What is Islamic Microfinance?

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Introduction

Microfinance helps many people in Somalia and across the globe lift themselves out of poverty by providing small loans to those lacking access to traditional financial services or funding opportunities. Microfinance institutions (MFIs) have grown popular over the past few decades because they offer impoverished people access to funds that can be used to develop small businesses that can then provide regular income, and they provide financial resources to underserved markets. As such, microfinance is an important tool not just to minimize the impacts of poverty, but also to promote business development.

Despite the many benefits, microfinance institutions face a range of challenges that limit their reach, especially in predominantly Muslim countries. One challenge is providing microfinance services under sharia, or Islamic law, which restricts the charging of interest for loans. While conventional microfinance is successful in many Muslim countries, including Bangladesh, where the Grameen Bank alone has 8.3 million borrower-owners (more than 8 million of whom are women),[1] there remain many people who could benefit from microfinance but who will not take advantage of the services offered because the services are not sharia-compliant. According to a 2009 case study of Pakistan, the vast majority of Muslims across the globe refrain from using conventional microfinance services because the element of interest is considered repugnant to sharia.[2]

In response, there is increasing recognition of the role that Islamic, sharia-compliant microfinance could play in reducing poverty in Muslim communities. This is an important consideration in Somalia, where the majority of people adhere to sharia, and therefore may refuse conventional microfinance opportunities.

Conventional Microfinance Institutions

Since it was first implemented in its modern form by Grameen Bank in the 1970s to help impoverished Bangladeshis, microfinance has grown dramatically both in terms of the number of clients reached and the types of products offered. It is now a standard development tool promoted across the globe to tackle poverty through support for small enterprises. It was originally provided by non-governmental organizations (NGOs), but the appeal of microfinance drew more players to the table and there is now a wide range of providers including commercial and state banks, insurance companies, and telecommunications companies. Some of these providers emphasize only social impact, while others base their models on a double bottom line taking into account both social impact and fiscal performance. In conventional microfinance, interest is a central element of the lending model. Conventional microfinance is often criticized for requiring high interest rates on loans that are designed to help alleviate poverty, which seems unfair for MFI clients. High interest rates are required to cover the cost of borrowing money, any default losses, and transaction costs. When spread over the smaller loan amounts that define microfinance, these costs do amount to relatively high interest rates. For example, the average interest rate in 2006 was 28%.[3] While this model is designed to promote sustainability in its coverage of all costs for the MFI, the resulting interest rate is much higher than the rate on standard loans in developed countries.

The easiest way to reduce interest rates would be to get MFIs to operate more efficiently and reduce administrative costs, which can be very high for small organizations. Unfortunately, this may incentivize MFIs to provide larger loans to more affluent clients so that the per capita overhead is lower. It is therefore a delicate balance to manage interest rates and outreach to those in greatest need.

Islamic MFIs

While conventional microfinance is well developed, with wide reach across the globe, Islamic microfinance has yet to penetrate its potential market. According to a survey by the Consultative Group to Assist the Poor, the total number of Islamic microfinance accounts and clients in 2007 was 380,000, which made up only 0.5% of the microfinance industry's total outreach.[4] There are strong arguments for its expansion. An estimated 72% of people living in Muslim-majority countries, such as Somalia, can be defined as "unbanked" because they do not have access to traditional financial services offering lending and savings components.[5] Furthermore, of the world's approximately 1.7 billion people who live below the poverty line, 44% reside in Muslim countries.[6] In Somalia, the majority of its ten million citizens fall into this category. These figures indicate that there are millions of people who could benefit from Islamic microfinance.

There is broad scholarly support for expanding and developing Islamic microfinance. The 2009 case study of Pakistan emphasizes that combining the Islamic social principle of caring for the less fortunate with microfinance's power to provide financial services access to the poor has the potential to reach out to millions more people.[7] In support of expanding Islamic MFIs, it is frequently noted that microfinance as a poverty alleviation tool is well aligned with the principles of Islam. "Islam views poverty to be a curse to be eradicated through productive efforts…there is therefore a convergence between the objectives of Islam and the avowed aims of 'best practices' microfinance."[8] Specifically, the concept of helping the poor is directly supported under the third of the five pillars of Islam; *zakat*, meaning giving support to the needy.[9]

Scholarly support for Islamic microfinance is mirrored in the expansion of organizations providing resources on the topic. The Islamic Microfinance Network was formed in 2011 to provide a common platform for Islamic MFIs around the world by coordinating the efforts of its members in jointly addressing poverty alleviation, establishing best practices in Islamic microfinance, and developing guidelines for adopting practices that comply with sharia law.[10] There are also financial resources available. The Islamic Development Bank committed $500 million to expand the reach of Islamic microfinance throughout the world. There are currently no specific plans to direct these funds to Somalia, but this shows that there are groups and funds available to provide these resources.

Islamic microfinance differs from conventional microfinance in that it must adhere to the same principles as Islamic finance, which is structured to provide products for Muslim customers that are in compliance with the code of ethics and conduct laid out under sharia law. It utilizes a range of models to avoid elements forbidden under sharia, namely interest (*riba*) and uncertainty and deceit (*gharar*). Financial instruments are therefore designed to provide funds in a manner that avoids both interest payments while still taking into consideration the

need to cover overhead and the cost of financing if the MFI is to be sustainable, and shares the risk of the investment between the financier and recipient or places it on the MFI alone.

Islamic microfinance's exclusion of interest could alleviate a major criticism of conventional microfinance–namely the high interest rates charged on loans. Commonly available types of Islamic microfinance contracts that work in lieu of conventional loan agreements include:[11]

- Cost plus markup (*murabaha*)
  - Under the *murabaha* model, the MFI buys goods and resells them to the micro-entrepreneurs for the cost of the goods plus a markup to cover administrative costs. The borrower often pays for the goods in equal installments, and the microfinance institution owns the goods until the last installment is settled. The goods legally remain in the MFI's possession until fully purchased, so the risk associated with the endeavor also remains with the MFI.
- Profit and loss sharing (*musharaka* and *mudaraba)*
  - *Musharaka* is equity participation in a business venture where the MFI and the client share profits and losses according to a predetermined ratio.
  - *Mudaraba* is a form of trustee financing with one party acting as the financier and the other providing managerial expertise and executing the project; profits are shared according to a predetermined ratio while losses are borne entirely by the MFI.

The profit and loss sharing models are the preferred forms of microfinance contracts among sharia scholars, while the *murabaha* model is the most widely used. Lessons learned from Islamic microfinance organizations reveal that from a microfinance standpoint, the profit- and loss-sharing models have more drawbacks than the *murabaha* model. This is because in order to implement a business model for *musharaka* or *mudaraba*, the MFI must not only be involved in buying the investment, but it must also carefully monitor the project. For example, if the investment is a calf to be raised for slaughter, a series of vet services along with counseling on how to best raise the animal might be involved. In most cases, this means a partnership is needed between the financier and the client.[12]

By comparison, the *murabaha* model requires less time and overhead. It also has a lower margin of error and provides immediate collateral for the MFI, which owns the goods until the last installment is paid.[13] For these reasons, it is the more common and cost-effective model. In all of these models, it is important that the employees of the MFI be well-trained in both the financial model and in the specifics of the enterprises that their clients seek to develop.

Determining the financial models for Islamic MFIs is a more involved process than that used with conventional MFIs. Because "sharia-compliant" microfinance adheres to the same principles as Islamic finance, financial principles must emphasize the process and structure of human interaction and its impact on society as a whole.[14] Further, these principles are based on the idea that welfare should be provided to people by prohibiting practices that seem unfair or exploitative.[15] This includes the previously discussed ban on charging interest on financial transactions, both loans and savings, because it is considered unfair to charge a fixed return without sharing any of the risk. Given the many elements that must be considered, Islamic finance scholars are required to complete years of training before they can be certified to issue financial rulings.[16] This inhibits the speed at which new sharia-compliant financial products can be developed and offered to clients.

Conclusion

The Koran and Islamic law provide important social elements that both align with and improve upon the goals of conventional microfinance. This makes Islamic microfinance a compelling choice for impoverished and unbanked Muslims across the globe and especially in Somalia. Challenges to expanding the reach of Islamic microfinance remain. For one, the funding models supported by sharia scholars require greater attention from the financier because the risk is shared between the MFI and the client. This requires more time and overhead for each client. Thus the number of potential clients may not be as high for Islamic MFIs as for conventional MFIs. It may also have the positive result of increasing the likelihood that the financier will work with the client and focus more on the success of the project than on the ability of the client to repay a loan.

Second, the avoidance of interest means that there is not a reliable cash flow with which to earn income that can be used to extend loans to additional clients. This creates challenges for both the sustainability and growth of Islamic MFIs. It also means that there is less likelihood that Islamic MFIs will overreach, which increases the ability of each financier to work closely and develop relationships with their clients, which may in turn lead to greater long-term health of the MFI. While the challenges are important to consider, the benefits of Islamic microfinance could be an effective tool for impoverished groups in Somalia.

Sources:

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[9] The Five Pillars of Islam:

1. Testimony of faith (*shahada*)
2. Prayer (*salat*)
3. Giving support for the needy (*zakat*)
4. Fasting (*saum*) the month of Ramadan
5. The pilgrimage (*hajj*) to Mecca

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