THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

Document: AGFSCB 28-030
Draft: **FIRST**
Source: ABAC Malaysia
Date: 25 July 2008
Meeting: Hangzhou, China

Third Meeting 2008
5 August 2008
Ballroom 3, Hyatt Regency Hotel
Hangzhou, People's Republic of China

Meeting Paper 6-C

ISLAMIC MICROFINANCE
A New Approach to Help Small Enterprises

ABAC Malaysia

ISLAMIC MICROFINANCE – A New Approach to Help Small Enterprises

Role of Islamic Microfinance

In recent years, microfinance has emerged as an important instrument to help a large number of "unbankable" members of society, as a tool to help reduce poverty and encourage economic growth in neglected parts of the world. However, despite being able to demonstrate successes, some have argued that conventional microfinance is not fully reaching the poorest of the poor and loans are going to activities unrelated to entrepreneurs.

In some Muslim communities, conventional interest based microfinance has always been rejected, principally of its non-compliance with the Islamic principles, particularly on the issue of paying of interest or riba, which is forbidden under the Shariah. This has to some extent caused failure of government initiatives to overcome poverty and promote economic development through microfinancing.

Meanwhile, conventional microfinance institutions (MFIs) have often been criticized for charging the poor exorbitant interest rates and fees. This is largely due to the higher transaction costs incurred, including the provision of services such as monitoring, advice and health insurance.

Islamic finance could help correct the shortcomings as it focuses on achieving social justice and disallows exploitation and also battles poverty. This is further strengthened by the fact that the philosophical basis of Islamic financial system lies in 'adl' (social justice) and 'ihsan' (benevolence).

In this respect, Islamic finance incorporates the social and equity elements along with the normal financing practices. This will ultimately be beneficial to the segment of the population that has been excluded from financial services and help to alleviate poverty. Providing the much-needed finance to micro-entrepreneurs can also gradually help them to become successful entrepreneurs.

It is estimated that about 35% of the world's 1.2 billion Muslims are poor, thus creating a large market for microfinance. However, there are very few Islamic MFIs and Islamic banks involved in microfinance. Many MFIs are operating under the conventional system, while Islamic banks tend to favor larger firms[1].

Principles of Islamic Finance

The principles of Islamic finance are laid down in the Shariah, which disallows riba and there is a consensus among Muslim scholars that riba is not only restricted to usury but

[1] Habib Ahmed, Waqf-Based Microfinance: Realizing the Social Role of Islamic Finance, Islamic Research and Training Institute Islamic Development Bank Group, Paper Written for the International Seminar on "Integrating Awqaf in the Islamic Finance Sector", Singapore, March 6-7, 2007

encompasses interest as well. Within the Islamic scholars, there are two interpretations of riba[2], namely the modernized view that allows reasonable interest rates and the conservative view, which prohibits any kind of fixed interest charges.

Islamic finance also prohibits transactions that have elements of "gharar"[3]. This prohibition relates to a transaction whose outcome is highly uncertain, such as gambling activity.

Islamic finance focuses on interest free methods of providing capital as the Shariah assumes lending as purely a charitable exercise, rather than as a means of making profit. Therefore, transactions by financial institutions are based on the concept of a social order of brotherhood and solidarity. In this regard, both parties involved in the transactions, clients and financial institutions are considered business partners that jointly bear risks and gains.

Islamic Modes of Financing

Mudarabah *(trustee financing)*

Under a mudarabah arrangement, the financial institution provides the required capital for a particular project, while the borrower offers labor and expertise. Profits are shared between both parties at a certain pre-determined ratio. Under mudarabah financial losses is assumed by the financial institution while the entrepreneur's liability is their time and efforts, unless proven negligence.

This mode of financing presents a series of problems, as micro-enterprises usually do not keep accurate accounts, which make it difficult to determine the exact share of profit.

Musharakah *(equity participation)*

It is a common instrument for short-term financing adopted from the conventional concept purchase finance or cost-plus markup sales. Islamic financial institutions use this approach to satisfy the requirement of small enterprises for financing raw materials, machinery, equipment and other short-term financing. Under this approach, the financier enters into an equity participation agreement with other partners to jointly finance and manage the investment activity. Profit and losses are shared among partners based on their respective contributions to capital.

Murabaha Model

Under this model, the microfinance institution buys goods and resells them to the micro-entrepreneurs for the cost of the goods plus a markup to cover up 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.

---

[2] Chiara Segrado, Islamic Microfinance and Socially Responsible Investments, MEDA Project, Microfinanance at University, University of Torino, August 2005

[3] El Gamal Mahmoud A. (2000), "A Basic Guide to Contemporary Islamic Banking and Finance, June, Rice University, www.ruf.rice.edu/-elgamal/file/Islamic.HtmI

Ijarah *(leasing)*

It involves pure leasing (Ijarah) or lease purchase (Ijarah wa iqtina') transactions, in which an entrepreneur leases a specific product for a specific time. In lease purchase arrangements a portion of each payment is applied to the final purchase of the product at which time ownership is transferred to the leaseholder.

Ar-Rahnu *(Islamic pawn broking)*

Ar-rahnu is a Shariah based pawn broking that extends short-term loans (between 14 days to 6 months) that requires collaterals such as gold, which are valued at current prevailing market price. The amount extended by lenders will be slightly lower at about 60-75% of the market value of the collateral.

During the lending period, the lender will hold the collateral and impose a fee for safekeeping services. At the end of the period, the financing must be repaid and the collateral reclaimed. No interest is charged, but if the financing is not repaid within the agreed duration, the lender retains the right to seize and auction off the collateral to cover the financing and the remaining balance to be returned to the borrowers.

Qard Al-Hasanah *(beneficence loans)*

Qard al-hasanah is an interest free loan, which is to help borrowers rather than benefit from his/her difficulties. However, the financier is allowed to charge the borrower a service fee to cover the administrative expenses on handling the loan and the fee is not correlated to the loan maturity or amount.

Sources of Funds

Waqf-Based Financing Institution Services and Qard Hassan Bank

There are various institutions and structures that Islam has instilled to redistribute income and wealth for the fulfillment of the basic needs for all in the society. These institutions include zakah, sadaqat, awqaf and waqf[4].

For this reason, some scholars have suggested the establishment of waqf-based financing institution services, as it is feasible in the cotemporary situation to serve the social objective in the society through providing cash from waqf to the poor. While most of waqf created are real estate, the cash waqf can be used for micro- financing. There was also suggestion for the setting up of qard hassan bank, a non-profit financial intermediary that gives interest free loan to finance lending to the poor and to finance productive micro-enterprises at subsidized rates.

---

[4] Zarqa, Muhammad Anas (1988), "Islamic Distributive Schemes, in Munawar Iqbal (editor), Distributive Justice and Need Fulfillment in a Islamic Economy, The Islamic Foundation, Leicester

Integrating Zakah and Sadaqat into Microfinancing

Zakah and sadaqat can also be integrated into microfinancing program to alleviate poverty and finance the small entrepreneurs[5]. While zakah and sadaqat given to the poor can be used for consumption, it can also be utilized for productive purposes to complement funds required by Islamic MFIs. The fund channeled to productive purposes may result in higher returns, as the probability of default is lower. Thus, integrating zakah and sadaqat with microfinancing will increase the probability of repayment of the funds to the Islamic MFIs.

Involvement of Islamic Bank in Microfinancing

The involvement of Islamic banks can also help to increase the scope of Islamic financing. It is argued that Islamic banks can provide microfinance at lower operating and financing costs compared with MFIs as it can operate from existing branches and do not require a whole range of professionals/staffs and not incur extra fixed costs[6]. Most Islamic banks have excess liquidity, given the lack of Islamic compatible money-market instruments to park funds for shorter periods. Therefore, these funds can be used to finance micro-enterprises at a lower cost compared with MFIs.

Islamic banks can also use income derived from late-payment penalties as well other proceeds, which cannot be included in its income, such as earnings from treasury operations[7]. These proceeds can be categorized as waqf and used for microfinance operations.

Implementation of Islamic Microfinance in Different Countries

There are not many Islamic microfinance institutions and they exist only in a few countries. These institutions largely use the group based lending format of the conventional MFIs and adapted Islamic principles and values. While utilizing various Islamic modes of financing, they usually encounter difficulty in obtaining funds from external sources. While some funds are available from government agencies, they are often subjected to terms and conditions that are not in compliance with Islamic principles.

Yemen: Hodeidah Microfinance Program

This program was launched in 1997 in Hodeidah, a port city with a population of nearly half a million. This program is funded by grants from the Yemen Social Fund for Development. It uses murabaha model and is based on a group lending approach. The average loan size is 38,000 Yemeni Rial (US$240).

Upon receipt of an application for loan, the credit officer investigates the group and does feasibility study for their activities. It is through the study, the amount of loan is determined. Once approved, the group would identify items (commodities /equipment) needed from the

---

[5] Habib Ahmed, Ibid
[6] Habib Ahmed, Ibid
[7] Habib Ahmed, Ibid

wholesaler and the price to be paid. The credit officer then purchases the item from the source and resells it to the group at the same price.

Payment of loan is made on equal installment and the last installment to include the service charge plus remaining balance, as earlier payments are only to cover for the principal. The implicit service charge rate is higher than what commercial banks charge[8]. There is no penalty in case of late payment, except for fees and transportation cost charged for legal follow up.

Mali: The Mali-North Program

This program was established with the cooperation from German Technical Cooperation and German Financial Cooperation) in the former civil war areas of Mali. A local bank, Azaouad Finance plc was selected to disburse Islamic based loans and also promote the collection of savings by not charging interest but participating in the profits and losses of the borrowers. The financial services provided by the bank have become very successful and the business relationship of the local merchants has reached Abidjan and the Arabian Peninsula. The bank has also a program intended to support woman entrepreneurs.

Afghanistan: FINCA Afghanistan

There are a number of organizations involved in providing Islamic microfinance in Afghanistan. One of these organizations is Foundation for International Community Assistance or FINCA, which began operations in 2004, offering a murabaha loan product. Since rolling out its revamped murabaha products, which incorporate the element of risk sharing, FINCA Afghanistan's operational sustainability has risen from 15 to 54%; the number of active clients has risen from 14,000 to over 44,000 and the total portfolio has more than quadrupled, increasing from US$1.7 million to nearly US$10 million in 2007.

Afghanistan: World Council Credit Union (WOCCU)-Islamic Financial Cooperative

WOCCU through the ARIES (Agriculture, Rural Investment and Enterprise Strengthening established by USAID) program has developed 20 Investment Finance Centers (IFCs) in a number of provinces including Nangahar and Kandahar. The objective is to provide clients with the opportunity to join a financial institution that is owned, controlled and operated by its members.

The model is in line with both the cooperative principles and the Islamic value attached to shared risk and reward, with members owning investment accounts, rather than traditional interest bearing share account. As at end of 2007, it managed to attract about 6,671 clients with a portfolio outstanding of US$926,251 and total deposits of US$182,107.

[8] Dahlia A,El-Hawary and Wafik Grais, "Islamic Financial Services and Microfinance, June 2005.

Sudan

There are several financial institutions in Sudan involved in providing finance to micro-enterprises. Most of these institutions are owned by private sector such as the Sudanese Islamic Bank, Faisal Islamic Bank of Sudan, Islamic Cooperative Development Bank and Farmers Bank. Murabaha is the most dominant mode of finance for small and medium enterprises, followed by musharaka.

To a certain extent, Islamic finance is more suitable for small and micro-enterprises in Sudan due to its participatory nature that benefits the recipient and encourages client loyalty. Another major advantage of implementing Islamic microfinance in Sudan is that it helps to develop trust between financial institutions and the entrepreneurs and this subsequently reduces repayment defaults. These favorable conditions have made Islamic financing viable for micro businesses in Sudan[9].

Malaysia: Amanah Ikhtiar Malaysia and Islamic Pawn-Broking

In general, about 80% of small and medium enterprises (SMEs) in Malaysia are micro-enterprises. To facilitate their financial requirements, various initiatives have been taken to help provide microfinancing to micro-enterprises in the country. Now micro-enterprises have greater access to financial services, with the banking institutions being the main source of financing. In 2006, about RM40 billion in new loans was approved to more than 84,000 SMEs accounts. Of this, Islamic banking institutions provided RM5 billion in new financing, compared with RM3 billion in 2005.

In addition to financial institutions, efforts have also been made to diversify sources of loans for micro-enterprises and the poor. This includes Amanah Ikhtiar Malaysia (AIM), which was established in 1987 with the aim to help the hardcore poor households. Its strategies are similar to that of Grameen Bank Model, except loans provided by AIM are given out without interest. Nevertheless, borrowers are required to pay for services charges, which are below the prevailing market rates. It was reported that since the inception of the scheme, AIM has disbursed more than RM2.3 billion in loans to its clients.

Meanwhile, the inclusion of shariah regulation in the banking system in 1983 has led to the establishment of Islamic pawn-broking (ar-rahnu) in 1993. Petty traders often use the facility to obtain working capital for their businesses. Ar-Rahnu does not charge interest for loan given out, but it requires collateral such as gold and valued at the current prevailing price. The amount given by lenders normally is lower than the market value of the collateral.

The services provided by this mechanism have been well received by Malaysians. As a result, a number of financial institutions have implemented this scheme, and these include Bank Rakyat, Bank Islam Malaysia, Agro Bank, EON Bank and cooperative outlets. It was reported that in 2004 the number of Ar-Rahnu clients stood at 1.22 million with an accumulated loan withdrawal amounting to RM1.17 billion.

---

[9] Prof.Dr.Badr-El-Din A.Ibrahim, Poverty Alleviation via Islamic Banking Finance to Micro-Enterprises in Sudan: Some lessons for Poor Countries, paper presented to the Workshop on "Poverty and Governance in the Middle East and North Africa Region", Sana'a, Yemen, 2-3 August, 2001, MEA Wards Program

Indonesia

Indonesia is one of the most renowned cases of microfinance with 44 million depositors, 30 million borrowers, including individuals and micro-enterprises and with a total asset size of US$141 billion. About 80% of Indonesia's micro-loans come from commercial sources[10].

In the case of Bank Rakyat Indonesia (BRI), it is the world's largest and most profitable commercial microfinance institution. Its microfinance outlets are the biggest provider of rural financial services and have been able of serving vast numbers of micro-savers and micro-borrowers at competitive interest rates. BRI mobilizes its funds internally and is able to cover its costs and finances its expansion from its profits. For BRI to maximize its outreach and remain profitable, it has to include among its clients both the poor and the non-poor and cater their demand for smaller and larger loan sizes. Under this approach, the latter will cross subsidize the former. In this regard, by including the non-poor from its clientele it allows BRI to widen its outreach to the poor. Recently, BRI and several other commercial banks have started venturing into Islamic banking through the setting up of Islamic units as a result of their initiatives in acquiring the art of Islamic banking.

In addition to commercial and rural banks, cooperative institutions are also involved in saving and lending activity. One of these institutions is Baitul Maal Wat Tamwil or Baitul Qirat, an Islamic cooperative institution that uses profit sharing schemes instead of charging interest rates.

Another type of institution that provides microfinance in Indonesia is pawnshop. All pawnshops in Indonesia are state-owned. There are 744 branches and 14 regional head offices. As of 2004, total loan asset of these pawnshops were US$0.7 billion. Lending is based on collateral, which includes jewellary, precious metal, electrical devices and even clothing. This institution provides fast loans and does not require much procedure.

Conclusion

Access to funding has been identified as a major problem to small enterprises. Various studies showed that small and micro-enterprises are restricted in their ability to source funds from the organized financial sector, arising from the perceived high risk of default and high administrative cost. Consequently, they resort to private moneylenders who charge substantially higher interest rates.

To a significant extent, conventional microfinance has been effective at supporting the development of small and medium enterprises and consequently uplifting the socio-economic of the poor in many countries. However, it is not fully reaching the poorest of the poor. Similarly, Islamic microfinance has witnessed some success but it is currently having a limited reach. Potentially, Islamic microfinance can chart a rapid growth given the prevailing high proportion of poor population (particularly in Muslim dominant countries) involved in small and micro-enterprises that are not having access to formal banking system.

---

[10] Pratish Halady, Indonesian Microfinance Sector

Islamic finance has one major advantage, namely risks are shared between financial institutions and beneficiaries, which allow entrepreneurs to concentrate on what they do best. At the same time, the disbursement of collateral-free loans in certain instances reflects the sharing of common objective between financers and enterprises, thus advocating entrepreneurship.

Islamic finance and conventional style interest-based finance should not be viewed as competitors. Instead, the application of Islamic finance should be seen as a supplement to interest rate credit financing to help small enterprises, particularly in the poor countries. In fact, both can learn from each other for the mutual benefit of their clients, including small enterprises.

The application of Islamic financing formula to small enterprises has not been without problems. These include difficulties in obtaining funds from domestic and external sources. While some have been able to harness funds from the traditional institutions such as waqf, zakah and sadaqat, most of the developments of Islamic microfinance programs have generally been financed by donor and government funds.

The involvement of Islamic international financial institutions and Islamic commercial banks potentially can also help widen the reach and scope of Islamic microfinance. Extensive research is also needed in the application of Islamic financing formula to small enterprises, if Islamic microfinance is to become more widely accepted and successful.

AmBank Group
Kuala Lumpur, Malaysia
July 2008