

Financing the Poor: Towards an Islamic Micro-Finance

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- Microfinance in an Islamic sense is very minimal even in Bangladesh, a Muslim country
- Despite 2005 being UN year of Microcredit (widely covered by media, academics, etc), entrance of philanthropists, mainstream banks coming in: a big surprise no session devoted to Islamic micro-finance.
- Role of philanthropy: key in micro-finance. Today we talk abt it in commercialization, expansion. They began with donor money, charity, zakat. Began with the idea of bringing financial services to those who did not have access to them. Philanthropy has played a very important role.
- Citigroup's role: 'banker to the banker of the poor'
- Vast majority of the countries not been reached by the banking system.
- At Citigroup: realized would actually have to apply this institution in hundreds of countries. With a \$ 1 trillion balance sheet.
- Microfinance is a consumer banking service for low income and the poor. For those who are not getting the range of financial services as we are used to.
- Its not just about credit.
- We tend to talk about the lower tiers of some very large countries.
- Characteristics of MFIs: tend to have very high operating costs. Very people-intensive. Heavy dependency, which is a great cost to people as well. Meeting in groups takes you away from your family and your work. Result: very high operating cost. Rich, can offset. Poor, only they pay. High cost of delivery: inefficiency paid by clients.
- Few banks have been active in int'l MF. Real concepts esp in risk-sharing is absent (e.g. in middle east). Have fixed interest borrowing rates, fixed time deposits. Risk may be mitigated by others in a group, but very rarely is it held by the institution itself!
- Its about scaling, efficiency. MF can be delivered in very high numbers. Some of the most efficient delivery is done by NGOs eg BRAC. This deal was done by the NGO, not the bank. So creative NGOs, efficient ones can deliver well.
- The definitions are much wider than just the NGO that transforms and becomes the bank.
- Depositors are the beneficiaries of any gain and loss.
- BRAC, Aasha, and Grameen are all operated on member ownership.
- Mixmarket.org is a website/source of transparent info on MFIs. Look at Middle East: 34 institutions reporting from MENA region.
- Pakistan: 18 MFIs reporting. Combined portfolio reaching 730,000 people. Only \$1.3 million. Enormous need and opportunity.
- Indonesia: 12 institutions. IRI, \$3.1 billion.
- MFIs reach more people than commercial banks combined. 53 of MFIs reporting to the mix: \$1.4 billion in loans reaching over 20 million people.
- In India: politicians, religious leaders spoke out: about these interest payments. Issues: are these usurious? Those who didn't understand, did they have to repay?

This was the first test. This will not be the only. There will be people who will be challenged. There will be a need to restructure these products

- Enormous opportunity to serve Muslims in largely populated Muslim countries, also in Europe, US: even those not of low incomes.
- Innovation needs to still be applied to middle-class people.

Aamir Rehman:

- I. Islamic finance industry
 - Islamic finance is more than financial contracts
 - Fundamental tenants are derived from Shariah
 - Concept is grounded in ethics
 - IF offers an alternative paradigm
 - IF is community banking
 - Industry initially had to demonstrate commercial viability
 - Is young and gaining mainstream relevance
 - Is building stakeholder connectivity
 - Develops link to economy
 - Responsibility of poor was sidelined for growth first
 - i. MitGhamr Savings e.g. in Egypt were focused socially. Had difficulty making it work commercially
 - ii. Commercial success not immediately forthcoming. Goal: to prove that financial services can be delivered in a Shariah-complaint fashion.
 - iii. Demonstrate first the viability of the industry.
- II. Engaging the poor is not easy (banking or MF perspective)
 - Bottom of pyramid market carries additional responsibility
 - As Islamic bankers, need to be very serious about engaging poor
 - Not easy to provide banking services to moderate-income populations
 - Half of planet lives on less than \$2 a day
 - Consumer finance business is very lucrative (conventional banking). Return on capital is very high. People collect very high interest rates. Default rates are alarmingly high. Lending responsibly/ethically is not easy
 - MF is fantastic opportunity to engage bottom of pyramid. Its economically productive. We have a challenge of moving away from a consumer debt orientation to a savings orientation.
 - MF is about building business. Help them to build business as opposed to borrow money which may lead them to be in debt for long periods of time.
 - Enable trickle down effect
- III. Industry has potential to lead & address the situation
 - Complimentarity b/w MF and IF
 - New market innovation: reach previously under-banked population
 - Asset orientation: finance based on worthiness of ventures and assets, not based on wealth. We always want to finance assets of economic value.
 - Core concerns: IF: routed in Shariah compliance. MF: fair access to capital

- Equitable: both models advocate financial inclusion, entrepreneurship, risk-sharing through partnership financing.
 - i. Part of principles of zakat: wealth not circulate amongst the wealthy.
 - ii. Islam's spread also rooted in trade
- IV. Next stages
- Microfinance fits the spirit of Shariah-based industry development
 - Move more towards savings and investment, away from debt
 - Typically commercial banks increase level of debt of consumers
 - Industry needs to Shariah-compliant to Shariah-based (
 - Microfinance fits need of Muslim communities: Muslim countries in spectrum of poverty and underdeveloped infrastructure
 - IF provides interest-free solutions for job creation: Musharaka/Mudaraba PLS arrangements, Murabahah/Ijarah commodity arrangements
 - IF is a platform to build MF
 - Is this a philanthropic pursuit or a commercial one?
 - Is this a business for bankers, or for specialists?

Good news:

- Institutional will
 - Modest capital commitment
 - Best-of-breed MF institutions
- = create successful partnership formula

our goal should be to help people with their economic needs. MF can have a strong economic impact.

Samer Badawi: Meeting the Demand for Sustainable, Shariah-Compliant Microfinance Consultative Group to Assist the Poor

- Walmart taking part in MF by providing consumer loans to people in Mexico. Less than \$250 GDP per capita, presumably. Is it as concerned with serving the needs of the poor?
- CGAP: talking about shifting from institutions towards products

The Opportunity: A true MF market

Demand: tens of millions of potential MF clients in Muslim world, many of whom require Shariah compliant products +

Supply: some 275 Islamic banks that have built an estimated \$300-400 billion asset industry

= Opportunity to develop a true market for IMF that can reach scale quickly

IMF can shift the focus back to the true intent of MF

- Demand is definitely there

- 3 bn people live below \$2 a day. \$2.5 bn of those live without access to financial services

The Current Microfinance 'Market'?

- Gov't banks still supply the bulk for financial services to the poor in developing & transition countries
- 750 million accounts being used by poor customers. Many of these are through state banks. These are the institutions that we have not reached out to.
- Interest rates: look at distribution of real yields for 320 sustainable MFIs. Huge diversity of interest rates.
- Regional differences: e.g. b/w south Asia (smaller loans, higher operating costs) vs. Latin America
- 20% of MFIs charging less than 17%. Very little competition in global MFI
- Latin American/Caribbean region: Compartamos in Mexico. Very mission driven organization, but is there a way for IF institutions to reach what Compartamos has achieved.

The role of foreign capital?

- MFIs are becoming sustainable over a shorter period of time.
- There's a role for grants, donor-funded interventions.
- CGAP is trying to determine what the funding flows of aid to MF are?
- Have a very difficult time arriving at a single number. b/w .5 million to 1.5 million. What do these subsidies do to the market?
- Diversity of institutions in MF are not reaching the poorest of the poor. Some institutions in America: average loan size does not fit description of MF
- How does MF remain mission-driven, committed to reaching the poorest of the poor. The principal of building entrepreneurship
- MF is true, micro-credit was developed to empower the poor
- If you look at the largest MFI: find that loans are going to many things other than entrepreneurship.
- Scandal that erupted is symptomatic, emblematic of backlash
- Is the industry actually doing good for the poor.

Q&A

Correlation b/w real rates of return and loss rates?

-real yields are shown in this chart.

-MFIs show low loss.

- Cost of MF transaction, cost of IMF transaction: need to distinguish b/w the two.
- IMF transaction: view as bundled transaction. Cost of accessing capital would be similar – methodologies would be the same. Cant lower the cost much more
- Microbanking bulletin: show operating expenses
- Isfund.org: 65 MIS systems listed: rated by CGAP as being valuable to MFIs. No standard. Potential of technology-innovative transactions. Mobile banking: using mobile phones in Philippines etc., to bank the poor (Branchless Banking). Potential is tremendous. Last 1 billion phones: 80% sold in developing countries. Can you leverage this use of cell phones? Much work to be done in terms of

institutional efficiency. In terms of operational efficiency: we don't know much about what is going on inside these MFIs.

- 2 of the MFIs in UP were implicated: so they reduced their interest rates virtually overnight. Still in existence. Still serving the poorest of the poor. A lot of work remains to be done.

Re-focus on poverty alleviation. MF is costly.

- 1) lets accept a certain rate of loss. IF will allow this part of equity to justify.
- 2) can be profitable to lend to the poor: just haven't innovated enough.

- Islamic banks are able to do R&D.
- Conventional MF are so-called graduation programs.
- Have grants, training, develop a cadre of microfinance clients?
- IGVD: a BRAC program. Very strong institution. 2 windows.
- Within an Islamic bank, have all of the instruments you need to reach the poor through qard hassan, murabaha, which would enable these businesses to develop something sustainable
- Its all there

Hans Deibel

Islamic MF in Indonesia: The challenge of institutional diversity, regulation and supervision

- MF history dates back to 110 years
- Islamic banking is not mandatory in Indonesia

Policy environment:

1983: full interest rate deregulation. Allowed bank to charge any interest rates

1988: institutional deregulation, passing of rural banking law

1998: financial crisis: due to fact that there was deregulation of financial sector.

Supervision was lacking!

1999: enforcement of prudential regulation, effective supervision of

2001: MF draft law

1998: central bank recognized a dual banking system: conventional & Islamic

Internal control of IFI and MFI: Shariah boards

Challenges

- Governance – absentee owners
- Orientation – social banking
- Market – informal sector, neglecting profitable sectors
- Management – retired conventional bankers
- Competence – lack of mastery for Islamic finance
- Auditing – not required of smaller banks

Options

- 1) Focus on Islamic banks, establish Islamic MF units

- 2) Reassess the opportunities of BPRS realistically, focus on effective internal control, external supervision, associations with apex support services, training of young managers
- 3) Limited scope for cooperative reform: build tightly supervised new cooperatives under new regulatory regime, like Baitul Qirad in Aceh under Qanun

Siraj Sait & Hilary Lin

Islamic Microfinance in Crisis Countries: The Unofficial Development Discourse

- Re-think methodologies
- Talk about tools

Context:

- IMF expansion and diversity
- Dynamics create distinctive microfinance initiatives
- Focus on Afghanistan (and contrast with Indonesia).
- Opportunities, challenges for MFIs
- Afghanistan touted as a success story, lessons learnt

Methodologies translating Islamic theory into practice

UN-Habitat sponsored study

Islamic MF is a key theme

Findings – Islam intersects State, custom

Global Land Tool Network

- Multi-staker innovative, pro-poor and gendered tools
- Islamic tools a priority area
- Cairo Initiative on Islamic Land Tools
- GLTN ‘added value’ multi-stakeholder initiative

Islamic MF in Afghanistan

- AFSG, MADRAC, FINCA, ODN examples

Process of Creating Islamic MF

- Nascent civil society
- Little state regulation
- Autonomy for MFIs
- Role of international partners

Afghanistan & Indonesia

Lessons Learnt:

- A success in relative terms?
- Are these dev’ts sustainable? Can they be replicated, upscaled elsewhere
- Does it matter that IMF emerges in other countries but are not discernable?
- Duality of general discourse as well as the reality that takes place?
- IMF is about faith or empowerment?
- A practical vehicle for Islamic & universalist goals

- Principles of equal opportunity, risk-sharing, & participation

What is Distinctive about IMF?

- Mirrors conventional?
- Can Islamic overcome limitations of the conventional?
- For land, property, and housing rights?

A methodology for IMF?

- No sufficient model: instead patchwork of initiatives
- Relative infancy
- Methodologies that reflect application of Islamic principles
- GLTN network: how to translates these principles into practice

Conclusions

- How to generate pro-poor, replicable, scalable tools
- Afghanistan: large no. of people are illiterate
- Cross-fertilization b/w universal/generic and Islamic tools
- Rigorous process and stages similar to professional tools
- Level of commercialization of banks is very low

Taha Abdul-

- a monetary waqf be used as the key element of a proposed solution
- a minority opinion amongst the fuqaha: allows the use of cash itself with which endowment is created
- 1) monetary waqf be used as the basis
- 2) entity guarantee repayment of money that's given.

4 classes of individuals

- 1) initial donors
- 2) individuals capable of lending/receiving money
- 3) guarantors of liquidity
- 4) guarantors of losses

creation of various projects that could be the target of any MF endeavour.

Zakat should be targeted at the unproductive poor such as the old and ill

- by having a separate guarantee of losses, enhance the attractiveness of people putting money for the use of this entity, reduce the cost of capital.
- Guaranteeing cash waqf, orphan/widow funds. Modern studies are underway on these subjects

Saif Shah Mohammed

Islamic Finance & Microfinance: An Insurmountable Gap?

Microfinance

- Discussed as possible solution to global poverty

- Not a panacea
- But an important role
 - Creating employment/income generation
 - Delivering additional services piggy backing: health care education, new technologies

Trends in Microfinance

- Moving away from subsidized & donor funding
- Moving toward commercial financing:
 - Bonds, microfinance funds, securitization

IF is entering MF when institutions do have choices

IFI may be better off partnering with MFIs

Technical Gap:

- Grameen model
 - Short term loans
 - Flat interest rates
 - Equal periodic installments
 - Grameen model can easily adjust to fit Murabaha model

Formalizing insurance component

- Reduce uncertainty
- Reduce abuse of discretion in the field

Understand these as loans with services

- Technical assistance
- Access to education
- External discipline mechanism for savings and building up of productive assets
- Advocacy, dispute resolution
 - Changing the balance of power

Scope for formalizing some of these services

This will prevent under-provision

Oversight & monitoring

Equity/PLS Models

- There is a need for new products
- Case for equity-based/PLS model
 - Underfinancing
 - of micro-entrepreneurial activities
 - Under supply of funds
 - Demand side issues also play a role

Perceptions Gap

Is the case for equity based products overstated?

Some views of Islamic sector from microfinance practitioners:

- Deep seated antagonism
- Distrust
- Suspicion

Ulama:

Need to be more proactive in approaching dev't activity

Explain their value-addition beyond transactional oversight

Look beyond formalistic terms to substantive terms

Role of mosque?

- Right now becoming increasingly outside funded
- Zakat funding is going to the mosques
- Doesn't answer the needs of the community

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Question posed to the panel: How much is microfinance applicable to Islamic microfinance?

- Difficult to see how we could apply conventional microfinance and apply Islamic microfinance to it
- At this stage, the microfinance industry is very small. A million customers out of a potential 35 million customers
- How important was Islamic mode of funding to customers of Tameer? These people have no access to credit -> at that stage they were looking for access to credit. Any form of financing they would appreciate.
- Poverty eradication is a purpose: Shariah recognizes and encourages.
- Micro-savings: should be focused on.

What impact can Islam have on microfinance?

- Microfinance has always been a part & parcel of the Islamic experience
- Abdur-Rahman ibn Auf: best example of this. Constantly contributed to Islamic causes in America. Many examples of people starting out with a small amount of money, and left very large estates
- The major contribution that Islamic micro-credit can make to the whole industry is the whole concept of wealth creation.
- Where institutions have been allowed: to take deposits, amongst the most successful deposits tends to be savings. Propensity to save is there
- Certainly working on remittances and insurance can do a great deal.
- Bangladesh: over 20 million people who have access due to microfinance
- Housing finance, desperate need. Home improvement: this kind of financing is absent, would work very well
- Creation of IFI where ownership is truly the members. Profit sharing.
- Scholars will help bring about a range of services: should get started
- Issue of savings: the number of savers as opposed to number of borrowers is 5x more. Microfinance burden is split into regulated & non-regulated entities.
- Central bank wants to make sure that you are regulating

- Tameer Bank: open an account with Rs. 100. Have bio-metric ATM branches through fingerprint identification.
- Financially sustainable? Cannot be if all of your savers are Rs. 100 depositors.

How is Islamic MF and conventional MF different?

- Instruments must be different
- IMF based on asset financing.
- Spirit is to fund businesses, entrepreneurship
- Murabahah involves transfer of several parties, etc.
- Instruments have asset-orientation.
- Hybrid model: combination of philanthropy & commercial activity
- Production of wealth, balanced distribution of wealth.
- Institutions working simultaneous: credit union (where business people have their accounts), zakat house, medina chamber of commerce (a group of businessmen and women providing services) => results in creation, retention and transfer of wealth to future generations.
- Strategic use of US tax code to facilitate creation of waqf.

Sharp distinction b/w microfinance based on subsidies vs. microfinance based on go-at-it-alone.

- Ongoing zakat making something possible. Can come from grant or from state.
- Subsidize livelihood decisions
- Zakat: an act of worship. How to distribute zakat? Not up to our discretion, clearly mentioned in Quran. Now the problem is that after the Islamic State ceased to exist, who is responsible for distributing/collecting the zakat?
- Are we allowed to delay the distribution of zakat for a while?
- We have to be careful when dealing with customers of Islamic microfinance. Looking for commercial transactions. default rates: is less than 1%?? - they have a very strong sense of responsibility.
- Scale microfinance: have to come up with a model which is financially stable.

Profile of microentrepreneur is not the same but challenges are

Asset-based lending: cash is one of the biggest assets

Education must be associated with this.

Has to be plain simple language documents.

2/3 key things would advise in starting it out:

- Have to know your clients, market. Too many people go into MF and don't understand their market. Get it from bankers, NGOs. Lot of people who don't know their market. First question: where's your business plan? Are you going to be crowded out? How many other people are in this field? Where are you going?
- Ownership & management. Many of the problems are that they are not owned by everyone, they are not responsible when they have problems. No proper diligence done when owners deserve to be owners. Owners may also be managers/largest borrowers.

Wrapping Up

- Figuring out the right business model/approach, how to do so in an effective manner. How are ways that IF industry is supporting establishment of MFIs?
- 1) funding from Islamic financial institutions – need to be Shariah compliant
- 2) securitization that has happened with Bangladeshi portfolio: can distribute those according to a wide network
- 3) commodity management: small scale MFI. Don't have a useful way to deploy those savings
- 4) core elements of products: special kinds/combinations that need to be developed. Have some of the core elements in the industry

IMF has a tremendous future

- market that needs to be defined & managed.
- Number of best practices that can be applied that represent the highest level of Islamic management.
- MFI dev't in our view represents a very low-cost entry into entrepreneurship, a tremendous way to make wealth across generations. No social costs.
- Particularly tremendous in the US

Eradicating poverty is one of the maqasid of Shariah.

So much at stake in the promulgation of microfinancing to build a cadre of nascent entrepreneurs at the grassroots level.

Legitimate to provide support to the up and coming MFIs. In the long-run these MFI must become profitable. (don't be dependent on subsidies in the LR). Should nurture them, hopefully they will grow up, and become profitable and self-sustaining.

Wealth: khayr.

Earn in a permissible way

Invest through permissible means

Spend it in permissible way

Give what is due in your wealth to Allah

Microfinance is not new in terms of Islamic history. Imam Abu Hanifa was a merchant and used to finance one of his students to start businesses. Traders refused to make any form of increments on deferred payment sales. Retail microfinance. Now things are becoming institutionalized, globalized. Local things are becoming disrupted. Need institutions that take this role. We hope that it will continue. “Media has power: can start wars & end wars”.

Not all microfinance is good. Some of it is taking exorbitant usurious amounts to cover the so-called cost of funding/administrative costs.

Qard ul Hassan: beautiful loan. Know that you are forgoing opportunity cost, just for the benefit of needy and for reward from Allah (swt). Micro-musharakah, micro-mudarabah.

Venue for microfinance are not banks. E.g. one cow etc. very costly. Very helpful to have a network of NGOs in every country. It is time that some institutions start a charitable trust. Generates profit, but all of these profits go to the charitable trust. Start a global Islamic finance institution.