Islam’s Perspective on Financial Inclusion

Zamir Iqbal and Abbas Mirakhor

Financial development and improved access to finance (also referred to as financial inclusion) is likely not only to accelerate economic growth but also to reduce income inequality and poverty in a country, a growing body of evidence indicates. Despite the essential role played by financial services in the progress of efficiency and equality in a society, 2.7 billion people (70 percent of the adult population) in emerging markets still have no access to basic financial services, and a great many of them come from countries with predominantly Muslim populations (Demirgüç-Kunt, Beck, and Honohan 2007).

In conventional finance, financial access is especially an issue for the poorer members of society, including potential entrepreneurs. They are commonly referred to as “nonbanked” or “unbankable,” and in the case of potential entrepreneurs, they invariably lack adequate collateral to access conventional debt financing. While access to finance may be important for economic growth, the private sector may not be willing to provide financing to some areas or some segments of the economy because of the high cost associated with credit assessment and credit monitoring and because of the lack of acceptable collateral.

Although the linkage of financial development with economic development exists, a high degree of the financial development in a country is not necessarily any indication of alleviation of poverty in the country. There is growing realization that in addition to financial development, the emphasis should be to expand the accessibility to finance and the financial services that can play a more positive role in eradicating poverty. Development economists are convinced that the goal should be improving access and making basic financial services available to all members of the society in order to build an inclusive financial system. Enhancing the access to and the quality of basic financial services such as

---

Zamir Iqbal is the Lead Investment Officer at the World Bank. Abbas Mirakhor is the First Holder of the Islamic Finance Chair at the International Centre for Education in Islamic Finance, Malaysia. The views expressed in this chapter do not represent the views of the management and Executive Directors of the affiliated institutions.
availability of credit, mobilization of savings, insurance, and risk management can facilitate sustainable growth and productivity, especially for small and medium enterprises (SMEs).

Conventional finance has developed mechanisms such as microfinance, SME finance, and microinsurance to enhance financial inclusion. Conventional techniques have been partially successful in enhancing access, but are not without challenges. This chapter provides Islam’s perspective on financial inclusion. Islamic finance, based on the concept of risk sharing, offers a set of financial instruments that promote risk sharing rather than risk shifting in the financial system. In addition, Islam advocates redistributive instruments such as zakat (a 2.5 percent tax for the welfare of the less fortunate segment of society); sadaqat (voluntary charitable contributions), and Qard-al-hassan (loans with no expectation of repayment), through which the economically more able segment of the society shares the risks facing the less able segment of the population. Such instruments of wealth redistribution are used to redeem the rights of the less able in the income and wealth of the more able. These are not instruments of charity, altruism, or beneficence but are instruments of redemption of rights and repayment of obligations. In addition, the inheritance rules specify how the wealth of a person is distributed among current and future generations of inheritors.

This study argues that the core principles of Islam place great emphasis on social justice, inclusion, and sharing of resources between the haves and the have-nots. Islamic finance addresses the issue of financial inclusion from two directions: one by promoting risk-sharing contracts that provide a viable alternative to conventional debt-based financing; and the other through specific instruments of redistribution of wealth in society. Both risk-sharing financing instruments and redistributive instruments complement each other to offer a comprehensive approach to enhance financial inclusion, eradicate poverty, and build a healthy and vibrant economy. With these instruments, the poor are not forced to rely on their low-level income, or cope with an absence of income, as they endeavor to maintain a decent level of subsistence living for themselves and their families. Increasing access to financial services holds the promise of helping to reduce poverty and improve development outcomes by enabling the poor to smooth consumption, start or expand a business, cope with risk, and increase or diversify household income.

Islamic finance provides a comprehensive framework to enhance financial inclusion by promoting microfinance, SME financing, and microinsurance structured on the principles of risk sharing, and through Islam’s redistributive channels, which are grossly underutilized in Muslim countries. The chapter argues that redistributive instruments should be developed as proper institutions to optimize the function of such instruments. Institutionalizing these instruments would require a better enabling environment, a sound legal framework, and transparent collection and distribution. Applications of financial engineering can devise innovative ways to develop hybrids of risk-sharing and redistributive instruments to enhance access to finance to promote economic development.
Instruments offered by Islam have strong historical roots and have been applied throughout history in various Muslim communities. Islam offers a rich set of instruments and unconventional approaches, if implemented in a true spirit, and can lead to reduced poverty and inequality in Muslim countries plagued by massive poverty. Therefore, policy makers in Muslim countries who are serious about enhancing access to finance or “financial inclusion” should exploit the potential of Islamic instruments to achieve this goal.

**What Is Financial Inclusion and Why Is It Important?**

Many poor families in the developing world have limited access to formal financial services, including credit, savings, and insurance. They rely instead on a variety of informal credit relationships with moneylenders, relatives, friends, or merchants. Traditionally, banks and other formal financial service providers, including insurance companies, have not considered the poor a viable market, and penetration rates for formal financial services in developing countries are extremely low.

The concept of financial inclusion initially referred to the delivery of financial services to low-income segments of society at affordable cost. However, during the past decade, the concept has evolved into four dimensions: (1) easy access to finance for all households and enterprises; (2) sound institutions guided by prudential regulation and supervision; (3) financial and institutional sustainability of financial institutions; and (4) competition between service providers to bring alternatives to customers (Demirgüç-Kunt, Beck, and Honohan 2007).

Typical indicators of the financial inclusion of an economy are the proportion of population covered by commercial bank branches, number of Automatic Teller Machines (ATMs), and sizes of deposits and loans made by low-income households and SMEs. However, availability of financial services cannot necessarily be equated with financial inclusion because people may voluntarily exclude themselves from financial services for religious or cultural reasons, even though they do have access and can afford the services (Demirgüç-Kunt, Beck, and Honohan 2007).

What distinguishes the use of financial services from access to financial services? To what extent is the lack of use a problem? The users of financial services can be distinguished from nonusers, who either cannot access the financial system or opt out from the financial system for some reason. Within the group of nonusers, first, there is a subgroup of households and enterprises that are considered unbankable by commercial financial institutions and markets because they do not have enough income or present too high a lending risk. Second, there might be discrimination against certain population groups based on social, religious, or ethnic grounds. Third, the contractual and informational infrastructure might prevent financial institutions from reaching out to certain population groups because the outreach is too costly to be commercially viable. Finally, the price of financial services may be too high or the product features might not be appropriate for certain population groups. In addition, there could
be a set of users who voluntarily exclude themselves from the system due to conflicts with their religious or ethical or moral value system.

Understanding the linkage of financial inclusion with the economic development is important. There is voluminous literature in economics and finance on the contributions of finance to economic growth and development. The main reason why “finance” or “financial inclusion” or “access to finance” matters is that financial development and intermediation has been shown empirically to be a key driver of economic growth and development. Development economists suggest that the lack of access to finance for the poor deters key decisions regarding the accumulation of human and physical capital. For example, in an imperfect financial market, poor people may find themselves in the “poverty trap,” as they cannot save in harvest time or borrow to survive starvation. Similarly, without a predictable future cash flow, the poor in developing countries are also incapable of borrowing against future income to invest in education or health care for children.

Given the significance of financial inclusion, a developed financial sector in a country can play a critical role in promoting growth and in reducing poverty by enabling the poor to borrow to finance income-enhancing assets, including human assets such as health and education, and to become microentrepreneurs to generate income and ultimately move out of the poverty (DFID 2004). In addition, financial sector development could enable the poor to channel savings to the formal sector: that is, to maintain bank accounts and other saving schemes and insurance, which would allow the poor to establish a buffer against future shocks, thus reducing their vulnerability and exposure to adverse events that otherwise would put undue strain on future income prospects.

Modern development theories analyzing the evolution of growth, relative income inequalities, and economic development offer two tracks of thinking. One track attributes imbalances in redistribution of wealth and income in the economy as an impediment to growth, while the other track identifies financial market imperfections as the key obstacle (Demirgüç-Kunt, Beck, and Honohan 2007). Proponents of the redistribution of wealth claim that redistribution can foster growth, and a focus on redistributive public policies in areas such as land or education reform targeting schooling, saving, or fertility changes that can lead to reduction in income inequalities and poverty.

The other school of thought traces the obstacle to growth to market failures and imperfect information leading to financial market frictions (Stiglitz and Weiss 1981). Financial market frictions can be the critical mechanism for generating persistent income inequality or poverty traps. Financial market imperfections, such as information asymmetries and transactions costs, are likely to be especially binding on the talented poor and the microenterprises and small enterprises that lack collateral, credit histories, and connections, thus limiting their opportunities and leading to persistent inequality and slower growth.

The main problems in delivering credit are linked to risks arising out of information asymmetries and the high transaction costs of processing, monitoring, and enforcing small loans, leading to an increase in the break-even interest rates for
These asymmetries can result from adverse selection (the inability of the lender to distinguish between high-risk and low-risk borrowers) or from moral hazard (the tendency for some borrowers to divert resources to projects that reduce their likelihood of being able to repay the loan, and the inability of the lender to detect and prevent such behavior). Depending on the specific information asymmetry and the ability of potential borrowers to pledge collateral, lenders may try to use the interest rate or a combination of the interest rate and collateral as a screening and sorting mechanism. If collateral is not available, lenders are forced to rely only on the interest rate, but in doing so, they risk excluding, or crowding out, safe borrowers.

There is growing evidence identifying the linkage between economic development and financial inclusion. Galor and Zeira (1993) and Banerjee and Newman (1993) imply that financial exclusion not only holds back investment, but results in persistent income inequality, as it adds to negative incentives to save and work and leads to vicious cycles of income inequality across generations in a society. Empirical studies by Demirgüç-Kunt and Levine (2008) show that countries with deeper financial systems experience faster reductions in the share of the population that lives on less than one dollar a day. Almost 30 percent of the cross-country variation in changing poverty rates can be explained by variation in financial development.

**Issues with the Conventional Approach to Financial Inclusion**

Although the tension continues between the two approaches of either redistribution policies or financial market frictions, there is realization that the evolution of financial development, growth, and intergenerational income dynamics are closely intertwined. Aghion and Bolton (1997) point out that an approach centered on redistribution policies may create disincentives to work and save. By contrast, Demirgüç-Kunt and Levine (2008) argue that focusing on financial sector reforms and reducing financial market imperfections to expand individual opportunities creates positive incentive effects—not negative ones. They further conclude that building a more inclusive financial system also appeals to a wider range of philosophical perspectives than redistributive policies can: redistribution aims to equalize outcomes, whereas better functioning financial systems serve to equalize opportunities.

The approach to remove financial market frictions to enhance financial inclusion consists of two tracks. First, the emphasis is on developing the overall financial sector infrastructure, targeting the banking, capital markets, and insurance sectors by promoting enhanced regulations, supervision, and transparency. This is in addition to building economic and legal institutions, which are deemed necessary for the efficient functioning of any economy. The second track focuses primarily on expanding credit to micro, small, and medium enterprises (MSMEs). For example, in the past three decades, access to microcredit has expanded dramatically and has brought formal financial services to the poor, reaching nearly 200 million microborrowers by some estimates (see Bauchet and others 2011).
The experience with microcredit or microfinance has been mixed, as there is growing consensus that the expectations were overestimated and there are serious challenges in achieving sustainable impact on poverty alleviation. The key challenges facing the microfinance industry are summarized below:

- **High interest rates.** Conventional microfinance institutions (MFIs) are often criticized for charging very high interest rates on loans to the poor. These high rates are justified because of high transaction costs and the high risk premium. However, this imposes undue stress on the recipient to engage in activities that produce returns higher than the cost of funding—which may not be possible in many cases.

- **Recognizing that not every poor borrower is a microentrepreneur.** Merely making capital accessible to the poor is not the solution, without realizing that not every poor person or recipient of microcredit has the skills set or the basic business sense to become an entrepreneur. There is need to provide proper training, skills building, and institutional support to promote entrepreneurship among the poor. Building such capacity requires funds that often are not readily available.

- **Diversion of funds.** The possibility exists that the funds will be diverted to nonproductive activities, such as personal consumption. In some cases, microcredit may lead the poor into a circular debt situation, where borrowing from one microlender is used to pay off the borrowings from another lender. Poor households clearly have other needs, such as school fees, risk mitigation against adverse events such as illness, disability, or failed crops, and even personal consumption.

- **Large-scale fund mobilization.** While some of MFIs have had a significant impact on poverty, others have been less successful. MFIs generally cannot mobilize funds on a large scale and pool risks over very large areas in the way that more traditional, formal financial institutions can. In addition, most MFIs have only limited coverage and are reaching only a minority of the bankable population (DFID 2004).

- **Product design.** The financial services needs of poor households may require different product features with different payment and delivery structures than typical debt-based lending to microborrowers. A more suitable product targeted to match the needs of the poor may prove to be more welfare-enhancing.

- **Absence of private sector participation.** As mentioned, the effectiveness of MFIs is often compromised because of limitations on the supply of funding, coverage, mix of products, and funding by the informal, semi-formal, and noncommercial sectors. There is a need to move toward a market-based or private sector-based solution within the formal financial sector or capital markets. Without participation by the private sector, some of the core issues may not be overcome.
It is worth looking at the evidence on the effectiveness of microlending. Recent experimental evidence from three randomized impact evaluations suggests that while increasing access to credit does not produce the kind of dramatic transformations expected by earlier literature, it does appear to have some important—though more modest—outcomes. There is some evidence of a shift away from nonproductive activities in favor of productive ones, but it is not drastic enough to result in significant improvement in the poverty levels. This suggests that microloans help some households reprioritize their expenditures and smooth consumption—a valuable function for poor households that suffer from irregular and unpredictable income streams (Bauchet and others 2011).

**The Concept of Financial Inclusion in Islam**

The central economic tenant of Islam is to develop a prosperous, just, and egalitarian economic and social structure in which all members of society can maximize their intellectual capacity, preserve and promote their health, and actively contribute to the economic and social development of society. Economic development and growth, along with social justice, are the foundational elements of an Islamic economic system. All members of an Islamic society must be given the same opportunities to advance themselves: in contemporary terms, there must be a level playing field, which in the Islamic view includes access to the natural resources provided by God. For those for whom there is no work and for those that cannot work (including the handicapped), society must afford the minimum requirements for a dignified life by providing shelter, food, health care, and education.

The concept of development in Islam has three dimensions: individual self-development, the physical development of the earth, and the development of the human collectivity, which includes both (Mirakhor and Askari 2010). In Islam, all three dimensions of development assign heavy responsibility to individuals and society—with both held responsible for any lack of development. Balanced development is defined as balanced progress in all three dimensions. Progress is balanced if it is accompanied by justice, both in its general (adl) and in its interpersonal (qist) dimension. The objective of such balanced development is to achieve progress on the path to perfection by all humans, through rule-compliance. The first dimension specifies a dynamic process of the growth of the human being toward perfection. The second dimension addresses the utilization of natural resources to develop the earth to provide for the material needs of the individual and all of humanity. The third dimension refers to the progress of the human collectivity toward full integration and unity. Happiness and fulfillment in a person’s life is not achieved by a mere increase in income but by full development of a person along all three dimensions. At the same time, economic progress and prosperity are encouraged in Islam, since they provide the means by which humans can satisfy their material needs and thus remove the economic barriers on the path to their spiritual progress.
Islam emphasizes financial inclusion more explicitly. However, two distinct features of Islamic finance differentiate its path of development significantly from conventional financial models: the notions of risk sharing and redistribution of wealth.

Individuals face two types of risks. The first is the result of the exposure of the economy to uncertainty and risk due to external and internal economic circumstances of society and its vulnerabilities to shocks. How well the economy will absorb shocks depends on its resilience, which in turn will depend on the institutional and policy infrastructure of the society. How flexibly these will respond to shocks will determine how much these risks impact individual lives when they materialize. The second type of risk that individuals face relates to the circumstances of their personal lives. These include risks of injuries, illness, accidents, or bankruptcies.

This kind of risk is referred to as idiosyncratic, and when idiosyncratic risks materialize, they play havoc with people’s livelihood. This is because often the level of consumption that sustains them is directly dependent on their income. If their income becomes volatile, so will their livelihood and consumption. Engaging in risk sharing can mitigate idiosyncratic risk and allow consumption smoothing by weakening the correlation between income and consumption so that should these risks materialize, and the shock reduce income, the consumption and livelihood of the individual do not suffer correspondingly.

In a society, risks can be shared among its members, between its members and the state, or even internationally. In both industrial and developing economies, people find ways and means of sharing risks to their livelihood. In particular, they use coping mechanisms to decrease the variability of their income relative to their consumption. In more developed financial systems, the coping mechanism is investing in financial assets or in acquiring insurance to mitigate against personal risks. In developing countries with weak financial markets, people rely on informal insurance, borrowing, or saving to cope with idiosyncratic risks. In such societies, theory suggests that perfect informal insurance is possible if communities fully pool their incomes to share risks.

According to Islamic perspective, risks are mitigated in various ways. First, the economic system is a rule-based system, which has provided rules of behavior and a taxonomy of decisions: actions and their commensurate payoffs based on injunctions in the Qur’an. Complying with these rules reduces uncertainty. Clearly, individuals exercise their freedom in choosing to comply with these rules—or not. That rules of behavior and compliance with them reduce uncertainty is an important insight of the new institutional economics. Rules reduce the burden on human cognitive capacity, particularly in the process of decision making under uncertainty. Rules also promote cooperation and coordination (Mirakhor 2009). Second, Islam has provided ways and means by which those who are able to, mitigate uncertainty by sharing the risks they face by engaging in economic activities with fellow human beings through exchange. Sharing allows risk to be spread and thus lowered for individual participants. However, if a person is unable to use any of the market
means of risk sharing because of poverty, Allah (swt) has ordered a solution here as well: the rich are commanded to share the risks of the life of the poor by redeeming their rights derived from the Islamic principles of property rights (Iqbal and Mirakhor 2011; Mirakhor 1989). Islam ordains risk sharing through three main venues:

- Contracts of exchange and risk-sharing instruments in the financial sector;
- Redistributive risk-sharing instruments through which the economically more able segment of the society shares the risks facing the less able segment of the population; and
- Inheritance rules specified in the Qur’an, through which the wealth of a person at the time of death is distributed among current and future generations of inheritors.

Islamic finance is based on the belief that such a system facilitates real sector activities through risk sharing. It has its epistemological roots firmly in the Qur’an—specifically chapter 2, verse 275 (Mirakhor 2011a; Mirakhor and Smolo 2011). This verse, in part, ordains that all economic and financial transactions are conducted via contracts of exchange (al-Bay’') and not through interest-based debt contracts (al-Riba). Since in the verse, the contract of exchange appears first and the stipulation against riba follows, it is reasonable to argue that requiring that contracts be based on exchange constitutes a necessary condition of a permissible contract. Based on the same logic, the requirement of “no riba” (no interest) constitutes the sufficient condition of contracts. The necessary condition (al-Bay’) and sufficient condition (no riba) must be met for a contract to be considered Islamic. Classical Arabic lexicons of the Qur’an define contracts of exchange (al-Bay’) as contracts involving exchange of property in which there are expectations of gains and probability of losses (Mirakhor 2010), implying that there are risks in the transaction.

One reason for the ban on interest-based contracts (al-Riba) is surely due to the fact that this type of contract transfers all risk, or at least a major portion of it, to the borrower. It is possible to imagine instruments that on their face are compatible with the no-riba requirement, but are instruments of risk transfer, and ultimately shift risk to taxpayers.

By entering into contracts of exchange, parties improve their welfare by exchanging the risks of economic activities, thus allowing division of labor and specialization. Conceptually, there is a difference between risk taking and risk sharing. The former is antecedent to the latter. An entrepreneur must first decide to undertake the risk associated with a real sector project before seeking financing. In nonbarter exchange, it is at the point of financing where risk sharing materializes or fails to do so. The risk of the project does not change as it enters the financial sector seeking financing. Not clarifying this distinction has led to a confusion that the two concepts are one and the same. In the contemporary economy, at the point of financing, risk can be shared, but it can also be transferred or shifted. The essence of financial intermediation is the ability...
of financial institutions to transfer risk. All institutional arrangements within the financial sector of contemporary economies are mostly geared to facilitate this function. One of the chief characteristics of the 2007–09 global crisis was the fact that many financial institutions shifted the risk of losses, but internalized the gains of their operation. Hence, the concept of “privatized gains and socialized losses” (see Sheng 2009).

Arrow (1971) demonstrated that in a competitive market economy, in which markets are complete and Arrow Securities—whose payoffs are state-contingent—are available, it would be Pareto optimal for the economy if its members were to share risk according to each participant’s ability to bear risk (Mirakhor 2010). In the absence of complete markets, which include all possible future contingencies, the efficiency of risk-sharing mechanisms will depend on the institutional structure, the degree and intensity of informational problems, and the effectiveness of policies designed to render the economy resilient to shocks.3

To summarize, the Islamic system advocates risk sharing in financial transactions, and a financial system based on risk sharing offers various advantages over the conventional system based on risk shifting. Use of risk-sharing instruments could encourage investors to invest in sectors such as MSMEs, which are perceived as high-risk sectors. Given an enabling environment, investors with an appetite for taking on such higher risks will be attracted to providing capital for these sectors. This argument can be supported by growing the market for private equity. If funds for these sectors become more available, financial inclusion in the system could be expected to increase.

**Redistributive Instruments of Islam**

The second set of instruments meant for redistribution are used to redeem the rights of the less able in the income and wealth of the more able. Contrary to common belief, these are not instruments of charity, altruism, or beneficence but instruments of redemption of rights and repayment of obligations.

The Qur’an makes clear that wealth is a blessing provided by the Creator for the sole purpose of providing support for the lives of all mankind. Thus, in practical terms, creating a balanced society that avoids extremes of wealth and poverty is desirable. The Islamic view holds that it is not possible to have many rich and wealthy people who continue to focus all their efforts on accumulating wealth without simultaneously creating economically deprived and destitute masses. The rich consume opulently while the poor suffer from deprivation because their rights in the wealth of the rich and powerful are not redeemed. To avoid this, Islam prohibits wealth concentration, and imposes limits on consumption through its rules prohibiting overspending (israf), waste (itlaf), and ostentatious and opulent spending (itraf). It then ordains that the net surplus, after moderate spending necessary to maintain a modest living standard, must be returned to the members of the society who, for a variety of reasons, are unable to work; hence the resources they could have used to produce income and wealth were utilized by the more able.
The Qur’an considers the more able as trustee-agents in using these resources on behalf of the less able. In this view, property is not a means of exclusion but inclusion, in which the rights of those less able in the income and wealth of the more able are redeemed. The result would be a balanced economy without extremes of wealth and poverty. The operational mechanism for redeeming the rights of the less able in the income and wealth of the more able are the network of mandatory and voluntary payments such as zakat (a 2.5 percent levy on asset-based wealth), khums (a 20 percent levy on income), and payments referred to as sadaqah (voluntary charitable contributions).

The most important economic institution that makes the objective of achieving social justice in Islam operational is the distribution-redistribution rule of the Islamic economic paradigm. Distribution takes place after production and sale, when all factors of production are given what is due to them, commensurate with their contribution to production, exchange, and sale of goods and services. Redistribution refers to the phase after distribution, when the charges due to the less able are levied. These expenditures are essentially repatriation and redemption of the rights of others in one’s income and wealth. Redeeming these rights is a manifestation of belief in the Oneness of the Creator and its corollary, the unity of creation in general and of mankind in particular. It is the recognition and affirmation that Allah (swt) has created the resources for all of mankind, who must have unhindered access to them. Even the abilities that make access to resources possible are due to the Creator. This would mean that those who are less able or unable to use these resources are partners of the more able.

The expenditures intended for redeeming these rights are referred to in the Qur’an as sadaqat, which is the plural of the term sadaqah, a derivative of the root meaning truthfulness and sincerity. Their payments indicate the strength of the sincerity of a person’s belief (Qur’an, 2:26; 2:272). The Qur’an insists that these are rights of the poor in the income and wealth of the rich; they are not charity (2:177; 17:26; 19:51; 38:30; 70:25). Therefore, the Qur’an asks that extreme care be taken of the recipients’ human dignity—of which the recipients themselves are fully aware and conscious, to the point that they are reluctant to reveal their poverty. The Qur’an consequently recommends that payment to the poor be done in secret (2:271–273). Moreover, the Qur’an strictly forbids that these payments be made either with reproach or accompanied by ill treatment of the recipient, or with any annoyance displayed by the person making the payment (2:262–265).

Sadaqat are a very important redistributive institution in Islam for two reasons: first, they operationalize the truthfulness of one’s belief in Allah (swt) in voluntarily giving of one’s income and wealth. Second, the importance of this institution derives from the fact that the receiver is not the person to whom sadaqat is given, but Allah (swt). In two verses of the Chapter of Repentance, it is noted that:

Of their goods (wealth) take sadaqat, so that you might purify and sanctify them; and pray on their behalf. Indeed, your prayers are a source of security for them: and Allah (swt) is One Who Hears and Knows. (9:103)
Do they not know that Allah (swt) accepts repentance from His servants and Receives their sadaqat, and that Allah (swt) is indeed He, the Oft-Returning, Most Merciful. (9:104)

Zakah is considered a component of sadaqat, but it has been given a special status in the Qur’an because it is ordained with obligatory prayer in at least 20 verses (see, for example, chapter 2, verse 110). Moreover, its collection was enforced by the governments in early Muslim history following the passing of the Messenger.

Qard-al-hassan is a loan mentioned in the Qur’an as “beautiful” (hassan), probably because in all the verses in which this loan is mentioned, it is stipulated that it is made directly to Allah (swt) and not to the recipient (see, for example, Chapter 64, verse 17). It is a voluntary loan, without any expectation by the creditor of any return on the principal. In addition, while the debtor is obligated to return the principal, the creditor, of his own free will, does not press the debtor for an exact timing of its return. Allah (swt) promises multiple returns to the “beautiful loan.” Unfortunately, the full potential of this institution to mobilize substantial resources for the empowerment of the economically weak or dispossessed has not been realized. Much has been written about microfinance and its potential to reduce poverty. However, it is an irony that institutions of microfinance are growing rapidly in Muslim countries, but it is seldom realized that Islam’s own institution of Qard-al-hassan is a more effective means of providing credit to those who cannot access formal credit channels.

Very early in the history of Muslim societies, the institution of waqf appeared, through which individuals could contribute the third of their wealth over which they are allowed by Shari’ah to exercise control at the time of their death. A waqf is a trust established when the contributor endows the stream of income accruing to a property for a charitable purpose in perpetuity. This institution has already been partially instrumentalized—although not in the sense intended in this discussion—since the legality of cash waqf (endowing the future income stream of a cash trust instead of a physical property) has been recognized in most Muslim countries. This instrument also offers substantial potential to mobilize large amounts of financial resources through instrumentalization of this institution by a globally credible Islamic financial institution.

The third dimension of distributive justice in the institutional scaffolding of an Islamic society is the institution of inheritance, which is crucial in the inter-generational justice framework envisioned by the Law Giver. Rules governing production, consumption, and distribution assure conservation of resources for future generations. Rules of redistribution ensure that those unable to benefit by participating directly in production and consumption in the market, through a combination of their labor and their right of access to resources provided by the Supreme Creator for all humans, are redeemed their rights through zakah, khums, sadaqat, waqf, and other redistributive mechanisms. Once these rights have been redeemed out of the income and wealth of the more economically able, the latter’s property rights on the remaining income and wealth are held
inviolable. These rights, however, expire at the point of passing of a person. At
death, the person loses the right to allocate his/her wealth as he/she pleases except on one-third of income, which believers can use to make *waqf*, *sadaqat*, or other transfer contributions as the person wishes. The remainder is broken up and must be distributed among a large number of persons and categories according to strict rules of allocation specified in the Qur’an (see 4:1–13).

**Public Policy Implications**

Analysts suggest that public policy and strengthened institutional framework in developing countries can go a long way to enhancing financial inclusion. Examples of policy improvements include better corporate governance, including supervision, monitoring, and management, which can reduce damage to households due to economic and financial mismanagement; achieving and sustaining economic and political stability; and developing the financial sector. In terms of the institutional framework, clear and secure property rights; contract enforcement; and the securing of trust among people and between government, citizens, and other institutions can reduce risk, uncertainty, and ambiguity; strengthen social solidarity; bring private and public interests into closer harmony; and ensure coordination to improve risk sharing (Mirakhor 2009, 2010). Public policy could also help in mobilizing savings of poor households and thus reduce their vulnerability to income shocks.

With regard to microfinance, as discussed, there is empirical evidence suggesting that while these contracts help reduce poverty in low-income countries by providing small, uncollaterized loans to poor borrowers, there is no evidence to suggest that those contracts allow businesses to grow beyond subsistence. High interest rates can reduce available resources. Moreover, the structure of typical microfinance contracts has features that can create tension between risk taking and risk pooling, such as peer monitoring and joint liability designed to reduce the risk of moral hazard risk. Risk pooling allows greater opportunity for informal risk sharing due to repeated interaction among the borrowers. Joint liability and peer monitoring are common to most microfinance programs; small groups of borrowers become responsible for one another’s loan, and all members are held responsible for the consequences of one member’s failure to repay the loan but do not reward other members in case of success. This arrangement can have the unintended effect of discouraging risk taking and dampening the development of entrepreneurial impulses among borrowers (Armendariz De Aghion and Morduch 2005; Chowdhury 2005; Fischer 2010).

In addition to mobilizing savings and encouraging microfinance, better access to the financial sector by developing microcredit and insurance markets in rural and poverty-stricken regions are promising ways by which public policy can assist the development of risk sharing to allow households to cope with risk.

There are powers available to a government that the private sector does not have. For one thing, in its capacity as the risk manager of the society and as its agent, government can promote risk sharing broadly. It can reduce information
problems, such as moral hazard and adverse selection, through its potentially vast investigative, monitoring, and enforcement capabilities. Through its power of implementing civil and criminal penalties for noncompliance, a government can demand truthful disclosure of information from participants in the economy. It can force financial concerns that would attempt to appropriate gains and externalize losses by shifting risks to others to internalize them by imposing stiff liabilities or taxes. Using its power to tax and to control money supply, a government has the significant ability to make credible commitments on current and future financing issues. It can use its power to tax to create an incentive structure for intergenerational risk sharing whereby the proceeds from taxation of the current income-earning generation is redistributed to reduce risks to human capital of the youth of current and future generations. Without government intervention, individuals are unable to diversify the risk to their most valuable asset: their human capital. The young have significant human capital but insufficient financial capital. For the old, the opposite is the case.4

Government as the Risk Manager Promoting Risk Sharing5

It could well be argued that in contemporary societies, risk management is the central role of government, and therefore, government is the ultimate risk manager in a society. In most economies, governments play a major role in bearing risk on behalf of their citizens. For example, governments provided social safety net measures and insurance for a variety of financial transactions. The history of economic explanation for government’s role in the economy spans more than a century, as economists have attempted to justify the role as being necessitated by the divergence between public and private interests. Some six decades ago, Arrow and Debreu (1954) focused on finding precise conditions under which public and private interests would converge, as envisioned in Adam Smith’s conjecture of the invisible hand. The result was an elegant proof that competitive markets would indeed have a stable equilibrium, provided some stringent conditions were met. It was clear, however, that even under the best of actual conditions, markets did not perform as envisioned either by Smith or Arrow-Debreu. Consideration of violations of the underlying conditions spawned a voluminous body of literature on the theory and empirics of market failure. This concept became the starting point of analytic reasoning that justifies government’s intervention in the economy to protect the public interest (Stiglitz 1993).

The reason that contemporary societies implement social safety nets, such as social security, health care, and public unemployment insurance programs, is that individual households face substantial risk over their life span, such as mortality risk, wage and other income-wide risks, and health risks. Because private insurance markets do not provide perfect insurance against all risks, there is said to be a market failure, and government intervention is called for to correct it. What has become clear in the wake of the global financial crisis is that even in the most advanced industrial economies, existing social safety nets have become incapable of coping with the adverse consequences of the crisis. Not only has the
crisis shaken previous levels of confidence in markets, but nearly all analyses of its causes attribute it to market failure in one dimension or another. This has intensified calls for government interventions to counter the adverse effects of the crisis on income and employment, to strengthen the social safety nets, and to reform the financial sectors. The most important lesson of the crisis has been that people at large carry too large a risk of exposure to massive shocks originating in events that are beyond their influence and control. Hence, attention has been focused on ways and means of expanding collective risk sharing.

Before the recent subprime crisis, it was assumed that government intervention, in the form of activities such as providing social safety nets, public goods, and deposit insurance, was solely for the purpose of addressing various kinds of market failure. While this is a crucial justification for intervention, there is an important dimension of government’s role that has not attracted much attention. Many of the steps to provide a social safety net, from a minimal amount in some countries to substantial amounts in welfare states, are also about collective risk sharing. This dimension has been particularly neglected in the analysis of government provision of social insurance and services, in which the sole focus has been on the issue of trade-off between equity and efficiency: the issue at the heart of debates about the roles of the state versus the market.

Need for Developing a Supportive Institutional Framework

As discussed, access to finance is hampered by informational asymmetries and market imperfections, which need to be removed before one can think of enhancing finance. When it comes to developing countries, where the financial sector is not very developed and the formal financial sector is underdeveloped, it is important that attention be paid to improving institutions critical for financial sector development. Improved access to finance in many developing countries is constrained by an underdeveloped institutional framework, inadequate regulations, and lack of a specialized supervisory capacity. Policy makers need to take steps to enhance key institutions such as the legal, informational, and regulatory institutions in the country.

Regulators should make financial inclusion a priority. Despite the significance of financial inclusion, it is still not a priority for financial regulators in most of the 57 member-countries of the Organization of Islamic Cooperation (OIC). OIC countries need to develop a regulatory and supervisory framework that supports wide financial inclusion based on sound risk management and with sufficient consumer protections. Financial inclusion should be considered as a goal alongside prudential regulation and financial system stability. The survey of financial regulators worldwide concerning financial access (CGAP 2010) found that regions that include financial access in their strategies and mandate their financial regulators to pursue such agendas are also the countries that reform the most. Regulators with a financial inclusion strategy are more likely to have more financial inclusion topics under their purview and more resources and staff dedicated to working on these matters (Pearce 2010).
Priority should be given to improving financial infrastructure, especially the current credit information system. Core components of the financial infrastructure such as credit information, investors’ rights, and insolvency regimes are essential, irrespective of the type of financing: whether conventional or Islamic. Deficiencies in financial infrastructure are one of the major obstacles blocking further SME lending in the Middle East and North Africa (MENA) region. Sharing borrower information is essential to lowering the costs of finance and overcoming information constraints. Lack of access to credit information and the fact that only a small portion of the population has established a credit history (low coverage ratio) are two main features that contribute to financial exclusion in OIC countries, especially for SME financing. Muslim countries interested in enhancing financial inclusion need to improve their financial infrastructure, which will entail expanding the range of collateral, improving registries for moveable assets, and improving enforcement and sales procedures for both fixed assets and moveables. Public credit registries should be upgraded. More importantly, private credit bureaus should be introduced; they are capable of significantly expanding coverage and the depth of credit information (Rocha and others 2011). Improvements in financial infrastructure will reduce the information asymmetry that constrains access to credit and raises the costs and risk of financial intermediation.

Infrastructure conducive to products compliant with Shari’ah should be developed. The growth of Islamic microfinance will depend to a large degree on whether financial institutions can develop sufficiently attractive financial products and services that are competitive with conventional products in terms of pricing, transparency, processing time, and burden on the client. Shari’ah-compliant microfinance and SME financing is limited in its scope and scale because of lack of knowledge concerning Shari’ah products, absence of accounting and regulatory standards for Shari’ah-compliant microfinance, and adequate monitoring and supervisory setups.

Integrating Shari’ah-compliant products and customer information into the formal financial sector will not only enhance access, but will also help integrate Islamic finance with conventional finance. For example, by bringing borrowers’ information to credit bureaus, financial institutions of all types could extend access to new customers, while managing risks and costs more effectively. This will also help Shari’ah-compliant financial institutions expand their funding source and enhance their risk-sharing mechanisms, as institutions with their clients’ credit information available to the public can establish their reputation much more easily than institutions with a system based on informal credit histories.

Microinsurance should be developed and promoted. There is evidence of a positive causal relationship at the country level between insurance penetration and economic growth. At the individual level, the policyholder benefits from increased access to a wider range of products with increased coverage and greater sustainability, and the partnering insurance company has access into a new market without taking on extensive marketing, distribution, or administration costs. More importantly, the partner-agent model facilitates the pooling of risks between the formal and informal sectors.
Despite the success and rapid growth of Islamic insurance (Takaful) and the contribution of microinsurance to poverty reduction, microTakaful institutions are still significantly underdeveloped in OIC countries. Like low-income individuals, SMEs are also less covered by insurance services in poorer OIC countries. In the MENA region, 34 percent of SMEs in Gulf Cooperation Council (GCC) countries have the access to insurance services, compared to only 19 percent of the SMEs in non-GCC countries (Rocha and others 2011). One major reason for the slow expansion of microTakaful may be linked to the fact that MFIs in populous Muslim countries are less likely to offer insurance services that are Shari’ah-compliant (Kwon 2010).

If the policy makers in Muslim countries wish to promote Islamic microfinance and SMEs, these measures need to be complemented by promotion of microTakaful by designing adequate regulatory frameworks and by providing incentives to insurance carriers to enter into this market. A study by the Islamic Development Bank rightly suggests that Qard-al-hassan funds could be used to develop microTakaful capacity in a country in addition to credit guarantee systems (Obaidullah 2008). Similarly, zakat funds can be utilized to cover the default risk of microenterprises run by poor microentrepreneurs, to build capacity and skills, and to reduce operating costs of microfinance and microinsurance. Implementation of such ideas and innovations require development of institutions that support transparent governance to ensure the effectiveness of such mechanisms.

Engagement by the formal sector should be encouraged. Based on the experience of microfinance, the development community is shifting the emphasis away from microcredit institutions to an array of other financial institutions, such as postal savings banks, consumer credit institutions, and—most importantly—the banking system, with the view that this broader approach can lead to overall financial system efficiency and outreach to the entire population. Widening of financial services to the poor and small enterprises by private sector institutions (particularly commercial banks) in the formal financial sector requires proper incentives and removal of regulatory barriers, without sacrificing promotion of stability or security of the financial system (DFID 2004).

Institutionalization of Islamic Redistributive Instruments

As discussed, Islam provides a set of redistributive instruments that could play a critical role in enhancing financial access and reducing poverty. Given Islam’s emphasis on social and economic justice and the eradication of poverty, Islamic instruments that address inequity, such as zakat, khairat (charitable donations), waqf, and Qard-al-hassan, could be expected to play an important role if the required institutional structures are developed. Therefore, there is a need to formalize or institutionalize Islamic redistributive mechanisms designed to empower the economically weak segments of society.

By institutionalization, we mean building nation-wide institutions and the related legal infrastructure to maximize the effectiveness of these redistributive
mechanisms. This institution-building exercise can take place in three steps. The first step is the development of institutions. An institution is nothing more than the legalization of the rules of behavior, and therefore, would require crafting rules pertaining to these instruments as envisioned by Shari’ah. The second step would be to establish these institutions and to integrate them with the rest of the economic and financial system. In this process, either existing channels of distribution, such as banks and post offices, can be utilized to interact with the customers, or new means can be introduced, leveraging new technologies. Finally, there should be mechanisms to ensure enforceability of rules through transparent means.

The objective of institutionalization of redistributive instruments is to formalize and standardize the operations to facilitate each instrument. For example, for zakat, khairat, and Qard-al-hassan, a formal network of institutions needs to be developed to collect, distribute, and recycle the funds in the most efficient and the most transparent fashion. In some countries, point of sale mechanisms such as ATMs or cash-dispensing machines are used to give the customers the choice and to make it easier for them to make donations or contributions on the spot. The financial institution can collect and aggregate funds and then disburse them to needy through selected channels.

The use of Qard-al-hassan for the microfinance sector should be exploited further. Many of the characteristics of the Qard-al-hassan–based funds could be shared by MFIs. Therefore, the infrastructure of the latter can be utilized to effectively achieve the objectives of the former. While it is difficult to explain why this very important Islamic redistributive institution is so underutilized in the Islamic world—and requires some research effort by sociologists and economists to investigate the behavioral causes—one can speculate that lack of knowledge, in the first instance, and concerns about safety and security of the contributed principal, in the second, may be important factors. The latter could be addressed by a credible Islamic financial institution by issuing financial instruments that would provide safety and security to the contributors. The Islamic financial institution could also instrumentalize the asset side of its balance sheet. Furthermore, it could provide Qard-al-hassan resources to existing MFIs to reduce the burden of their interest rate charges on their borrowers. How would such an Islamic financial institution cover its administrative costs? There are two possible sources. The first is by investing a fraction of the mobilized resources. The second is through profit-sharing via Qard-al-hassan resources. The Islamic financial institution could invest in productive investment projects of young entrepreneurs that have no access to formal credit markets.

Policy makers need to pay attention to this set of tools to enhance access. They should encourage development of such institutions through development of the legal framework to protect the institutions, donors, and stakeholders, and to ensure transparent governance. With well-developed redistributive institutions, supplemented by formal and semi-formal sector financial institutions, a more effective approach to poverty reduction could be undertaken.
Financial Engineering

Financial innovation and financial engineering have changed the face of the global financial landscape in the last three decades. Although some of the innovations have been criticized and have been the source of volatility in the markets, their positive contribution cannot be denied. There is no reason why financial engineering cannot be used in the area of financial inclusion and to enhance financial access. One way would be to securitize assets generated by microfinance and SMEs. Sukuk (Islamic bonds) are a successful application of securitization. Along the same lines, a marketable instrument could be introduced to provide funding for much-needed microfinance and SME financing. With the introduction of securitization of microfinance and SME financing, financial institutions would be able to pool their assets and issue marketable securities. In this way, they could share risks with the market, as well as free up the capital for further mobilization of microfinance and SME financing.

Several researchers have suggested ways to formalize and institutionalize Islamic modes of redistribution through an integrated approach by applying financial engineering and by combining different modes (see Mohieldin and others 2011 for details). These approaches include establishing a nonprofit financial intermediary based on the Qard-al-hassan model or establishing MFIs based on a hybrid of zakat, awqaf, and sadaqat. The institution of awqaf (trust or endowment) was once a very well-established institution in Muslim societies, but with gradual decline, the institution has lost its effectiveness. Policy makers need to encourage revival of these institutions and should encourage financial engineering to create hybrid solutions whereby Islam’s redistributive instruments are mixed with market-based instruments to address the issue of sustainable development.

Consider an example of financial engineering where a market-based solution is combined with a redistributive instrument to strengthen its viability in the market. As argued, securitization could be used to securitize assets in the MSME sector and to mobilize funding from the market. However, given the perception of high risk for such undertakings, and the lack of credit enhancement tools—which are a standard feature in conventional securitization—both the originators and structurers shy away from securitization of such portfolios. In addition to conventional credit enhancement techniques through tranching, sufficient funds could be raised based on Qard-al-hassan to provide an additional buffer of security to the investors against the credit risk. If the securitized portfolio consisted of microlending, a default by the microborrower could be covered by the Qard-al-hassan, which could be forgiven if a business loss occurs despite the earnest efforts of the borrower.

Similarly, issuing an equity instrument on the portfolio of domestic development projects has an added advantage of improving domestic income distribution. Provided that these instruments are issued in low denominations sold in the retail market, these instruments could serve households and firms in their attempts to hedge their idiosyncratic risks. In essence, they would be macro-market instruments similar to those proposed by Shiller (1993, 1999, 2004).
These instruments could anchor the development of the high-end of the risk spectrum.

Innovative techniques like these should be explored further by the Islamic financial institutions. Policy makers should aim to develop a financial system where financial innovation is encouraged, but where there are checks and balances as well as incentive mechanisms to avoid misuse of financial engineering. An enabling environment and the supporting institutions are prerequisites, and should be developed before such innovations could take place.

**Conclusion**

Risk sharing serves one of the most important goals of Islam: the unity of mankind. Islam is a rules-based system in which a network of prescribed rules governs the socio-economic-political life of society. Compliance with these rules renders the society a union of mutual support by requiring humans to share the risks of life. Risk sharing intensifies human interaction. The dazing pace of financial innovations of the several decades preceding the recent financial crisis created opportunities and instruments of risk shifting—whereby risks were shifted to investors, borrowers, depositors and, ultimately, to taxpayers—rather than risk sharing. The financial sector became increasingly decoupled from the real sector, with the growth of the former outpacing that of the latter by double-digit multiples (Epstein 2006; Menkoff and Tolksdorf 2001; Mirakhor 2010).

Instruments of Islamic finance allow risk sharing and risk diversification with which individuals can mitigate their idiosyncratic risks. On the other hand, mandated levies, such as zakah, are means through which the idiosyncratic risks of the poor are shared by the rich as an act of redemption of the former’s property rights in the income and wealth of the latter. Other recommended levies, beyond those mandated, such as sadaqat and Qard-al-hassan, also play the same role. They help reduce the poor’s income-consumption correlation. In other words, the poor are not forced to rely on their low-level income, or cope with an absence of income, to maintain a decent level of subsistence living for themselves and their families. It is possible that at some future time, even these levies could be instrumentalized to be included in the full-spectrum Islamic finance menu of instruments for risk sharing. In such a way, Islamic finance could help governments become better risk managers for society.

Islamic instruments of risk sharing could help blunt the impact of economic shocks, disappointments, and suffering for individuals by dispersing their effects among a large number of people. Instruments of finance could be available for all classes of people to allow them to reduce their idiosyncratic risks and smooth their consumption. They could help ensure that innovators, entrepreneurs, and micro, small, and medium firms have access to financial resources without the need to bear all risks themselves or, alternatively, to abandon productive projects altogether. Instruments of insurance could not only provide protection against health and accident risks but also insure against risks to livelihoods and home
values to protect people’s long-term income and livelihood. Such a full-spectrum Islamic finance could then truly be said to have “democratized finance” without transferring risks of any venture to a particular class or to the whole society. This would be in sharp contrast to the results of the “democratization of finance,” which led to the recent global financial crisis of the conventional system, in which the risks of financial innovations were shifted away from financiers. The consequence was that while the gains were privatized, the pain was socialized (Sheng 2009).

Given the rules governing property rights, work, production, exchange, markets, distribution, and redistribution, it is reasonable to conclude that in an Islamic society—that is, a rule-complying and Allah-conscious society—absolute poverty could not exist. It can be argued that there is no economic topic more emphasized in Islam than poverty and the responsibility of individuals and society to eradicate it. The Prophet said that poverty verges on disbelief, and that poverty is worse than murder. It is almost axiomatic that in any society in which there is poverty, Islamic rules are not being observed. It means that the rich and wealthy have not redeemed the rights of others in their income and wealth, and that the state has failed to take corrective action.

Notes

1. For example, in Bangladesh, Pakistan, and the Philippines, it takes more than one month to get a small business loan processed. In Denmark, the wait is only one day (Demirgüç-Kunt, Beck, and Honohan 2007).

2. The Qu’ran uses two words for justice: qist and ádl. Qist is the chief characteristic of appropriate human relations and of human relations toward the rest of creation. It is entirely a human phenomenon; it is not a divine trait. Ádl, on the other hand, is a feature of Allah’s Actions that manifests itself in the perfect balance of the cosmos; it characterizes the Action of Allah to place everything in its rightful place (Mirakhor and Askari 2010).

3. Mirakhor (2010). The economy-finance nexus defined by Arrow-Debreu-Hahn general equilibrium models were risk-sharing conceptualizations in which securities represented contingent financial claims on the real sector. Equity share claims represent first-best instruments of risk sharing and satisfy characteristics required of Arrow Securities. It would appear that had the financial markets in industrial countries developed their financial sector along the lines suggested by the Arrow-Debreu-Hahn model, they could have had much more efficient risk sharing and, perhaps, avoided the crises that have plagued conventional financial system. See Arrow and Debreu (1954) and Arrow and Hahn (1971).

4. As Merton (1983) suggested, a trade is possible between these generations, but laws prohibit trade in human capital (except through wage employment). The young cannot make credible commitment of their human capital through private contracts. There is no possibility for private contracts to commit future generations to current risk-sharing arrangements. This, in effect, represents another case of commitment failure. Using its powers of taxing and spending, unparalleled monitoring and enforcing capabilities, and its control of money supply, government can resolve these issues. No private entity can credibly commit not to default on an obligation, as can government.
5. This section is based on Mirakhor (2011b).

6. The Doing Business Report, as the most comprehensive measurement of business environment faced by SMEs across countries, shows that OIC countries as of 2011 on average rank 118, much lower than the average developing countries (100) in terms of ease of doing business (World Bank 2011). In addition, OIC countries lag far behind in all four aspects of ease of getting credit: depth of credit information, public credit registry coverage, strength of legal rights, and private credit bureau (Mohieldin and others 2011).

7. For example, Mohieldin and others (2011) estimate the resources needed to fill the poverty gap using zakat collection. They find supporting evidence that 20 of 39 OIC countries could lift the poorest (those living on less than $1.25 per day) above the poverty line simply with collection of zakat from domestic payments and remittances. They argue that they do not consider zakat a totally new poverty reduction mechanism, as it is already collected and distributed to the poor in several Islamic countries. However, they argue that proper collection, streamlining, accountability, prioritization, and allocation to productive activities can have significant impact on enhancing access and opportunity for the poor segment of the society, which will ultimately lead to a reduction in poverty.

8. See Mirakhor (2004) for further details. Mirakhor argues that given the number of poor in Islamic countries, critics argue that, a priori, Islamic institutions, which were meant to redistribute income and wealth from the more well-to-do to the weaker segment of the society, have not shown the necessary potency in performing their function, and they could be right (see also chapter 11). It is a serious problem that very little effort has been expended by Islamic and other researchers and scholars to empirically investigate the behavior of Muslims vis-à-vis these institutions: that is, why the latter have failed to achieve the objectives for which they were designed and how the situation could be remedied. Admitting that these institutions have, by and large, failed to alleviate poverty in Muslim countries does not obviate the need to consider their potential.

9. An example of a Muslim country where the institution of Qard-al-hassan has been utilized effectively to provide microfinance is the Islamic Republic of Iran, where these institutions are widespread throughout the country. They provide small consumer and producer loans and, in some cases, engage in profit-making activities that supplement the principal amounts deposited with the fund. These Qard-al-hassan funds are usually associated in each locality with mosques or other religious organizations and, at times, with guilds or professional group associations. The capital is contributed by the more well-to-do, who are at liberty to withdraw their funds at any time. These funds operate with very low administrative costs, since most are managed through volunteer services contributed by the people within the group. See Sadr (2007).

References


