

Applying Koranic thinking to microfinance

The Islamic finance sector shares with conventional microfinance ethical and moral behaviour that offers real opportunities for the poor and society, writes Alberto G Brugnoli

ALTHOUGH THE ISLAMIC financial services industry has experienced impressive growth in the last decade, it has failed to make financial services accessible to the poor.

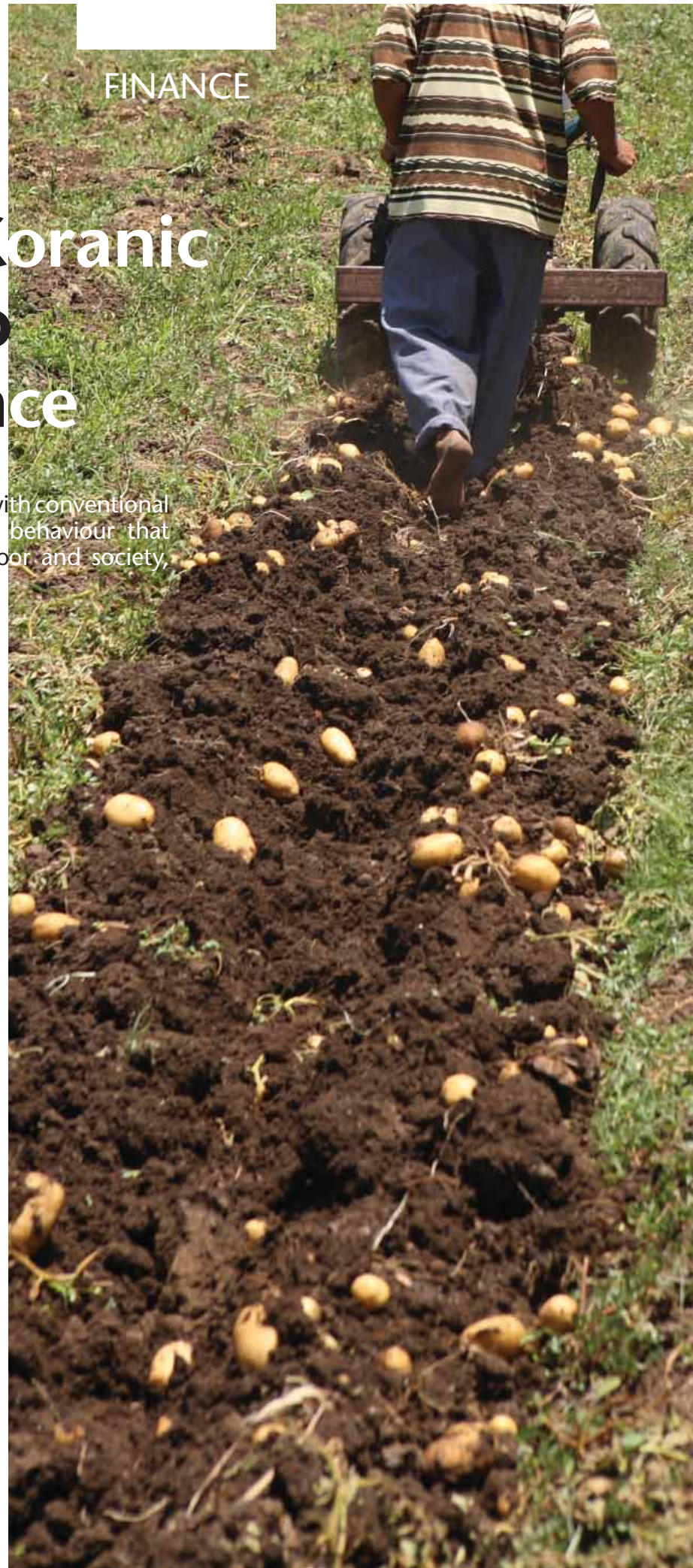
This is in spite of poverty in both urban and rural parts of the 1.2 billion-strong Muslim world being high and that five predominantly Muslim countries—Indonesia, Bangladesh, Pakistan, Nigeria and Egypt—account for more than 500 million of the world's poor, with incomes below the national poverty line.

The need to align Islamic finance developments with the Koranic injunction to feed the hungry and help the distressed is increasingly felt throughout the industry as a moral obligation and as natural for its policies. Great attention has been given to microfinance as a well-suited conduit to channel much-needed resources to the Muslim living in deprivation.

Of particular relevance to this challenge is the notion of financial inclusion gaining wide international acceptance. Major supra-national organisations such as the European Union and the World Bank have repeatedly expressed the views that giving the non-bankable a chance in life is a key element for social stability and sustainable development.

The Consultative Group to Assist the Poor (CGAP), the multi-donor consortium dedicated to advancing microfinance—has, for example, specifically included financial inclusion and the integration of microfinance with the formal financial systems as one of its key principles.

In the context of Muslim societies,



FINANCE

A combination of Shariah-compliant services and microfinance products required for an effective Islamic strategy			
Mobilisation of funds to be achieved through...	Charity, including <i>zakah</i> , <i>sadaqa</i> , <i>awqaf</i> and gifts (<i>hiba</i> and <i>tabarru</i>). While <i>sadaqa</i> , <i>hiba</i> and <i>tabarru</i> have their equivalent in the donations of conventional microfinance, <i>zakah</i> and <i>awqaf</i> are peculiar to the Islamic system, even though the latter's role as vehicles of microfinance are still underestimated.	Deposits, including <i>wadiyya</i> , <i>qard-hasan</i> and <i>mudharaba</i> . This is perhaps the sector where Islamic microfinance institutions have lagged far behind their conventional counterparts.	Equity participation, which takes the form of the classical <i>musharaka</i> . This risk-sharing instrument is perceived as the most Islamic, even if seldom used.
Instruments of financing that can be divided into...	Debt mechanisms, such as <i>qard al-hasan</i> , with recovery of actual costs of service, and <i>murabaha</i> with <i>bai-bithaman ajil</i> . The former is perceived as being the purest way of financing the poor, as it has a much stronger religious undertone than other Shariah-compliant mechanisms being directly ordained by the <i>Koran</i> . The latter is the preferred instrument of Islamic microfinance institutions, primarily because a well-defined contract exists, with pre-defined amounts that eliminate the need for written records, often unavailable at the micro-enterprise level. This results in a less-complicated process and a lower implementation cost to the lender. The popular perception of the <i>murabaha</i> is that it is a close substitute of <i>riba</i> . This perception is quite wrong if the <i>murabaha</i> is properly carried out	Lease-based models such as <i>ijara</i> , <i>ijara wa iqtina'</i> and <i>bai-salam</i> . It is quite popular among Islamic microfinance institutions as costs of loan administration and monitoring are low due to simple repayment schedule that allow for flexibility.	Participatory profit-loss-sharing such as <i>mudharaba</i> and <i>musharaka</i> . These have high costs of loan administration and monitoring given the complexity of the repayment schedule and lack of proper accounting. They are perceived to be the ideal Islamic models but in practice are not much used.
Instruments of savings	Shariah-compliant micro-deposit products that are free from <i>riba</i> , but score equal on safety, security and liquidity must be offered by financial institutions even though there is still an inadequate understanding of the needs of their clients.		
Transfers	Microfinance institutions should start offering this much-needed service to their clients that have relatives living in other countries or cities in an efficient and economical way based on available technology and strategic partnerships.		
Microinsurance	In the Islamic framework this takes the form of micro-takaful based on mutual guarantee. Different types of insurance might be relevant for the poor: credit life insurance to protect the lenders from the death of their clients; savings life insurance to stimulate savings; property insurance linked to a loan, health insurance and agricultural insurance. The first micro-takaful products—Amana Takaful of Sri Lanka and Takmin of Indonesia—are just appearing in the marketplace.		
Instruments of risk management	In the Islamic microfinance framework these are based on the concept of guarantee (<i>kafala</i>) and collateral (<i>damanah</i>) whereas the former is often used to replace the latter in cases of financing individuals. One way to mitigate the risk of default and delinquency for the microfinance institutions and to lure the mainstream Islamic banks to microfinance is to offer them a safety net in the framework of <i>kafala</i> .		

or Muslim groups living in non-Muslim societies, this notion of financial inclusion can only mean the integration of microfinance within the Islamic finance framework and the conceptualisation of Shariah-compliant microfinance within the conventional financial system.

In other words, to build an inclusive financial system and minimise exclusion there is a need of diverse approaches that take into account the religious and cultural sensitivities of Muslims. This will contribute to bring a large segment of the world's poor population into the fold of formal financial systems.

Integration

The integration between the two systems should be seen as a natural outcome, as

Islamic finance shares with conventional microfinance ethical and moral behaviour, responsibility towards the environment and fairness to promote equality for the good of society as a whole.

Its encouragement of risk sharing, individual rights and duties, property rights and the sanctity of contracts is also consistent with the goals of microfinance. Both advocate entrepreneurship and risk sharing through partnership finance, developmental and social goals and advocate financial inclusion. But the widespread use of Islamic microfinance could even represent an improvement and an advancement with regard to conventional microfinance.

Conventional microfinance providers charge rates of interest that are found to

be high, even when benchmarked against mainstream banking rates. This interest-related liability can compound and accentuate the financial problems of a project experiencing difficult times and hasten its failure.

In the case of Islamic profit-sharing mechanisms, on the other hand, there is a clear alignment between profitability of the project and the cost of capital. The latter rises and falls in line with the realised profits of the venture.

With Islamic debt financing, the negative effects of financial risk arising from fixed-rate financing are limited as compared with interest-based debt. This is because the former does not allow for compounding of the debt in case of possible default. It is sometimes forgotten

the other face of credit is debt. Loans to the destitute may make the poor poorer if they lack opportunities to earn the cash necessary to repay the loans!

Added value

As an additional argument to strengthen the case of having comprehensive Shariah-based microfinance products available, one must remember that there is a sizeable substratum of poor living in both rural and urban areas around the world whose lives are unlikely to be touched, let alone improved, by conventional financial services. They are not bankable on their own, yet they are the ones that most need assistance.

In their case one must admit that microfinance is not the best solution for fighting poverty and that financial services are not an appropriate tool. Islamic microfinance, on the other hand, identifies being the poorest of the poor as the primary criterion of eligibility for receiving public support and it is geared towards eliminating absolute poverty through institutions based on two instruments that occupy a central position in the Islamic scheme of poverty alleviation.

These instruments are the koranic-inspired and ordained *zakah* and *sadaqah*. *Zakah*, one of the five pillars of Islam and whose payment is an obligation on the wealth of every Muslim, has been described in the literature as a redistribution of income, a tool of public finance and as a mechanism of development and poverty alleviation.

The rules of Shariah clearly state who is liable to pay *zakah* and who can benefit from it and, of course, the first and foremost category of beneficiaries is the poor and the destitute. *Sadaqah*, on the other hand, enjoys a greater degree of flexibility with respect to beneficiaries. A case can be made that basic requirements such as food and shelter are better met with *zakah* and *sadaqah*-based institutions.

The concern of sustainability and careful planning of *zakah* and *sadaqah*-based institutions, as they are essentially rooted in voluntarism, has historically been addressed in the Muslim world by the institution of *awqaf*. These trusts generate permanent income through the possession of physical assets.

A revamping of their legal structure will allow for a greater flexibility in the development and use of assets. In the same line of thought, a number of well-known *hadith* stress the case for the use



MR BRUGNONI Effective strategy needed

of *zakah* and *sadaqah* in favour of the destitute, while encouraging the able and fit to assist one another in ways very familiar to the proponents of modern microfinance. An effective Islamic strategy that aims at poverty alleviation requires a comprehensive approach that complements the microfinance products with a variety of other Shariah-compliant services.

Islamic microfinance must develop links with the formal Islamic banking sector and capital markets as there is little capital market activity that allows for securitisation



These range from credit beyond enterprise finance, to savings, money transfer facilities and micro-insurance (*takaful*) while consumer loans and loans for speculative purposes are, of course, excluded from the range of *halal* financing.

Combinations must be available over the long-haul if their impact has to produce the expected results and they can be categorised in the sectors as shown in the table.

Future

Despite the strong evidence that support the case for Islamic microfinance, experiments in Muslim societies are not numerous. One can mention Amana Ikhtiar Malaysia (AIM), a sort of Shariah-compliant replication of the Grameen model, and the Bait ul Maal wa al-Tamwil in Indonesia as the most important. The AIM model has been implemented at Jabal al-Hoss in Syria as the Sanadiq project.

Other initiatives are the Mu'assasat Bayt al-Mal in Lebanon; the Hodeidah microfinance programme in Yemen; the Akhuwat initiative in Pakistan and a *murabah*-based experiment by FINCA in Afghanistan.

Usually these institutions are not integrated into the formal financial systems and in most cases these projects have been initiated by international donor agencies, religious or political groups as in the case of Islamic Relief in Bosnia or Mu'assasat Bayt al-Mal in Lebanon. Cases of Islamic banks practising microfinance are even fewer.

Let alone the divergence of views among Shariah scholars, a problem shared with mainstream Islamic finance, Islamic microfinance must address a number of issues if it intends to move forward. The industry remains highly *murabah*-centric and even *ijara* is not routinely used.

Profit-loss-sharing, although highly acclaimed as ideal in *fiqh* literature, is hardly used. Also, the actual number of institutions based on *zakah* and *awqaf* is nowhere near the vast potential these institutions and instruments can offer. Savings, deposits services, insurance, remittance and other services are generally not available.

Islamic microfinance must also develop strong links with the formal Islamic banking sector and the capital markets as there is, at least in our knowledge, hardly any capital market activity by Islamic microfinance providers that nowadays allows for securitisation.

Finally, an efficient institutional credit guarantee system, perhaps based on the model of the Grameen-Jamil initiative for development of microfinance in the MENA region or on *zakah* funds, must be developed. This would be a catalyst to take matters forward. ■

Alberto G Brugnoni is based in Milan and runs ASSAIF, an international consultancy on Islamic finance. T: +39(0)2653964; E: alberto.brugnoni@assaif.org