Abstract

Islamic finance started its operation in 1975. Since then Islamic scholars and policymakers have been working for the development of this mode of finance on a larger scale. The result of this attempt has been the addition of Islamic Microfinance as a mode of financing the poor. The contribution of Islamic microfinance to poverty reduction as well as empowering the poor are well documented in the existing financial literature. The literature also highlights that there is a huge demand for Islamic microfinance in society. However, the organizations that supply this finance have an outreach that is unexpectedly low compared to the demand for, even in Muslim countries.

Microfinance Institutions (MFIs) are a special type of organizations that works for profit with a specific vision to help the poor to get out of poverty. Though the mission of microfinance is to finance this transition, the current literature, however, does not convincingly argue that MFIs are at par with their stated objectives. Rather, there are plenty of evidence that suggests that most of the conventional microfinance organizations have drifted away from their initial mission. This can be seen in the fact that microfinance organizations at present focus mainly on upper poor or non-poor clients. This can be termed as 'mission drift.'. Like their conventional counterparts, Islamic MFIs might also have fallen into the mission drift situation. Although the burgeoning literature of Islamic finance identifies various other constraints to the expansion of Islamic microfinance, the mission-drift hypothesis has largely remained under-examined. The current research is an attempt to fill this gap.

To analyze the mission drift of MFIs, this research developed a theoretical framework with the help of the current literature on the two types of mission drift: Type-I mission drift occurs when MFIs fail to reach the poor, and Type-II mission drift typifies a situation in which MFIs fail to serve their clients at a lower interest rate or they exploit their clients by charging astronomical interest rates. In analyzing type-I mission drift, this research sought to identify whether Islamic MFIs reach poor clients compared to their conventional counterparts. In determining their client's poverty status, a poverty possibility index (PPI) was calculated which was then compared to national poverty levels. To identify Type-II mission drift, this research looked at whether Islamic MFIs exploit their customers by charging excessive interest rates compared to their conventional counterparts. Present value calculation and effective interest rate methods were applied to calculate interest rate.

The research used Bangladesh as a case study area because the largest Islamic MFI in the world, Rural Development Scheme (RDS), is located there. RDS covers almost fifty percent of the total global Islamic microfinance outreach. Analysis of the data obtained shows that both types of MFIs in Bangladesh have failed to finance the poor, which confirms the existence of Type-I mission drift. In addition, both conventional and Islamic MFIs drift from their mission to *cheaply* finance the poor, which confirms the occurrence of Type-II mission drift. A typical MFI charges an interest rate six to seven times the market interest rate. In addition, their ROA is higher for MFIs than for the banking industry by two to three times.

Even though this study did not find any particular difference between Islamic and conventional microfinance, the analysis was extended to identify what other causes might restrict the growth of Islamic microfinance in Bangladesh. By comparing different financial products offered by conventional microfinance in Bangladesh and Islamic microfinance in Malaysia, this research showed that RDS falls into the Murabaha syndrome, an approach that fails to finance working capital as liquid cash and an important problem for businesses.

Based on the findings, the research offers some policy recommendations, which are expected to help Islamic MFIs to grow.