Ethical Microfinance – Rethinking the concepts

By Amjad Mohamed-Saleem[1]

At the most basic level, the key to ending extreme poverty is to enable the poorest of the poor to get their foot on the ladder of development. The ladder of development hovers overhead, and the poorest of the poor are stuck beneath it. They lack the minimum amount of capital necessary to get a foothold, and therefore need a boost up to the first rung.
Jeffrey D. Sachs

Microfinance is very much seen as the boost that Jeffrey Sachs talked about to push the poorest of the poor onto the first rung of the ladder of development. As a concept, microfinance has attained renewed vigour and has become a new symbolic recognition of the fight against poverty following the 2006 Nobel Peace Prize being awarded to Mohamed Yunus and the Grameen Foundation. Despite this renewed status, there is still a lot of debate surrounding the claim that 'microfinance is a key contributor to the alleviation of poverty'. Whilst the Consultative Group to Assist the Poor (CGAP) talks about a vision of an inclusive financial system which allows the poor and under privileged to move out of poverty into a state of increasingly better standard of living, it is apparent that microfinance (with its high interest rates) as it is currently practised still has a long way to go in its fight to eradicate poverty.

The Islamic concept of finance and business transaction model could have a lot to offer in providing 'ethical microfinance' with much needed tools in order to build an ethical and inclusive financial system to empower the poor. However, there is very little written about the Islamic concept of poverty and microfinance, the article by Dr Mohamed Obaidullah[i] being a notable exception and consequently there is very little tested knowledge in the context of a modern economy.

What has been written though has shown that it is possible 'for a microfinance model based on Islamic principles to make a significant contribution to poverty alleviation by providing basic conditions of sustainable and successful microfinance thereby blending wealth creation bearing in mind the needs of the poorest of the poor'. What is now lacking is the amount of practical experience to back the theoretical arguments.

Muslim Aid, a British INGO, is now in the process of piloting over the next three years, a variety of different microfinance models based on Islamic Finance perspectives in an attempt to provide grass root and practical backup to the whole 'Islamic' microfinance debate.

Since the early nineties, Muslim Aid has been implementing a simple micro credit program mainly in Bangladesh of disbursing loans and recovering them without incurring service charges whilst being subsidised by the head quarters. However more recently, Muslim Aid has begun to take stock of its micro credit operations, trying to develop schemes for giving grants to the ultra poor, micro credit with a service charge as well as investment for the Small and Medium Enterprise (SME) sector. Muslim Aid has increasingly realised that what is needed is a better approach to help the poor.

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In particular, Muslim Aid has piloted schemes in response to major emergencies prompted by the 2004 tsunami, an unprecedented global disaster which changed the nature of emergency and development work and pushed Muslim Aid into a new sector, working within a majority Non Muslim country serving all communities, like in Sri Lanka. In more recent times, the earthquakes in Pakistan and Indonesia, the floods in Bangladesh and Pakistan and the conflict in Sri Lanka and Lebanon has meant that Muslim Aid is increasingly responding to emergencies and looking at post emergency recovery.

In this context one of the key issues is how to help people to recover after an emergency. With this in mind, this article looks to share some of the lessons learnt in Sri Lanka following the tsunami of 2004 and subsequently conflict related rehabilitation in 2006.

Sri Lanka as a nation has a long history of micro credit and microfinance with many existing government subsidised institutions already available. However as a result of the tsunami, it became apparent that it would take many years before any semblance of normalcy could be restored to the country. Of particular concern was the inability of various NGOs and the government infrastructure to develop a comprehensive portfolio for the economic regeneration of tsunami affected areas. Most of the studies conducted to review post tsunami reconstruction were united in pointing out that in the aftermath of the Tsunami there was a significant lack of coordination between Government, (I)NGOs, international donors and private relief operators in planning and implementing Tsunami recovery and development programs and projects.

In particular what had suffered was the restoration of livelihood, as it became apparent that the livelihoods of people were restored in a piecemeal fashion often by just providing the tools of the trade. In this context, the Chinese philosophy of '*Give a man a fish and you feed him for one day; teach a man to fish and you feed him for a lifetime*' did not seem to apply.

The livelihood projects undertaken were based on the assumptions that the trades of people prior to tsunami were good enough to keep them out of poverty. Very often this was far from true as was identified by Dr Judith Shaw of the RMIT University at the Pan Asia Forum on Capacity Building for Microfinance in Crisis Situations in Colombo, June 2005, where she stated that 'there were opportunities for post tsunami reorientation of livelihoods' which would mean looking at new business development services and for development agencies to think outside of the box

It is a known fact that the most severely affected by the tsunami were the low income sector, those people who had no stable assets or means of income generation before the tsunami. What has been noticed is there has so far been no comprehensive and forward thinking approach towards the economic regeneration of these affected people. The concept of 'Build Back Better' as coined by Bill Clinton on his visit to Sri Lanka in June 2005 appeared to be virtually non existent.

Muslim Aid started off its 'post tsunami' livelihood program by providing equipment and grants to about 50 weavers affected by the tsunami in the village of Marathumunai, a village on the east coast of Sri Lanka in June 2005.

The weavers were organised into small cooperative groups of about 5 with a compulsory savings scheme and a small grant in order to obtain the raw materials. After about 6 months, the weavers were provided with a Rs 1 million interest free loan to supplement the start up of their business.

However some interesting developments were noted. Firstly, only a few of the cooperatives set up were able to make use of the assistance and improve their situation. A lot of the weavers fell into the dependency syndrome and thus were unable or not willing to work their way out of their situation, rather depending on handouts to supplement their existence.

The tsunami had heralded vast amounts of money for NGOs to spend in a short amount of time. This meant that in order to expend money, grants were usually given to people to restart their livelihoods thereby creating a dependency syndrome. They were used to getting their handlooms and spent more time focussing on getting handouts than actually doing something productive.

The other challenge arose when people after getting capital to start up their business had problems with access to markets and sustaining their business. Many of the people did not have business acumen and skills needed to remain a long term viable business. In particular for the weavers, the main market was the government who were notoriously bad at paying on time.

Hence there was a difficulty of repayment of the loan by the weavers because of the fact that they were not able to sell their products in a timely fashion. In addition to this, there was very little variety in terms of product and design which meant that the existing market was very limited for the sale of the products.

The second experience came about in December 2006 following the rehabilitation of displaced people from Mutur, north eastern Sri Lanka in the Trincomalee District. In August 2006, around 50,000 people were displaced from Mutur following a deterioration in security. Following a return to normalcy and an improvement of security, returning inhabitants found that they were able to access farming land after many years. Muslim Aid stepped in to provide microfinance assistance to the farmers. The transactions were done in two stages.

The first stage was a salaam[2] transaction which was a value of about Rs 3 million which was given to two farmer associations, whereby farmers were given a loan to help them purchase the necessary accessories to allow them to restart their farming. Whilst collateral was not needed like the banks, there needed to be a recommendation from the local mosque and community leaders who acted as guarantors. The total budget for the total project was about Rs 3.9 million which was to be used for[3]:

- Hiring of the tractors
- Expenditure for fertiliser and agrochemicals
- Expenditure for seed paddy
- Labour charges

[2] Salaam Transaction - seasonal loan given primarily for agricultural purposes
[3] For the full breakdown of costs and analysis of figures, please contact the author

The work consisted of land preparation, distribution of the fertiliser, the sowing of the seed and the harvesting of the paddy. Once harvesting was done, the farmers repaid their loan in kind which also included a zakah[4] payment (depending on the total harvest received) from the total harvest of the paddy yield, back to the association which subsequently returned them back to Muslim Aid.

At this stage, the loan returned back to Muslim Aid was in kind with the cost of the paddy being low due to the harvest.

The second stage of this project is that Muslim Aid then went into a Mudarabah deal (on a 70/30 deal basis) with a mill owner. The mill owner came recommended from the community and a legal agreement was entered into whereby he would proceed to mill the paddy and sell the processed paddy at a high rate. This profit was then shared between Muslim Aid and the miller. After taking back their loan, Muslim Aid then proceeded to share the profit back with the farming associations after taking into account necessary service charges. All of this was done in a ten month cycle.

A simple example will illustrate the stages of the whole project:

- Farmers wanted to purchase seed and fertiliser at say Rs 1200 a bag (this is also generalised inclusive of the operational costs etc).
- For example, they take a loan of Rs 12,000 from Muslim Aid which is equivalent to 10 bags
- On top of this Rs 800 is charged by the farming association for service
- At harvest, the price of the paddy nominally drops to say Rs 1000 per bag as is normal practice. The payback of the farmers for the Rs 12,000 is now 12 bags at least (barring any zakat payment on the paddy)
- A deal is then struck with a mill owner to store the paddy and refine it. After refining the miller may get about 9 bags of rice, worth about 450kg (1 bag is approximately 50kg)
- At Rs 32 per kg, the miller can sell the rice and earn about Rs 14,400. There is now a profit of Rs 2440 which needs to be shared between the miller and Muslim Aid.
- If the miller incurs an operational expense of Rs1000, then there is a net profit of Rs1440 left over
- Based on the profit sharing model agreed between the miller and Muslim Aid, say (30/70), then a profit of say Rs 1008 will come back to Muslim Aid and the Miller will get an additional Rs432.
- If the service charge of Rs 800 for the farmer's association is now paid, there is a profit of Rs208 to be shared between Muslim Aid and the farmers.
- From this, a share goes back to the farmers association and the rest goes back into the roling capital of Muslim Aid's microfinance. If the agreement is 70/30 as

[4] Compulsory tax on the earnings which is calculated based on the agricultural work done and is different to the normal calculation of the zakah

before, then the farmer's association gets Rs62.4 and Muslim Aid gets Rs145.60 paid back into the rolling fund.

The advantages of this type of project were as follows:

- The farmer's associations are spared the problem of getting a loan at very high interest rates and paying back a higher sum.
- Often banks require collateral which can be difficult to come by.
- In order for the miller to obtain the paddy to process, he would have to take a loan from the bank in order to finance the purchase of the paddy. The loan on average would come at 14% interest which means that the miller would have to sell the final product at substantially higher rate in order to pay back the loan and make a profit.

The disadvantages from this experience were as follows:

- The lack of seriousness in paying back the loan on the part of the farmers who saw it more as a grant since it was disbursed from an INGO
- The risk in going for agricultural loans where the payback is dependent on a lot of factors some of which are uncontrollable such as weather or unfavourable environmental conditions
- The risk being borne by the beneficiary for the failure of the crop
- The lack of proper agricultural expertise in monitoring the progress of the project effectively.
- Purchasing of necessary equipment should have been identified and done beforehand.
- Proper preparation of the budget to account for price fluctuations

Overall the lessons learnt from these two experiences are first and foremost that a holistic approach to livelihood development should be considered which not only looked at microfinance or the provision of equipment but also with equipping, empowering and training the beneficiaries to be able to take charge of their business more professionally and with more technical know how. The premise was taken that entrepreneurship and microfinance would be needed at the heart of any livelihood program.

There should also be engagement and coordination with government and other non government agencies who have the required expertise in the various sectors being explored for the microfinance. It is better to work in partnership than in isolation thereby sharing resources and knowledge.

In addition to this, a concept of takaful or insurance should be considered so that there is some way of compensating for the loss of the business so that the entrepreneur does not lose out, if something unforeseen happens to the business.

The perception that NGOS give grants and not loans has now prompted Muslim Aid to deal differently as regards the provision of financial assistance. The new model being developed is for Muslim Aid to look at the mobilisation of the community, monitoring and training whilst having a finance institute on board to make the recovery and handling of the loan. There is a win-win scenario here where the finance institution provides the technical expertise for Muslim Aid, whilst for the finance institution, Muslim Aid is able to give it access to a community it would not have previously gone to. The presence of Muslim Aid on the ground also means that the overheads and service charge incurred by the finance institution is reduced.[ii]

What the two experiences have shown is that Islamic finance can have a part to play in developing an ethical microfinance model. There is definitely a long way on the road to alleviating poverty through provision of ethical microfinance and entrepreneurship training. The key is to first stop thinking of the poor as victims or as a burden and start to recognise them as resilient and creative entrepreneurs and value-conscious consumers. The second step is to realise and make use of the symbiotic relationships and partnerships that are on offer within this sector.

Muslim Aid has started this journey and over the next three years will be piloting several different models in an attempt to develop a series of useful products to add to this rich discussion.

As C.K. Prahalad wrote

'New and creative approaches are needed to convert poverty into an opportunity for all concerned. That is the challenge'

References

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End Notes

[i] See ‘Islam, Poverty and Microfinance “Best Practices”’ by Dr Mohamed Obaidullah

[ii] Muslim Aid is now piloting this concept with Amana Investments Ltd in Slave Island, in an attempt to tackle urban poverty in Colombo.