

THE ECONOMIC NECESSITY OF ESTABLISHING ISLAMIC MICROFINANCE
INSTITUTES IN IRAN

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(Received on: 18-09-12; Revised & Accepted on: 18-11-12)

ABSTRACT

Making use of the available literature in the field of micro finance in conventional economics, this study tries to show that although Islamic banks and Gharz-al-hassan funds are available in Iran, as an Islamic country, it is economically necessary to establish Islamic micro finance institutes and this will strengthen the Islamic banking level in Iran. In addition, the paper tries to look at the characteristics and potencies of Islamic micro finance and also, shed some light on the probable challenges they might face and tries to find some solutions for this challenges. The findings of this study which are based upon theoretical analyses show that there is room for establishment of micro finance institutions in Iran and this will improve the access of the poor and middle income people to the financial services.

Key words: *Iran, micro finance, Islamic microfinance, Islamic economics, economic necessity.*

1- INTRODUCTION

Micro-finance can be described as a tool to extend various financial services to lower income groups such as artisans, small farmers and contractors. Since this group of people has a low credit-worthiness, are not regarded as good borrowers by banks and other conventional financial institutes. In addition, because of high assessment and supervision costs of micro-loans, lack of proper collateral and the high default probability rate involving the poor, banks and financial institutes usually do not extend loan to them (Kaleem and Ahmed, 2009, p. 3).

In addition, the growth of Islamic micro-finance in recent decades is a fact. In fact, since when Professor Mohammad Yuness and Grameen bank obtained noble prize for their activities in micro-finance, micro-finance practice in Bangladesh and other developing countries has gained impressive growth. For instance, Grameen bank total extended loans showed 113.5 percent increase, and its micro-loans has increased from \$229.14 million in 2001 to \$448.41 million in 2002 (Ahmed, 2002).

It can be claimed that the main reason for the success and expansion of micro-finance is that this kind of financing is based upon two main elements which can be regarded as strong points of it. These points are: "group lending" and "inside peer pressure". By group lending we mean that in micro-finance structure, people are classified in different groups by their own choice and loans are extended to these groups. The incentive structure of the loans is so designed that extending loan to each member of the group is conditioned to the paying back the loans obtained by other members of the group, and in this way, the challenge of providing collateral for poor people has been removed. By inside peer group we mean the regulations of structure of micro-finance is designed in such a way that each member of the group persuade each other to pay back the loan and therefore, there is no need of external enforcement (Besley and Coate, 1995; MacIsaac, 1997).

In spite of these advantages of the micro finance, because of its traditional problems, especially because of involvement of interest in this method, Islamic economists decided to adjust it in compliance with Islamic structure. In this regard,

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several researches have been conducted in Islamic micro-finance. Reviewing the available literature (as in the next section of the paper) shows that in most cases, only theoretical background of Islamic micro finance is shed light on and very rarely its economic necessity is analyzed. Considering what mentioned, this study tries to answer these questions:

1. Regarding the availability of Islamic banks and Gharz-al-hassan funds, is the establishment of Islamic micro finance institutes necessary and economically justifiable?
2. What are the characteristics and potencies of Islamic micro finance?
3. What probable challenges they might face? By reviewing micro finance experience around the world, is it possible to find solutions for these challenges?

After introduction, we start with the discussion of some of the previous research in the field of Islamic micro finance. Then, the theoretical analysis of the necessity of the establishment of Islamic micro institution in Iran is examined. Before conclusion, the models potencies and probable challenges will be discussed and some solutions will be given.

2- A REVIEW OF THE LITERATURE

The review of available literature show that although there are several studies about Islamic micro finance in recent years (Toghiani, 1385 lunar year; Kahf; Habib, 2002; Mannan, 2007), but usually these studies are concerned with elimination of interest by Islamic contracts such as “installment sale”, therefore, the concept of applying Islamic micro finance in real world and the necessity of it is not discussed enough. Here are some of these studies:

Arab Mazar and Motamed Farzin (2003) have put forward the new methods of micro-finance in enabling low income group, especially women. While comparing the characteristics of micro-finance methods of Bank Keshavarzi, this study has analyzed these credits in the framework of four plans implemented in this bank.

Motamed Farzin and Nematian (2004) have shown in their paper that although micro-finance is extended as a service by financial institutes, but also can provide gains for the institutes.

Hassanzadeh Et al (2006) have studied the effectiveness of micro-finance on alleviation of poverty and in-equality in different provinces of Iran by panel data method. The results which use interest-free loans as a substitute for total extended micro-finance variable, shows that micro-finance can only alleviate poverty if the lower income group is well distinguished, and the credit is spent for job creation.

Hassan and Ashraf (2010) presented a model in their study in which Zakat and Islamic are mentioned as sources for micro finance. After explaining the characteristics of Zacat and Islamic and presenting a model, they show that the application of their model will reduce the challenges faced by interest bearing micro finance institutes (including viability of the micro finance institute).

After discussing economic, accounting and risk management challenges in his study, Habib (2007) shows that if micro finance institute is established by money Islamic and Qharz-al-hassan financing, it wouldn't face challenges facing traditional micro finance institutes (including credit risk, moral hazard, and economic viability).

As it is seen, definition, characteristics and Fighi dimensions of micro finance institutes have been discussed in previous studies and little research have been done on the economic necessity of Islamic micro finance. Therefore, by presenting a more comprehensive model for mobilizing and allocation of fund and explaining the economic necessity of establishment of these institutes in Iran and finally reviewing probable challenges and providing solutions by reviewing traditional micro finance practices, this study makes a difference with previous studies and therefore have contribution.

3- EVALUATING THE ECONOMIC NECESSITY OF ESTABLISHMENT OF ISLAMIC MICRO FINANCE INSTITUTIONS IN IRAN

The question we should answer here is that regarding the prevailing Islamic banking in Iran and regarding the fact that Gharz-al-hassan contract is amongst the Islamic contracts they use, according to Usury-free Banking Law, and there are many Gharz-al-hassan funds as well in Iran¹, working with the aim of alleviation of poverty by extending micro finance loans to the poor, what is the necessity of establishing Islamic micro finance institutes in the country? Here we will answer this question by comparing the similarities and dissimilarities of Islamic micro finance institutes, Islamic banks and Gharz-al-hassan funds. Although these three have many things in common, but it seems that they have many differences in various dimensions, which justify the necessity of establishment of Islamic micro finance institutes in Iran. We will study these dimensions in the following:

¹. Some researches count the number of these funds to be 7000 (Mousavian, 2004, p12).

A- The nature of the institute As it was mentioned previously, Islamic micro finance institute is a non-profit institute. This means that if this institute applies sharing or transaction contracts and earns profit, this profit would not be transferred to consecrators as deposit profit, but should be used for developing the institute activity and its durability and stability. Therefore, Islamic micro finance institute is different with Islamic banks and Gharz-al-hassan funds.

B- Contracts used

As it was also mentioned in previous sections, Islamic micro finance institute uses sharing, transaction and Gharz-al-hassan contracts. From this point of view, this institute has similarities with available banks in Iran, working according to Usury-free Banking Law¹, but is different from Gharz-al-hassan funds. This is because of the fact that according to article 22 of “Executing Instruction of Establishment, Operation and Supervision of Gharz-al-hassan Funds”, these funds can only use Gharz-al-hassan contract for allocation of funds.

C- Asking for collateral or credible guarantor

Banks and Gharz-al-hassan funds use two methods to guarantee the return of the loans extended to people. Receiving collateral, and asking for guarantor². But according to the nature of Islamic micro finance institutes, the concept of group collateral is used instead of other guaranties. They do not ask for any collateral and guarantors, but customer has to enter a group of people who want to obtain loan³. It can be bravely said that the group collateral concept is the most important characteristic of micro finance, which has proved its success in repayment of loans at international level⁴.

D- Group lending

No banks and no official Gharz-al-hassan funds in the country extend group loans at the present time⁵. But all consumption and production loans presented in the Islamic micro finance institutes are group loans and all members of the group are responsible for repayment of extended loans to group members. This operation facilitates extending loans by Islamic micro finance institutes to the poor people who have no collaterals or guarantee.

This operation guarantees that the extended loan is used where it was aimed for. Meanwhile, this joint responsibility will reduce the risk; because firstly, it causes group not to accept dishonest members and prevent untrue selection risk. Secondly, this method creates an incentive among members to persuade each other to use the loan for the aimed purposes; so that they have to be able to pay back the extended loan. Thirdly, this causes the members to persuade members who have not paid back their loans to pay back the loan and even accept the pay back of the loans of defaulted members; this will eliminate the cost of default for the institute (Toghiany, 2006, p 210).

E- Discretion between production and consumption loans

Islamic Banks and Gharz-al-hassan institutes do not discrete between the purpose of obtaining loan and the actual consumption of extended loan (whether it is for production purposes or consumption). But according to prevailing practices in other countries, the Islamic micro finance institutes discrete between poor who need consumption and production facilities. It seems that this discretion is in accordance with the aims of Islamic economics. This is because regarding the verses about Gharz-al-hassan, this contract is mainly for fulfilling consumption needs of poor people and Islam has introduced sharing and transaction contracts for production-trade needs which not only fulfill the user’s needs, but also provides a portion of the profit of this activity for the provider of the fund⁶.

¹. The text of this law is available at the site of Central Bank of Islamic Republic of Iran: <http://www.cbi.ir>.

². The Usury-free Banking Law and “Executing Instruction of Establishment, Operation and Supervision of Gharz-al-hassan Funds” allow them to ask for collateral and guarantor, but regarding the group loans and reciprocal guaranties instead of collateral. It does not have any suggestions.

³. Regarding the collaterals asked by Gharz-al-hassan Funds it should be mentioned that because of the small amount of loans, administration cost of achieving money out of collateral is very high and is not economical.

⁴. It should be mentioned that traditional micro finance institutes in most cases have a higher rate of loan repayment in comparison with banks. Some studies have shown that repayment rate in Grameen Bank of Bangladesh (which extends group loans) is above 98 percent (Mafi, 2008, p508).

⁵. Usury-free Banking Law and “Executing Instruction of Establishment, Operation and Supervision of Gharz-al-hassan Funds” are silent about group loans.

⁶. We should consider that according to Figh principles and Usury-free Banking Law and “Executing Instruction of Establishment, Operation and Supervision of Gharz-al-hassan Funds”, gharz-al-hassan contract is a possessory contract and can be used for production purposes as well. But the discussion is that the historic request of this Islamic financial tool is mostly alleviation of consumption needs. This has caused some of scholars such as Islamic scholar Bojnourdy, Sanehee and Dr. Katousian, to consider Gharz-al-hassan loan mainly for consumption purposes; even though some others have dismissed this view according to some historic evidences (Mousavian, 2007, p 155), but we can conclude

F- Providing permanent consulting and supervision services for the activities of those who have obtained loans

No banks and no Gharz-al-hassan institute provide consulting services to loan applicants at present time. In addition, bank does not persuade how the recipient of loan has used the money and is just worried about the pay back of the loan. While, in micro finance institutes, providing consulting services (about the economic opportunities, rules and regulations and the like) to poor who have no capability of economic activity (in order to make them capable), is something important and indispensable and in addition, by conducting group sessions, the supervisor of the institute supervises the way the extended loan is used (Mafi, 2008, p 54).

Table (1): Similarities and dissimilarities of Islamic micro finance institutes with Islamic banks and Gard alhasan funds

	Islamic banks	Gharz-al-hassan institutes	Islamic micro finance institutes
1- The nature of the institute	Profit institute	Non-profit institute	Non-profit institute
2- Contracts used	Transaction, sharing and Gharz-al-hassan contracts	Gharz-al-hassan contracts	Transaction, sharing and Gharz-al-hassan contracts
3- Asking for collaterals or guarantors	Has	Has	Does not have
4- Group facilities	Does not have	Does not have	Has
5- Discretion between consumption and production facilities	Does not have	Does not have	Has
6- Providing permanent consulting and supervision services	Does not have	Does not have	Has

4- THE ADVANTAGES OF ESTABLISHMENT OF ISLAMIC MICRO FINANCE INSTITUTES IN THE COUNTRY

It seems that the establishment of Islamic micro finance institutes has important economic and social advantages. In fact, if micro finance uses Islamic institution for fund raising and apply Islamic financial tools for allocation of funds, this will create positive characteristics which will be reviewed here.

A- Solving "fund shortage" challenge

According to the results of some studies, one of the problems of traditional micro finance institutes is fund raising problem. This means that these institutes usually face source shortage. For example, Ahmed (2002) in his study conducted on several Bangladesh micro finance institutes showed that the shortage of financial sources is one of the main shortcomings for expansion of these institutes. While it seems that if the Islamic micro finance institutes are correctly established in Iran, considerable funds can be collected for them. In fact different Islamic ways of finance can be used by these institutes for money collection.

B- Correct management and efficient use of Islamic sources

One of the challenges facing Islamic finance system of our country and other Islamic countries is the improper and inefficient use of Islamic sources. In fact, as some studies show, income created from the vast amount of Islamic properties (like Waqf) are very small and today, Islamic finance does not have the tasks it had in old Islamic societies (Mesbah Moghaddam et al, 2009, p 5). While, there are special characteristics in the Islamic micro finance institutes which lead to a more efficient use of Islamic sources. In fact, because of the existence of economies of scale in Islamic micro finance institutes, they are provided with capabilities which are not available for each consecrator. For example, distinction between real poor people and those who are not really poor, or between production and consumption needs, creation of loan to groups and offering group loans, supervising the efficient use of Islamic funds, assessing the proposed projects in group loan applications and selecting the most efficient amongst them, permanent supervision of consumption and production loans, risk management and so on, are not possible for individual consecrators.

C- Fund raising and optimum application of micro funds

that in Islamic finance sharing and transaction contracts are for non-consumption purposes and Gharz-al-hassan loans for consumption needs.

It is not economical for people to consecrate their small assets at present time. This is because consecration needs an administrator to look after the property and ensures the fulfillment of the goals of the consecrator. But, regarding the smallness of the Islamic property, its income does not ensure administrator's salary. While, institute, as the administrator, examines all the Islamic properties free of charge in the Islamic micro finance models. Thereof, small funds can be made use of, in Islamic micro finance institutes.

D- Increase of economic efficiency

Efficiency means producing more with using less input and, the technical efficiency, which is considered here, means the allocation of community sources in such a way that maximizes total production. This condition is gained when the

marginal return of all industries of the community are equal in the whole economy. The result is rather ideal, and it means that capital should be invested where it has the maximum return (profit) (Al-Jarhi, 2002). In Islamic micro finance institutes, if group members had enough sources to pay back the loans before receiving the loan and the repayment was not conditional to the success of the project, the financier's worries were eliminated in best way. This is why the creditworthiness of group members is the first concern in traditional micro finance system. Of course, forecasting creation of profit by group members is also important; but this the second rank indicator considered by the financier. But, since the loans are extended to production/trade institute according to Islamic contracts in the Islamic micro finance institutes, the micro finance institute is not worried about the success of the project. Therefore, the first indicator considered by Islamic micro finance institute is the success and profitability of the project (proposed by various groups of loan applicants) and creditworthiness of the group members have second priority (Seddighi, 2004, p 103).

E- Optimum allocation of sources and increase of employment

Since a main portion of Islamic micro finance institute facilities is productive/trade and proposed projects are assessed and the most profitable and best projects are selected, Islamic funds are allocated optimally. In addition, these facilities lead to employment of the poor and will have considerable economic and social effects in the long run. In fact, by using the capacity of the poor, employment is created in Islamic micro finance institutes.

F- Observing the lowest income groups

As micro finance studies show, micro finance institutes usually do not pay attention to weaker groups (the poorest of the poor) (Nuruzzaman, 1997; Chodhury, 1999; Karashawy, 2007). The usual justification presented in this regard is: "extending micro finance to extremely poor not only saves them, but also because of the disability for repayment, makes them more indebted and will make them more poor in future" (Boudreaux and Cowen, 2008, p 189). But, in the Islamic micro finance institute consumption loans are extended to the poor on the basis of Gharz-al-hassan contract.

G- Decrease of moral hazard challenge

By moral hazard we mean that the existence of a contract may change the behavior of one or both sides of the contract. In fact, the moral hazard challenge is related to the end of contract period in order to obtain a larger share of the profit when the receiver of loan does not report the real profit or loss of the activity (Farough, 2006). It seems that the Islamic micro finance institute models will not have such a problem. This is because in the case of production/trade facilities, where moral hazard may occur, the agent (or supervisor) of the micro finance institute has a continuous supervision and consultation with the receiver of the facility and therefore, the challenge of moral hazard will fade.

H- Asymmetric information

Asymmetry in information is created when receiver of the financial facility (loan) does not want to release complete income and expenditure information of the project for the institute (lender) (Kara, 1999, p101). It seems that asymmetric information challenge which is one the Islamic banks reasons for not inclining to extend sharing facilities, fades in the Islamic micro finance institute model. As it was mentioned above, this is because the agent (or supervisor) of the micro finance institute has a continuous supervision on the activities of the recipient of sharing facility which marginalizes asymmetric information challenge.

I- Lower probability of deviation of production facilities

One of the problems facing traditional micro finance institutes is that the received facility may be used in a different project and does not enter production and perhaps is used in commodity profiteering. This is because traditional institutes extend interest bearing loans without regular supervision. But, in Islamic micro finance institutes a relation is created between real and money sector of the economy which will decrease deviation of facilities. This is because of the fact that most Islamic contracts are based on real commodities and commodity (not money) is delivered to the loan applicant (entrepreneur) (Eivazlou & Meisami, 2008, p 13).

J- Being private and minimizing government size

One of the characteristics of the Islamic micro finance institute model is its being non-governmental. In fact, the money financing ways of Islamic micro finance institutes are non-governmental. This quality is one of the important characteristics of the Islamic micro finance model which reduces the incumbency of Islamic government in the field of poverty alleviation; the subject that, with no doubt, is one of the most important tasks of government in Islam.

5- Challenges facing the establishment of Islamic micro finance institutes in in Iran and the probable remedies

It seems that the establishment of Islamic micro finance in the country faces some challenges. By using traditional micro finance practices, we will review the probable challenges and solutions for minimizing these challenges in this section.

A- Shari'ah challenge

One of the probable challenges in fund raising for the institute is that of some kinds of Islamic institutions, such as money Waqf. But, as it was mentioned before, cash money Waqf has been one of the disputes between Islamic scholars, some of whom consider it acceptable and some others believe it is not in compliance with shari'ah (Dadgar and Saadat Far, 2007, p 16). The solution which can be introduced is that, as some of the researches have clearly shown, consecrators can use "Solh" (donation) contract (Mousavian and Nasr Abadi, 2009). That is to say, instead of using Waqf contract for obtaining the funds, they go through a Solh contract. Of course, all other Islamic conditions are preserved in the Solh contract; for example, the institute undertakes to use the received money just for consumption or production facilities extended to the poor.

B- Supervision challenge

One of the challenges facing the Islamic micro finance institutes (similar with Islamic banks), is the supervision problem. In fact, one of the characteristics of all micro finance models (including the proposed model) is this problem. In practice, micro finance institute is bound to define a supervisor for each group and he should permanently supervise the group activity and consult the group. This creates the expensiveness of the supervision. The point which can be explained here is that this costs less than similar costs in Islamic banking for two reasons. Firstly, because of using group pressure, each member of the group supervise each other for correct spending of the fund and repayment of the received loan; otherwise, other members of the group fail to receive any loan in the second phase. Secondly, since supervision is on group activity (not individuals), according to economy of scale principle, the supervision cost will be lower (Mafi, 2008, p 220).

C- The challenge of small facilities

Another challenge facing the Islamic micro finance institutes is the inherent characteristic of micro finance institute which is extending micro credits. This characteristic does not create any problem for consumption facilities which are extended by Gharz-al-hassan contract; but, regarding production facilities, which are extended through sharing contracts, it creates problems. This is because of the fact that production activities (such as establishment of a factory) usually needs a lot of capital which is in contrast with the micro characteristic of group loans. The solution proposed for this problem in micro finance literature is aggregation. This means that the institute tries to combine several groups in one complex as far as possible, and extend the facilities to all groups (not to individuals) involved. In this case, various groups are placed in one complex and guarantee each other. This method will increase the volume of extended facility¹ (Rahimi, 2001, p 22).

D- Legal challenge

It is necessary for an Islamic micro finance to work in the legal framework of micro finance in the country. But the review of two regulations concerning micro finance which are "Executing Instruction of Establishment, Operation and Supervision of Gharz-al-hassan Funds", and "Establishment Instruction of Gharz-al-Hassan Banks and their supervision" shows that although in raising fund for Gharz-al-hassan banks and funds, Islamic sources are considered as a source of financing, but for allocation of resources, there is not the possibility of using transaction and sharing contracts for them. Therefore, Islamic micro finance institutes can not develop in the present legal framework. The solution we can propose here is that the honorable government, together with the central bank, prepare and obtain the approval of the establishment and operation regulations of Islamic micro finance institutes or amend the existing rules and regulations so that these institutes obtain activity permission.

E- Inflation challenge

Another challenge which faces the Islamic micro finance institutes is inflation. This is because, according to definition, these institutes can raise a portion of their fund from Islamic money Waqf and the like; and as it was mentioned, consecration of money is only correct when the purchasing power of it is preserved. The solution which can be proposed here is to keep a reserve amount of money equal with decrease of money value because of inflation during the last period of time (Ahmed, 2007, p 17).

¹. It is necessary to mention that the idea of group production loans is applicable only for some of the poor and not for all of them. For example, institute can extend group production facility to a group of farmers who cultivate a joint peace of land.

6- CONCLUSION AND POLICY RECOMMENDATIONS

Islamic banking system of Iran and the world have been focused on Shairah and performance problems and are far from its social, humanitarian and Islamic goals such as fairness, alleviation of unjust social inequalities and alleviation of poverty. By necessary adjustments and improvements, the practice of conventional micro-finance can be one of the institutions which is capable of being applied in Islamic banking system to help the fulfillment of social goals of Islamic banks. In spite of the success of conventional micro-finance, this method has several criticisms from the Islamic point of view; the leading of them is the doubt of usury involvement. This problem, together with other challenges, makes it necessary to use Islamic banking capacities in applying this tool.

This study tried to show that although Islamic banks and Gharz-al-hassan funds are available in Iran, it is economically necessary to establish Islamic micro finance institutes and this will strengthen the Islamic banking level in Iran. In addition, the paper tried to look at the characteristics and potencies of Islamic micro finance and also, shed some light on the probable challenges they might face and tried to find some solutions for these challenges.

According to the theoretical analysis presented in this paper, the policy recommendation of this study is that institutions active in Islamic and micro finance in Iran, such as Islamic and Charity Organization, Islamic Economic Organization (which has the responsibility of supervision of Gharz-al-hassan system), Central Bank (which is responsible for supervision of all active institutes of money markets of the country) and Imam Khomeini ^{pbu} Help Committee (which is responsible for alleviation of poverty and deprivation), try to improve the Islamic system of the country by establishment of Islamic micro finance institutes. These efforts can be one of the dimensions of Islamic banking system. In addition, from legal point of view, by amending the prevailing rules and regulations, it is possible to design Gharz-al-Hassan System in such a way that Gharz-al-hassan institutes, by meeting some conditions, be able to change into Islamic micro finance institute and in addition to extending consumption facilities, be able to offer group production facilities.

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Source of support: Nil, Conflict of interest: None Declared