The Role of Islamic Microfinance for Poverty Alleviation in Mogadishu, Somalia: An Exploratory Study

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Abstract

This research aims to investigate the current practice of Islamic microfinance in Mogadishu, Somalia and to examine the effectiveness of Islamic microfinance institutions in Somalia on poverty reduction. In total, 65 microfinance recipients participated in the survey. This research adopts a quantitative methodology, using a survey and descriptive analysis. Findings show that the current practice of Islamic microfinance in Mogadishu is serving the poor and that these microfinance activities are effective in terms of obtaining loans, enhancement of standards of living and usefulness of the system. Nonetheless, there is a low level of awareness among the locals regarding the availability of Islamic microfinance.

Keywords: Microfinance; Islamic Microfinance; Interest-free Microfinance; Poverty Alleviation; Microcredit; Somalia

Received: 26 April 2019
Revised: 23 July 2019
Accepted: 18 Oct 2019

ISSN 2056-757X

https://doi.org/10.18646/2056.64.19-027

1. Introduction

Microfinance has been credited with improving the general economic wellbeing of the poor and also enabling micro-entrepreneurs to build and grow their businesses. The provision of microfinance or microcredit to the poor via small loans (less than USD 500) has received global acknowledgement as an effective poverty alleviation tool (Masih, 2017; Van Rooyen et al., 2012; Yunus, 2004). This is particularly notable in places where institutional finance for start ups has been limited and most micro-entrepreneurs rely on informal sources of finance to fund their businesses (Nor and Masron, 2019).

An interest in the microfinance sector in Africa has been growing since the 1990s (Buckley, 1997). Buckley (1997) studied the microfinance sector in Kenya, Malawi and Ghana; the author concluded there is little evidence to suggest that microfinance brings significant positive impacts on the growth and development of entrepreneurship in these African countries. Years later, Basu et al. (2004) found that the number of entrepreneurs seeking microfinance assistance is relatively small compared to those seeking deposit services. Consistent with the findings of Buckley (1997), Van Rooyen et al. (2012) reported that microfinance in sub-Saharan Africa does not have uniform positive impacts on entrepreneurship development or poverty alleviation; in some countries, microfinance brings more harm than benefits. Van Rooyen et al. (2012) found that microfinance also brings negative impacts such as the exploitation of women or causing the borrowers' children to drop out of school.

Following a massive state collapse, Somalia continues to experience political instability and economic challenges. For the past two decades, the Somali economy has been functioning informally due to the absence of a formal financial system (Nor and Masron, 2019). Although banks are still operating (e.g. Dahabshil Bank and Salaam African Bank) in Somalia, Deacon (2013, p. 43) reported that "traditional money transfer operators provide the only functioning financial services in the country" and that all international organisations and companies operating in Somalia use money transfer operators. Notwithstanding its political unrest and economic challenges, there are microfinance-providers operating in Somalia offering small loans for the Somali people (World Bank, 2019). One of the microfinance providers is Kaah International Microfinance Services (KIMS), which offers Shariah compliant financing and micro-savings to Somali micro and small businesses. However, little is known about the Islamic microfinance sector in Somalia. Therefore, the objectives of this study are to study the recipients' views regarding Islamic microfinance products and to examine the effectiveness of microfinance in alleviating poverty in Somalia.

2. Islamic Microfinance

Microfinance is a way of helping financially disadvantaged individuals to improve their economic well being. Group-based lending, small loans, periodic frequent repayment and being collateral-free are among the features of microfinance (Abdul Rahman, 2010; Ahmed, 2002; Smolo and Ismail, 2011). To obtain a loan, a prospective borrower has to join a microfinance recipient group. The borrower receives a small loan and agrees to shoulder a monetary penalty in the case of default by a peer (Abdul Rahman, 2010). Under such group-based lending arrangements, the group members have incentives to monitor each other for the greater good (Abdul Rahman, 2010; Ahmed, 2002). Although microfinance has been widely recognised as a poverty alleviation tool, some scholars criticise interest-based microfinance as being exploitative (Hudon and Sandberg, 2013). Ahmed (2002) pointed out that the borrowers of conventional microfinance often take additional loans from other sources to pay the instalments and thus become trapped in a vicious debt cycle. Furthermore, Ahmed (2002) noted that microfinance has a high drop out rate and rate of non-graduation from poverty. This view is supported by other researchers such as Abdul Rahman and Dean (2013) as well as Smolo and Ismail (2011).

Islamic microfinance, on the other hand, complies with the Shariah principle of prohibiting riba (interest). Islamic microfinance is built upon the concept of interest-free loans (qard-hasan) and the idea of mobilising funds between finance seekers and fund providers (Usman and Tasmin, 2016). The main differences between Islamic microfinance and its conventional counterpart are as follows: sources of financing, modes of financing, dealing with defaults, and repayment amount (Ahmed, 2002). Unlike conventional microfinance, Islamic microfinance can benefit from religious endowments such as waqf and zakat, which could be used as sources of financing (Smolo and Ismail, 2011). Furthermore, Islamic microfinance providers could lease waqf land and assets to those in need. Islamic teachings could also encourage devoted, religious borrowers to consider the repayment of debt as a religious obligation (Ahmed, 2002).

Table 1 illustrates the main differences between conventional and Islamic microfinance.

Table 1: Differences between conventional and Islamic microfinance

	Conventional microfinance	**Islamic microfinance**
Sources of funding	External funds from investors; Donation from NGO; Savings	Religious endowment; Donation; Savings;
Mode of financing	Cash	Cash; Endowment land and asset
Dealing with defaults	Interest-based penalty; Peer pressure; Mutual assistance	Islamic teachings; Peer pressure; Mutual assistance
Repayment amount	Principal and interest	Principal amount

Adapted from: Ahmed (2002)

According to GIFR (2016), there are at least four types of Islamic contracts suitable for microfinance, these are: charity (waqf and zakat), rental (ijarah), trade (murabahah and istisna), and equity (musharakah and mudarabah). Except for religious endowment (waqf and zakat), Islamic financial contracts are based on the concept of profit and loss sharing. In particular, mudarabah and musharakah are equity based contracts, where the parties involved share profits according to an agreed ratio. There is scope for commercial undertakings under these Islamic financial instruments (Abdul Rahman, 2010). However, GIFR (2016) observed that current Islamic microfinance providers are predominantly using interest-free loans (qard-hassan) and murabahah. Murabahah by definition is cost-plus financing, in which microfinance providers acquire assets or equipment and then sell the asset to the microfinance borrower at a mark-up (Abdul Rahman, 2010). The borrowers repay the microfinance provider by instalment. Because of its debt-based nature, Smolo and Ismail (2011) refer to the murabahah mode of microfinance as micro-credit.

2.1. Challenges of Islamic Microfinance

Abdul Rahman and Dean (2013) summarised four main challenges Islamic microfinance providers face, these are: market penetration, economic viability of Islamic finance, high transaction costs, and the effectiveness of Islamic microfinance in alleviating poverty. To a large extent, these challenges mirror the challenges faced by conventional microfinance providers identified by Ahmed (2002). Operating a microfinance institution requires high transaction costs to maintain economic viability. However, as Smolo and Ismail (2011) pointed out, many Islamic microfinance providers have not used all sources of funding or Islamic financial instruments; in particular, religious endowment (waqf and zakat) could be added into the sources of funding for helping financially disadvantaged groups. Moreover, microfinance providers are created for the purpose of helping people who typically live in deprived areas with a high unemployment rate, recurring natural disasters, or a challenging macroeconomic environment (GIFR, 2016). When an entire community is below the poverty line, the major challenge for the microfinance provider is to determine which business model could sustain in such an environment.

In practice, poverty alleviation requires more than financial support. Borrowers often lack the necessary skills to run a successful business and are thus unable to repay the loan on time (Abdul Rahman and Dean, 2013; GIFR, 2016). Other factors such as market opportunity, physical health, consumer demand, and adverse weather all affect the ability of borrowers to repay their loans. Therefore, Abdul Rahman and Dean (2013) suggested a combination of microfinance services with educational programmes. This requires collaboration between multiple organisations or experts, which is complicated and difficult to coordinate. The success of microfinance in alleviating poverty as shown by the Grameen bank is debatable because critics argue that Grameen model of microfinance could not be sustained without grants (Abdul Rahman and Dean, 2013). Other researchers found that the success of Grameen bank in helping the economically disadvantaged groups was partly due to its village phone programme, where borrowers can purchase mobile phones and provide payphone service to villagers (Yunus, 2004). It thus appears that the Grameen model of microfinance requires joint efforts from multiple organisations (i.e. grant provider and network provider).

Islamic microfinance is still at its early stages. With an estimated 650 millions Muslims living on less than USD2 per day (GIFR, 2016), Islamic microfinance could play an important role in improving the economic wellbeing of the poor. To maintain economically viability, the Islamic microfinance provider needs external help, which may include religious trusts and multinational companies. The village phone programme organised by the Grameen bank indicates a market opportunity for entrepreneurs to solve the pressing needs of low-income communities at a profit and create real value for those in need. Therefore, it is important to support low-income households with joint efforts and continued innovation.

2.2. Islamic Microfinance in Somalia

According to the World Bank (2019), the Somalia microfinance industry is unregulated. There are three microfinance institutions operating in the country, which are either registered as non-governmental organisations or affiliated subsidiaries of commercial banks. These microfinance institutions are: MicroDahab (www.microdahab.com), Kaaba Microfinance (www.kaabamfi.org), and Kaah International Microfinance Services (www.kimsmfi.com). Apart from these institutions, banks such as Amal Bank and Somali Development and Reconstruction Bank also offer microfinance to the Somali people. Additionally, the Swedish International Development Cooperation Agency cooperated with three banks (Dahabshiil Bank International, Premier Bank, and International Bank of Somalia) to provide small loans for small and micro businesses. The average loan is approximately USD1000 with a short term of less than a year (World Bank, 2019).

Islamic microfinance is quite limited in Somalia. Kaah International Microfinance Services (KIMS) provides Shariah-compliant microfinance to the Somali people. According to the official website of KIMS, the institution has provided a total of $12,278,122 to over 13,215 clients since their launch. In addition to interest-free loans (Qard Hassan), KIMS offers murabahah and ijarah financial products (Hassan, 2017). Furthermore, KIMS also provides a number of initiatives for the Somali people, including refugee returnee training, fisheries value chain financing project, and a solar energy financing scheme (KIMS, 2018).

3. Research Methodology

This study is a pilot study for a series of studies, intended to be conducted on the topic of Islamic microfinance in parts of Somalia. To explore the effectiveness of Islamic microfinance in Mogadishu, a total of 65 recipients of Islamic microfinance were recruited using a random sampling technique. The questionnaires were distributed to 70 recipients, of which 5 had to be removed due to incomplete data. The current study was designed on the cross-sectional research approach, based on quantitative research techniques and a self-reported survey questionnaire. The collected data were analysed using descriptive analysis.

The participants of this study consist of males (83 percent) and females (17 percent). Over half of the respondents are students (65 percent), and less than a tenth of the respondents are business owners (9 percent). Most of the participants are single (82 percent). The income level of the recipients varied, ranging from below USD100 (14 percent), between USD 100 and USD 300 (52 percent), to above USD 300 (34 percent). The vast majority of them were aged between 20-30 years old (80 percent), and more than half of the respondents had no business experience (60 percent). With regard to the loan amount; the majority of the respondents do not take a loan more than

USD 500 (69 percent), while nearly a tenth of the respondents take a loan more than USD 1000 (9 percent). To sump up, majority of the respondents are male students, with little or no business experience. The profile of the respondents is summarised in Table 2.

Table 2: Demographic Profile of Respondents

	Frequency	Percentage (%)
Gender		
Female	11	16.9
Male	54	83.1
Marital status		
Married	12	18.5
Single	53	81.5
Age		
Below 20 years old	6	9.2
20 – 30 years old	52	80.0
Above 31	7	10.8
Occupation		
Business owner	6	9.2
Housewife	1	1.5
Student	42	64.6
Others	16	24.6
Income per month (USD)		
50 - 100	9	13.8
101 - 200	17	26.2
201 - 300	17	26.2
301 and above	22	33.8
Years of business experience		
Less than 1 year	39	60.0
1 - 5 years	18	27.7
6 - 10 years	7	10.8
Above 10 years	1	1.5
Amount of Loans (USD)		
Less than 500	45	69.2
501-1000	14	21.6
More than 1000	6	9.2

4. Results

The first part of the survey is about the Islamic microfinance offered in Mogadishu, Somalia. Questions include “Do you consider the terms and conditions for Islamic microfinance reasonable?”, “Do you consider the rate of return charged by Islamic microfinance acceptable?", "Do you think that the procedure for obtaining Islamic microfinance is convenient?". The respondents were required to rate their level of agreement with statements using five-point scales, ranging from "strongly disagree" (1) to "strongly agree" (5). The mean score, standard deviation, and the percentages of opinions were calculated for the purpose of descriptive analysis. The results are presented in Table 3.

Table 3: Islamic Microfinance Products in Somalia

1= Strongly Disagree (%), **5**= Strongly Agree (%)

No	Statement	1	2	3	4	5	Mean	Std. Dev.
1	The rate of return charged by the Islamic microfinance institution is acceptable.	15.4	13.8	12.3	41.5	16.9	3.31	1.33
2	The terms and conditions of getting an Islamic micro loan are reasonable (e.g. solid project proposal, guarantor).	16.9	6.2	26.2	30.8	20.0	3.31	1.33
3	The procedure for obtaining Islamic microfinance is easy and convenient.	20.0	10.8	16.9	23.1	29.2	3.61	1.50
4	Islamic microfinance services are available for all, including those who live below the poverty line.	4.6	7.7	18.5	41.5	27.7	3.8	1.08

On an average, 41.5 percent agreed and 16.9 percent strongly agreed that the rate of return charged by Islamic microfinance is reasonable and acceptable. Half of the respondents opined that the terms and conditions for applying for a Shariah compliant micro loan are acceptable, with 16.9 percent strongly disagreeing. 20 percent of the respondents strongly disagreed and 10.8 percent disagreed with the view that the procedure for obtaining a Shariah compliant microloan is easy. The vast majority of the respondents (69.2) believe that Islamic microfinance services are available for all, including those who are living below the poverty line.

The second part of the survey is to explore the effectiveness of Islamic microfinance in reducing poverty in Mogadishu, Somalia. Respondents were asked about their views on how Islamic microfinance could help to improve their lives, especially their monthly incomes and living standard. Respondents were also asked whether Islamic microfinance helps to create job opportunities in Somalia and brings social impact for the Somali people.

The majority of the respondents indicated that Islamic microfinance has improved their living standards and monthly income. 47.7 percent agreed and 13.8 strongly agreed that Islamic microfinance has increased their monthly incomes, while only 3.1 strongly disagreed and 13.8 disagreed. More than half of the respondents agreed with the statement that Islamic microfinance indirectly increases job opportunities in Somalia and brings positive social impacts to society.

The survey results are presented in Table 4.

Table 4: Effectiveness of Islamic Microfinance Institutions in Somalia

1= Strongly Disagree (%), **5**= Strongly Agree (%)

No	Statement	1	2	3	4	5	Mean	Std. Dev.
1	Islamic microfinance has improved their living standard	6.2	13.8	18.5	32.3	29.2	3.65	1.22
2	Islamic microfinance in Somalia has increased their monthly income	3.1	13.8	21.5	47.7	13.8	3.56	1.00
3	Islamic microfinance in Somalia brings positive social impacts to society	6.2	9.2	21.5	40.0	23.1	3.65	1.12
4	Islamic microfinance indirectly increases job opportunities in the country.	4.6	6.2	9.2	55.4	24.6	3.90	1.00

5. Discussion

This study is a pilot study in exploring the effectiveness of Islamic microfinance from the borrowers' perspective. This study discovered that Islamic microfinance plays an important role in improving economic wellbeing and living standards of borrowers. This study is consistent with the study of Ahmed (2002) that Islamic microfinance has been successful in helping borrowers to improve their lives. However, an in-depth study is necessary in order to understand how and why the borrowers using Islamic microfinance consider that to be true. Since this is a pilot study, the survey was a preliminary inquiry into a topic that deserves an in-depth investigation or perhaps longitudinal empirical research. It is crucial to investigate the factors that lead to a successful implementation of Islamic microfinance in order to replicate its success to other parts of Somalia and other countries.

The current study provides an indication that the Islamic microfinance in Somalia is highly appreciated and recognised as a viable tool to improve living standards. Most of the borrowers consider that the rate of return, terms, and conditions of the small loans as reasonable. Over half of the respondents (52.3 percent) think that the procedure for obtaining a micro loan is easy and convenient. Despite the fact that Islamic microfinance institutions do not provide loans to people who have no ability to repay, more than half of the respondents (69.2 percent) think that Islamic microfinance is open to all. This implies a high level of product awareness with regard to Islamic microfinance in Mogadishu, Somalia. It is unclear, however, whether the borrowers were attracted to Islamic microfinance because of religion or the product itself (e.g. interest-free, reasonable rare of return, convenience). It is equally not clear, whether the borrowers would switch to conventional microfinance in the future, especially if the conventional microfinance institutions offer interest-free loan with a longer term of repayment. Future research could compare and contrast two groups of recipients, with one group receiving Islamic microfinance and the other group receiving conventional microfinance.

5. Conclusion

This study explores the perspective of borrowers regarding Islamic microfinance products and their effectiveness. The contributions of this study are threefold. First, this study reviews the main challenges to the Islamic microfinance sector and examines solutions to overcome these challenges. Second, it examines the demographic profiles of Islamic microfinance borrowers giving a snapshot of the main beneficiaries of Islamic microfinance in Mogadishu, Somalia. Third, it lays a foundation for future research into the Islamic microfinance sector in the context of Somalia or similar environments.

Several caveats to the study should be noted. First, since this is a pilot study with a relatively small sample, the generalisability of the findings to other contexts remains to be determined. To address this, future studies should enlarge the recruitment and selection of respondents involving other regions or perhaps countries in order to produce research findings that are more comparable. Second, the findings of the current study are confined to the perception of the borrowers regarding the Islamic microfinance product and its effectiveness. Future studies may consider a wider and richer set of data, including not only financial consumers but also institutional factors such as the perception of staff or bankers regarding Islamic microfinance and possible ways to improve the product and services.

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