and Shari'ah (Meera, 2015; Ahmed et al, 2012).

4.0 The Potential of Equity-Based Islamic Microfinance Products for the B20 Communities

The equity-based financing which is profit-and-loss sharing schemes of musharakah and mudarabah are not widely offered by Islamic microfinance providers even though there are the Islamic financial contracts most encouraged by Shariah scholars as best reflecting Shariah principles. These contracts unpopular because it requires particularly vigilant reporting and a high level of transparency for profits and losses to be distributed fairly. Besides, it needs contribution by both parties in handling the project. Bank Negara Malaysia (BNM) (2016) defines musharakah as a partnership between two or more parties, whereby all parties will share the profit and bear the loss from the partnership. Musharakah is equity financing. It refers to financing provided by partners based on a partnership arrangement. All parties will share the profit and loss of a project on a pre-agreed ratio depending on their shares of capital contribution. Musharakah could also mean any form of business where two or more persons pool their financial resources, entrepreneurship, skills, or goodwill to venture into a certain business activity. All partners share the profit in a pre-agreed ratio while loss is borne in proportion to each partner's contribution or as agreed upon at the inception of the partnership.

While mudarabah is a partnership in which one or more partner(s) or a financial institution gives fund to one or more partner(s) for investment in a business enterprise; this other partner(s) provides the skills to manage the mudarabah capital accordingly. The capital provider is called *rab-al mal*, while the other party, the mudarib, is responsible for managing the investment. The profits generated from the business are shared in a predetermined ratio. In case of loss, only the *rab-al-mal* suffers the loss, provided that the

loss is not due to misconduct, negligence or breach of contract. This is because the *mudarib* did not invest anything; he does, however, lose the opportunity cost of his efforts. *Mudarabah* contract works well in the context where both capital provider and the *mudarib* are trustworthy. If there is dispute between the two, for instance the capital provider claims that the business losses due to negligence of *mudarib*, the former needs to establish evidence to support his/her claim. The investment could be either cash or other forms of assets. This means that *rab-al-mal* will share the profit with the entrepreneur based on a predetermined ratio, but in case of loss, only the *rab-al-mal* will bear the loss. In the case of misconduct, negligence, or breach of the contract, the *mudarib* is fully responsible and should provide reason for the loss.

There is a great potential to attract depositors amongst the rich who intend to do charity via the Islamic participatory approach of risk and profit-sharing. For instance, in *musharakah* model of fund-raising, the public can buy shares and become owners of the whole microfinance program initiated by Islamic microfinance institutions or choose a 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 purposes. 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 (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 microfinance institution to monitor and follow up on 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 on 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 labor 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 and at the same time, the farmer can gradually buy the land until it finally owns by the farmer.

Therefore, the most suitable technique of musharakah for microfinance could be the concept of diminishing partnership or musharakah mutanaqisah. Musharakah Mutanaqisah (MM) is a diminishing partnership concept that combines two basic Islamic contracts which are musharakah (partnership), and ijarah (renting). Musharakah mutanaqisah may be entered into by two or more parties on a particular asset or venture which allows one of the partners to gradually acquire the shareholding of the other partner through an agreed redemption method during the tenure of the musharakah contract (BNM, 2016). Musharakah mutanaqisah is an agreement between two or more parties on participation in ownership of an asset or services/work on its existence or one of them pay the other kinds for work on it with intention of investment and sharing of the returns between them. Then one of them sells his share to his partner from the returns of the project or from the money from outside payment at once or periodical payments based on the conditions pre-agreed on until the ownership of the project turns to him at the end of the contract or rent/lease the property to a third party and they share the rental/lease payment between the partners according to their shares (Abushareah & Naim, 2015).

As an equity-based financing, MM has been argued by many researchers, notably by Meera and Abdul Razak (2009) as a better alternative to replace the famous and controversial Bai' Bithaman Ajil (BBA) contract. MM is often cited as a fair and efficient Islamic financing (Smolo and Hassan, 2011). In the case of MM, 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 model is more suitable for the existing business that needs new or additional capital for expansion (Shahinpoor, 2009). Many scholars suggest MM 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); Sadique (2008) and Ahmed (2008). In both methods (musharakah and musharakah mutanaqisah), the risk is shared by both sides of the transaction and the participants have to 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.

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. Islamic microfinance is an alternative to the conventional microfinance that still not fully utilized especially to the B20 communities. It is because current Islamic microfinancing products are debt-based financing that may burden the hardcore poor to payback the financing in time. In addition, they need to pay high profit rate of financing that make them self-exclusion from the current service. 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 financiers and entrepreneurs share the profit and loss (PLS) of the project. However, many scholars believe musharakah mutanaqisah is suitable to be implemented as an Islamic microfinance model especially to the hardcore poor (B20).

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