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Islamic Microfinance Model for Small Businesses in Uganda in the Post-Covid-19 Era

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Abstract

The measures taken to contain the Coronavirus are having a huge socioeconomic impact all over the world. Uganda has been subjected to some of the most severe lockdown measures in the world. Many businesses are forced to close on a regular basis or operate under strict social distancing rules and curfews. Small and medium-sized businesses face severe consequences, including high transportation and input costs, lower demand, losses, bankruptcies, and so on. This has nearly wiped out micro and small businesses, raising the possibility of an increase in extreme poverty in the post-Covid-19 period. There is evidence that Micro Finance Institutions (MFIs) help developing countries recover economically after major shocks like wars, droughts, floods, and pandemics. Indeed, microfinance institutions (MFIs) are a promising tool for eradicating poverty, increasing income and employment, and improving food security. However, MFIs in Uganda have historically overcharged the public by charging exorbitant interest rates. As a result, the overall goal of this research is to create a more affordable and viable Islamic microfinance model for Ugandan small businesses. The study employed a qualitative research method, reviewing existing literature on both Islamic and conventional microcredit finance, as well as secondary data. Because charging interest on loans is prohibited in Islam, the model was built on charitable contracts such as *Sadaqah, Waqf, Zakat,* and *Qardh Hassan*. *Waqf* and *Sadaqah* will be used to raise funds for the Islamic Microfinance Fund, and *Qardh Hassan* will be used to carry out the loan. We anticipate that the model will benefit the poor and low-income groups by providing them with access to interest-free loans that will allow them to start businesses and improve the welfare of the Muslim community.

Keywords: Islamic Microfinance Model; small businesses; Post Covid-19 Era; Uganda.

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1. Introduction

Microfinance has grown in popularity over the past decade and is now recognized as one of the most promising tools for fighting poverty in the developing world. According to empirical evidence, microfinance has the potential to reduce poverty, contribute to food security and improve social welfare. Microfinance services help the poor diversify their income sources, accumulate material, human and social wealth, focus on good money management, rebuild household income and wealth bases after economic shocks, and smooth consumption [1].

The microfinance sector in Uganda consists of formal and informal microfinance institutions [2]. The formal institutions are either corporations governed by banking laws; financial intermediaries that are not banks but are regulated by the government as microfinance deposit institutions; unregulated companies that only offer credit; or formally registered cooperatives and societies serving their members. The formal institutions are members of the Association of Microfinance Institutions of Uganda [3]. The main goal of microfinance institutions is to create social welfare, prosperity, and sustainable development by accelerating financial development, reducing poverty, and stimulating economic growth through entrepreneurship [4].

The development of microfinance institutions in Uganda was a direct result of earlier attempts by government and donor-funded rural loan programs to reach poor families and landless households in rural areas. In the 1980s, poverty alleviation NGOs gave way to today's dynamic and economically viable microfinance institutions. Microfinance institutions had a total gross loan portfolio of Ugx. 1.125 trillion at the end of 2019 with over 677,387 borrowers and 2.2 million savers. Market penetration is high and competition in urban areas is fierce, resulting in multiple debts. According to the 2013 Microfinance Index of Market Outreach and Saturation (MIMOSA), the country has a normally functioning market with a score of 3 out of 5 [5].

It is worth noting that the small businesses targeted by microfinance institutions lacked the traditional collateral that serves as a basis for acquiring credit in the formal banking sector. Access to credit is a major issue for the rural poor, and microfinance institutions and credit programs are being developed to meet this demand. Such organizations often educate community members about the benefits and methods of saving and provide microcredit to start small businesses [4]. Microfinance is now seen as the most obvious vehicle for providing financial services to urban, suburban, and rural low-income residents [6]. Therefore, the objectives of this paper are threefold: to review the impact of Covid-19 on small businesses, to examine the state of microfinance institutions in Uganda, and to propose Islamic microfinance for small businesses in Uganda.

2. Impact of Covid-19 on the Business Sector in Uganda

The COVID-19 pandemic is having a significant, unprecedented impact on businesses around the world. The first case of the COVID-19 virus in Uganda was confirmed on March 21, 2020, and strict measures including lockdowns, bans on public gatherings, closures of schools and universities, and a night curfew were implemented in the same month. In addition, travel restrictions have been imposed, and land and air borders have been closed until October 2020 [7]. While these virus containment measures may have been successful, they have had a significant impact on business operations [8]. Low-income members of society, mainly served by microfinance institutions, experienced severe economic disruption. According to the Microfinance Support Center (MSC), 92 percent of small traders, particularly market vendors who trade in perishable goods, have lost their capital entirely, while a preliminary assessment by the Minister of Finance, Planning and Economic Development on March 20, 2020, forecast one Increase in the number of poor people by 2.6 million [9].

Reference [7] study emphasizes that almost all Ugandan businesses were affected in some way by the outbreak of the pandemic. Two-thirds of all companies surveyed reported lower demand for their goods and services. That share rose to 80% for wholesale, retail, lodging, tourism, beauty, and life services companies. IT service providers were less affected than other sectors. In addition, the corporate sector experienced a lack of access to credit, increased input prices, and disruptions in the supply chain. Another survey by the Economic Policy Research Center (EPRC) in Uganda shows that compared to large companies, small and medium-sized businesses are disproportionately affected by Covid-19 containment measures. Most of the country's micro and small businesses have shut down because they have been unable to implement preventive health measures such as housing employees on site and disinfectants and hand washing equipment for customers. These precautionary measures have increased operating costs for the stores that have remained open. As a result, if the pandemic continues and current restrictions are maintained, most micro and small businesses, particularly in the service sector, expect to be shut down within one to three months [8].

Risks related to COVID-19 have exacerbated already existing credit and liquidity constraints in micro, small and medium-sized enterprises, according to a survey report by the Economic Policy Research Center (2020). In fact, 69 percent of the companies surveyed reported a decrease in access to credit, with 34 percent reporting a sharp decrease [11]. (EPRC survey report, 2020). In addition, a relatively high percentage of small and medium-sized enterprises in the service sector reported lower access to credit and financial liquidity compared to large enterprises. This trend is because lending institutions already see them as very risky, and these businesses are more likely to fail if COVID-19 persists and restrictions are maintained. Compared to agriculture, high percentages of firms in the manufacturing and service sectors reported a decrease in the ability to repay an outstanding debt as a result of the COVID-19 outbreak. This result may mean fewer farms are eligible for loans. Even for those who have credit, the amounts are small, showing how underfunded agriculture is in terms of credit [9].

3. Critical Assessment of Conventional Microfinance Institutions

Milton Friedman once said that the poor stay poor, not because they are lazy, but because they have no access to capital. Until today, a sizable portion of the global population has remained outside of the formal banking system. Many of the poorest people do not have access to credit, and if they do, they are frequently forced to borrow from loan sharks. This not only traps them in spiraling debts due to exorbitant interest rates but also prevents them from growing their small businesses. Henceforth, microfinance can increase the income of the poor through entrepreneurship, making it easier for them to afford better housing and more nutritious food, as well as pay for medical bills and education [10]. Microfinance institutions are the only ones equipped to reach the "unbanked" masses and provide them with financial services [11]. However, macroeconomic data indicate that while microcredit offers some non-economic benefits, it does not significantly alleviate poverty. In some cases, microcredit makes life worse at the bottom of the pyramid. Microfinance critics have highlighted incidents in many countries, including Bolivia, Nicaragua, and Morocco, where clients have been forced into deep debt and some have committed suicide due to peer pressure. Debt collection practices in microfinance, for example, have come under increased scrutiny, particularly after a crisis in the Indian state of Andhra Pradesh in 2010, in which microfinance loans were blamed for a spate of borrower suicides [12]. (Dugan, 2016). Several scholars have documented the discrepancy between the benevolent goals and descriptions of microfinance and the systematic abusive and exploitative practices of microfinance agents, as well as the pressure, violence, and abuse that borrowers experience from members of their borrower groups [13,14, 15].

According to [12], after years of credit promotion and laissez-faire policies, Uganda now has one of the most diverse and competitive microfinance landscapes in sub-Saharan Africa, with little effective regulation or oversight for most lenders operating in the country. In this environment, some borrowers have lost savings and property in excess of their debt, while others have had collateral confiscated despite never missing a payment or obtaining a loan. Malicious lenders have also been able to operate for decades despite widespread abuses and repeated attempts to shut them down, and as a result, the sector has lost public trust.

Reference [16] emphasize that microfinance borrowers often go through several procedures before receiving credit. It involved a lot of paperwork, such as filling out various forms, finding sponsors, contacting local authorities, getting recommendations from employers, and collecting signatures and photos of the sponsors. These procedures require multiple visits to microfinance offices in search of sponsors and letters of recommendation. This deters applicants who may drop out before receiving loans. Another factor limiting borrowers' access to microfinance loans, particularly women, is a lack of collateral. It is important to note that collateral is required for individual borrowers to receive microfinance loans. This limits women's ability to borrow large sums of money for long-term investments that could improve their lives in the long run. Also, borrowers must bribe the loan officers before their loan application is approved. This practice makes borrowing not only difficult but also costly.

Moreover, group tensions over loan repayment are another major obstacle for borrowers. Because most microfinance loans are granted as group loans with joint liability. The goal is not to promote a sense of community, but to ensure that these women guarantee each other because they have no substantive guarantees to back their loans in the event of a default. It should be noted that in most of the microfinance institutions in the study areas, the loan repayments are scheduled weekly, and groups meet for an hour and collect installments in a pool, which they present to the loan officers, or the chair of their group submits the loan to the loan officers. The fact remains, that people aren't always able to make weekly payments. If a member misses a meeting, the remaining members of the group must pool their funds to compensate the absent member. However, such a situation puts borrowers in a bind. Borrowers must pay several fees in addition to the interest they pay. These fees include withdrawal fees, administration fees, loan processing fees, and forced stock purchases. Fines and penalties are imposed on borrowers who fail to meet their payment obligations. As a result, the cost of servicing the loan is high, which can lead to default. Sometimes the fees are deducted without informing borrowers and they only discover this when they update their savings accounts. In fact, the interest rates that microfinance institutions charge for loans are extremely high, ranging between 24 and 27 percent per month compared to commercial interest rates, which are typically 22 percent per year [16]. Generally, high-interest rates are one of the main issues raised in the industry. High-interest rates often push borrowers deeper into debt and poverty. For example, Muhammad Yunus, founder of Grameen Bank, has chastised Compartamos Banco, a Mexican microfinance company, for charging interest rates of almost 100 percent per year [17].

4. Islamic Microfinance Models

Access to low-cost, Shariah-compliant financing remains a significant challenge in many Muslim communities. More than 500 million people in Indonesia, Pakistan, Bangladesh, Egypt, and Nigeria live on less than $2 per day. These people struggle due to a lack of adequate liquidity, savings management, and the ability to transfer and receive money [18]. Islamic microfinance has been proposed as a novel tool for poverty alleviation. Islamic microfinancing is a growing sector of modern finance in Muslim-majority countries. It provides low-income people with low-cost financing options. It eradicates poverty while avoiding some of the challenges associated with traditional banking, such as high collateral requirements and solid credit history [19]. It is estimated 72 percent of the population in Muslim-majority countries do not use them. This is because some Muslims consider traditional financial products incompatible with Islamic law as they contain prohibited elements such as riba. In this regard, Islamic microfinance institutions have recently emerged to serve the low-income Muslim population seeking Islamic financial products. Indeed, Islamic microfinance has the potential not only to meet unmet Muslim demands but also to combine the Islamic social principle of caring for the less fortunate with microfinance's ability to provide financial access to the poor through traditional Islamic tools used for poverty alleviation such as *Zakat, Awqaf, Sadaqah and Qhardh hassan*. While Islamic microfinance is gaining popularity, it is still concentrated in a few Muslim-majority countries such as Indonesia, Bangladesh, Malaysia, Pakistan, and Afghanistan [20].

According to [21], Islamic microfinance products can be classified into three types: microcredit, micro equity, and charity. Microcredit involves the use of Qardh Hassan, Murabaha, Ijarah, and Salam contracts to make loans to small businesses. *Mudharabah* and *Musharakah* can be included in the Micro Equity model. Micro-equity brings together factors of production while profit/loss is shared according to agreed-upon formulae. *Zakat, Sadaqah*, and *Waqf* are examples of the charity-based model. The charity type of Islamic microfinance provides additional empowerment in the form of safety nets and for long-term sustainability.

In the micro-credit model, using the Murabaha mechanism to provide credit, the MFI purchases the goods as per the specifications and requirements of the client. For instance, the bank will buy the machine and sell it to the customer at cost-plus on deferred payment. In this mode, the customer fully owns the machine but has the liability of paying the purchasing price to the bank either in a lump sum in the future or in installments [22]. Under this mode of investment, the cost price and profit are to be disclosed separately. In this arrangement, more emphasis will be on trade, and less emphasis on credit henceforth there is no need for collateral. Most importantly, it prevents finances from being misused and misdirected by the borrower for other consumption or economic activities. In addition, Ijarah financing can be the viable mode for the above model. Al-ijarah is a contract whereby the lessor (MFI) will rent the asset(s) to the lessee (customer) over a certain period and at a monthly rental amount as agreed by both parties. An example can be a person who wants the machine to start his business. In this case, the MFI will buy the needed machine say at $ 1000 and rent it to the customer. The customer in turn will be paying rentals for its use. The remaining money after all expenses are deducted will be either saved or used in expanding the business thus re-invest in the same business [23].

In charitable-based microfinance, Islam's redistributive instruments such as mandatory levies (zakat), or philanthropic contributions (sadaqat and waqf, Qard al-Hassan) can be used to provide microfinance loans. Islam has made zakat obligatory and encouraged charities to ensure the welfare of the poor who lack basic survival needs as well as financial support to engage in economic activities [24]. (Iqbal, 2015). According to [20], an integrated *Zakat–Awqaf* Islamic microfinance model may reduce the likelihood of loan default because the basic inherent tendency of poor borrowers to use loan funds for consumption purposes will be met. Since their basic consumption needs are met, micro-entrepreneurs may be able to focus more on their business. Indeed, this model is likely to yield better results if properly designed. The financier went on to say that it is important to note that this model will be financially viable and sustainable in the long run, ensuring proper use of Zakat funds that do not require a return. This, in turn, will create a win-win situation for all stakeholders, resulting in lower default rates and faster higher graduation from poverty.

4.1 Propose Islamic Microfinance Model for Small Business Sector in Uganda

The proposed Islamic microfinance model is based on the Alkhuwat Islamic microfinance model in Pakistan, as well as the models of [25] and [26], with some modifications. The proposed model is shown in Figure 1. Under the model, donors contribute *cash Waqf, Sadaqah,* and *Zakat* to Islamic Microfinance Institutions. Second, the donation will be used to set up microfinance funds at the facility. Third, the client applies to IMFI for a *Qardh Al-Hassan* loan and the institution evaluates the application based on predefined eligibility criteria. Fourth, IMFI staff conduct social and business assessments. Based on the information in the application form, the social assessment assesses the personality and creditworthiness of the applicant. In addition, staff visit the applicant's home and interview family members and friends to determine the borrower's creditworthiness. In addition, the institution examines the business proposal, assesses the viability of the business, determines whether it is sustainable and capable of generating enough income to repay the loan and improves the well-being of the borrower. Family members are also interviewed to ensure they are aware of the borrower's business plan and whether they support it. Fifth, the prospective borrower must provide two guarantors for individual loans and members of the group for group loans. The guarantors are responsible for monitoring the borrower and ensuring that the loan is repaid on time. Sixth, IMFI provides interest-free loan to borrowers after proper verification. The contract will clearly state the repayment schedule with fixed instalments. The borrower must take a religious oath before the Imam, promising not to use the funds elsewhere and to repay the loan on time and in full. When disbursing the loan, the borrower must present the two guarantors in the case of an individual loan and all group members in the case of a group loan. Finally, there is recovery and follow-up. Once the loan is disbursed, IMFI will contact the borrower and regularly monitor business activities. If the instalments are not paid on time, the IMFI will contact the borrower, determine the reasons and occasionally ask the guarantors to contact the borrowers. The institution will provide training to the recipients of the loans on how to market and manage the businesses. It can also provide social media platforms for small businesses to sell their products online.

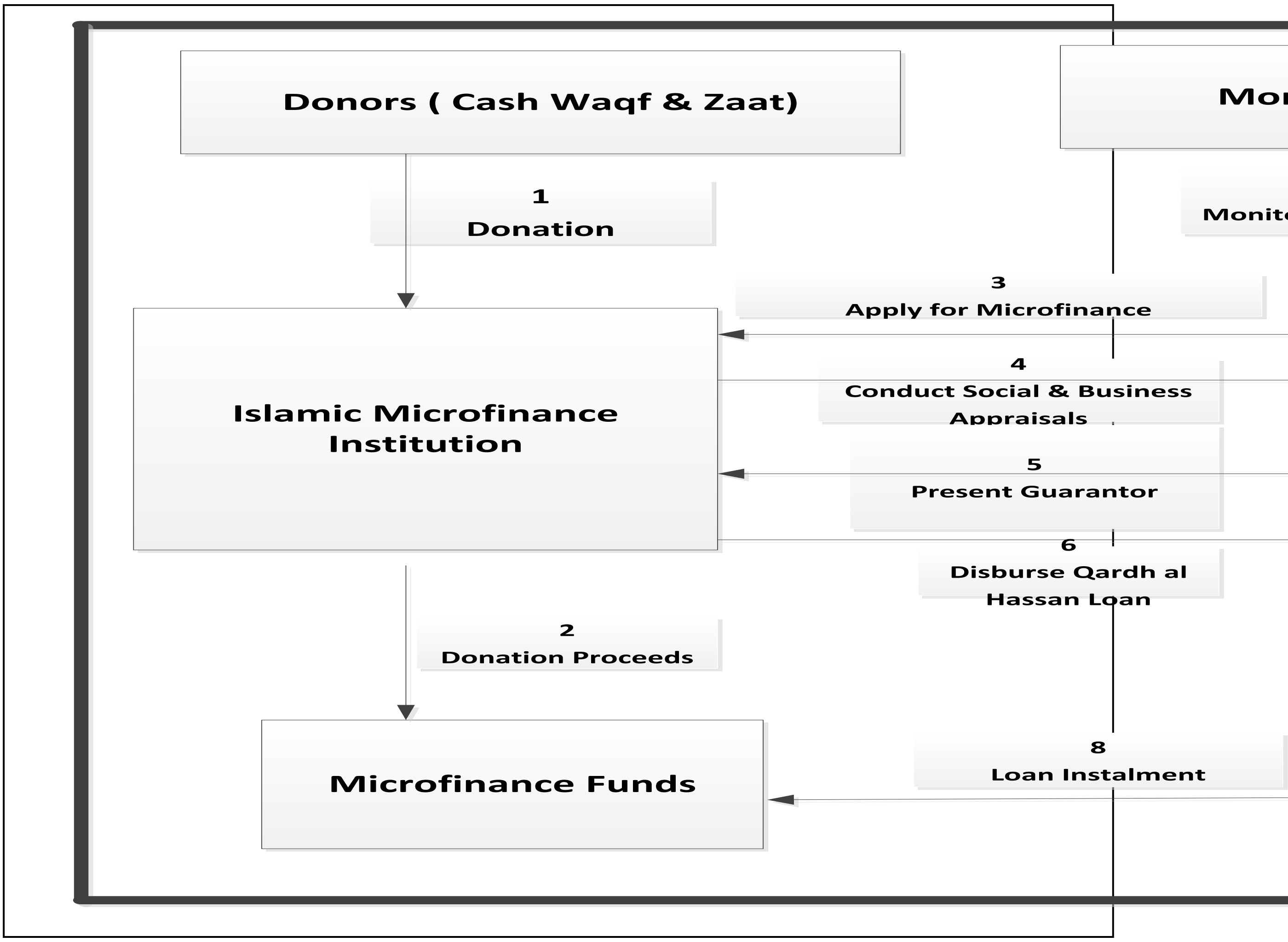

Figure 1: Proposed Islamic Microfinance model for Small Businesses in Uganda

5. Conclusion

The Covid-19 pandemic has devasted small businesses and Uganda's poorest communities. Most small traders, especially market vendors who trade in perishable goods, lost all their capital, while the government predicted that extreme poverty would increase in the post-Covid-19 era. In fact, the traditional conventional microfinance institutions to some extent have failed hard-working poor and small businesses due to the exploitative nature of their businesses, making poor borrowers more vulnerable to their creditors. There is evidence of abuse, theft, and fraud, which has resulted in a lack of public trust in entire financial institutions. Through inclusive and innovative models based on zakat, sadaqah, and waqf, Islamic microfinance can now become a viable tool to promote financial inclusion and fight poverty in the post-Covid-19 era. The proposed model is based on charitable contracts of *Sadaqah, Waqf, Zakat,* and *Qardh Hassan*. *Zakat, Waqf* and *Sadaqah* will be used to raise the Islamic Microfinance fund and *Qardh Hassan* will be used to execute the loan. We expect the model to give poor and the low incomes groups access to interest-free loans that will enable them to set up businesses. Henceforth, it will create jobs, increases income, provide access to health and education, and improve the well-being of the Muslim community. The study has significant implications for industry, academics, and policymakers. The industry should introduce Islamic microfinance where it can provide interest-free loans to the poor and the low-income groups. The paper offers researchers a way to validate the viability of the model. The model can help policymakers to address the weaknesses of conventional MFIs and introduce appropriate regulations to facilitate the establishment of the Islamic microfinance institution**.** Despite this, there are a few caveats associated with this study. Since Islamic microfinance institutions are often only implemented in countries with a Muslim majority population, implementing this model in nations with a Muslim minority population like Uganda will require considerable time and effort spent on public education. Second, the concept relies solely on the trust of the public and does not call for any form of collateral. This may be difficult to achieve given that some people may choose to exploit the resource for their own consumption rather than for productive purposes. In conclusion, it is possible that a survey will be required to validate the model and determine whether or not it is viable.

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