

Islamic Microfinance Model Needs Changing



Islamic microfinance should shift from a charity-based, donor-dependent approach to a market-based, for-profits approach, says **Alberto Brugnoni**.

“Poverty can bring someone to a state of disbelief” and “The best among you are those best in paying off debt” hadiths of the Prophet (PBUH)

Microfinance is the supply of banking or financial services to people who experience difficulties in accessing the banking system. These difficulties may relate either to a lack of guarantees or to cultural and religious issues. In the first case, people are unbankable because they are in want of means, collateral or even the simplest form of financial literacy: this situation is found in poor Muslim countries where much of the population lives below the poverty line. In the second case, they are unbankable because the conventional financial brokerage system contravenes precepts deemed to be compulsory: this situation is found in communities living in affluent Muslim or Western societies where Shari’ah compliance becomes less a religious principle than a cultural one and even the less religiously observant may prefer Shari’ah-compliant products.

Whatever the reasons, the case for Islamic microfinance is solidly built upon the fact that the majority of the models implement-

ed nowadays are based on interest rates which makes their application unacceptable. Interest, high or low, is rejected by Muslims as *tanta-mout* to *riba*, something that is prohibited in no uncertain terms by Shari’ah. Besides, microfinance providers increasingly strive to satisfy the wishes of their donors, many of whom want the funds they provide be spent in a *halal* manner. These two factors, coupled with the growing desire of microfinance providers’ staff to stay away from interest-based brokerage systems, indicate the existence of a strong pent-up demand for Islamic microfinance products.

A gap wide open

This notwithstanding, Islamic microfinance is still in its infancy with less than 1% of total global microfinance outreach: a few hundred thousand customers are managed by a couple of hundred institutions (mostly NGOs) operating in not more than 20 countries. Challenges in reaching a sustainable scale are mainly due to the not-for-profit culture of the Islamic microfinance intermediar-

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ies (IMFIs) that feature an over-dependence on grants coupled with a lack of operational efficiency and of proper risk management. This, in turn, obliges the IMFIs to constantly look for injections of funds to keep running, to ration their funds thereby limiting access to financial services by some people or geographical areas and, above all, does not entice them to collect the extra savings necessary to build those permanent local financial institutions that can attract domestic deposits, recycle them into loans, and provide other financial services.

On the donor and investor side, unprecedented wealth creation and gentrification in the Muslim world is driving a new generation of actors to move away from the traditional voluntary contributions to the greater public welfare and to fix societal problems – a long standing and important aspect of Islamic culture – to channel their private giving into new institutional forms. In significant ways, current Muslim philanthropy is becoming more focused in its aims to use available resources more effectively to tackle the underlying causes of important social problems without confining itself to assuage the effects of social issues. And in this respect microfinance becomes an essential tool.

The way forward

To blossom and be sustainable the industry should shift from a



72% of people in Muslim countries do not use the formal financial services because the financial system is interest-based.

CGAP survey - 2008

charity-based, donor-dependent approach to a market-based, for-profits approach and clearly separate the role of donors' funds from that of private capital. On the one hand, grants should be temporary start-up support, designed to get an institution to the point where it can tap private funding sources (investors with equity/loans and deposits). Donors should focus their support on capacity building at all levels (macro, micro and institutional): external funds are needed particularly during the initial stages of operations, when the savings of members are small but with the passage of time as savings of beneficiaries accumulate and get

recycled, the dependence on external funds must be reduced. On the other hand, the private sector should move away from a mere desire to meet corporate social responsibility objectives and make a significant contribution to achieving the providers' goals by contributing high quality services at reasonable price.

This for-profit approach will help to address the issues of operational efficiency, transparency, risk management, product diversification and authenticity and will help to establish much needed performance benchmarks. Microfinance must pay for itself if it is to reach large numbers of people and unless

microfinance providers cover their costs, they will always be limited by the scarce and uncertain supply of subsidies from governments and donors.

The Islamic Microfinance International Fund

To help bridge the gap between pent-up demand and possible investors a market mechanism should be devised to kick-start the whole process of Islamic microfinance. This mechanism, perhaps an umbrella fund, should target investors looking initially at Islamic microfinance as an alternative investment, in which participants might like to engage, and subsequently as an asset class on its own, in which participants might like to invest. The mechanism should appeal to Islamic investors because it will provide a convenient method of acquiring a position in a new class of assets that combines the objective of having a social impact and providing a reasonable return to the investors.

This Islamic Microfinance International Fund should be based in a country recognised as a financial centre, having extensive experience and skills in the investment funds industry (with particular focus on the microfinance funds) and attractive and flexible regulations for the various types of microfinance investment vehicles. A modern legal, regulatory and supervisory framework continuously updated and easily adaptable to other




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national legislations so to enable registration and distribution in foreign jurisdictions, the implementation of pragmatic regulations, a friendly tax regime for the fund industry with regards to dividends, expenses and capital gains, the existence of double taxation treaties with OIC countries and a long track record in Islamic finance will help to shape an almost irresistible proposition.

Unlocking the potential of Islamic microfinance is the key to providing financial access to millions of Muslim poor and an essential tool to achieve the goal

of making poverty history by 2015, as pledged in the United Nations' Millennium Development Goals. To achieve a more balanced world it would require only \$21 billion to provide microfinance facilities to world's poorest 100 million families. The final outcome will also contribute towards inclusiveness and the integration of Islamic microfinance into the Islamic financial system. 

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