

## **Islamic Financial Services and Microfinance**

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*Hussein works as a driver at an agency in a country in the Middle East. His work day starts at 8:00 am when he picks up a high official and drives her to the office. The rest of his work day, Hussein is supposed to be waiting, ready for any call. On normal days, at around 3 pm he drives the official back home. Hussein's salary is hardly sufficient to cover the expenses for his household's essential needs. He has to take care of his wife, a new born child, his mother, nephew and two nieces. To expand his income, Hussein looks for opportunities to earn some more and make ends meet. His entrepreneurial spirit leads him to offer to paint apartments and houses, contracts he gets through his contacts at the ministry. So Hussein organizes small teams of friends his neighborhood to perform the jobs. He goes to the work sites after his day job and sometimes drops by during the day to supervise the work when times permit. But Hussein's painting activity is constrained in its volume and quality by the lack of tools. Banks would not consider him for a small loan to buy hand tools and his perception of the whole process deters him from submitting an application. A micro-credit would unlock more opportunities. But Hussein is reluctant to borrow and pay interest as that would go against his desire to abide by his religious belief. Hussein would expand his painting business were micro-financial services, consistent with his beliefs, available. He would earn more for his own household, provide income for the members of his team and contribute to an improved economy and welfare around him. Hussein's constrained access to conventional financial services may not be unusual. His reluctance to transact in non Islamic debt contracts may be less familiar however. It may be a factor limiting the reach of conventional financial services and their potential role in poverty reduction and economic growth. The following considers first basics of Islamic finance. It then points out the limited availability of micro Islamic financial services (MIFS). Finally it suggests that public policy needs to consider the opportunities and constraints MIFS can play for poverty reduction and social inclusion.*

Financial services are in constant evolution in response to market forces. Islamic financial services (IFS) can be viewed as an element of the broad process of financial innovation and diversification of the financial landscape. IFS are continuing to evolve in response to market demand and regulatory developments.

Islamic finance is broader than interest rate prohibition. The general perception of Islamic finance is that it prohibits the practice of paying and receiving interest. Actually the prohibition is that of engaging in transactions that have elements of "riba" and "gharar".<sup>1</sup> The former relates to a transaction based on the exchange of a commodity of the same nature but with an augmentation or decrease in amount. Money exchanged for more money or dates for more dates are given often as examples. The second is engaging in a transaction whose outcome is highly uncertain, as for instance gambling would be. These two prohibitions stems from concerns of justice and fairness. In fact it amounts to prohibiting extracting a surplus value in an unfair way.

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<sup>1</sup> EL Gamal Mahmoud A. (2000) "A Basic Guide to Contemporary Islamic Banking and Finance", June , Rice University , [www.ruf.rice.edu/~elgamal/file/Islamic.html](http://www.ruf.rice.edu/~elgamal/file/Islamic.html)

The prohibition of “riba” and “gharar” may be translated into four basic principles: a) risk - sharing -- the terms of financial transactions need to reflect a symmetrical risk/ return distribution each participant to the transaction may face; b) materiality -- a financial transaction needs to have a “material finality”, that is it is directly or indirectly linked to a real economic transaction; c) no exploitation – a financial transaction should not lead to the exploitation of any party to the transaction; and d) no financing of “haram” or sinful activities such as the production of alcoholic beverages. An interest based debt contract may breach the first three principles. Indeed a borrower has to service his debt irrespectively of the performance of the project he engages in, even if poor performance obtains through no fault. Accordingly the lender and borrower do not share in the risk of the venture. Moreover their contract is purely financial as the debt contract is independent of the material transaction that may take place. Consequently a debt contract may entail exploitation of the condition of a party to the contract by the other one. Taken together these conditions feature elements of “riba” and “gharar” as a party gets more out of a transaction of money for money, and the activity outcome may be uncertain.

IFS have developed products to comply with the prohibition of “riba”and “gharar”, and the ensuing principles of risk-sharing, materiality and no exploitation. Islamic finance products emphasize the concern for risk sharing between the user and provider of funds. These include but are not limited to “*mudaraba*” (trustee financing) and “*musharaka*” (equity participation). In “*mudaraba*”, the owner of funds finances the entire project while the entrepreneur offers her/ his labor, time and expertise. Profits are shared between them at a certain pre-determined ratio, whereas any financial losses are exclusively borne by the financier. The financial partner does not participate in project management. The liability of the entrepreneur is limited only to his time and effort unless it is proved that losses resulted from negligence or mismanagement on his part. In “*musharaka*”, the financier enters into an equity participation agreement with other partners to jointly finance an investment project and participate in its management. Profits (and losses) are shared among partners based on their respective contributions to capital<sup>2</sup>.

Other products emphasize the “materiality” aspect. These include contracts in the nature of leasing where the provider of funds is the lessor and the user the lessee.<sup>3</sup> The latter pays a rent to the former. They also include products generally used for trade financing but with increasingly wider application, including notably housing finance. A widely used product is the “*murabaha*” where the provider of funds actually purchases the commodity and resells it to the user with a mark up against installments or delayed payment. Deferred payments and sales contracts are also widely used.

The concern for social equity is reflected in the principle of “no exploitation” and flows into support to the needy. It has led to the formulation of contracts such as “*qard al hassanah*” (beneficence loans) and “*zaqat*”. The former are zero – return loans that the *Qur’an* encourages Muslims to make to the needy, and where the financier is allowed to

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<sup>2</sup> El-Hawary, Grais & Iqbal (2004) “Regulating Islamic Financial Institutions: The Nature of the Regulated” World Bank Policy Research Working paper, No 3227.

<sup>3</sup> These contracts are known under “*Ijara*” .

charge the borrower a service fee to cover the administrative expenses of handling the loan provided that the fee is unrelated to the loan maturity or amount. The latter is a type of religious tax that is deducted from wealth to be paid to the needy.

Micro finance facilities can expand their reach by offering IFS in communities reluctant to deal with conventional financial instruments. Microfinance emphasizes the concern with increased penetration of financial services, support to poor entrepreneurs, and service to the community. It relies on small repeatable short term financing instruments as well as group responsibility. These features would find a natural home in the framework of Islamic finance as outlined above. Furthermore Islamic insurance or “*takaful*” and the “*kifala*”, or mutual guarantee product are very much in the spirit of mutual responsibility and could be adapted to accommodate the requirement of group lending. Accordingly microfinance organizations can use Islamic financial products to offer deposit taking, financing products as well as other financial services to Hussein and promote financial inclusion.

*Micro IFS (MIFS) are not widespread.* Available evidence reports on experiences in Bangladesh, Syria, and Yemen. The instruments used are essentially the “*murabaha*” and deferred sale contracts (“*bai mu’ajal*”). The performance track record of MIFS is limited. However, the evidence appears to confirm the positive role of having members directly own and manage MIFS facilities.

MIFS appear to be recent in Bangladesh where NGOs appear to face a growing demand and offer MIFS based on group lending principles.<sup>4</sup> They do not extend cash credit in compliance with the “materiality” principle, and use sale on credit through “*bai mu’ajal*” and “*murabaha*” The mark-up rate ranges between 12 – 12.5% with a compounding annualized implicit interest rate of 24 – 25%. MIFS programs rely on members’ savings and funds from PKSf, like their conventional counterparts.<sup>5</sup>

In the Syrian region of Jabal Al Hoss, the UNDP supported the establishment of a small network of community based village funds that are owned and managed by member shareholders, both women and men.<sup>6</sup> The initial funds were contributed by members who share in the profits according to their shareholding. They offer MIFS based on “*murabaha*”. Over 5,600 “*murabaha*” contracts were concluded between the start of the program in 2000 and the end of 2003.<sup>7</sup> Rates of mark up are considered high but transaction costs are negligible. Women have equal access to funds. Repayment rate

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<sup>4</sup> Hassan & Alamgir (2002) “*Microfinance Services and Poverty Alleviation in Bangladesh: A Comparative Analysis of Secular and Islamic NGOs*”, in Iqbal, M., editor: “Islamic Economic Institutions and the Elimination of Poverty”. Leicester, UK: The Islamic Foundation.

<sup>5</sup> The Palli Karma Sahayak Foundation, or PKSf is a government apex institution lending to micro finance organizations.

<sup>6</sup> Seibel, H. D., Lubbock, A. and Dommel, H. (2002) “Women and Men in Rural Finance in the Syrian Arab Republic: State Owned Banking vs. Self-Managed Microfinance”, University of Cologne Development Research Center.

<sup>7</sup> Brandsma, J. and Bujorjee D. (2004) “Microfinance in the Arab States. Building Inclusive Financial Sectors”, United Nations Capital Development Fund.

reached 100% by the end of first year of operation. Demand for small emergency loans and for big loans appears unmet.

The Yemen Hodeidah microfinance program was launched in 1997 and funded by grants from the Yemen Social Fund for Development. It uses “*murabaha*” and is based on a group lending approach. The program purchases the goods and resells them to the borrower with a mark up who repays in equal installments. The final installment being the service charge plus remaining principal as earlier payments are only for the principal. The implicit service charge rate is higher than what commercial banks charge. There is no penalty in case of late payment, except for fees and transportation costs charged for legal follow up. The program may have suffered from high transaction costs and contract servicing performance.

*MIFS present opportunities and challenges to public policy.* By now, it is well documented that increased penetration of financial services raises the rate of economic growth.<sup>8</sup> But also it reduces poverty. For example a 1% increase in financial development may raise the growth in the incomes of the poor by .4%; while a 10% change in the ratio of private credit to GDP may reduce poverty ratios by 2.5 to 3 percentage points in terms of headcount.<sup>9</sup> Accordingly public policy concerned with growth and poverty reduction cannot ignore financial penetration and consequently microfinance. However, the degree of financial penetration remains limited in many Islamic communities.<sup>10</sup> It may be related to the overall development of financial services, but there are indications that people may refrain from seeking financial services for fear of breaching their religious beliefs. For example, it would appear that Muslim groups in non-Islamic countries bank less than the general population at the same level of education. Even if one wants to consider the above in the nature of assumption, it is the responsibility of public policy to clarify the issue given that Muslim communities may account for around 1.3 billion people in the world.

The legal and regulatory framework governing MIFS will need attention, if research and market tests confirm their potential role and a growing demand. The orientation towards considering microfinance as an integral part of mainstream finance, and recent developments in the regulation of Islamic finance can provide a lead and guidance in considering the regulation of MIFS. In particular, it is worth mentioning the development brought about by the activities of the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB). The former, an international self regulatory organization issues accounting standards and

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<sup>8</sup> King and Levine (1993), “Finance, Entrepreneurship and Growth: Theory and Evidence”. Journal of Monetary Economics, 32 (3), pp 513-42. Also Gine and Townsend (2004), “Wealth Constrained Occupation Choice and the Impact of Financial reforms on the Distribution of Income and Macro Growth”, mimeo.

<sup>9</sup> For the first result see Jalilian and Kirkpatrick (2001) “Financial Development and Poverty Reduction in Developing Countries”, Working Paper No 30, IDPM, Manchester University. The second result is provided by Honohan P. (2004) “Financial Sector Policies and the Poor: Selected Findings and Issues”, World Bank, mimeo.

<sup>10</sup> The number of households with bank accounts does not exceed 20% while old age pension may not cover more than 15% of the population in a number of countries of the Middle East and North Africa.

auditing guidelines as well as provides advisory services. The IFSB is an international regulatory standard setter founded by central banks. It is concerned notably with capital adequacy, risk management, corporate governance, supervision, transparency and market discipline as well as liquidity management.

Organization offering MIFS will need to provide comfort to their stakeholders that they abide with Islamic finance principles. The current practice of businesses offering Islamic financial services is to set up a *Shariah* supervisory board (SSB) to confirm the eligibility of financial products and consistency of operation with *Shariah*. For MIFS, this approach may be costly and alternatives would need to be considered. For example, associations of organizations offering MIFS could set up a joint SSB, but other solutions can also be considered.

Finally, the reluctance to license full service microfinance organizations, including those that would offer MIFS need to be seriously addressed. In a number of jurisdictions, authorities remain reluctant to permit microfinance organizations to offer resource mobilization services, including deposit-taking thus limiting the scope of services to small clients. Recent progress in the policy framework to fight money laundering and terrorism financing (AML/CFT) should provide guidance to deal with authorities' concerns and unleash the potential of full service microfinance services.