Institute of Halal Investing

# ISLAMIC MICROFINANCE

By Blake Goud

As the microfinance industry grows from humble beginnings in Bangladesh and Latin America to an industry with broad worldwide scope, there has been a growing effort to create an 'Islamic' model of microfinance. An Islamic model of microfinance presents a new paradigm of social enterprise in which profit and loss sharing replaces interest-based financing. The growth of Islamic microfinance has led organizations such as the Consultative Group to Assist the Poor (CGAP), a multilateral organization distributing knowledge about microfinance, and the Islamic Development Bank (IDB) to begin understanding this new way of approaching poverty.

Almost 80 percent of Pakistanis are poor according to the Economic Survey 2005-06 (defined as 'extremely poor', 'ultra poor', 'poor', 'vulnerable' and 'quasi-non poor'). The number of people in the lowest three of these income categories is over 36 million yet according to a USAID study, only 600,000 people in Pakistan received microfinance in 2005. Although this is significant growth from 60,000 in 1999, it leaves many people out. While some people not using microfinance are just not interested in it, many may opt out of conventional microfinance due to its reliance upon interest-based financing, prohibited by Islam as *riba*.

In order to reach a greater number of people, new models of microfinance are being studied and developed by the IDB, Muslim Aid and a nonprofit think tank in the United States, the Institute of Halal Investing (IHI). In the early days of Islamic microfinance, the loans were usually given with no fee (*qard hasan*) and any costs incurred were covered with *sadaqa* and loan forgiveness with *zakat*. While using *qard hasan* is an easy method to ensure Shari'ah-compliance, it is not a sustainable model. Even when repayment rates are between 97% and 99%, comparable to the most successful microfinance institutions (MFIs), the reliance on voluntary contributions makes the continuing operation of the organizations uncertain.

As one of the early adopters of microfinance, Bangladesh was also one of the first to introduce Islamic microfinance. A recent study of three Islamic MFIs in Bangladesh, which have existed for between 10 and 12 years, show disappointing results: the three MFIs disbursed only $530,000 in financing in 1999 (compared to $376 million disbursed by the Grameen Bank in the same year) and most of this was based on *murabaha*. Another early experiment in Islamic microfinance occurred in Hodeidah, Yemen starting in 1997 that also used *murabaha* starting in 1997. *Murabaha* is a transaction where the bank buys a good for the customer and charges the client the cost of the good plus a markup where the amount including the markup is repaid in a fixed number of installments.

Many organizations recently entering Islamic microfinance combine a Shari'ah-based microfinance program with *zakat* to help those too poor to be able to use microfinance. While the track record of halal microfinance institutions using profit-and-loss sharing products is mixed, all the new microfinance programs include the use of *mudaraba* and *musharaka* to provide financing to microbusinesses and allow microentrepreneurs to save. Some microfinance providers use an individual methodology while others use the group methodology that has been successful in conventional microfinance like the Grameen Bank.

In a group *mudaraba*, the microfinance institution provides the financing and the client makes profit-sharing payments each week based upon a pre-agreed ratio. The losses are borne by the MFI and the MFI has the option of ending the agreement if the losses are excessive, but may end up losing the initial investment. When the client makes profit-sharing payments, she will also purchase shares of the MFI's equity stake in her business. At the end of the financing period, the client takes full ownership of the business and the microfinance institution earns the principal plus weekly shares of profits or losses.

As with conventional microfinance, the primary problem in administering the *mudaraba* microfinancing is dealing with a principal-agent problem between the microfinance institution (the principal) and the client (the agent), where the latter has an incentive not to repay the former because there is no direct monetary cost for doing so. The analogous problems in *mudaraba* is that the client has an incentive to underreport the profits realized in order to reduce the amount she shares with the microfinance institution and the MFI does not have the ability to fully monitor the client.

The solution to the principal-agent problem in conventional microfinance was to use a group lending methodology in order to create peer pressure which acts as a form of collateral and reduces the incentive for the microfinance client to borrow money they have no intention of repaying. In effect, the group members act on behalf of the microfinance institution to increase the other group members' incentive to repay.

In a similar way, a group financing methodology can be used to fix the principal-agent problem in the Shari'ah-based microfinance system. Each member monitors the other members' businesses and the profit reporting and profit-sharing payments are made available to the other group members. Members have to present their microenterprise profits in front of the other members of the group with the recognition that the other members may report them to the microfinance institution if they systematically understate profits.

The *musharaka* product works in a similar way to the *mudaraba* except that the incentive problem is eased because the client is required to make a personal financial investment in her business. The group methodology is still important because the profit-sharing agreement creates the same principal-agent problem as in *mudaraba*. In addition to these products, Islamic microfinance institutions need to develop savings accounts in order to give people a way to save money. The U.N. Capital Development Fund estimates that there is potential for 7 million borrowers and 19 million savers, so the availability of microsavings products may be more important than microfinancing, a fact recognized only recently.

The principles of Islam provide the inspiration for a new model of microfinance, but this model need not be limited to helping Muslims. Using the principles of Islam to create a nondenominational microfinance institution can serve as a unique alternative to the traditional Grameen-style microfinance institution and help reduce poverty and create sustainable microbusinesses.

*Blake Goud is the executive director of the Institute of Halal Investing, a non-profit think tank based in Portland, Oregon, U.S.A. He can be contacted at blake@investhalal.org*