Journal of Economics and Business Research,
ISSN: 2068 - 3537, E – ISSN (online) 2069 – 9476, ISSN – L = 2068 – 3537
Volume XXI, No. 2, 2015, pp. 15-31

Islamic Microfinance: an Interest free Microfinance Model for Poverty Alleviation

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Abstract

This theoretical paper deals with Islamic microfinance and its rationality in Indian context as a panacea of Muslim poverty. Conventional microfinance system is very effective to alleviate poverty of developing countries. But it could not touch all community of people because of 'interest' component in debt and high degree of interest. Muslims dislike that microfinance which is based on 'interest' as it is strictly prohibited in Islam. Therefore the motto of financial inclusion is out of reach through conventional microfinance. An alternative interest free microfinance model has been developed in some part of world to include all Muslim poor people within the banking system. India is yet to adopt Islamic microfinance though 20% of total population is Muslim. The author strongly opines that India should adopt Islamic microfinance as a tool for poverty alleviation of Muslims as well as other communities.

Keywords: Microfinance, Interest Free Finance, Islamic Microfinance, Interest (Riba), Poverty Alleviation

Introduction

Microfinance is a financial service of small quantity provided by financial institutions to the poor. Besides size and clientele group what makes micro credit different from normal credit is that the latter is 'walk in' and the former is 'walk out' business for the financial institution. Besides, credit is provided with collateral substitute. After the successful operation of the Grameen Bank model in Bangladesh, the concept of microfinance has drawn the attention of the development economists all over the world. The microfinance has become of late a development fad in many less developed countries. It has created a euphoria that is unparallel in the recent history of development practice. India has become home to one of the largest micro credit programmes in the world. India's share in the global micro credit market in 2005 was 15% of all clients and 20% of the poorest clients (Karmakar, 2008).

There are five models of micro finance based on different philosophies and target groups viz. Grameen and solidarity model developed in Bangladesh and now popular in South Asia, Self-Help Groups (SHG) model popular in India, Indonesia and Kenya, Individual Credit – mostly priority sector lending in India, Community Banking – developed in Latin America and replicated in Africa and Central Asia, Credit unions and Co-operatives – popular in Sri Lanka. The self-help group is the latest breeds of the microfinance industries in India. The SHGs proved beyond doubt that they are the fastest growing and most cost-effective micro financial initiatives in the world. In India there have been many significant state initiatives in the major institutional and policy spheres since the early 1990s to promote SHGs and their microfinance activities.

But these conventional models of microfinance are not sufficient to include financially all community of people in the world. Muslim community is not interested in interest based loan as the interest (Riba) is strictly prohibited in Islam but they are interested in debt as it is permitted in Islam. Till date, a part of world Muslim population is excluded from microfinance. A considerable (28.26%) portion of world population is Muslim and half of world poor people are lives in Muslim countries. So, microfinance is a very effective tool to reduce the Muslim poverty, but the problem is the interest component of debt. To trim down the poverty among the Muslim community a new microfinance model has been developed all over the world: interest free microfinance i.e. Islamic microfinance. It is very popular among the Muslims as there is an absence of the interest component in debt and free from religious constraint. Islamic microfinance is exclusively based on 'faith' not on 'Riba (interest)'. India is a country where Muslims are 20% of total population, suffering from the problem of acute poverty. The financial regulatory authority of Government of India is yet to adopt the Islamic microfinance as a tool for financial inclusion, as well as poverty eradication.

Eradication of poverty has been an important issue before the developing countries of the world. This is a big challenge for South Asian nations, as about half of the world's poor live in this region. Again the intensity of poverty is high in India. One of every three persons in India is officially poor, and two of every three are either undernourished or malnourished. The more rational way to help the poor could be the provision of sustainable economic opportunities at gross-root level, especially provision or required financial services at competitive rates to support their investments and viable business activities. India is perhaps the largest emerging market for micro finance. Over the past decade, the micro finance sector has been growing in India at a fairly steady pace. Though no microfinance institution (MFI) in India has yet reached anywhere near the scale of the well known Bangladesh MFIs, the sector in India is characterized by a wide diversity of methodologies and legal forms.

Literature review

Microfinance is an interesting field of research for the researchers of business studies. In recent past there are numerous research conducted on the topic over the world. The author tried to highlight some previous research works to the related field, below.

Karmakar, K.G. (2001) focuses on the concept and functions of SHGs and discusses the micro finance needs of various groups including tribals, the rural non-firm sector, rural women and micro entrepreneurs. Morduch, J. and Haley, B. (2001) are of the view that micro finance has proven to be an effective and powerful tool for poverty reduction. Like many other development tools, however, it has insufficiently penetrated the poorer strata of society. Range (2004) underlines how the prohibition of Riba in Islamic finance does not constitute an obstacle in building sound microfinance products; on the contrary, the side effects of an Islamic foundation could probably enhance it. These effects are: the high rate of return (compared to a fixed interest rate), the holistic approach in supporting businesses and productive activities, a more effective mobilization of excess resources, a fairer society. Montgomery, H. and Weiss, J. (2005) surveys the evidence from Asia by carrying out a rigorous study and states that microfinance may have had positive impacts on poverty but its reach to the core poor is very limited. Swope, T. (2005) shows that microfinance can lead to an increase in income, better nutrition for families, greater high school attendance, empowerment of women and alleviation of poverty. Moreover, there is abundant support to demonstrate that micro-finance can lift families out of poverty and is also able to expedite the completion of sex of the seven millennium development goals. Segrado, C. (2005) expresses that Islamic banks have grown recently in the Muslim world but still constitute a very small share of the global economy compared to the Western debt banking paradigm. Misra, A. (2006) brings out the missing link impact assessment in the Indian context, which is a precondition for poverty reduction on account of the influence of new paradigm of institutional viability under commercial microfinance.

Dusuki, A.W. (2007) suggests the use of special purpose vehicle, SPV as one of the possible alternatives for channeling funds to the poor. With its unique bankruptcy-remote feature, Islamic banks are fully protected from any failure of SPV that involves microfinance activities. Islamic banks can practice microfinance without compromising with institutional viability, competitiveness and sustainability. The tentative findings of Yusuf, T. O. and Mobolaji, A. H. I. (2012) study suggests that Islamic Micro Insurance Company might be doing better than its conventional counterparts. In an exploratory study Aziz and Alam (2012) developed a conceptual promising microfinance model (Interest Free Microfinance Model) to address the challenges of the existing models.

The study of Haneef Md. (et.all 2014) found that in OIC member countries religious and cultural norms drive preference of Islamic microfinance over conventional microfinance. The study further developed an integrated waqf based Islamic microfinance model (IWIMM) for poverty reduction in OIC member countries.

Objectives of the study

The major objective of the paper is to analyze the conceptual aspects of Islamic microfinance with traditional microfinance and to assess the rationality of Islamic microfinance in India. In order to do that the author sub-divided the broad objective into five sub-objectives.

a. To study the conceptual aspects of microfinance
b. To study the concept of Interest free microfinance and its status in India
c. To study the theoretical aspects of Islamic microfinance and its rationality in India
d. To study the difference between traditional microfinance and Islamic microfinance
e. To study the relation between microfinance and economic development
f. To study the role of Islamic microfinance to trim down poverty.

Methodology

This study is purely based on the information collected from different sources like websites, articles published in reputed national and international journals, newspapers and reputed reference books related to this field. Phase wise discussion of different aspects relating to innovative microfinance models has been done to realize the objectives of the study. Finally the author reaches to the conclusion and recommends something for a better implementation of Islamic microfinance in India.

Evolution of Microfinance Market

A system of providing small amount of credit to the poor i.e. the delivery of microfinance is not a new phenomenon in India. It began formally with the nationalization of commercial banks in 1969. It gained strength after the introduction of RRBs in 1975. It got momentum by the commencement of IRDP and man other poverty alleviation programmes in 1980s. The government has supported micro finance schemes by providing subsidy to the beneficiaries. The approach to microfinance in all these initiatives is individualistic and group.

Although the microfinance market has expanded rapidly, both in its quantum and coverage tills the early 1990s, it failed to reach the poorest among the poor. The individualistic approach to micro credit delivery system has revealed many deficiencies. To highlight a few of them:

I. There is gender inequality in micro credit. The proportion of male in small borrowing accounts and the outstanding credit amount exceeded 80% as against the share of female hanging around 14% to 16% in both respects.

II. The high transaction cost involved in reaching out the poor, both for banking institutions and the borrower.

III. Improper identification of borrowers and/or loan purposes which lead to misuse of credit, non-payment of loan and eventually resulted in mounting NPAs of banks.

IV. Formal banking agencies are involved in multiple activities and hence cannot devote the attention to the poor, particularly the poor women they deserve.

V. Finally there was lack of mutual trust and confidence between the bankers and the rural poor.

Due to the problems mentioned above banks were skeptical about the business viability of microfinance sector. Against this background the group approach towards microfinance has been conceived and its delivery by non governmental organizations and no formal groups has started. The earliest step in microfinance in India by the NGO may be traced to the initiative undertaken by the Self-Employed Women's Association (SEWA). The SEWA has been providing banking services to the poor and self employed women working as hawkers, vendors and domestic servants etc. in Ahemadabad.

Similarly working women's cooperative societies in Tamil Nadu since 1980, Shreyas in Kerala since 1988 are the examples of the organizations involved in microfinance operations. By the same time a good number of NGOs spread throughout the country began to sponsor loan to the poor and encouraged the poor to organize themselves as self-help-groups. An important mile-stone in this direction is the NABARD's SHGs - Bank linkage programme started in 1991. The RBI has also encouraged the growth of SHGs by pursuing a policy of reckoning credit to SGHs as priority sector credit. Several state governments including Karnataka are giving some financial assistance in the form of seed money to these self-help-groups.

Microfinance

The concept of microfinance can be described as small, short, unsecured lending of money and provision of money and provision of very small loans that are repaid within short period of time. It is essentially used by the low income individuals and households to empowered them economically and enable them financially. Microfinance refers to a movement that envisions a world where low-income households have permanent access to high-quality and affordable financial services to finance income-producing activities, build assets, stabilize consumption and protect against risks. Initially, the term was closely associated with micro credit - very small loans to unsalaried borrowers with little or no collateral - but the term has since evolved to include a range of financial products, such as savings, insurance, payments and remittances (Microfinance Gateway, 2014). The microfinance is used as a sustainable tool to combat poverty. Micro finance can lead to micro solutions to poverty. The features of microfinance are:

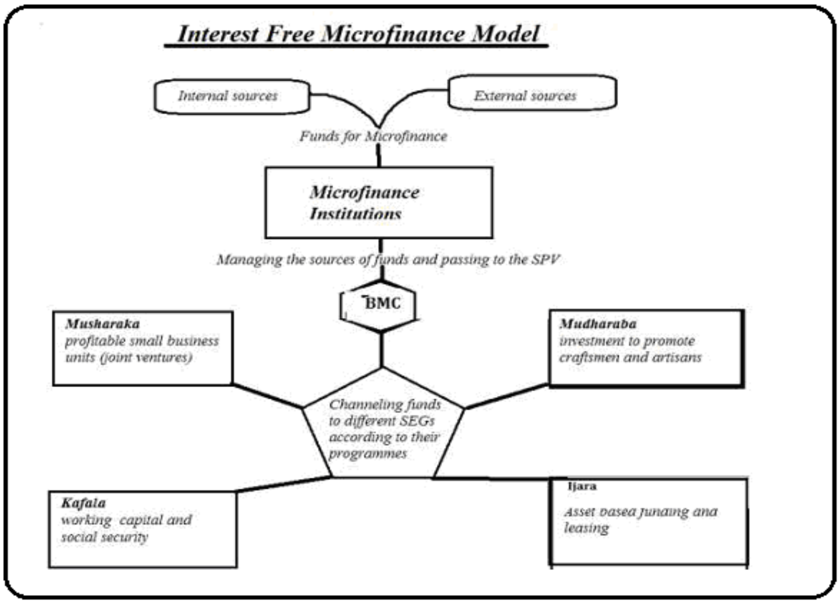
- It is a tool for empowerment of the poorest.
- Micro credit is delivered normally through Self-Help Groups.
- It is essentially for promoting self empowerment and productivity in formal sector of economy.
- It is generally used for direct income generation and consumption smoothing.
- It is not just a financing system, but a tool for social and economic change, especially for women.
- It provides for seasonality, allow repayment flexibility and avoid bureaucratic and legal formalities.
- It assists the women to perform traditional roles better and to take up micro entrepreneurship.

Interest free microfinance

Interest free microfinance is an interesting concept of microfinance, growing in the country in different models and becomes influential organizations in several parts of the country. This financing system is exclusively based on ‘faith’ not on ‘interest’. It’s very popular among the poor people as an alternative of traditional microfinance system as well as existing banking system based on interest component. Interest free microfinance helps to reduce the vulnerability of the needy poor persons and disadvantaged section of population through economic empowerment, which benefits to the poor people through creating new employment opportunity to reduce poverty.

There are two types of microfinance model which operates in the country viz: mainstream and alternative. Mainstream microfinance is similar to the traditional banking system but alternative microfinance is based on faith (Christian, Islamic, Judaic, Hindu etc), exclusively interest free potential tool of inclusiveness and poverty alleviation. In India are two legal routes of availability of microfinance: Non Banking Financial Companies (NBFC) and Cooperative Credit Societies established under State/Central Act. NBFC route has to face many problems when it consider for microfinance operation but Cooperative Credit Societies are specially established to offer interest free microfinance to the poor people.

A classic example of interest free microfinance institution in India is Nidhis or Paraspara Sahaya Nidhis which emerge as influential microfinance institution in Kerala. The Nidhis collects fund by donations, charities, small savings etc. and offers interest free microfinance up to Rs. 25000 with repayment period of 3 to 12 months. The default rate of finances provided through Nidhis, operating more than 500 units in village area of Kerala, is very interesting i.e. near about zero percent.



Source: Aziz and Alam (2012)

Islamic Microfinance

Islamic microfinance is an alternative model of interest free microfinance. Some people of Muslim community don’t participate in traditional banking system because of ‘component of interest’ involved in it. Since interest is strictly prohibited in Islam so they prefer to remain out of the banking system. In those cases Islamic banking should be encouraged and government should incorporate suitable working environment to operate these institution at par with other institutions. Islamic banking is growing at a rate of 15% for the last three decades. Islamic microfinance is a new concept in micro credit that caters needs of poor all over the world. Islamic microfinance is becoming an increasingly popular mechanism for alleviating poverty, especially in developing countries around the world. The Islamic finance industry as a whole is expected to reach over $2 billion dollars in 2012 and is a continually growing sector due to its ethical principles and prohibition of riba/interest (International Islamic News Agency, 22 Feb. 2012). Funds to Islamic microfinance may be provided by religious contributions through the institutions like Awqaf, Zakat, Sadaqat, Qard-Hasan and other charities.

A comparison between Islamic microfinance and the conventional counterpart shows that both have similarities in terms of focusing on economic development and social objective, aiming to achieve a better life for whole people, supporting additional income, promoting entrepreneurship, encouraging risk sharing, believing that the poor should get involved in entrepreneurship activities (Obaidullah, 2008). Also, both are expected to rely on providing wider access to the poor, being a sustainable institution which can achieve “market based for profit approach”, supported by efficient system and transparency reporting, with the focus on capacity building, combining with integration between microfinance and official financial system (Obaidullah, 2008).

Table no. 1. Differences between conventional microfinance and Islamic microfinance

Category	**Conventional Microfinance**	**Islamic Microfinance**
Category of poor	One category	Two levels: 1. deeply poor who do not need loan but social safety net and charitable fund (*zakah*) 2. moderately poor who will be better to obtain credit for running micro enterprises
Based of financing	Debt based and interest based approach	Profit and loss sharing (PLS) approach, free of interest (*riba*) and uncertainty (*gharar*)
Approach/target of empowerment	The poor and woman	The poorest and family
Sources of fund	External funds, saving of clients	External funds, saving of clients and Islamic charity fund.
Dealing with default	Group/centre pressure and threats	Group/centre/spouse guarantee and Islamic ethics.
Social development program	Secular	Religious (behavior, ethics and social

Source: Obaidullah (2008), Ahmed (2002)

Islamic Microfinance: Causes of Popularity

Islamic microfinance is popular not only for Muslim community, but also for people of other religion. The specific terms and conditions make Islamic microfinance products more favorable and accessible to the most vulnerable populations. These are discussed below:

Risk-sharing: By sharing potential risks between investors and clients, Islamic microfinance becomes more attractive for borrowers who will not carry the full risk as compared to many conventional products.

Profit-sharing: In Islamic microfinance, the lending institution is no longer a sole financier but becomes a co-owner of the business with a strong interest in its success.

Fixed repayment rate: In line with the Shariah, which prohibits any rate of return on financial transactions, Islamic microfinance products have a fixed repayment rate with no possibility of making profit through interest.

Transparency: Islamic microfinance stipulates contracts with a fixed liability that is known to the customer upfront.

Social welfare and justice: The ultimate goal of Islamic microfinance modalities is to ensure growth with equity for social welfare and justice. In line with this principle, Shariah-compliant financing foresees that, in a context of default, the penalty is limited to no more than 1 per cent of the outstanding installment.

Need for Islamic Microfinance in India

Although many secular countries in the world viz. UK, France, Hong Kong change their laws in favor of Islamic microfinance, India is still orthodox in this regard. India is a country where 20% of total population is Muslim; about 50% people living below poverty line needed the financial system which is considering human values, mercy and justice. Islamic microfinance addressed the human values and best fit for country like India. Islamic banking is not only for Muslims but for all community, basically for the poorest of the poor. It is free from exploitative mode of interest. A part of the Muslim people in the world does not take part in traditional microfinance or banking system because of interest (Riba) component which is strictly prohibited in Islam. So the people who believe in God should support the Islamic banking system. Opening the window of Indian regulatory system for Islamic finance and insurance system will drive to flow of foreign direct investment to the country which promotes the growth of the nation. In Indonesia the role of Islamic microfinance institutions to reduce the poverty is very significant. SMEs create employment opportunity and employment reduces poverty of the nation. There is a close relation between SME and availability of microfinance in Indonesia. For empowering the poor Micro Thakaful (Islamic insurance) in Indonesia is very helpful.

Islamic banking is a rapidly growing phenomenon in the international financial market. The global market for Islamic investment products was growing at a remarkable pace of approximately 15 to 20% annum. After the emergence of the era of globalization Indian financial sector had opened up. Foreign investors, both, individual and institutional were allowed to invest in India and Indian investors make similar investments abroad. The international financial market enjoyed the existence of Dowjones Islamic index. Malaysian financial market had Shariah index. In this scenario Indian financial regulatory authority also made enough steps to promote Islamic financial products. It will promote the flow of foreign direct investment and growth of the country. Islamic financial instruments are fit for infrastructure financing than the conventional interest based system. In Islamic finance various instruments including Isthisna, Mudaraba and Musharaka are best fit for infrastructure finance. Several projects in the country including Kerala and Maharashtra state government are thinking on the way. India needs a jump in the infrastructure sector by constructing new roads, bridges, metros, railway lines etc. for the growth of the country. But the financing is problem. If India are ready to raise funds by using Islamic modes of financing it is expecting flow of funds from different nations. So the government tries to increase infrastructure facilities by attracting funds, using these modes.

Microfinance and Economic Development

The real idea of microfinance is to help increase income of poor people, particularly women. It is based on the notion that with small scale loans and access to other financial and business services, the poor can help themselves to generate income by creating or expanding small businesses. The fight against poverty has taken many widely differing forms that cannot be readily encapsulated into one single concept. Food and clothes, for example, are needs addressed by the government and donor policies.

Both, however, are elements of the same drive to change the situation of the poor. It is estimated that nearly out of 400-500 million people worldwide, about 80% of those who are in need of financial services are yet outside the mainstream of formal financial systems (Batra and Sumanjeet, 2011). In order to reduce the poverty among the village people, Microfinancial Institutions come forward to provide financial services to the needy people. Asia is the most developed continent in the world in terms of volume of Micro Finance Institutions (MFI) activities.

Conclusions

The study reveals that traditional microfinance failed to include all poor people under the system because of its high interest rate and also interest component of debt which holds back Muslims as it (Riba) is strictly prohibited in Islam. But half of global poverty resides in Muslim world while the Muslim population is 28.26% of the total global population. If the dangerously increasing poverty in the Muslim community is not controlled soon then it will hinder the economic development. India has a vast Muslim population exceeding 175 million and a major part of this population does not participate in the Indian financial market largely dominated by interest-yielding instruments and conventional interest-based banking. According to a report by the Reserve Bank of India ('RBI'), India's Central Bank, the Credit to deposit ratio of Muslims in the country is 47% against the national average of 74%. It can be observed from the above statistics, India offers a huge potential for Shariah finance. Islamic microfinance may be the panacea of present dilemma. Financial regulatory authority of India still not adopts Islamic microfinance as an alternative way of financial inclusion, while interest free microfinance is working in few part of the country. Not only that other financial products in the form of mutual funds, real estate funds, financial investment companies and lots of Shariah based shares are available in Indian market.

The various causes of rapidly increasing poverty in the Muslim world are lack of education, lack of employment, political instability and so on. But on the other hand, the main snag is unavailability of the proper financial products which are in line with the Muslim's religious values and social norms. Microfinancing is not use by Muslim population due to interest and thus is excluded from financial inclusion. On the other hand, Muslim world can be led out of the poverty by extending financial inclusion through Islamic microfinance. According to the statistical information of multilateral development agencies, 300 million people were graduated from Micro to SME level in past year, and the countries mentioned in the list are China, India, Brazil and Chile etc. but when we look at the enlisted countries we will come to know that then countries mentioned in the list are not Muslim and by this we will come to know that the poverty is decreasing in non Muslim countries and increasing in Muslim world.

Unfortunately, Islamic microfinance is not given the proper place in the poverty alleviation strategies of International development agencies (e.g. World Bank, UNDP, IFC, USAID etc) in the way it should have been given. Islamic microfinance is just 1% of the total microfinancing of the world that is just 1 billion US$. There is no religion of poverty, but religion plays an important role in poverty alleviation. This is the reason why Islamic microfinance should be given a proper place in the modes of poverty alleviation through which both Muslims and non-Muslims can take benefit.

The famous columnist M. D. Nalapat blames the government of India especially the financial regulatory authority for not adopting Islamic banking in India while giving valedictory remarks in an international seminar on Islamic finance held in Kochi on 4^{th} to 6^{th} October, 2014. Acting against Islamic finance due to religious matters is not a good thing. If it has a capacity to contribute Indian financial sector it should be promoted.

Islamic microfinance products have huge potential in the country and if it is utilized by introducing Shariah based products India will improve the growth. India should adopt Islamic microfinance model for the development of nation.

Suggestions

Suggestions to change the Indian regulatory system in favor of Islamic banking and finance are incorporated below:

1. Government of India should accept the recommendation of the Committee on Financial Sector Reforms (CFSR) of Planning Commission of India headed by Dr. Raguram Rajan to introduce interest free banking in main banking sector for inclusive growth through innovation.

2. Government of India should suitably amend Banking Regulation Act 1949 and taxation law to provide a level playing field for Conventional Banking as well as Islamic banking as done in several modern, secular and industrialized countries.

3. The Indian government should accommodate Shariah compliant mechanism in Microfinance institutions which are mainly operating as NBFC's along with conventional mechanism based on interest.

4. Reserve bank of India (RBI) should open interest free windows as a pilot project in few conventional banks which can operate within the framework of Indian Banking Regulation Act 1949.

5. Insurance Regulatory and Development Authority (IRDA) should amend the Insurance Act in order to introduce Micro Takaful (Muslim Insurance).

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