


MICRO-FINANCE

Micro-finance has the potential to even further distinguish Islamic and Western finance, argues **Sayd Farook**

A close-up photograph of a young boy's face, looking directly at the camera with a serious expression. He is holding a photograph in front of his face. The photograph shows an older woman wearing a white headwrap and a dark jacket, looking down with a sad expression. She is holding a white sign with handwritten text. The background of the photograph is a rural, outdoor setting with some greenery and a building.

WHY ARE
WE STILL
POOR?

NAKITTO Family Uganda

Social responsibility

THERE HAS BEEN NO SHORTAGE OF ARTICLES that have posited the importance and potential for Islamic micro-finance as the real conduit to prove to the world what Islamic finance is really supposed to achieve. Behind the legal form characteristic of contemporary Islamic finance is an overarching social development goal that provides the impetus for millions of Muslims to believe in an “Islamic” sort of finance. Yet there is much that Islamic finance can do to change the world in a manner profitable to its shareholders.

Many practitioners and a few academics will argue that social development is not necessarily an immediate objective of Islamic finance. These responsibilities should lie with the state as a matter of public policy and shifting such responsibilities to private institutions places an intolerable burden on their shoulders. So long as Islamic financial institutions (IFIs) abide by the cardinal rules prohibiting usury (*riba*), intolerable uncertainty (*gharar*) and gambling (*maysir*), IFIs owe no definite obligation to greater society. This sort of rationalisation is strangely similar to the Friedman-style analysis of the role of corporations: to make profit for its shareholders. Perhaps it became convenient for Islamic financiers to adopt such an ideology to rationalise their existence. Then there are some who will claim that, just by abiding by this set of cardinal rules, they are better than conventional banks and somehow more ethical. After all, Islamic finance does not only make profits; but also makes profits in a manner compliant with Islamic law. Islam has a well developed contract law that, fundamentally, parallels the development of common law. Parties to an agreement are required to have capacity (understand the implications of the transactions) to undertake bilateral contracts of value.

There should be no ambiguity in the contractual clauses or in the outcome of the contract, let alone any element of extreme probability. This is to ensure that one party does not go out of the deal losing everything and the other party gaining everything. Most importantly, one cannot lend another an asset and expect something greater in return without actually conducting a trade or an investment. Some would say these are ethical rules. While this is true, others would argue these sorts of rules were developed in parallel in the common law system and there is nothing unique about the system.

However, there is a section of academics who propose that Islam and its branches, such as Islamic finance, have a bigger vision—that it is not necessarily all about the minute details of the contracts. The contractual restraints handed to us through

injunctions in the *Holy Quran* and the traditions of the Prophet (PBUH) manifest some greater purpose. The most obvious is to ensure a fair bargaining position for both parties in a contract, as discussed.

But one look at the conceptual map of permissible nominate contracts suggests that Islamic law primarily advocates two forms of business activity: trade (bay in its various forms including *murabaha*, *musawama*, *salam*) and investment (*istithmar* through *mudaraba*, *musharaka* and other partnership-based contracts). Of course, there are unilateral contracts, reward contracts and usufruct-based contracts. But the dominant activity remains through trade and investment.

What is glaringly missing in all these contracts is complete risk transfer, unless it is done through legal stratagems. Even within trade, the contracts are structured in such a manner that they necessitate some form of risk sharing, such as in *salam* where both the producer and the buyer share in the risk of crop failure. What is equally obvious is that Islamic law requires some sort of re-distribution of wealth and opportunity. This is most evident in contracts such as *mudaraba* and *musharaka*, where the capital-deficient entrepreneur can climb his way out of his position through active engagement in productive investment with a well capitalised financier. The Almighty himself states that in the *Quran*:

He has raised you in ranks, some above others: that He may try you in the gifts He has given you: for your Lord is quick in punishment: yet He is indeed oft-forgiving, Most Merciful.

The Livestock (Surat Al-Anaam) 165

Granted, Islamic practitioners for decades complained that *mudaraba* and *musharaka* cannot necessarily be utilised in environments with high moral hazard and poor governance, oversight and control mechanisms. Normative academics and scholars have finally recognised that *mudaraba* and *musharaka* cannot be the only way to their utopian society. We must first develop institutions, infrastructure and controls the likes of credit bureaus to reduce moral hazard. We must also develop a strong culture of governance to be able to implement *mudaraba* and *musharaka* in their true form.

Yet, the truly Islamic objective of wealth and opportunity redistribution does not necessarily require them. This was proven to us by conventional financial institutions that rose to the challenge of helping the poor in the form of micro-finance. This will again be proven to us soon through other non-Islamic innovations that have evolved to serve public interest, such as

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public-private residential ownership, while Islamic finance and its rationalising masses delve deep into legal semantics.

While no one disagrees that adherence to Islamic law is equally emphasised in the means and ends, scholars and academics are saying too little is being done to achieve the ends while too much concentration is being placed in ensuring the means are compliant. Arguably, doing the latter is relatively arduous and requires a long-term perspective; doing the former is relatively straightforward and can be easily achieved in the short term. Islamic finance is slowly but surely moving toward the achieving the end, in its natural course of evolution, while it develops the infrastructure required to support such ends.

Moreover, it's easy to see the extensive deliberations over contracts (the means), because they occur more apparently through conferences and press releases compared with viewing the big picture (the ends), which is usually hidden in the heap of regulations and infrastructure. This is where Islamic micro-finance and other ethical investments can really bridge the gap between means and ends.

Some of the tried and tested initiatives in the Islamic finance market space to bridge this long-standing gap between means and ends are reviewed to see how they can fit in with the overall architecture of a socially responsible industry. Three initiatives could provide a complete socially responsible and development-orientated framework, including investment of depositors' low-risk funds through Islamic micro-finance, investment of equity funds with socially responsible managers, and minimally re-engineering the policies and incentives of Islamic financial institutions to provide for an ethical and socially responsible operations base. However, this is not to say that Islamic financial institutions need wholly to adopt such initiatives to be viewed as socially responsible and ethical institutions. They merely need to undertake whatever is in their capacity. Yet, if all of these initiatives are applied to an Islamic bank, it is likely that the whole architecture of banking as we know it can change significantly while Islamic banks potentially exceed profitability benchmarks.

Micro-finance

We have seen numerous articles written on Islamic micro-finance. Yet, they offer little solace to Islamic bankers who frown on such alien and untested concepts.

However, micro-finance really has the potential to be the saving grace of Islamic finance and rationalise its existence beyond legal stratagems to provide a coherent picture, including both its means and ends.

Viable models of Islamic micro-finance have already been tested. They don't operate on *mudaraba* or *musharaka*, nor should they because that would bring about immeasurable moral hazard concerns. Instead, they operate through the usual host of sale contracts such as *murabaha* and *musawama*. Many an article has been written about the potential marriage of micro-finance and Islamic finance, seeing that micro-finance achieves the end goals of Islamic finance: wealth and opportunity redistribution.

But ask any Islamic banker and this is the last thing on their minds. Why? To the Gulf, British or South East Asian Islamic banks, micro-finance offers little more than a distant project in some poor non-investment grade country with little or no potential in their home countries.

This is about the biggest issue hindering the marriage of Islamic finance and micro-finance. Borders between Muslim countries mean the countries producing the greatest wealth (arguably the Gulf states and oil-producing nations) are far removed from and desensitised to the countries that require the greatest amount of wealth and opportunity redistribution, such

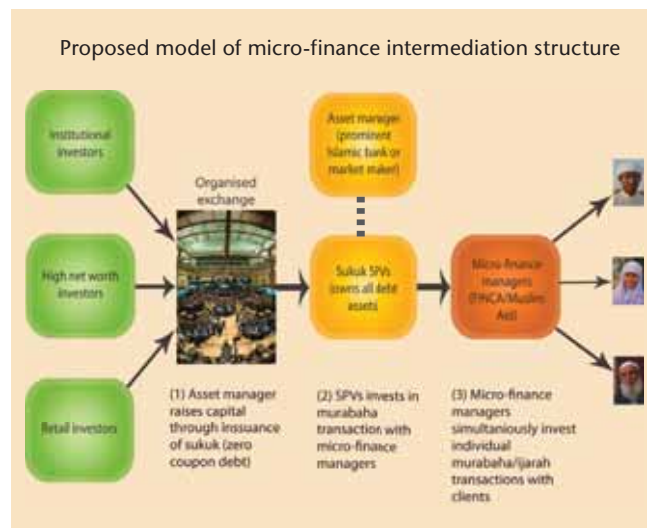
as Indonesia, South Asia and Africa. Why should we invest in Islamic micro-finance in Bangladesh when we have so many better and less riskier opportunities in the UAE?

Yet Islamic micro-finance has proven to be resilient, and much like the conventional micro-finance pioneered by Mohammed Yunus, Islamic micro-finance is able to stand the test of time with low risk (low default rates) only if it is supported by sufficient pools of liquidity. This is precisely what is lacking for Islamic micro-finance to spread across the disadvantaged and disenfranchised world. While all this is

good, few have really attempted to suggest a solution for how Wall Street Islamic financial institutions can implement main street Islamic micro-finance. It is obvious there is limited need for Islamic micro-finance in developed or oil-producing Muslim nations, as most of these countries have a small population of opportunity-deficit poor people.

Organisations such as FINCA and Muslim Aid have developed models that might be potentially appealing to Islamic financial institutions as liquid investments. The models have a proven track record of performance that can be relied on by Islamic financial institutions to extend credit and achieve above-average financial and social returns.

Muslim Aid implemented a project in Colombo in partnership with Amana Investment to provide micro-finance to the urban poor. Muslim Aid invested on a *mudarabah* basis with Amanda Investment, which then proceeded to manage the



Islamic micro-finance will work only if

micro-finance fund. Amanda Investment disbursed and recovered while Muslim Aid was responsible for community mobilisation and training and motivating the community to pay back the loan. A scheme like this could also be operated on a *musharaka* basis. Loans were given to these small and medium enterprises on a *mudarabah* and *murabaha* basis. The whole principal was recovered.

The same model could potentially be applied on a for-profit basis with a fixed income stream. Micro-finance loans can be provided to individuals to lease or sell assets, for which they would provide the lease payments or sale price payments over a period.

FINCA did the same in Afghanistan, utilising conventional funds but providing *murabahas* to customers to ensure Shariah compliance. These asset pools could effectively be utilised as the basis for Shariah-compliant zero coupon sukuk. The sukuk could be marketed primarily to Islamic banks that have surplus charitable funds available for disbursement. These funds could be returned to the banks at the end of the period or be utilised in subsequent rounds of investing. When the model establishes a track-record of performance and stability, it could be categorised as an investment class asset with a strong rating from a ratings agency and subsequently be marketed to institutional investors and Islamic financial institutions as part of their performing asset pool.

However, the asset manager would still have to oversee the quality of financing disbursed and the methodology of financing approvals, and monitoring should be audited continually to ensure performance of the asset pool.

Restricted investment funds

In the past decade or so, we have seen the expansion of the ethical mutual fund market, with fund managers attempting to provide ethical or socially responsible returns by abiding by guidelines of ethical screening, which are usually negative and sometimes positive. Negative screening occurs when certain assets are excluded as a result of the primary activities of the income, such as those arising from alcohol or casinos. By contrast, positive screening occurs when particular companies are specifically invested in because they are positively contributing to social or environmental change.

While the former method provides a broader range of investable assets, investments with the latter method really have the ability to change social and/or environmental dynamics through concerted efforts. Many have cited the similarities between the Islamic criteria for screening and the ethical or socially responsible investing (SRI) movement. This is largely accurate because Islamic funds cannot invest in ventures involved in alcohol pro-

duction or distribution, gambling, tobacco production, illicit entertainment (pornography and night clubs), pork-based products and any other activities forbidden in Islamic law. Yet, most Islamic funds have focused largely on the negative screening. The potential for Islamic finance to differentiate itself and really wear the “ethical” investment tag can be realised if positively screened investments that provide social returns are made.

Model

Organisations such as cru Investment Management have developed a revolutionary model that addresses both form-based Shariah compliance and substance-based Shariah adherence.

Cru Investment Management launched a fund called Africa Invest in March 2008. The purpose of this fund was to mobilise investment capital to help alleviate poverty in sub-Saharan Africa, through business enterprise and not just aid or charity.

In the summer of 2005, Jon Maguire (chairman of cru Investment Management), grew increasingly concerned about predictions of orphan numbers in sub-Saharan Africa. He decided to start an investment in Malawi, one of sub-Saharan Africa’s poorest countries. At the time, Jon had no idea if the venture would be profitable, but as he started seeing substantial returns on his investment, the Africa Invest Fund was born.

Cru Investment Management advocates investment should create something, and primary investment is a better use of funds than secondary or tertiary investment. For example, buying listed stocks simply transfers wealth from one individual to another, however, investing directly into a business creates jobs and employment. Cru IM is also trying to prove the case for investment over charity.



Following the success of Africa Invest and the Malawi business, cru IM set up AFRICA-Agri Asset Management and is now looking to roll the business model out across other sub-Saharan African countries through a new fund called the Africa Transformational Agri-Fund. The aim of the fund is to provide investors with excellent returns on capital in the range of 15–20% per annum as well as alleviate poverty through employment and development.

The fund will be an open-ended investment vehicle and will channel investor’s funds directly into commercial agriculture, growing staple crops to improve food security in sub-Saharan Africa. The aim will be to reduce by at least 20% the import of staple foods in the African countries that the fund invests in. Many African governments import staple foods, even though they have the land available to grow much of it themselves. What they are lacking is investment capital.

supported by sufficient pools of liquidity

In most countries the investment will work through outgrowers and large commercial farms. It is estimated that 20% of the crops will come from large commercial farms leased from the government, and 80% of the crops will come from farmers who own small plots of land and grow the crops on their own land. The investment capital allows economies of scale, efficient use of irrigation and good quality seeds and fertilisers. The combination can more than treble crop yields.

In addition, the aim is to capture as much of the value chain as possible. Therefore, production facilities will be set up in the vicinity of the farms—not only does this create more employment, but it also dramatically improves profit margins. AFRICA-Agri Asset Management has brought onboard development specialists to assist in helping the communities it works in to achieve the UN millennium development goals before the target of 2015. It aims to create micro-economies within rural Africa to allow sustainable development.

The fund will be Shariah-compliant, as the investments are mainly in staple crops. The basic nature of the fund is already Shariah-based, as its aims to create employment and development. There are a few technicalities that need to be examined from an Islamic perspective. The two main ones are liquidity management and currency hedging. Both will be structured to be Shariah-compliant. Micro-loans that are extended to outgrowers to help them pay for fertilisers and good quality seeds will be on a *Qard-Hassan* basis and no interest will be charged.

Ethical internal policies

A number of Islamic financial institutions, probably led by their PR department, have the misconception that social responsibility equates to funding charities or, worse, funding football clubs or professional race car drivers. While these initiatives go a long way in promoting the bank, they have little to do with direct social responsibility, as encouraged by the *Quran* or the actions of the prophets. These are merely capitalistic ploys to promote self-interest.

Real social responsibility occurs when an individual or organisation conducts all activities ethically but does not promote one's own reputation. While being accountable and disclosing your ethical activity to relevant stakeholders is important, it is not a PR exercise—it is an accountability exercise. A handful of Islamic financial institutions have appreciated this subtle, yet crucial distinction between PR-based self-promoting social responsibility and Islamic social responsibility.

Islamic social responsibility does not require grand schemes or significant monetary expenditure, it requires a concerted mindset by management to incorporate ethical conduct in all their activities, particularly in those where they are specialists. Islamic financial institutions are financial intermediaries. As a result, they yield significant influence on where and how their funds are sourced and invested.

Two methods have been described where fixed income and equity-based investment are truly Islamic. However, the same mindset can be extended elsewhere into all the policies of the institution.

Socially responsible recruitment policies A significantly overlooked area in Islamic financial institutions is their recruitment policies. Some Islamic institutions in the Gulf still discriminate when hiring their potential employees and the payment due to existing employees. For instance, some institutions provide a higher total pay to expatriate employees from cer-

tain countries than to local staff, even though both provide the same value or even better value. Other “Islamic” institutions may discriminate by not hiring employees from certain regions. While such criteria may be based on previous experience, these types of policies are far from Islamic ideals of equality and activity-based pay.

In fact, Islamic institutions should not only prohibit negative discrimination but should also promote discrimination or affirmative action where appropriate. Under-represented groups such as women, disabled, individuals from a low socio-economic background should be given preference where two or more equally qualified individuals apply for the same position. Further, Islamic institutions should spell out specific enforceable policies in dealing with discrimination and harassment at work.

Environmental awareness Awareness of the environment does not necessarily imply that Islamic financial institutions need to invest in environment-based programmes. It means that Islamic financial institutions do their best to implement policies to develop environmental awareness among its employees. This can be saving and recycling paper, reducing electricity consumption or utilising reusable materials where appropriate. For instance, the Bahrain Institute of Banking and Finance has implemented a policy to place strategically located recycling bins next to each printer. The paper in these bins is then donated to a charitable children's welfare organisation that sells the paper to recycling firms to earn income for their activities. In this manner, all aspects of the activity are socially responsible.

Ethical client disclosure and debt recovery policies A significant part of Islamic financial institution policy is dealing with clients. How the institution deals with clients should be governed by morals and manners (*akhlaq*) enunciated by the Prophet (PBUH) and by the Shariah. For instance, ethical client disclosure from an Islamic perspective requires that the client is made aware of the implications of the financing facility extended to him, because the Islamic bank has a superior knowledge and bargaining position than the client, who may have a limited or no financial knowledge and experience.

The same type of ethical conduct should be extended to debt-recovery practices. Some Islamic banks such as CIMB Islamic have codified their policies in debt recovery in a “code of ethics on repossession”.

Ethical savings and credit products As part of their social responsibility, Islamic banks should encourage savings and investment to build wealth and discourage consumption-based credit, particularly by clients who are unaware of the dangers of debt on their social lives. Yet, there are some Islamic banks in the Gulf that blatantly encourage credit cards for extravagant spending outside the means of their clients. However, there are some encouraging signs that Islamic banks are making the move to the Islamic social responsibility mentality in their savings and credit products.

Some Islamic banks have gone further and incorporated positive social responsible activities into their savings products. For instance, CIMB Islamic has an Ecosave account that is completely paperless and invests 0.2% of the total portfolio balance into environmental activities. ■

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