Asian Social Science; Vol. 11, No. 9; 2015
ISSN 1911-2017 E-ISSN 1911-2025
Published by Canadian Center of Science and Education

A *Shariah* Perspective Review on Islamic Microfinance

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Received: November 22, 2014 Accepted: December 28, 2014 Online Published: April 2, 2015

doi:10.5539/ass.v11n9p273 URL: http://dx.doi.org/10.5539/ass.v11n9p273

Abstract

Islamic micro finance is a growing industry in several Muslim countries such as Bangladesh, Nigeria, and Malaysia. Islamic microfinance is at the heart of Islamic finance as it addresses one of the fundamental roles of financial intermediaries demanded by *Shariah*. Over the past few decades, many initiatives have taken place to alleviate poverty in Muslim countries. This paper provides the Islamic thoughts and motives behind these initiatives and then, it discusses the mechanisms proposed by Islam to improve the life of poor, prevent them to become poor, and also to improve the general economic relations among members of society. Later on, *mudarabah, Musharakah, murabahah, Ijarah*, and *qard al-hasan* are discussed as different types of *Shariah* compliant contracts that can be used as the base of micro financing business model.

Keywords: Islamic microfinance, micro-finance, Islamic finance, mudarabah, Musharakah, murabahah, Ijarah, qard al-hasan

1. Introduction

According to the Economist (2008), Muslims are one third of the world poor communities. Even though microfinance has been known as a useful tool to aid failing economies (Comim, 2007; Dowla & Barua, 2006; Islam, 2007; Wright, 2000), the Muslims do not take full advantage of the existing microcredit products (Karim, Tarazi, & Reille, 2008). Based on the findings of a global survey conducted in 19 Muslim countries by The Consultative Group to Assist the Poor (CGAP), 20-40 percent of the respondents said that religious reasons is one of the main reasons why they do not take advantage of the existing, interest based microcredit products. Thus, constructing and making the Islamic based microfinance available would encourage the reach of microfinance and aid of the Muslim poor in all countries which had only reached about 380’000 customers globally and it was accounted to an estimated of one half of one percent of total of microfinance outreach.

The Muslims view conventional microfinance principles as not compliant to the principles set forth in the Islamic finance law. According to Honohan (2008), an estimated 72% of people living in Muslim-majority countries did not use formal financial services. Therefore, even though many microfinance institutions had stepped in to help the low income Muslim clients, the demand for Islamic microfinance product has become the new driving force in the market.

Islamic financial principles and microfinance are two major elements in the fast growing Islamic finance industry. Islamic financial principles do not only relate to financial need of the poor but also the social principles in caring for the less fortunate. Even though Islamic microfinance is at its infancy stage, but by providing financial products which comply with the Islamic financial principles would encourage the acceptance by the Muslims toward the financial aid provided by the microfinance institutions and also fulfil the demands among the Muslim clients.

Therefore, to have better understanding of this issue related to Islamic financial principles in terms of *Shariah* – the Islamic law – we are going to look into Islamic perspectives in alleviating poverty, *Shariah* compliance, Islamic instrument in microfinance, instrument for mobilization of fund, *Shariah* compliant instrument of microfinance, risk management in Islamic microfinance and finally we are going to discuss financial sustainability and poverty reduction.

2. Islam and Poverty Alleviation

Islam believes that even though individuals are given the same opportunities, each person would not have the same level of economics status. It is because individuals are different in term of their ability to acquire a certain level of economic status. Islam defines poverty as a state where the individual fails to fulfil any of the five basic requirement in life which are religion, physical self, intellect or knowledge, offspring and wealth (Hassan & Ashraf, 2010).

Thus, in order to alleviate poverty, Islam views it as a part of social justice and faith in *Allah.* One of the pillars of Islam is to pay *zakat* which means purifying one's wealth for the will of *Allah*; to acknowledge that everything we own belongs to *Allah* and to work towards the betterment of the Muslim *Ummah* (*i.e.* community or society). It is not only an obligatory for every Muslims who can afford to pay *zakat* but it is a form of worship to *Allah* by sharing the wealth with the less fortunate.

However, poverty cannot be alleviated simply through income redistribution and providing equality in opportunities but it needs a holistic approach which in Islam it is a combination of poverty alleviator initiatives including income level increment biased toward improving poor population, offering an equitable wealth distribution mechanism and finally ensuring that all groups of society has equal opportunities (Hassan, 2006).

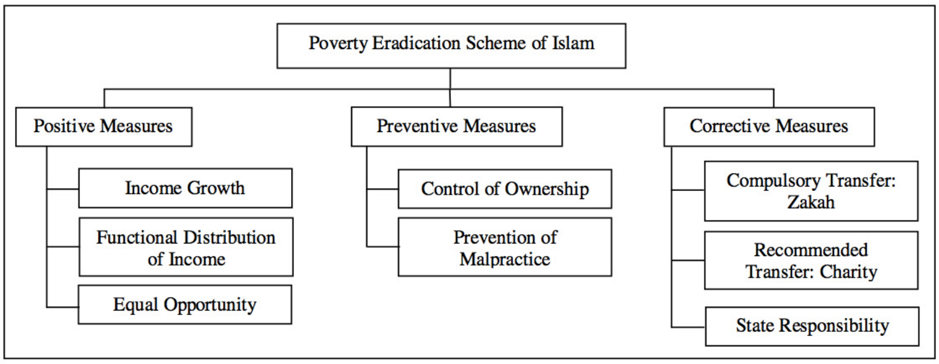

Figure 1. Poverty eradication scheme of Islam - Source: Sadeq (1995)

Poverty Alleviation Strategies in Islam

As stated in Figure 1, the strategies in alleviating poverty include three kinds of measures (Sadeq, 1995); (a) positive measures, (b) preventing measures and lastly (c) corrective measures. Each of these measurements is further divided into few other elements which define the Islamic measures taken to alleviate poverty.

2.1 Positive Measures

According to Hassan (2006), the positive measures taken to alleviate poverty in Islam include income growth, functional distribution of income and equal opportunities provided to public. Each of these elements is a part of the positive measures in Islamic approach toward alleviating poverty.

2.1.1 Income Growth

Islam emphasizes on *halal* earning and moderate consumption by individual which also includes savings for both individual and the economy. Muslims are encouraged to lead a moderate lifestyle but at the same time, they need to make an effort to improve the quality of life through better earnings.

In the *Quran*, *Surah An-Najm*; (53:39) *"And that there is not for man except that [good] for which he strives"* which means that man will only get what he deserves and thus to have something positive in the sense of earning a certain level of economics status, he needs to work for it.

In *Surah Al-'Isra'*: (17:29) "And do not make your hand [as] chained to your neck or extend it completely and [thereby] become blamed and insolvent". Allah revealed this verse as guidance to the Prophet for not to be too open hand (Narrated by Ibn Marduwaih and others from Ibn Mas'ud). In other word, in this verse, Allah clarifies that despite of what is available, a person should do not spend it all. (Narrated by Said bin Mansur from Yasar Abu Hakam) which could only means to remind, not only Prophet but also the Muslims to be moderate in everything that would also include spending and giving donation.

2.1.2 Functional Distribution of Income

This is the second element in positive measures which refers to the equability in income distribution in production factors needed to alleviate poverty despite of the high income.

In Surah *Al-Nahl; (16:90)*, "*Allah commands justice, the doing of good, and liberality to kith and kin, and He forbids all shameful deeds, and injustice and rebellion: He instructs you, that ye may receive admonition*" which means that it is imperative to do Allah's bidding and to avoid the things that Allah forbids. This particular verse emphasizes on fairness (al-'adl) which related to justice (al-inshâf), goodwill (al-Ihsan) and giving the right to one's family (dzî al-qurbâ).

Where else, in Surah Al Mutaffifin: (83, 1-3), "Woe to those who give less [than due]. Who, when they take a measure from people, take in full. But if they give by measure or by weight to them, they cause loss" reminds the Muslims of the repercussion of being defrauders and the rewards for the righteous.

2.1.3 Equal Opportunity

The Islamic approaches in distribution of income among the people emphasize on equability such as profit sharing and prohibiting *riba*. According to Sadeq (2002), the distribution of income in Islam is based on ratio instead of nominal fixed interest among the stakeholder.

2.2 Preventive Measure

The second aspect in Poverty Alleviation Scheme in Islam is preventive measures which include control of ownership and prevention of malpractice (Hassan, 2006).

2.2.1 Control of Ownership

Islam believes that everything in this world belongs to *Allah.* This is the main concept in Islam in regards to ownership of the resources available. Although man has secondary ownership but natural resources are not allowed to be owned privately. Such resources are to be owned by the state as a mean of assurance of public access to them. Business and industries are allowed by Islam, to be privately owned as long as it is based on Islamic ethical mandates.

2.2.2 Prevention of Malpractice

Interest *(riba),* gambling, cheating, hoarding, bribery and any other malpractice are prohibited by Islam because it can lead to economic disparity. *Surah An-Nisa'*; (4:26) "*O you who have believed, do not consume one another's wealth unjustly but only [in lawful] business by mutual consent. And do not kill yourselves [or one another]. Indeed, Allah is to you ever Merciful"* clearly to remind Muslim to respect the ownership of one another's properties. In the present time, malpractice also includes company fraud and white collar crimes which can affect the equability in income distribution (Sadeq, 2002).

2.3 Corrective Measures

As stated in Figure 1, Corrective Measures in Poverty Alleviation Scheme in Islam includes (a) Compulsory Transfer (*zakat*) (b) Recommended Transfer (charity) and (c) State Responsibility.

2.3.1 Compulsory Transfer (Zakat)

Zakat is one of the five pillars of Islam and being Muslim, it is a part of the well-off Muslims' responsibility to fulfil this obligation to the society in order to share and distribute a certain amount of income equally among the people especially the poor. It is mandatory and the foundation of Muslim lifestyle. In *Quran*, it is also stated, "*Zakah expenditures are only for the poor and for the needy and for those employed to collect [zakah] and for bringing hearts together [for Islam] and for freeing captives [or slaves] and for those in debt and for the cause of Allah and for the [stranded] traveler - an obligation [imposed] by Allah. And Allah is Knowing and Wise"* (*Surah Al-Tawbah;* 9:60).

2.3.2 Recommended Transfer (Charity)

Unlike *zakat*, charity (*sadaqah*) is encouraged and will be highly rewarded because it is a benevolence act by the well-off Muslims in order to help the less fortunate Muslims and in a way, it can help to alleviate poverty. In the sense of strong economic disparity, it is then become an obligation and thus mandatory (Sadeq, 2002). It is also mentioned in *Surah al Baqarah*, in length and depth, the importance of charity and *zakat*.

2.3.3 State Responsibility

It is the Islamic state government's responsibility to provide favourable environment and implement Islamic law to ensure that any malpractice does not go unpunished and the state's wealth benefits all population. The state is also responsible to enhance the institution of *zakat* and provide the equability in opportunity for its people (Hassan, 2006).

3. Shariah Compliance

Shariah compliant finance can be defined as financial activities and investments that comply with Islamic law and regulations which prohibiting interest charges and involvement in any enterprise associates with any activities or products forbidden by Islamic law. *Shariah* compliant finance is a factor that differentiates conventional and Islamic financial institutions (Obaidullah & Khan, 2008). Therefore, Islamic microfinance must not only comply to the *Shariah* but to be accepted by their Muslim clienteles, it must be perceived to be as such.

3.1 Shariah Board

Shariah Supervisory Board (SSB) consists of distinguished scholars and experts of *fiqh* who would monitor and confirm that the activities or operations of the financial institutions comply with the *Shariah*. The board would be able to give such comfort to the stakeholders of the Islamic financial institution and by setting it up would be a factor to encourage the Muslims, in general, to benefit from the Islamic microfinance. However, referring to the review of Islamic microfinance, none of them have instituted SSB due to the cost of setting it up and so to have an alternative to the above approach is quite a challenge (Obaidullah & Khan, 2008).

3.2 Bai Contract Issue

The divergences among the *Shariah* scholars have become a major challenge in implementing and developing Islamic microfinance. Some of the debates which often occur among the *Shariah* scholars are pertaining to the nature of the practice of microfinance which allows a variation in the standardized set of contracts and ways of dealing with delays and delinquencies through penalty. There are also many unresolved issues in the mainstream Islamic finance that have become challenges in Islamic microfinance as well.

Many Islamic microfinance providers view techniques such as *murabahah* (mark-up financing) and *ijarah* (lease-purchase and finance lease variety) as substitute for interest-based loan. On the other hand, the concept of *qard al-hassan* becomes attractive due to its benevolence nature. It focuses on recovering the ‘actual’ service charge from the beneficiary. However, this kind of practice does not allow the growth of the portfolio in the long term and the decreased of their value during inflation can jeopardize its survival. Even though, there is a suggestion to link the loan to a physical commodity, it fails to reach a full consensus.

Despite of these issues, many interest-based loans would like to be treated as *Shariah* compliant due to its ‘benevolent’ nature. For example, the successive government in India which provided microfinance loans at lower interest compare to the prime lending interest rate. They would even, at periodic interval, waive the entire loan due to the hardship such as crop failures. In the Grameen bank system of Bangladesh, it labels the features of the interest bearing conventional loans differently such as (i) cap on the interest loan no due; (ii) no recovery due to project failures; (iii) no formal contract for interest payments; and (iv) no shareholder-owners. However, these kinds of practice have renewed the discussions on the presence of *riba* in such finance mode.

3.3 Divergence in Clients’ Perception

Often times, the clients have different perceptions on*, mudarabah, murabahah* and *qard al-hasan* which makes implementing and developing Islamic microfinance difficult and challenging, Their lack of knowledge in *fiqhi* rules which govern the *riba*-free mechanism caused further challenges in Islamic microfinance.

First, the clients seem to display initial preference to *mudarabah* which has profit sharing mechanism. However, only a few understand that profit-sharing mechanism may, under certain design, more expensive compared to other alternatives in Islamic finance. Secondly, some clients recognize the conflict between the microfinance programs and the borrowers in determining profits. Besides that, the borrowers may also prefer not to reveal their profit to the program (and their group).

In term of *murabahah*, which relates to buy-resell mechanism, some clients express their concern in term of its similarity in the practice of fixed interest rate (*riba*). However, when this concern is properly addressed, it is acceptable by the clients and local religious leaders. They understand and accept that the cost incur in carrying out a microfinance program has to be recovered in order to ensure that the program continues. They also appreciate the transparency of it model which provides equal instalments. It is easier to monitor and administer.

Clients’ perception towards *qard al-hasan* also causes some concern because of its ‘pure’ form. Even though, *Shariah* distinguish the concept of *qard al-hasan* and *sadaqah,* some borrowers may misconstrue it as ‘free’.

Though there are some borrowers who understand the difference and accept the need to repay but the flexibility in this mechanism does not determine the 'when' to do so.

The 'hot and cold' response by the clients due to their perceptive does not encourage further developing the products in Islamic microfinance and creating major problems for the professionals to create alternative modes in this sector.

4. Islamic Microfinance Mechanisms

4.1 Mudarabah

Mudarabah is a scheme in Islamic finance where the capital is provided by the Islamic financial institution or investor(s) which is known as '*rab-ul-maal'* to the small entrepreneur who is known as '*mudarib'*. The profit from the project is shared between the capital provider and the entrepreneur at an agreed predetermined ratio. However, the loss will be borne entirely by the capital provider because a *mudarib* invests the *mudarabah* into a project based on trust basis except in cases of misconduct or negligence by the *mudarib.* A *Mudarib* is liable to the full amount of the capital if he is negligent or breach the terms of the *mudarabah* contract (Safari, 2013). The *mudarib* also has full control over the management and the *rab-ul-maal* can only monitor or oversee the operation without making any interference (Rahman, 2010).

Mudarabah structure is based on an arrangement between the entrepreneur and the financial institution or it can also be based on two-tier structure or *re mudarabah* between the capital provider (public, *zakat,* government, *waqf*, etc), intermediate *mudarib (*financial institution), and the final *mudarib* (micro entrepreneur). The profit sharing ratio in *mudarabah* is predetermined. It is a percentage of the profit which has to be clearly stated and not a lump sum of payment. Profit can only be claimed when the *mudarabah* operation is making profit and any losses must be compensated by the profit in the future operation. However, according to Dhumale and Sapcanin (1999), practically due to unavailability of financial statement from entrepreneur, the total profit to be shared is difficult to determine.

There are two types of *mudarabah;* (i) *Mudarabah Muqayyadah* (restricted *mudarabah*) and (ii) *Mudarabah Mutlaqah* (unrestricted *mudarabah*). In *Mudarabah Muqayyadah,* the capital provider specifies a particular business or place for the *mudarib* to invest in. On the other hand, in *Mudarabah Mutlaqah*, the *mudarib* has full freedom to decide the kind of business to invest in. However, he is not allowed to either lend the *mudarabah* to another *mudarib* or mix his own investment in any *mudarabah* without the consent of the *rab ul maal.*

Due to the features of *Mudarabah,* the financial institution who acts as the capital provider or *rab ul maal* is exposed to the risk of capital erosion caused by the loss making operation of the micro entrepreneur. In addition to this, since the *mudarabah* does not require collateral, it exposes the financial institution to credit risk on bad investments. Thus, to mitigate these risks, the microfinance institution still can do supervision even though the micro entrepreneur has the full control of the management (Mirakhor & Iqbal, 2007).

4.2 Mushakarah

Unlike *mudarabah, mushakarah* is about partnership between the microfinance institution and the micro entrepreneur. They will also have profit sharing at a predetermined ratio but they also share the loss based on capital contribution ratio. According to Ariff et al. (2012), the most suitable technique for *mushakarah* is the *mushakarah mutanaqisah* that has a concept which involves diminishment of partnership. It means that the partnership is not perpetual. The repayment of the capital by the entrepreneur reduces capital provider's total capital ratio and thus increases the entrepreneur's capital ratio until he becomes sole proprietor of business. The duration of repayment depends on the pre agreed period between both parties. This form of mechanism is mostly suitable for the existing business that needs additional capital for expansion.

There are other forms of *mushakarah* such as *musaqat* and *muzara'ah. Mushakarah* is a partnership form in commercial-industrial sector of the economy. Where else, *muzara'ah* is its counterpart in agriculture and *musaqat* in orchard keeping. In these forms of *mushakarah,* the harvest is shared among the equity partners including the micro entrepreneur based on the predetermined ratio in profit sharing. All the principles of *mushakarah* also apply to both of them. However, these forms of partnership do involve high risk due to the need to have both capital and expertise to be directly involved.

Since *mushakarah* ranks lower than debt instruments upon liquidation, it is exposed capital impairment risk where the capital may not be recovered (Haron & Hock, 2007). However, mitigation risk techniques can be adopted through a third party guarantee. For example, Small Medium Enterprise (SME) financing in Malaysia helps to obtain and structure the loss of capital of some or all the partners through active role of Credit Guarantee Corporation (CGC).

4.3 Murabahah

It is a type of Islamic finance transaction which is *Shariah* compliant. The financial institution would acquire and purchase an asset and then sell it to a micro entrepreneur at a fully disclosed profit (Figure 2). The financial institution will retain the ownership of the asset until the repayment is fully settled. This had been introduced in Yemen in 1997 and its response was very encouraging, In 1999, there were over 1,000 borrowers actively involved in this type of financial transaction (Dhumale & Sapcanin, 1999). The scheme acquires a group of five entrepreneurs where all entrepreneurs will act as guarantors if anyone of them default the scheme. The financial institution will keep monitoring and the entrepreneurs who have good credit or repayment record will be offered extra loan.

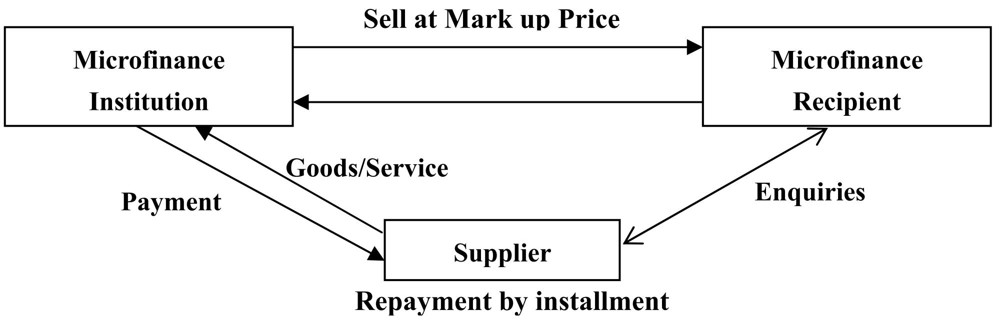

Figure 2. *Murabahah* structure for microfinance

Figure 2 illustrates how *murabahah* concept is applied in a financial transaction. The entrepreneur would enter a sale and repurchase agreement or a memorandum where the entrepreneur would acquire an asset or equipment through a financial institution at a marked up price. The entrepreneur would then pay either a lump sum or in instalments (*bai muajal*) over a predetermined period. To ensure that the contract is valid, a number of *Shariah* principles should be met (Haron and Hock, 2007) at the time of purchase such as; (i) the goods exist and its ownership remains with the bank (ii) the good has commercial value (iii) the goods is not used for *haram* purposes (iv) the goods must be identified and known (v) the goods will be delivered unconditionally after full settlement and (vi) the price is fixed at a marked up price (Safari, Ariff, & Shamsher, 2014).

Murabahah can be implemented for microfinance purposes and can be exemplified by using deferred payment sale (*bai' muajal*). However, to reduce the risk borne by the financial institution, a third party guarantee can be requested or a pledge of asset can be acquired. In addition to that, the financial institution can form a payment structure where they can directly debit the payment from the entrepreneur's account, centralize a blacklisting system and apply a non-compounded penalty to deter delinquent entrepreneur. On the other hand, to mitigate risk in a situation where the seller fails to deliver the goods or comply to the specification specified by the entrepreneur, the financial institution can request a performance guarantee from the seller (Safari et al., 2014).

4.4 Ijarah

Ijarah by definition means rent, lease or wage. It is a long-term lease contract which has specified conditions comply with the *Shariah*. Unlike conservative lease contract, the lessor (microfinance institution) not only owns the asset, the lessor also monitors its usage but however, discharge the responsibility in the maintenance of the asset which is not caused by wear and tear. Prior to the execution of *ijarah*, the financial institution will have the possession of the asset and borne the risk associate with the asset.

Ijarah Muntahia Bitamleek is an elaborate lease *ijarah's* concept where at the end of the contract the micro entrepreneur will have the possession of the asset. The asset's ownership will be transferred to the lessee at a predetermined price before the contract is finalized. This kind of micro financing is mostly suitable for the micro entrepreneur who needs to acquire asset or equipment. The financial institution will acquire the assets required by the micro entrepreneur and lease it to the qualified entrepreneur. The particular entrepreneur will pay the lease on a certain schedule for a period of time which at the end of it, the asset will become the entrepreneur. During the period of the lease, the lessee is responsible to safeguard the assets and at the same time, the lessor will monitor the usage.

Similar to any other finances, *ijarah* is also exposed to risk if the lessee unable to fulfil his end of the contract. However, the micro financial institution can request for an advancement of the lease. Alternatively, the micro financial institution can repossess the asset (Haron & Hock, 2007).

4.5 Qard al-hasan

"Qard al-hasan" or interest free loan is one of the most advanced and suitable tools for microfinance purposes. In principle, "*Qard al-hasan"* is a kind of borrowing of money that lender does not have any expectation from borrower except the receiving the principle. In fact, Muslims would use *"Qard al-hasan"* to help one another when they need financial help in order to please *Allah* (Mirakhor & Iqbal, 2007). The only different between *"Qard al-hasan"* and *sadaqah* is that *sadaqah* is pure charity and the giver does not have any expectation of money but in *qard al-hasan* borrower must return back the principle within the agreed period of time (Mirakhor & Iqbal, 2007).

Qard al-hasan can be used as an instrument to provide fund for micro financing to support small business and start-ups as it is less expensive compared to other source of Islamic finance. The term of repayment can be agreed by instalment in the certain agreed period of time. The only extra charge for *qard al-hasan* is the service charge fee that micro-finance institution is allowed to receive (Mirakhor & Iqbal, 2007).

5. Conclusion

This paper reviews the issue of poverty alleviation from perspective of Islam. Income growth, functional distribution of income and also promoting equal opportunities for all members of society are highly promoted by Islam as positive measures to improve the life of the poor. In addition to that, Islam also enforces means of controlling the ownership of resources and also prevention of malpractices as preventive measures. Finally, the state's role in improving the quality of life of less fortunate people, *zakat* and *sadaqah* are major methods of correction of the poor's condition.

This paper also reviews the major *Shariah* compliant contracts that can be used as an underlying model for Islamic Microfinance as *mudarabah, Musharakah, murabahah, Ijarah*, and *qard al-hasan.* Each of these contracts has features that may provide some benefits or impose certain restriction for parties of micro financing contracts. While *mudarabah* and *Musharakah* have the benefit of risk sharing, they demand higher rates from borrower (as a result of sharing parts of profit). *Murabahah* and *Ijarah* are based on the payment of a certain pre-agreed and predetermined instalments, which might be not possible for all borrowers at all times. *Qard al-hasan* demands no interest from borrower, which make it financially non sustainable business model for the financier. However, recent trends show the increasing popularity of this type of contract especially among those micro financiers who have access to public or *zakat* or *sadaqah* funds.

Acknowledgements

This research was funded through Fundamental Research Grant Scheme (FRGS), Ministry of Education of Malaysia. This paper solely reflects the findings of the study conducted by research team and do not represent the views of funding body. All errors remain with authors.

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