



Islamic Research and Training Institute  
A Member of the Islamic Development Bank Group

# ISLAMIC MICROFINANCE DEVELOPMENT

## Challenges and Initiatives

**Policy Dialogue Paper No. 2**

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### **Purpose**

The purpose of the Institute is to undertake research for enabling the economic, financial and banking activities in Muslim countries to conform to Shariah, and to extend training facilities to personnel engaged in economic development activities in the Bank's member countries.

### **Functions**

The functions of the Institute are:

- (i) to organize and coordinate basic and applied research with a view to developing models and methods for the application of Shariah in the fields of economics, finance and banking;
- (ii) to provide for the training and development of professional personnel in Islamic Economics to meet the needs of research and Shariah-observing agencies;
- (iii) to train personnel engaged in development activities in the Bank's member countries.
- (iv) to establish an information center to collect, systematize and disseminate information in fields related to its activities; and
- (v) to undertake any other activities which may advance its purpose.

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## **FOREWORD**

Access of the poor to financial services is indeed important for the success of market based and sustainable poverty alleviation programs. In this regard, microfinance has been recognized worldwide as an important policy instrument. However, the Islamic financial services industry although has progressed significantly during the last 3 decades, but has yet to develop Islamic microfinance services. Therefore, the Islamic Research and Training Institute during the last two years has addressed the subject of Islamic microfinance development through various activities.

First, a stock-taking of the existing knowledge regarding Islamic microfinance services was undertaken by organizing the 'First International Conference on Islamic Inclusive Financial Sector Development' in collaboration with the University of Brunei Darussalam. Second, the Institute addressed the 'Role of Microfinance in Poverty Alleviation' through a case study of three member countries of IsDB. Finally, as a companion of the above two works this paper on 'Islamic Microfinance Development: Challenges and Initiatives' has been prepared as a strategic framework for systematically addressing the main challenges relating to policy initiatives to develop Islamic microfinance services.

It is hoped that together these three works will bridge the existing gap in the area of Islamic microfinance. Comments and observations are invited to improve the knowledge in this important area. It is expected that these efforts will contribute to initiatives in removing the barriers to accessing financial services by the poor.

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## EXECUTIVE SUMMARY

Poverty alleviation and development of Islamic Financial Services Industry (IFSI) are two key strategic objectives of the Islamic Development Bank Group in addition to enhancing economic cooperation among the member countries. These are also enshrined in the IsDB Vision 1440H and the OIC 10-Year Work Plan. In implementing the IFSI development objective, during 2006 IRTI anchored the preparation of “Ten-Year Framework and Strategies (TYFS) for Development of the Islamic Financial Services Industry”, a joint initiative of the IsDB Group and Islamic Financial Services Board (IFSB). After an extensive consultation process with all stakeholders, the IFSB Council approved the document in its Meeting held in Kuala Lumpur on March 26, 2007. During the consultation process on the TYFS document and at the IFSI Development Forum held in Kuwait as a side activity of the 2006 IsDB BoG meetings, and organized jointly by IsDB/IRTI, IFSB and General Council of Islamic Banks and Financial Institutions (CIBAFI), it was widely felt that there is a need to focus on Islamic Microfinance Development as top priority initiative in order to align *IFSI development* with *poverty alleviation*.

Despite progress in all significant segments, the IFSI has not addressed the challenge of poverty alleviation by making financial services accessible to the poor. This document is being developed with a view to forming the basis for a dialogue among the various stakeholders, including, scholars, academicians, regulators, policy makers, the IFSI and multilateral institutions. The document uses a structure similar to one used in the well-known study “Access to the Poor” – a comprehensive work undertaken by the Consultative Group to Assist the Poor (CGAP), the multi-donor consortium dedicated to advancing microfinance. The study examines the landscape and challenges confronting Islamic microfinance at three levels – the micro level, the meso level and the macro level and suggests strategic initiatives as solutions to the challenges.

The document highlights the importance of microfinance as a tool to fight poverty. It presents the “best practices” models of microfinance and the consensus principles of the microfinance industry. It goes on to argue that diverse approaches are needed to minimize exclusion and that the cultural and religious sensitivities of Muslim societies must be given due emphasis in any attempt to build inclusive financial systems in order to bring a very large segment of the world’s poor population into the fold of formal financial systems. It undertakes an analysis of the levels of poverty in the IsDB member countries and also juxtaposes measures of financial access to highlight the extent of exclusion in these countries. It highlights the Islamic approach to poverty alleviation through microfinance and underscores the need for a dual approach: a *zakah* and *awqaf*-based charity program for the destitute, disabled and “unbankable” and a micro-finance program of wealth creation. Some of the principles inherent in the latter are *access* of the poorest of

the poor to the program; careful *assessment* of the financial health of the poor; *enquiry* blended with empathy; insistence on contribution and *beneficiary stake*; *transformation of unproductive assets* of the beneficiary into income-generating ones through valuation (on the basis of price discovery through auction method); *involvement of the larger community* in the process; *meeting of basic needs* on a priority basis and investment of the surplus in a productive asset; *direct involvement* of the program in *capacity building* in the run-up to income generation and *technical assistance* to the beneficiary; *commitment of top management* of the program; *technical assistance in the form of imparting requisite training* to the beneficiary for carrying out the business plan/ income-generating project; *monitoring* through a time-bound schedule and *impact assessment* through a *feedback mechanism*; and finally, *transparent accounting* of operational results. In short, the Islamic approach to poverty alleviation is more inclusive than the conventional one. The entire gamut of Islamic financial contracts for deposit mobilization, financing and risk management in a Shariah compliant framework are also reviewed.

The document examines Islamic microfinance at three levels – micro level (microfinance institutions, contracts/products and resources), meso level (financial infrastructures) and macro level (policy and regulatory framework). The landscape is analyzed, followed by discussing the major challenges and offering strategic solutions to the challenges.

At a micro level the major challenges to microfinance providers emanate from their diverse organizational structures, issues relating to Shariah compliance, lack of product diversification and poor linkages with banks and capital markets. Some strategic initiatives are suggested as solutions, such as, a move towards collective resolution of Shariah issues, enhancement of product range through research and financial engineering and increased participation of banks in microfinance through provision of credit guarantees and safety nets. Meso level initiatives constitute provision of education and training, better coordination and networking, technical assistance through *Awqaf* and *Zakah* Funds, provision of rating services specific to Islamic microfinance institutions in view of their unique risks through creation of a rating fund. Macro level initiatives constitute development of an enabling regulatory and policy environment. It is observed that the IsDB member countries that have Islamic-finance-specific regulations do not have micro-finance-specific regulations with a few exceptions. A number of regulatory and policy issues have been identified for further deliberation and implementation.

The document envisages that Multilateral institutions like the IsDB can play a major role in micro-, meso- as well as macro-level initiatives to strengthen the Islamic microfinance industry. Some specific initiative that would go a long way in strengthening the Islamic MF sector are:

### **1. At a micro-level**

- i. Participate in equity of Islamic financial institutions with a view to creating specialized MF Divisions;
- ii. Create *Qard al-Hasan*-specific Funds to support various *qard al-hasan* based microfinance institutions across the globe;
- iii. Create refinance facility to act as a whole-seller of Islamic microfinance products for a chain of Islamic and conventional microfinance retailers;
- iv. Participate in equity of *takaful* and *retakaful* companies with a view to developing micro-*takaful* products and services;
- v. Design a Credit Guarantee Scheme for Islamic microfinance providers; and
- vi. Promote dialogue among Shariah scholars for collective resolution of *fiqhi* issues related to microfinance.

### **2. At a meso level**

- i. Develop knowledge base through research in issues pertaining to building Islamic inclusive financial systems;
- ii. Document, collate and translate best-practices from across the world of microfinance;
- iii. Undertake training and education programs to impart microfinance related special skills to bankers and training of trainers;
- iv. Encourage formation of apex and regional industry associations with a view to develop of Islamic microfinance through human resource development, technical assistance, operational standardization and financial product development, facilitation of vertical and horizontal communication among Islamic financial institutions, advocacy and participation in policy dialogue;
- v. Create *Zakah* and *Awqaf* Funds at a global level dedicated exclusively for poverty alleviation and linked to microfinance institutions downstream; and
- vi. Help create rating mechanism in member countries for Islamic microfinance institutions.

### **3. At a macro level**

- i. Assist member countries to develop a regulatory framework for Islamic microfinance;
- ii. Support policy makers to ensure an enabling policy framework conducive to the development of Islamic microfinance;
- iii. Support and facilitate the integration of *zakah* and *awqaf* in financial sector reforms and
- iv. Build an effective alliance and forum of Islamic microfinance providers and other stakeholders.





# 1. INTRODUCTION

Microfinance (MF) is a powerful poverty alleviation tool. It implies provision of financial services to poor and low-income people whose low economic standing *excludes* them from formal financial systems. Access to services such as, credit, venture capital, savings, insurance, remittance is provided on a micro-scale enabling participation of those with severely limited financial means. The provision of financial services to the poor helps to increase household income and economic security, build assets and reduce vulnerability; creates demand for other goods and services (especially nutrition, education, and health care); and stimulates local economies. A large number of studies on poverty however, indicate that *exclusion* of the poor from the financial system is a major factor contributing to their inability to participate in the development process. In a typical developing economy the formal financial system serves no more than twenty to thirty percent of the population. The vast majority of those who are excluded are poor. With no access to financial services, these households find it extremely difficult to take advantage of economic opportunities, build assets, finance their children's education, and protect themselves against financial shocks. Financial exclusion, thus, binds them into a vicious circle of poverty. Building inclusive financial systems therefore, is a central goal of policy makers and planners across the globe. These concerns are reflected in the Millennium Development Goals (MDGs) set by the United Nations in the year 2000 and the international initiatives that have followed. (See Box I)

## 1.1. Models of MF

Microfinance operating along conventional lines has witnessed enormous growth during the last couple of decades. IsDB member countries that have led the microfinance revolution are Bangladesh (with world leaders like Grameen and BRAC), Indonesia and Morocco. Among non-member countries India, Sri Lanka have sizable Muslim population. These countries have witnessed some of the pioneering experiments to eliminate poverty.

Microfinance institutions provide to the entrepreneurial poor financial services that are tailored to their needs and conditions. Good microfinance programs are characterized by small, usually short-term loans; streamlined, simplified borrower and investment appraisal; quick disbursement of repeat loans after timely repayment; and convenient location and timing of services.

### **Box I. MDGs, Poverty Alleviation and MF**

The Millennium Development Goals (MDGs) are eight goals to be achieved by 2015 that respond to the world's main development challenges. The MDGs are drawn from the actions and targets contained in the *Millennium Declaration* that was adopted by 189 nations-and signed by 147 heads of state and governments during *UN Millennium Summit* in September 2000.

- Goal 1: Eradicate extreme poverty and hunger: Halve, between 1990 and 2015, the proportion of people whose income is less than one dollar a day; Halve, between 1990 and 2015, the proportion of people who suffer from hunger
- Goal 2: Achieve universal primary education
- Goal 3: Promote gender equality and empower women
- Goal 4: Reduce child mortality
- Goal 5: Improve maternal health
- Goal 6: Combat HIV/AIDS, malaria and other diseases
- Goal 7: Ensure environmental sustainability
- Goal 8: Develop a Global Partnership for Development

Towards achieving the goals the United Nations General Assembly adopted 2005 as the *International Year of Microcredit* to “address the constraints that exclude people from full participation in the financial sector.” At the World Summit at the United Nations in September 2005, Heads of State and Government recognized “the need for access to financial services, in particular for the poor, including through microfinance and microcredit.” The Monterrey Consensus that Heads of State and Government adopted at the International Conference on Financing for Development in 2002 explicitly recognized that “microfinance and credit for micro, small and medium enterprises...as well as national savings schemes are important for enhancing the social and economic impact of the financial sector.” They further recommended that “development banks, commercial banks and other financial institutions, whether independently or in cooperation, can be effective instruments for facilitating access to finance, including equity financing, for such enterprises....”

It should be noted here that access to credit, savings, or other financial services is only one of a series of strategies needed to reduce poverty and achieve the MDGs. Financial services need to be complemented by access to education, health care, housing, transportation, markets, and information.

Microfinance institutions thus have distinct characteristics that make them specialized components of the formal financial system. The main point of departure of microfinance from mainstream finance systems is its alternative approach to collateral that comes from the concept of joint liability. In this concept individuals come together to form small groups and apply for financing. Members of these small groups are trained regarding the basic elements of the financing and the

requirements they will have to fulfill in order to continue to have access to funding. Funds are disbursed to individuals within the group after they are approved by other members in the group. Repayment of the financing is a shared responsibility of all of the group's members. In other words they share the risk. If one defaults, the entire group's members face a set back. This is a basic but effectual credit scoring mechanism that may mean a provisional suspension from the program and therefore no access to financing for the group or other penalties. In most cases, microfinance programs are structured to give credit in small amounts and require repayment at weekly intervals and within a short time period— usually a month or a few months. The beneficiary looks forward to repetitive financing in a graduated manner and this also helps mitigate risk of default and delinquency.

The model that has popularized the above methodology and has been replicated in many countries in a wide variety of settings is the **Grameen Bank** model. The model requires careful targeting of the poor through means tests comprising mostly of women group. The model requires intensive fieldwork by staff to motivate and supervise the borrower groups. Groups normally consist of five members, who guarantee each other's loans. A number of variants of the model exist; but the key feature of the model is group-based and graduated financing that substitutes collateral as a tool to mitigate default and delinquency risk. An early Grameen replication that sought to offer Shariah-compliant MF is Amana Ikhtiar Malaysia (AIM).

A second model that has been widely replicated mainly in Latin America and Africa, but with substantially less total outreach than the many Grameen Bank replications is the **Village Bank** model. The model involves an implementing agency that establishes individual village banks with about thirty to fifty members and provides “external” capital for onward financing to individual members. Individual loans are repaid at weekly intervals over four months, at which time the village bank returns the principal with interest/ profits to the implementing agency. A bank repaying in full is eligible for subsequent loans, with loan sizes linked to the performance of village bank members in accumulating savings. Peer pressure operates to maintain full repayment, thus assuring further injections of capital, and also encourages savings. Savings accumulated in a village bank is also be used for financing. As a village bank accumulates sufficient capital internally, it graduates to become an autonomous and self-sustaining institution (typically over a three-year time period). This model has been very successfully implemented in a Shariah-compliant manner in Jabal al-Hoss, Syria. A new experiment by FINCA in Afghanistan also seeks to implement this model.

The third type of MF model is a **Credit Union (CU)**. A CU is based on the concept of mutuality. It is in the nature of non-profit financial cooperative owned and controlled by its members. CUs, mobilize savings, provide loans for productive and provident purposes and have memberships which are generally based on some

common bond. CUs generally relate to an apex body that promotes primary credit unions and provides training while monitoring their financial performance. CUs are quite popular in Asia, notably in Sri Lanka,

A fourth model originating in India is based on **Self-Help Groups (SHGs)**. Each SHG is formed with about ten-fifteen members who are relatively homogeneous in terms of income. An SHG essentially pools together its members' savings and uses it for lending. SHGs also seek external funding to supplement internal resources. The terms and conditions of loans differ among SHGs, depending on the democratic decisions of members. Typical SHGs are promoted and supported by NGOs, but the objective (as with village banks) is for them to become self-sustaining institutions. Some NGOs act as financial intermediaries for SHGs, while others act solely as 'social' intermediaries seeking to facilitate linkages of SHGs with either licensed financial institutions or other funding agencies. The SHG model is a good platform for combining microfinance with other developmental activities.

Conventional microfinance over the years has witnessed a paradigm shift - from the traditional donor-based approach to a for-profits approach in building inclusive financial systems. The underlying assumption is that the demand for these services is simply too great to be filled by government and donor funds on a sustained basis. The excess demand will, need to be met by commercial capital available at a "fair" market price. The focus therefore, has sharply shifted from charity to profits. Of all the models above<sup>1</sup>, the Grameen model and the village bank model that are the more structured than the rest have been able to enhance their outreach. Indeed the Grameen model has now become the text-book model of microfinance.

## 1.2. Key Principles of MF

A major initiative towards achieving the MDGs is formation of the Consultative Group to Assist the Poor (CGAP), a multi-donor consortium dedicated to advancing microfinance. It is a consortium of 31 public and private development agencies working together to expand access to financial services for the poor, referred to as microfinance. CGAP envisions a world in which poor people everywhere enjoy permanent access to a range of financial services that are delivered by different financial service providers through a variety of convenient delivery channels. It is a world where poor and low-income people in developing countries are not viewed as marginal but, rather, as central and legitimate clients of their countries' financial systems. In other words, this vision is about *inclusive financial systems*, which are the only way to reach large numbers of poor and low-

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<sup>1</sup> The four-model classification is based on John D Conroy, "The Challenges of Micro-financing in South-East Asia", *Financing Southeast Asia's Economic Development*, Institute of Southeast Asian Studies, Singapore, 2003.

income people. As a way forward to realize this vision, CGAP has come up with eleven key principles of MF<sup>2</sup> based on decade-long consultations with its members and stakeholders. These are as follows:

1. Poor people need a variety of financial services, not just loans. In addition to credit, they want savings, insurance, and money transfer services.
2. Microfinance is a powerful tool to fight poverty. Poor households use financial services to raise income, build their assets, and cushion themselves against external shocks.
3. Microfinance means building financial systems that serve the poor. Microfinance will reach its full potential only if it is integrated into a country's mainstream financial system.
4. Microfinance can pay for itself, and must do so if it is to reach very large numbers of poor people. Unless microfinance providers charge enough to cover their costs, they will always be limited by the scarce and uncertain supply of subsidies from governments and donors.
5. Microfinance is about building permanent local financial institutions that can attract domestic deposits, recycle them into loans, and provide other financial services.
6. Microcredit is not always the answer. Other kinds of support may work better for people who are so destitute that they are without income or means of repayment.
7. Interest rate ceilings hurt poor people by making it harder for them to get credit. Making many small loans costs more than making a few large ones. Interest rate ceilings prevent microfinance institutions from covering their costs, and thereby choke off the supply of credit for poor people.
8. The job of government is to enable financial services, not to provide them directly. Governments can almost never do a good job of lending, but they can set a supporting policy environment.
9. Donor funds should complement private capital, not compete with it. Donor subsidies should be temporary start-up support designed to get an institution to the point where it can tap private funding sources, such as deposits.
10. The key bottleneck is the shortage of strong institutions and managers. Donors should focus their support on building capacity.
11. Microfinance works best when it measures—and discloses—its performance. Reporting not only helps stakeholders judge costs and benefits, but it also improves performance. MFIs need to produce accurate

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<sup>2</sup> Brigit Helms, *Access to All: Building Inclusive Financial Systems*, Consultative Group to Assist the Poor, World Bank, 2006, P XI

and comparable reporting on financial performance (e.g., loan repayment and cost recovery) as well as social performance (e.g., number and poverty level of clients being served).

To sum up, the principles broaden the definition of MF from micro-credit to provision of an array of financial services, such as, savings, insurance and remittance. They emphasize that *access* to MF and not *cost* of MF should be under focus in designing and implementing a poverty alleviation strategy. The strategy should aim at *sustainability* through a shift from a charity-based donor-dependent approach to a market-based for-profits approach emphasizing *systemic efficiency* and *transparency* and restricting use of donor funds to *capacity building*. The principles also underscore *inclusiveness* and *integration* of MF with the formal financial system.

### **1.3. Enhancing Inclusiveness through Islamic Microfinance (IsMF)**

Even while the principles reflect a consensus, they do not imply or advocate a single and uniform approach to microfinance. As CGAP emphasizes, "diverse approaches are needed—a one-size-fits-all solution will not work. Diverse channels are needed to get diverse financial services into the hands of a diverse range of people who are currently excluded. Making this vision a reality entails breaking down the walls—real and imaginary—that currently separate microfinance from the much broader world of financial systems."<sup>3</sup> In the context of Muslim societies, building inclusive financial systems would most certainly require integration of microfinance with Islamic finance.

Microfinance and Islamic finance have much in common. Islam emphasizes ethical, moral, social, and religious factors to promote equality and fairness for the good of society as a whole. Principles encouraging risk sharing, individual rights and duties, property rights, and the sanctity of contracts are all part of the Islamic code underlying the financial system. In this light, many elements of microfinance are consistent with the broader goals of Islamic finance. Both advocate entrepreneurship and risk sharing and believe that the poor should take part in such activities. Both focus on developmental and social goals. Both advocate financial inclusion, entrepreneurship and risk-sharing through partnership finance. Both involve participation by the poor.<sup>4</sup>

There are however, some points of difference, discomfort and discontentment. Conventional microfinance is not for the poorest of the poor. There is a sizeable

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<sup>3</sup> Brigit Helms, Access to All: Building Inclusive Financial Systems, Consultative Group to Assist the Poor, World Bank, 2006, P2

<sup>4</sup> Rahul Dhumale and Amela Sapcanin, An Application of Islamic Banking Principles to Microfinance, Technical Note, Regional Bureau for Arab States, UNDP

substratum within the rural poor whose lives are unlikely to be touched, let alone improved by financial services. They are not "bankable" in their own or their neighbor's eyes, even when the bank is exclusively for poor people. Yet they desperately need some sort of assistance. An Islamic microfinance system, on the other hand, identifies being the poorest of the poor as the primary criterion of eligibility for receiving *zakah*. It is geared towards eliminating abject poverty through its institutions based on *zakah* and *sadaqah*.

Most conventional microfinance providers charge rates of interest that are found to be high when benchmarked against mainstream banking rates. Several reasons are usually given in defense. First, returns on investment in micro-enterprise are very high, by the standards of banks and other investors – the reason being the miniscule size of investments compared to the earnings numbers. Hence, entrepreneurs can “afford” to pay high interest rates as cost of funds (sometimes as high as sixty-seventy percent) as long as the same are lower than rates of return. And that interest rates are much less important to micro-enterprises than access, timeliness and flexibility. Second, interest rates on microfinance are pegged relatively higher, since they entail higher administrative charges, monitoring costs and are by definition, riskier than a traditional financing portfolio.

There is indeed a general agreement on the issue that administrative and monitoring costs are higher with micro-financing. While this helps explain the differential in cost of financing of an MF portfolio as compared to a traditional portfolio, the method of financing need not be interest-based.

It is commonly believed that rates of returns on micro-projects tend to be very high. However, the same is true only for the “successful” projects passing through “good times” and not true of all projects at all times. Interest related liability can compound and accentuate the financial problems of a project experiencing bad times and hasten its failure. The pace, frequency and intensity of such failure is directly related to the levels of interest rates. In case of Islamic profit-sharing mechanisms on the other hand, there is a clear alignment between profitability of the project and cost of capital. The latter rises and falls in line with the realized profits of the venture. In case of Islamic debt financing too, the negative effects of financial risk arising out of use of fixed-rate financing are limited as compared to interest-based debt. This is because the former does not allow for compounding of the debt in case of possible default.

Interest rate – high or low, is rejected by large sections of the Muslim societies as tantamount to *riba* – something that is prohibited in no uncertain terms by the Islamic Shariah.

One of the potential benefits of microfinance in Muslim societies is the empowerment of Muslim women. While the ability of microfinance institutions to

deliver financial services to rural women in gender-segregated societies is commendable, working with Muslim women is a sensitive issue that often raises accusations of meddling with social codes. Some IsMF institutions seek to overcome this through a shift in their focus from “women empowerment” to “family empowerment”. In a few other IsMF programs, a culturally appropriate way has been found of empowering women through gender-segregated ownership of the financing entity and involving separate appraisal of loan applications by women who develop their own gender-sensitive products and strategies for the future.

From the above, it is clear that the cultural and religious sensitivities of the Islamic world are somewhat unique and these must be given due emphasis in any attempt to build inclusive financial systems and bring the over one-billion Muslims into the fold of formal financial systems.

#### **1.4 Objectives**

The objectives of the document are to:

1. Examine the challenges facing the development of Islamic microfinance services with a view to promoting dialogue among the various stakeholders to integrate Islamic microfinance services in national financial sector development policies of member countries.
2. Integrate *Zakah*, *Awqaf* and Islamic financial contracts in the financial sector development strategies with a view to making financial services relevant for the masses;
3. Facilitate policy, financial infrastructure and financial institution development with a view to making financial services accessible and affordable to the masses and
4. Promote cooperation and knowledge sharing in the development of Islamic microfinance services.



## **2. THE POOR IN THE ISLAMIC WORLD**

In this section we measure the extent of poverty and of exclusion in the Islamic world. We also seek to understand the needs of the poor as clients of Islamic microfinance.

### **2.1. Poverty Levels in the Islamic World**

The Islamic world is enormous with over 1.2 billion people, stretching from Senegal to the Philippines – comprising six regions: North Africa, Sub-Saharan Africa, the Middle East, Central Asia, South Asia, and Southeast Asia. Except for a handful of countries in Southeast Asia and the Middle East, there are high and rising poverty levels in both urban and rural parts of most Muslim countries. Poverty levels have also been associated with high inequality alongside low productivity. In Indonesia alone with world's largest Muslim population, over half of the population - about 129 million are poor or vulnerable to poverty with incomes less than US\$2 a day. Bangladesh and Pakistan account for 122 million each followed by India at approximately 100 million Muslims below poverty line. Annexure I provides a snapshot of poverty in the IsDB member countries.

An analysis of data provided in Annexure I reveals that only five of the member countries – Indonesia, Bangladesh, Pakistan, Nigeria and Egypt account for over half a billion (528 million) of the world's poor with incomes below \$2 a day or national poverty line. All these countries except Nigeria have Muslims constituting over ninety-five percent of their respective population. With another five countries - Afghanistan, Sudan, Mozambique, Turkey and Niger, they account for over 600 million of the world's poor. If one considers another comprehensive measure of poverty – the Human Development Index compiled for 120 developing countries by UNDP, it is observed that a large number of IsDB member countries rank extremely low in the 1-120 rank. Mali, Burkina Faso and Chad have ranks below 100 at 102, 101 and 100 respectively, closely followed by Niger and Guinea at 99 and 96.

Among IsDB non-member countries with significant Muslim population are India at 180 million and Russia at 28 million. A large percentage of Muslim population in these two countries is poor. India alone accounts for over 100 million Muslims that live below the national poverty line.

### **2.2. Exclusion in the Islamic World**

While poverty is widespread, access to financial services in the Islamic world is either inadequate or exclusive. In an attempt to measure access to financial services some studies have made use of sample surveys of households or individuals.

However, the number of countries covered by these studies is very small and excludes much of the Islamic world. Further, questions about the reliability some of the data collected in these studies have been raised. A second set of studies have used a different method of collecting data on the number of accounts maintained at financial institutions. This has been done in respect of microfinance in 148 developing countries by Christen et al. (2004) of CGAP,<sup>5</sup> building on earlier compilations. This study covers specialized microfinance institutions, savings and credit cooperatives, credit unions and other socially-oriented intermediaries including some microfinance-oriented commercial banks. More recently, Peachey and Roe (2006)<sup>6</sup> have augmented the CGAP database with figures for a number of *additional savings banks* (members of the World Savings Banks Institute), which had not been included by Christen et al. The most recent study however, is by Honohan (2007)<sup>7</sup> that provides indication of access for more than 160 countries using a composite measure. The measure is an estimate of the fraction of the adult population using formal financial intermediaries.

Annexure II provides values of this composite measure of access to financial services for 44 of the 56 IsDB member countries. It reveals that out of the 44 countries for which the estimate is available, in as many as 17 countries only one-fifth or less of their adult population have access; in 21 countries one-fourth or less have access and in 31 countries one third or less have access to formal financial services. The countries that fare well with over half of their population with access are Lebanon (79 percent), Saudi Arabia (62 percent) and Malaysia (57 percent). Five other countries Kazakhstan, Turkey, Tunisia, Egypt and Indonesia rank next with over 40 percent of their adult population having access. Though there is no data available, countries like Bahrain, UAE, Kuwait and Qatar are likely to figure in this category.

Among non-member countries with significant Muslim population India and Russia provide for better access at 48 and 69 percent. However, these numbers should be interpreted with caution as the national percentage may not be representative of the percentage of their respective Muslim population.

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<sup>5</sup> Christen, Robert Peck, Veena Jayadeva and Richard Rosenberg (2004) "Financial Institutions with a Double Bottom Line: Implications for the Future of Microfinance" Occasional Paper No. 8. Washington DC: CGAP

<sup>6</sup> Peachey, Stephen and Alan Roe (2006) "Access to Finance, Measuring the Contribution of Savings Banks", World Bank Savings Institute.

<sup>7</sup> Honohan, Patrick (2007) "Cross-Country Variations in Household Access to Financial Services", World Bank Conference on *Access to Finance*

### 2.3. Understanding the Needs of the Poor

The needs of the poor in Islamic countries are no different from the poor in other societies except that these are conditioned and influenced by their faith and culture in a significant way. They need financial services because they are often faced with events that call for spending more money than might be available around the house or in the pocket. Rutherford in his path-breaking book, *The Poor and Their Money*, points to three main categories of such events: life-cycle events, emergency needs, and investment opportunities. Life-cycle events include those once-in-a-lifetime occurrences (birth, marriage, death, home building, old age) or recurrent incidents (expenditure related to education, festivals, harvest time) that every household faces. Emergencies include personal crises like sickness or injury, the death of a bread winner or the loss of employment, and theft. Opportunities to invest in businesses, land, or household assets also come up periodically. To come up with the financial outlays required by life-cycle events, emergencies, and opportunities, micro-credit is needed. However, the poor need more than credit. They need a range of options, from credit (beyond enterprise finance), to savings, to money transfer facilities, and insurance in many forms.

*Micro-credit:* Micro-credit as offered by conventional MFIs in Muslim countries violates the fundamental prohibition of *riba* that the Islamic Shariah mandates. While some poor Muslims, devoid of options and hard-pressed for cash avail of interest-bearing credit, many prefer to stay away. The Islamic MFIs offer micro-credit using a variety of Shariah-nominate mechanisms, such as, *qard al-hasan* (with recovery of actual costs of service), *murabahah* with *bay-bithaman-ajil*, *ijarah*, *bay-salam* etc. Less popular are partnership-based financing based on *mudarabah* and *musharakah*. (see the following section for more details)

*Micro-savings:* Poor people want to save, and many of them do save. But they are constrained by the multiple demands on their low incomes and a lack of available deposit services that matches their needs expectations. The importance of savings is underscored by the fact that there are four times as many savings accounts as loans, as uncovered by CGAP's 2004 survey<sup>8</sup> of "alternative" financial institutions around the world. Poor people want secure, convenient deposit services that allow for small balances and transactions and offer easy access to their funds. Poor people in Islamic countries like their counterparts elsewhere, prefer high returns. They also want their deposits to score high on safety, security and liquidity. However, there is an additional dimension to their needs and expectations in the matter of deposits. They want the returns to be *halal* even while they may be using interest rates as a benchmark for comparison. A hotly debated issue relates to

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<sup>8</sup> Christen, Robert Peck, Veena Jayadeva and Richard Rosenberg (2004) "Financial Institutions with a Double Bottom Line: Implications for the Future of Microfinance" Occasional Paper No. 8. Washington DC: CGAP

expected behavior of savers when faced with a trade-off between returns and Shariah compliance. Indeed, many Islamic FIs seek to artificially smoothen returns on their deposits on the basis of a fear of losing clients if “realized” volatile returns are passed on to savers. Arguably, there is not enough understanding of savings behavior in Islamic societies. What is certain however is that deposit products that are free from *riba*, but score equal on other dimensions would certainly be the preferred choice. Recent experience of Islamic MFIs in the matter of offering Shariah-compliant deposit products (refer to subsequent section for details) also shows that they are yet to gain an adequate understanding of the needs of their clients.

*Micro-transfers:* Money transfers encompass more than just remittances, which are defined as the portion of migrant-worker earnings sent to family members or other individuals in their place of origin. Remittances include both domestic and international transfers. Massive numbers of poor people have relatives living in other countries or cities and face serious constraints to sending and receiving this money. Some mainstream Islamic FIs, with emphasis on technology and strategic partnerships have been quite successful in offering this service that is efficient, economical and also Shariah-compliant. A case in point is the Al-Rajhi Banking and Investment Corporation catering to migrant workers in the Gulf. However, few Islamic MFIs offer such services to their clients.

*Micro-Insurance:* Few poor households have access to formal insurance against such risks as the death of a family breadwinner, severe illness, or loss of an asset including livestock and housing. These shocks are particularly damaging for poor households, because they are more vulnerable to begin with. Micro-insurance is the protection of low-income people against specific perils in exchange for regular monetary payments (premiums) proportionate to the likelihood and cost of the risk involved. As with all insurance, risk pooling allows many individuals or groups to share the costs of a risky event. To serve poor people well, micro-insurance must be responsive to priority needs for risk protection (depending on the market, they may seek health, car, or life insurance), easy to understand, and affordable. Several different types of insurance might be relevant for poor and low-income clients. Credit life insurance is the most common and it protects the lenders from the death of their clients. Term life or personal accident insurance is often offered alongside credit life insurance to cover the family if a borrower dies. Savings life insurance is often offered by credit unions and stimulates savings. Property insurance is nearly always linked to a loan and may help a borrower continue repaying his or her loan only if something happens to the property (usually livestock). In some cases, replacement of the property is also covered. Endowment policies combine long-term savings and insurance with emergency loans against the savings balance. In this case, the premium payments accumulate value. Though there is great demand for health insurance and agricultural insurance among the poor, it is difficult to

provide this insurance viably in a commercial mode.<sup>9</sup> Micro-insurance, as is discussed in the subsequent section, takes the form of micro-*takaful* in the Islamic framework.

Provision of the above financial services to the poor is expected to lead to poverty alleviation. However, available research evidence shows that the poor must have access to such services over a fairly *long-term* before the real impact can be seen. It takes time and repeated use of financial services, often combined with other services, to make a dent in poverty. It should also be noted here that microfinance is *not* the sole solution for reducing poverty. Financial services, and especially credit, are not usually appropriate for the destitute (for instance, those who go hungry or without a cash income). It is sometimes forgotten that the other word for credit is debt. Loans to the destitute may in fact make the poor poorer if they lack opportunities to earn the cash flow necessary to repay the loans. Basic requirements like food, shelter, and employment are often more urgently needed than financial services and should be appropriately funded by government and donor subsidies.<sup>10</sup> Microfinance should not be seen as a substitute for investments in basic education, health, and infrastructure.

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<sup>9</sup> Latortue, *Microinsurance: A Risk Management Strategy*

<sup>10</sup> Robinson, *The Microfinance Revolution. Vol. 1, Sustainable Finance for the Poor.*



## 3. FOUNDATIONS OF ISLAMIC MICROFINANCE

### 3.1. Approach to Poverty Alleviation

*Zakah* and *sadaqah* as instruments of charity occupy a central position in the Islamic scheme of poverty alleviation. *Zakah* is the third among five pillars of Islam and payment of *zakah* is an obligation on the wealth of every Muslim based on clear-cut criteria. *Zakah* has been variously described by scholars as a tool of redistribution of income, a tool of public finance, and of course, as a mechanism of development and poverty alleviation. Rules of Shariah are fairly clear and elaborate in defining the nature of who are liable to pay *zakah* and who can benefit from *zakah*. The first and foremost category of potential beneficiaries is the poor and the destitute. A greater degree of flexibility exists with respect to beneficiaries of *sadaqah*.

The primary issue with *zakah* and *sadaqah*-dependent institutions is the issue of sustainability as they are essentially rooted in voluntarism. Funds mobilized through charity could fluctuate from time to time and may not lend themselves to careful planning and implementation.

The issue of sustainability is addressed in the institution of *awqaf* through creation of permanent and income-generating physical assets. *Awqaf* has historically been the major vehicle for creating community assets. On the flip side, the restrictions on development and use of assets under *waqf* for pre-specified purposes introduce rigidity into the system.

While estimates of *actual zakah* collected in Muslim countries reveal that the quantum is grossly inadequate to meet the financing needs of the poor, the impact of *zakah* and *sadaqah* on poverty alleviation, once their full potential is realized, remains to be seen. If charity-based funds are inadequate, then recourse must be found in a commercial approach. Islamic microfinance institutions should be able to mobilize resources, either through accepting savings deposits or obtaining funds from local Islamic banks for onward financing or from the capital market. This commercial approach entails charging and sharing of profits and is quite consistent with Islamic Shariah.

While Islam strongly encourages charity from the giver's point of view, it seeks to minimize dependence on charity from the beneficiary's point of view and restricts the benefits to flow to the poorest of poor and the destitute, who are not in a position to generate any income and wealth. This is evident from the following *hadith* about *sadaqah*.

Narrated Ubaydullah ibn Adl ibn al-Khiyar: Two men informed me that they went to the Prophet (peace be upon him) when he was at the Farewell Pilgrimage while he was distributing the *sadaqah* and asked him for some of it. He looked us up and down, and seeing that we were robust, he said: If you wish, I shall give you something, but there is nothing spare in it for a rich man or for one who is strong and able to earn a living. (*Sunan Abu Dawood, Kitab al-Zakah, Book 9, Number 1629*)

Another famous *hadith* not only underscores the essence of the above *hadith*, but also demonstrates how to design and implement a strategy of poverty alleviation. The *hadith* is broken down into numbered statements so as to highlight the key principles of such a strategy that follow from them.

Narrated Anas ibn Malik: A man of the Ansar came to the Prophet (peace be upon him) and begged from him. (#1)

He (the Prophet) asked: Have you nothing in your house? He replied: Yes, a piece of cloth, a part of which we wear and a part of which we spread (on the ground), and a wooden bowl from which we drink water. (#2)

He said: Bring them to me. He then brought these articles to him and he (the Prophet) took them in his hands and asked: Who will buy these? A man said: I shall buy them for one dirham. He said twice or thrice: Who will offer more than one dirham? A man said: I shall buy them for two dirhams. (#3)

He gave these to him and took the two dirhams and, giving them to the Ansari, he said: Buy food with one of them and hand it to your family, and buy an axe and bring it to me. (#4)

He then brought it to him. The Apostle of Allah (peace be upon him) fixed a handle on it with his own hands (#5)

and said: Go, gather firewood and sell it, and do not let me see you for a fortnight. (#6)

The man went away and gathered firewood and sold it. When he had earned ten dirhams, he came to him and bought a garment with some of them and food with the others. (#7)

The Apostle of Allah (peace be upon him) then said: This is better for you than that begging should come as a spot on your face on the Day of Judgment. Begging is right only for three people: one who is in grinding poverty, one who is seriously in debt, or one who is responsible for compensation and finds it difficult to pay. (*Sunan Abu Dawood, Kitab al-Zakah, Book 9, Number 1637*).



The components of the *hadith* can be seen to emphasize the following fundamental conditions of a successful microfinance program:

1. *Access* of the poorest of the poor to the program
2. Careful *assessment* of the financial health of the poor; *enquiry* blended with empathy; insistence on contribution and *beneficiary stake*;
3. *Transformation of unproductive assets* of the beneficiary into income-generating ones through rigorous valuation (on the basis of price discovery through auction method); *Involvement of the larger community* in the process;
4. *Meeting of basic needs* on a priority basis and investment of the surplus in a productive asset;
5. *Direct involvement* of the program in *capacity building* in the run-up to income generation and *technical assistance* to the beneficiary; *Commitment of top management* of the program;
6. *Technical assistance in the form of imparting requisite training* to the beneficiary for carrying out the business plan/ income-generating project; *monitoring* through a time-bound schedule and *impact assessment* through a *feed-back mechanism*; and
7. *Transparent accounting* of operational results and *liberty* to use part of income to meet higher needs.

In short, the Islamic approach to poverty alleviation is more inclusive than the conventional one. It provides for the basic conditions of sustainable and successful microfinance, blending wealth creation (as in section 1.3) with empathy for the poorest of the poor. There are certain aspects of the Islamic approach that need added emphasis.

One, transparency through meticulous accounting and proper documentation is a fundamental requirement of financial transactions in the Islamic framework. As the holy Quran asserts:

“O ye who believe! When you deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing” and “Let a scribe write down faithfully as between the parties” (2:282)

The import and significance of this verse is often not fully understood. Indeed, lack of proper documentation and accounting by beneficiaries is a major challenge confronting microfinance.

Two, as discussed earlier, a common feature of successful microfinance experiments is group-based financing and mutual guarantee within the group. This

is a highly desirable feature of Islamic societies. Mutual cooperation and solidarity is a norm central to Islamic ethics. The second verse of *Surah Al Maida* in the holy Quran says:

"Assist one another in the doing of good and righteousness. Assist not one another in sin and transgression, but keep your duty to Allah" (5:2)

The following *hadith* by the Prophet (pbuh) reinforces this principle of cooperation and mutual assistance.

"Believers are to other believers like parts of a structure that tighten and reinforce each other." (Al-Bukhari and Muslim)

The Islamic approach to poverty alleviation needless to say, must also be free from *riba*, *gharar*, *jahl* and *darar*.

### **3.2. Shariah-Compliant Instruments of Microfinance**

Prohibition of *riba*, *gharar*, *jahl*, *darar* and other constraining norms in Islamic finance does not constitute an obstacle in building sound microfinance products. On the contrary, the need for Shariah compliance has led to considerable research into product development. While the conventional system provides for simple interest-based deposits, donations and loans, the Islamic financial system comprises an array of instruments for mobilization of funds, financing and for risk management.

#### **3.2.1. Instruments for Mobilization of Funds**

Instruments for mobilization of funds may be broadly divided into (1) charity that includes *zakah*, *sadaqah*, *awqaf*; gifts that include *hiba* and *tabarru*; (2) deposits that may take the form of *wadiyah*, *qard al-hasan* and *mudarabah* and (3) equity that may take the form of classical *musharakah* or the modern stocks.

3.2.1.1. While *sadaqah*, *hiba* and *tabarru* have parallels in conventional microfinance, such as, donations or contributions, *zakah* and *awqaf* have a special place in the Islamic system and are governed by elaborate *fiqhi* rules. *Zakah* is one of the five pillars of Islam and is meant to finance the poorest of the poor. These sections of the society are unlikely to have positive-NPV projects in need of financing and hence, are "unbankable". *Awqaf* creates and preserves long-term assets that generate income flows or indirectly help the process of production and creation of wealth. By targeting its benefits towards the poor, *awqaf* can play an important role in poverty alleviation. Though there has been significant improvement in management of *zakah* and *awqaf* in recent years, their role as vehicles of microfinance and poverty alleviation is grossly underestimated. Their

growing popularity evidenced through establishment of many a *zakah* fund and *awqaf* fund is an indication of their vast potential in Muslim societies.

3.2.1.2. Deposits in the form of *wadiah*, *qard al-hasan* and *mudharabah* have their parallel in savings, current and time deposits respectively and are a regular source of funds for Islamic microfinance institutions, especially those in South-East Asia. *Wadiah* deposits attract gifts to compare favorably with returns available on interest-bearing deposits. *Qard*-based deposits do not provide any return and in some cases, involve a charge. *Mudharabah* deposits are based on profit-loss sharing with the depositor as *rabb-al-mal* and the microfinance institution as the *mudharib*. Available empirical evidence from Indonesia asserts that Islamic microfinance institutions have lagged far behind their conventional counterparts in raising funds through deposits. Clearly there is a need to redesign many of the deposit products by taking into account customer needs and preferences.

3.2.1.3. Microfinance institutions also have the option of raising funds through participatory modes, such as, *musharakah* or modern equity. There is one microfinance program that has successfully demonstrated the practicality of the Islamic participatory approach of risk and profit-sharing: the village-bank-like Sanadiq program in Jabal Al Hoss, Syria. Here, villagers buy shares and become owners of the program. Financing of course is made using the *murabahah* methodology and dividends are distributed annually to the shareholders if profits are sufficient.

### 3.2.2. Instruments of Financing

Instruments of financing may be broadly divided into (1) participatory profit-loss-sharing (PLS) modes, such as, *mudharabah* and *musharakah*; (2) sale-based modes, such as, *murabahah*; (3) lease-based modes or *ijarah* and (4) benevolent loans or *qard* with service charge. (See Box II)

3.2.2.1. Real-life experience shows that *murabahah* is preferred over *mudharabah* primarily because it eliminates the need for written records, often unavailable at the micro enterprise level or if available, the client may be unwilling to share them. Further, in case of *murabahah* a well-defined contract exists, with pre-defined amounts; a fixed contract creates a less complicated process and a lower implementation cost to the institution.

3.2.2.2. A microfinance program has to make several trade-offs when selecting an appropriate financing methodology based on Islamic finance principles. The program must account for the administrative costs and risks of a particular methodology not only to the program but also to borrowers. Often the choice could depend on the nature of the client. As practiced in Indonesia, clients may be broadly divided into two categories: (i) clients with existing businesses and

successful operations for at least two years. (ii) new entrepreneurs without prior business experience. The vast majority of clients are those with existing businesses and a good track record; they can be financed through such financial products as *murabahah*, *musharakah* and *mudarabah*, which involve some form of profit-sharing. New clients without a track record are considered very risky and represent but a small minority; they can be financed through *qard al-hasan*, soft loans without any charge or profit-sharing. Consumer loans and loans for speculative investments, which could be ruinous to the borrower, are excluded from the range of permissible purposes of financing.

3.2.2.3. Unlike mainstream Islamic finance that does not quite treat *qard al-hasan* as a financing mechanism, Islamic microfinance has found this mechanism to be a “pure and effective” way of financing the poor. Many Islamic microfinance programs are modeled solely using *qard al-hasan* - both as an effective fund-raising and financing mechanism. *Qard al-hasan* has a much stronger religious undertone than other “*halal*” mechanisms, being directly ordained by the holy Quran.

<b>Box II: Instruments of Financing in Islamic Microfinance</b>					
<i>Instrument</i>	<i>Suitable for</i>	<i>Cost of capital</i>	<i>Risk to Borrower</i>	<i>Risk to Institution</i>	<i>Remarks</i>
<b><i>Mudarahah/ Musharakah</i></b>	Fixed assets, working capital (Declining form suitable for housing and equipment finance)	Very high	Low	Very high	Costs of loan administration and monitoring are high given the complexity of the repayment schedule and lack of proper accounting; Perceived to be ideal but not popular in practice
<b><i>Ijarah</i></b>	Fixed assets	Moderate	High	Moderate	Costs of loan administration and monitoring are low given simple repayment schedule allowing for flexibility and customization based on client preferences; Popular among Islamic MFIs and potential for easy adaptation by conventional MFIs
<b><i>Murabahah</i></b>	Fixed assets and Working capital	Moderate	High	Moderate	Costs of loan administration and monitoring are low given simple repayment schedule; multiplicity of transactions in working capital financing can push up costs; Highly popular in practice notwithstanding popular perception of it being a close substitute of <i>riba</i> -based lending
<b><i>Qard</i></b>	All-purpose	Very low	Very low	Moderate	Charity-based usually combined with voluntarism; low overheads; Popular because perceived to be the purest form of financing
<b><i>Salam</i></b>	Working capital	High	High	High	Back-to-back nature creates risk of lack of double coincidence; Untried
<b><i>Istisna</i></b>	Fixed assets	High	High	High	Back-to-back nature creates risk of lack of double coincidence; Untried
<b><i>Istijrar</i></b>	Working capital	Moderate	Moderate	Moderate	Ideal for micro repetitive transactions; Complexity not easily understood by parties; hence not a popular mechanism

Such programs popularly known as *Bait-ul-Maals* are administered often through mosques and Islamic centers resulting in low overheads, leading to low service charge. A combination of financing with Islamic teachings and oaths

administered in mosques helps reduce defaults and delinquencies to the minimum. *Ulama* in rural settings wield considerable influence over the masses and are some times used as “factors” entrusted with the task of collection of debt.

### 3.2.3. Instruments of Risk Management

Instruments of risk management and insurance in Islamic microfinance are based on the concept of guarantee (*kafalah*) and collateral (*daman*). In case of financing individuals, guarantee is used as an alternative to collateral (e.g. *kafalah* or guarantee by two persons is considered adequate by Pakistan-based *Akhuwat*) and as a tool to manage the risk of default and delinquency. As stated earlier, in case of financing groups; mutual guarantee (*kafalah*) is used by almost all microfinance institutions – both conventional and Islamic.

3.2.4.1. A relatively smaller number of Islamic microfinance institutions require collateral in the form of physical assets (e.g. the Lebanon based Hasan Fund and the Indonesian BMTs).

3.2.4.2. For protection against unforeseen risks by borrowers/ members, micro-insurance would take the form of micro-*takaful* based on mutual guarantee. However, micro-*takaful* products are yet to appear in the market place. In the absence of micro-*takaful* products, real life projects seek to protect their members in a variety of ways that are informal and perhaps inefficient. For example, in case of the Syria-based Sanadiq, members facing adversities are provided the option of a short-term emergency loan against payment of a fixed fee. Of course, such a loan is not automatic and requires careful deliberation between project management and the sanadiq central committee. Sanadiq also require their members and their family members to go for conventional life insurance. The life insurance not only contributes to social security, but also serves as loan protection when a borrower dies. Recourse to conventional insurance obviously raises Shariah-related concerns. Another known Islamic microfinance program – the *Hodeidah* program has created an insurance fund out of contributions from borrowers. This fund compensates borrowers who face emergencies—such as fire, flood, and death—that affect their businesses. Borrowers are eligible for compensation from the insurance fund if group members and the responsible loan officers approve.

3.2.4.3. The risks confronting individual and group borrowers translate into risk of default and delinquency for the MFI. One way to mitigate this on the part of the MFI is to insist that borrowers participate in a micro-*takaful* program. However, this may not be enough to convince a mainstream FI to go for microfinance. The mainstream Islamic banks and financial institutions financing large corporations and high networth individuals may not be comfortable with the unique risks with microfinance. This highlights the need for a “safety net” or guarantee offered by a third party. This product can be offered in the framework of *al-kafalah*.

## 4. ISLAMIC MF PROVIDERS: MICRO LEVEL

Islamic microfinance providers who offer services at a micro-level directly to poor and low-income clients constitute the backbone of the system. In the Islamic countries, current and potential providers of Islamic MF are likely to be either the conventional MFIs expanding the scope of their services to include Islamic MF or the Islamic FIs expanding the scope of their services to include MF. In section 4.1 we briefly survey the disparate categories of MF providers across the globe highlighting their pros and cons. In section 4.2 we present an exhaustive set of cases of Islamic MF experiments undertaken in IsDB member countries and in selected non-member countries with significant Muslim minorities.

### 4.1. The Landscape

Globally, MF providers may be discussed in two categories- informal and formal.

#### 4.1.1. Informal MF Providers

Most poor people obtain financial services through informal arrangements with friends and neighbors. Interestingly, these informal arrangements take on similar forms and can be divided into two rough categories: individual providers and collective clubs or associations.

Individual informal providers include friends and relatives, moneylenders, savings collectors, pawnbrokers, traders, processors, and input suppliers. Loans in the Islamic framework must be based on *qard al-hasan* and this rules out the “commercial” moneylender. Savings collectors can operate on the basis of fee (*ujrat*). Pawn-brokering is a form of informal lending, although in many countries this practice has become more formal and regulated. Pawnbrokers lend on the basis of collateral. Unlike other lenders, though, they take physical possession of the collateral. In South East Asian countries, Shariah-compliant pawn-brokering on the basis of the concept of *al-rahn* has generated considerable interest. In agriculturally dependent rural areas, traders, processors, and input suppliers are important sources of credit for farmers. In the Islamic framework such financing may be extended on the basis of *bay-salam* and *bay-istijrar*.

Collective forms of informal service providers include rotating savings and credit associations (ROSCAs). These are defined as associations of participants who make regular contributions to a central “pot.” The pot is given, in whole or in part, to each contributor in rotation or chosen by lottery. The funds are managed by the members themselves. The functioning of these need to be carefully evaluated from Shariah point of view.

Many of the above informal services, while appealing and useful for many reasons, are also very expensive, rigid, highly risky, less transparent. Also informal financial services are vulnerable to collapse or fraud, where people can lose their money, whether because of corruption, lack of discipline, or collective shocks like a natural disaster or a bad harvest.

#### **4.1.2. Member-Based Organizations**

Member-based organizations typically rely on their members' own savings as the main source of funds. Members often share some common bond, such as where they work or live. The village banks, self-help-groups, credit unions discussed in section 1.1 fall in this category. Financial cooperatives (sometimes called credit unions or savings and credit cooperatives) are more formal organizations than others. In many countries, some financial cooperatives have evolved into large, successful financial institutions. Unlike banks who make money for shareholders, credit unions and financial cooperatives return some earnings in excess of operational costs to their members. These benefits come in the form of dividends on member shares, increased returns on savings, decreased costs of financing, or new and better services. In most financial cooperatives, each member has one vote: power is not distributed according to the proportion of shares held. As discussed in the next section, many successful Islamic MF experiments are member-based.

#### **4.1.3. Non-Government Organizations**

NGOs usually have multiple bottom lines and pursue social objectives in addition to microfinance. NGOs have clearly led the way in the development of microfinance. They are often donor dependent, particularly the smaller ones, because many were launched with donor funds. Their governance structures are unsuited for bearing fiduciary responsibility, since board members do not represent shareholders or member-owners with money at stake. The range of financial services they can offer is restricted. NGOs cannot usually mobilize savings legally; this function is limited to banks and other intermediaries supervised by banking authorities. The *Zakah* and *Sadaqah*-based organizations fall in this category. Among conventional NGOs, the recent trend has been a move towards greater commercialization in the interest of sustainability, with some NGOs even transforming themselves to formal financial institutions. This has put the issue of "mission drift" on the front burner.

#### **4.1.4. Formal Financial Institutions**

Formal financial institutions hold enormous potential for making financial systems truly inclusive. This is more so for banks with some social mission, such as, the Islamic banks. Islamic banks often have wide branch networks; the ability to



offer a range of services, including savings and transfers; and the funds to invest in systems and technical skills. They can use these strengths to reach massive numbers of poor people, both on their own and in partnership with other financial service providers, including NGOs. Among the conventional banks that have traditionally shown interest in the microfinance sector are state-owned banks, agricultural and postal banks who are generally observed to be inefficient in the matter of credit-delivery, but quite successful in savings mobilization. Among private financial institutions are: small community or rural banks, NBFIs, specialized microfinance banks, and full-service banks with microfinance as a line of business. The first three categories of financial institutions are more likely to see poor clients as a key market. Full-service commercial banks have been slower to realize the potential of poor clients. NBFIs include mortgage lenders, leasing companies, consumer credit companies, insurance companies, and certain types of dedicated MFIs.

## **4.2. Islamic MF Providers across the Globe**

Cases of successful Islamic microfinance experiments in Muslim societies are small in number. Further, these institutions are not integrated into the formal financial systems, with the notable exception of Indonesia. In most cases these are in the nature of experimental projects initiated by international donor agencies, religious or political groups. Cases of Islamic banks practicing microfinance are even fewer. Islamic microfinance institutions display wide variations in the models, instruments and operational mechanisms. While, in terms of reach, penetration and financial prowess, Islamic microfinance institutions lag far behind their conventional counterparts they certainly score better in terms of richness and variety. Islamic microfinance institutions similar to conventional microfinance institutions, use group financing as a substitute to collateral, have a high concentration of women beneficiaries and aim at alleviation of poverty in all its forms.

### **4.2.1. Middle East North Africa (MENA)**

It was a microfinance initiative in Egypt - the Mit Ghamr project that laid the foundation of modern Islamic banking, notwithstanding the short lifespan of the project. In the Middle East North Africa (MENA) region several successful experiments have been undertaken recently: (i) the Sanadiq project at Jabal al-Hoss in Syria; (ii) the Mu'assasat *Bayt Al-Mal* in Lebanon; and the (iii) *Hodeidah* Microfinance Program in Yemen.

4.2.1.1. The Jabal Al Hoss “Sanadiq” (village-banks) in Syria is an excellent model worth replication. Some of the unique features of this model are: (i) *musharakah*-type structure owned and managed by the poor; (ii) financing based on the concept of *murabahah* – high profit rates with net profits shared among members; (iii) good

governance through committees with sound election and voting procedures; (iv) project management team responsible for creating awareness of microfinance practices, training of committee members; (v) financial management of the funds based on standardized by-laws and statutes for each of the village funds resulting in “fair” credit decisions and low transaction costs. (vi) financially viable operations with repayment rates close to cent percent (vii) equal access to both men and women as owners and users; (viii) sanadiq apex fund for liquidity exchange and refinancing; and (ix) support from UNDP in the form of matching grant equal to minimum share capital of village fund.

4.2.1.2. The Mu’assasat Bait Al-Mal in Lebanon is an affiliate of a political party – the Hezbollah and comprises the Hasan Loan Institution (*Al-Qard Al-Hasan*) and its sister organization called Al-Yusor for Finance and Investment (Yusor lil-Istismar wal Tamweel). The former provides *qard al-hasan* financing while the latter provides financing on a profit-loss-sharing mode. The uniqueness of the Mu’assasat Bait Al-Mal is its emphasis on voluntarism. It has maintained a very close relationship with the people and is seen as a very creditable organization with volunteers entirely taking care of collection and disbursement of funds. It has a network of donors with complete confidence in the activities of the Institution and also enjoys high repayment rate. Financing is backed by collateral in the form of capital assets, land, gold, guarantor and bank guarantee.

4.2.1.3. The *Hodeidah* Microfinance Program in Yemen predominantly uses group and graduated financing methodology that was successfully pioneered by Grameen. Unlike Grameen however, it uses a *murabahah* mode for financing.

#### **4.2.2. South Asia**

Among South Asian countries Bangladesh leads the group with organizations like Islami Bank Bangladesh, Social and Investment Bank Bangladesh, Al-Fallah and Rescue. *Akhuwat* in Pakistan is notable for its unique mosque-based model. India with its second largest Muslim population in the world has witnessed some experiments largely outside its formal financial system, such as, AICMEU and Bait-un-Nasr.

4.2.2.1. The Islamic microfinance institutions in Bangladesh have been primarily using deferred-payment sales (*bay mu’ajjal*) mode of financing. They have been facing tough competition from conventional giants like Grameen Bank and BRAC. Though according to some studies, Islamic microfinance institutions have displayed better financial performance than their conventional counterparts, the latter have a far greater outreach. Indeed, institutions like Grameen and BRAC have pioneered models of microfinance that are replicated across the globe. (see Box III)

4.2.2.2. In Pakistan a model of micro-financing that has generated considerable interest among observers is *Akhuwat*. The financing is in the nature of small interest free loans (*qard al-hasan*) in a spirit of Islamic brotherhood where most activities are performed by volunteers. There is no funding from international donors or financial institutions. All activities revolve around the mosques and involve close interaction with the community. There are no independent offices; loans are disbursed and recovered in mosque and therefore involve low overheads. It uses collateral-free group and individual financing based on mutual guarantees. Loans are disbursed in a mosque, which also attaches a religious sanctity to the oath of returning it on time.

#### **4.2.3. South East Asia**

In South East Asia Malaysia made an early beginning with Tabung Haji aimed at financing the Hajj related expenditure of poor Malaysian farmers who used to sell their only source of livelihood - agricultural land for the purpose. Tabung Haji was primarily a savings-and-investments-institution and has since grown into a large specialized finance house. Indonesia has largely followed Malaysia in the development of the Islamic financial sector including the microfinance sector. Cases of Islamic microfinance projects have also been documented for Thailand, Brunei and Philippines.

4.2.3.1. With its rather developed Islamic banking system and capital markets, Malaysia has established several organizations under the aegis of government agencies to finance small and medium scale enterprises using a wide range of Islamic financial instruments.

### **Box III: Replicating the Grameen Model in Muslim Societies**

The pioneering contribution of Grameen and its founder Professor Muhammad Yunus towards poverty alleviation can hardly be overemphasized. Recipients of Nobel Peace Prize for the year 2006, Grameen and Prof Yunus have provided a model of microfinance that is being replicated through one of the largest international networks of microcredit organizations for the poor in the world. There are currently eighty-six Grameen type credit and savings programs in twenty-eight countries. The key features of Grameen model, such as, entrepreneurship development among the poor, lending to groups based on mutual guarantee, small sized recurring loans, have all now become features of the text-book model of microfinance.

With widespread poverty in the Islamic world, the Grameen methodology has naturally attracted proponents of Islamic finance who share a common goal. However, the major discomfort in replication of the Grameen model in Muslim societies is its interest-bearing product portfolio. Though Grameen is part of the conventional interest-based system, it is very different from the conventional banking system. In the words of its founder, Grameen model “is almost the reverse of the conventional banking methodology.” Some major points of departure are as follows:

“There is no legal instrument between the lender and the borrower in the Grameen methodology. There is no stipulation that a client will be taken to the court of law to recover the loan, unlike in the conventional system. There is no provision in the methodology to enforce a contract by any external intervention. When a client gets into difficulty, conventional banks get worried about their money, and make all efforts to recover the money, including taking over the collateral. Grameen system, in such cases, works extra hard to assist the borrower in difficulty, and makes all efforts to help her regain her strength and overcome her difficulties. Further, in conventional banks there is compounding of interest; in Grameen, no interest is charged after the interest amount equals the principal. All interests are simple interests. Conventional banks do not pay attention to what happens to the borrowers' families as a result of taking loans from the banks. Grameen system pays a lot of attention to monitoring the education of the children, housing, sanitation, access to clean drinking water, and their coping capacity for meeting disasters and emergency situations. Grameen system helps the borrowers to build their own pension funds, and other types of savings. In case of death of a borrower, Grameen system does not require the family of the deceased to pay back the loan. There is a built-in insurance program which pays off the entire outstanding amount with interest. No liability is transferred to the family.”

The points of departure perhaps push Grameen very close to Islamic ideals. It appears that *with some modification*, especially with a financial engineering approach to development of Shariah-compliant products, the Grameen model has all the potential for eradication of poverty from Muslim societies in a manner that is compatible with Islamic Shariah – both in letter and spirit.

#### **Box IV: Shariah Compliance with Spiritual Treatment**

Indonesia has a long history of microfinance. Its strong emphasis on its Islamic roots has enabled itself to experiment with a dual system of Islamic finance and a system of microfinance that is not just Shariah-compliant, but actually uses Islamic “spiritual treatment” along with financial and technical assistance to develop its micro-enterprises and work towards elimination of poverty. A recent pilot study conducted by Bank Indonesia (BI) divided beneficiaries into groups based on those receiving: (i) financial assistance only; (ii) financial and technical assistance only; and (iii) financial and technical assistance along with spiritual treatment. It was observed that group (iii) outperformed all other groups highlighting the importance of spiritual treatment. BI plans to use the findings to develop a model of microfinance that is not only integrated but also uses spiritual treatment as an important intervention.

In Indonesia, at the grassroots level, the *Baitul Maal wal Tamwils* (BMTs) are a large network of over two thousand institutions serving millions of poor Indonesian Muslims. These BMTs are floated by a wide variety of organizations including Islamic banks, BPRS and are at times backed by Islamic organizations, such as, Nahdatul Ulama and Muhammadiyah that currently have over hundred million members. *Zakah* funds are also an integral part of the BMTs.

Unlike many single-product (*murabahah* or *qard al-hasan* based) Islamic microfinance programs and projects in other regions, the financing portfolios of Indonesian IsMFIs are reasonably balanced with an array of products – based on *mudharabah*, *musharakah*, *murabahah*, *ijarah* and *qard al-hasan*.

4.2.3.2. Islamic microfinance institutions in Indonesia may be placed in three categories- the microfinance divisions of Islamic banks, the Islamic rural banks (BPRS) a subcategory of the rural banks (BPR); and the Islamic financial cooperatives that are not part of the formal financial sector. They are generally referred to as *Baitul Maal wal Tamwil* (BMT). (see Box IV)

Islamic microfinance institutions (IsMFIs) in Indonesia have displayed their sustainability and robustness in the face of grave financial crises even when the mainstream banks had to depend on governmental assistance to tide over serious financial problems. It should be noted that Indonesian BMTs at the grassroots largely fall outside the financial regulatory mechanism since they operate as member-based cooperative organizations (similar to a *musharakah* structure) without governmental assistance or intervention. These organizations have been found to be less vulnerable to systemic risks that arise due to interdependence, as each BMT is an independently operating entity. As such, the system poses a serious challenge to the regulator – how to strike a balance between the need to strengthen the linkage between formal financial system and the BMTs while retaining the benefits of flexibility and independence.

#### 4.2.4. Sub-Saharan Africa

In Sub-Saharan Africa the only Islamic microfinance program that has been documented well operates in Northern Mali. It was borne out of a development project by the GTZ (German Technical Cooperation) and KfW (German Financial Cooperation) in the former civil war areas of Timbuctu', Mali. The aim of the project, inter alia, was to provide financial services to all the tribes of the area, the Moors, the Tuareg and various black African groups. It was felt that a bank that would be acceptable to all previous civil war opponents had to be an Islamic one and this led to establishment of the Azaouad Finances plc. The bank operates primarily on a PLS basis, is linked with the SWIFT international payments system, thus giving a fillip to local trade and commerce in a big way.

#### 4.2.5. Central Asia

Out of the countries with large Muslim populations in Central Asia - Afghanistan, Azerbaijan, Kazakhstan, Tajikistan, Uzbekistan, Kyrgyzstan only the former two have witnessed experiments in Islamic microfinance.

4.2.5.1. The only Islamic microfinance program being run in Afghanistan is by FINCA. The program involves *qard al-hasan* with service charge that is not related to amount of financing as a percentage and that is charged upfront as a fee. FINCA's Village Banking methodology targets the working poor with its "solidarity" group guaranteed loans. FINCA Afghanistan also plans to launch a *Murabahah* Compliant Loan (MCL) to provide larger loans for loan capital and fixed assets for individual clients interested in more traditional methods of Islamic financing.

### 4.3. Challenges

#### 4.3.1. Diverse Organizational Structures

The majority of microfinance institutions in the MENA and South Asia are set up as NGOs (Societies, Trusts, Foundations and Associations etc.). Generally, NGOs are allowed to *make* profits but not to *take* profits. This would be inconsistent with a partnership-based model as in case of Sanadiq in Syria, which pays dividends to its shareholders using a profit-sharing scheme. The for-profit institutions generally seek registration under the company law in their country, as a preferred institutional option. Banks that are into microfinance are naturally governed by the respective banking laws. A significantly large number of microfinance institutions (especially in Indonesia) are organized as cooperatives registered under the Cooperatives Act and come under the purview of the Ministries of Cooperation and not the Ministries of Finance. Many are not

registered at all and operate in an informal manner, especially where they perceive additional hassles subsequent to the registration (such as, in Palestine Occupied Territories for political reasons). Registration however, brings with itself many benefits, such as, the ability to raise funds from the formal banking and financial system. The non-registered entities may also suffer from low credibility as large-scale cases of fraud (as with pyramid schemes and ROSCAs) are reported in this sector.

### 4.3.2. Shariah Compliance

Shariah compliance is indeed the differentiating factor between a conventional and Islamic microfinance institution. Islamic microfinance institutions must not only conform to Shariah in all their products, processes and activities, they should be perceived to be so by their clientele.

#### 4.3.2.1. Shariah Boards

Mainstream Islamic financial institutions provide comfort to their stakeholders that they conform to Islamic finance principles by setting up Shariah supervisory board (SSB)s. The members of SSBs are usually distinguished scholars and experts of *fiqh* who confirm the compliance of financial products and consistency of operations with Shariah. A review of Islamic microfinance institutions reveals that none of them have instituted SSBs. A simple reason may be that this approach is costly. The challenge before Islamic microfinance institutions is therefore to seek alternatives to the above approach.

#### 4.3.2.2. *Fiqhi* Issues

Divergence of views among Shariah scholars on many issues needs no elaboration and continues to be a major challenge to development of Islamic finance. The problem becomes particularly acute in the context of Islamic microfinance. The local nature of the practices in microfinance allows for many variations from the standardized set of contracts discussed in *fiqh* literature and can open up rooms for debate.

Unlike mainstream Islamic bankers, many Islamic microfinance providers with multiple bottom-lines are not comfortable with techniques like *murabahah* and *ijarah* (lease-purchase and financial lease variety) and view them as interest-based-loan-substitutes. The Islamic alternative to them is *qard al-hasan* – what attracts them is its benevolent nature. Use of *qard al-hasan* where only the “actual” service charge is recovered from the beneficiary, does not allow the portfolio of financings to grow while inflation is likely to erode their real value, seriously threatening their long-term survival. Some suggestions like linking the loan amount to a physical commodity have been made; but without much of a consensus.

On another level, many interest-based loans would like to be treated as Shariah-compliant because of their “benevolent” nature. For instance, successive governments in India have routinely provided through a network of microfinance outfits loans at interest rates grossly below the prime lending rate in the economy and would, at periodic intervals, waive the entire loan amount in the face of hardships (such as crop failure, or even small enterprises becoming sick); consequently claiming to be more equitable than profit and loss sharing. Another instance is the Grameen system that cites the following features of its loans to be labeled differently than interest-bearing conventional loans: (i) cap on the total interest due; (ii) no recovery in case of project failure; (iii) no formal contract for interest payments; (iv) no shareholder-owner(s) as counterparty to receive interest etc. Such variations naturally lead to renewed discussions on the existence or otherwise of *riba* in such financing modes.

Issues, such as, dealing with delays and delinquencies through penalties invariably lead to divergent views. Besides, many other unresolved issues in mainstream Islamic finance also are a challenge to Islamic microfinance.

#### 4.3.2.3. Divergent Perceptions

Client perceptions towards *mudarabah*, *murabahah*, *qard al-hasan* which are predominant forms of Islamic microfinance in the Islamic world show wide variations and this can pose a major challenge for the Islamic microfinance sector. At times, such perceptions are rooted in the ignorance of the clients about *fiqhi* rules governing the various *riba*-free mechanisms.

It is pertinent to note a few survey findings on attitude of Muslim borrowers towards alternative modes of financing. One, borrowers display an initial preference for the profit-sharing mechanism—that is, *mudarabah* as it is perceived to be more Islamic in spirit. Two, only some borrowers understand that the profit-sharing mechanism may, under certain designs, be more expensive for them than other alternatives within Islamic banking. Three, only some borrowers recognize the potential for conflict between the microfinance program and the borrower in determining profit. Four, some borrowers do not like the profit-sharing of *mudarabah* because they do not want to reveal their profits to the program (and their group). Five, borrowers initially express doubts about the appropriateness of the “buy-resell” mechanism (*murabahah*) because it appears too similar to the forbidden practice of fixed interest rates (*riba*). But once the mechanism is properly explained to borrowers and local religious leaders, it is accepted. Six, borrowers accept that a microfinance program incurs costs and that these costs have to be recovered in order for the program to continue offering financial services. Seven, borrowers also appreciate the simplicity and transparency of the “buy-resell” model, which allows repayments in equal installments. It is easier to



administer and monitor. This “blow-hot-blow-cold” attitude of the clients towards alternative modes creates major problems for professionals engaged in product development for the Islamic microfinance sector.

Client perception towards *qard al-hasan* is no less worrisome. It is perceived to be “free” by many borrowers even when Shariah clearly distinguishes between *qard al-hasan* and *sadaqah*. There are still others who are aware of the difference and realize the need to repay the loan; but assert that *qard al-hasan* in its “pure” form provides them with flexibility (right) in deciding *when* to repay.

#### **4.3.3. Lack of Product Diversification.**

Islamic microfinance in spite of the richness of *fiqh* literature remains highly *murabahah*-centric. Even *ijarah* has not witnessed many takers unlike mainstream Islamic finance. Profit-loss-sharing, though highly acclaimed as “ideal” is hardly used (with a few exceptions, such as, in Indonesia). The “actual” number of institutions based on *zakah*, *awqaf* and *qard al-hasan* is nowhere near the vast potential these institutions and instruments offer. Voluntary savings, deposits services, insurance, remittance and other fee based services are generally not offered.

Agency problems with Profit-Loss-Sharing (PLS) in mainstream Islamic finance have already been highlighted as a matter of grave concern that pushes Islamic FIs to opt for debt-based products. They become particularly acute in rural settings. Other problems that are usually cited with PLS-based modes as compared to sale and lease based modes are as follows: One, PLS mechanisms require long-term involvement by the microfinance institutions in the form of technical/business assistance which raises the cost of implementation. Two, the uncertainty about profits is a major drawback of the PLS models. Although microfinance programs have information on local market behavior, weekly profits fluctuate. Fluctuating profits make it extremely difficult for institutions to predict their cash flows. Micro-entrepreneurs make the job doubly difficult by not keeping accurate accounts. Three, the PLS model is difficult to understand for loan officers and borrowers alike. Even in the hypothetical situation that profits were known, the borrower has to repay a different amount each period (and the loan officer has to collect a different amount each period). This lack of simplicity—relative to equal repayment installments—is a source of confusion for borrowers and loan officers.

#### **4.3.4. Linkages with Banks and Capital Market**

If microfinance is to help build inclusive financial systems, it must develop strong linkages with the formal banking sector and the capital markets. The absence of such linkages except in certain economies like Malaysia and Indonesia

constitutes a major challenge to policy makers interested in bringing the “excluded” and “non-bankable” into the fold of formal financial systems.

4.3.4.1. While Islamic financial institutions have experienced phenomenal growth in terms of numbers, funds mobilized and managed, their activity in the microfinance sector leaves much to be desired. They have mostly been catering to high-networth individuals leaving out the poor. Indeed they have much to learn from commercial banks that have dedicated microfinance divisions.

An important factor contributing to the lack of interest in microfinance is the absence of institutional credit guarantee systems in most Muslim countries. The individual borrower guarantee that is prevalent lifts the burden of loss of the business due to natural hazards, death or disability of the borrower. Nevertheless, the “portfolio” guarantee approach, whereby the guarantor covers whole or part of the default of the microfinance institution according to a specific agreement, is non-existent.

Commercial banks – both Islamic and conventional have generally accorded low priority to microfinance perhaps because its distinct features. For example, the reliance on reputational collateral and lack of physical collateral are not easily comprehended as sound banking by traditional bankers.

4.3.4.1. There is hardly any capital market activity by Islamic microfinance providers. Capital markets in modern times provide the efficient alternative to raise capital. Lack of liquidity and capital are among the perpetual problems confronting the Islamic microfinance players. Conceptually, the problem may be overcome through profitable and performing microfinance providers being able to raise additional resources from the capital market or through processes of asset securitization. Securitization may be attempted, if necessary, after creating single agency to pool together cash-flow-earning assets of several microfinance providers together. The absence of any real capital market activity by Islamic microfinance providers may be due to various possible reasons, such as, the lack of awareness on the part of microfinance providers and/or lack of conducive legal and economic environment. Rating agencies that play an important role in raising of debt capital by providing indicators of default risk are also conspicuous by their absence in the Islamic microfinance sector.

#### **4.4. Strategic Response**

##### **4.4.1. Collective Resolution of Shariah Issues**

4.4.1.1. A problem with instituting individual Shariah Supervisory Boards (SSBs) in line with mainstream Islamic financial institutions is that it is costly. As an alternative, Islamic microfinance institutions may consider pooling together their

resources and forming associations of organizations which could then set up a joint SSB.

4.4.1.2. The issue of unresolved *fiqhi* issues may be addressed by initiating a dialogue on a common forum on the same. In the past many a divergence of views has been resolved through the process of dialogue. The Annual *Fiqh* Seminars organized by Dallah Al Baraka or those organized under the aegis of Islamic Fiqh Academies have successfully resolved many intricate and complex issues in the past. These and other institutions should be routinely approached by microfinance providers jointly through their associations to resolve on specific matters pertaining to microfinance.

4.4.1.3. The issue of divergent perceptions is directly related to lack of proper education among the clients and beneficiaries. Microfinance providers may seek the help of local religious leaders to convey the exact nature of Islamic instruments and also to influence them for timely servicing of debt.

#### **4.4.2. A Diverse Range of Products**

There is need and considerable scope for Islamic microfinance providers to develop new products as solutions to a variety of financial problems. However, the right approach to product development is a strategic one that takes a holistic view of microfinance as a composite product meeting the needs for financing, savings-and-investment, insurance, remittance and other services.

4.4.2.1. A rational response to the agency problem with profit-loss-sharing financing would be to reduce uncertainty around profits by generating information. Given that microfinance projects deal with local products and markets, often dealing with a few known types of commodities and assets (such as, poultry, bee-keeping, fisheries, dairy), it is possible on the part of the financier to generate reliable business forecasts and develop products with realistic sharing ratios and expected returns. While cases of negligence of *mudarib* leading to losses are taken care of in *mudarabah*, proper systems should evolve to establish such negligence and ascribe the losses to the *mudarib*. Further, accounting skills could be imparted to the *mudarib* and made a pre-condition to financing (as in case of the Sanadiq project).

4.4.2.2. Financing products using *bay-istijrar* (typically suitable for micro-transactions), *salam*, *istisna* and other permissible contracts are but a few of the potential products that offer a challenge to microfinance-engineers.

4.4.2.3. It is important that deposit products using *mudarabah* should use realistic financial projections and a variety of product or sector-specific *mudarabah* products could be designed to raise resources and provide a realistic return to

depositors. Similarly, in lieu of simple *qard al-hasan*, a linking of the same with specific physical commodities available locally (commodity selected after careful evaluation of price volatility) could be more attractive as a hedge against inflation. A problem typical to small deposits is that these savings do not qualify for investment, even at a micro level, and savers from the "economically active poor" with adequate amounts to be invested, in most cases, lack the know how and professional ability to decide on who to invest with. The answer to this problem is to treat micro savings as a pool for investment funds to be operated on the basis of *mudarabah*, thereby yielding profits to savers.

4.4.2.4. Micro-insurance developed and offered successfully in many regions has shown the way to development of **micro-takaful** along similar lines instead of inefficient holding of cash to meet unforeseen adversities. Given the overwhelming importance of risk management, micro-*takaful* is in urgent need of development. There is clearly a possibility of establishing community-based micro-*takaful* schemes with the involvement of NGOs, *zakah* funds and donor agencies. Support from the mainstream *takaful* sector could come in the form of technical expertise, financial assistance. The partner-agent model as in mainstream *takaful* could also be used for micro-*takaful*. A beginning has already been made in this regard by a handful of organizations, such as, Amana Takaful of Sri Lanka and Takmin of Indonesia,

#### **4.4.3. Banks' Participation in Microfinance**

The formal banking system, as it is structured at present, is not designed to serve the financing needs of the poorer segments of the Muslim society. A strategic response to this would call for a review of Central Bank policies in Muslim countries policies to encourage banks to engage in microfinance. This would necessitate formulation of modified banking regulations to accommodate special characteristics of the microfinance sector. The regulations should license new banks dealing exclusively with microfinance; prescribe capital requirements, capital adequacy norms and limits on unsecured lending and provisioning of loans. The regulations should also encourage more effective microfinance delivery through establishment of new specialized formal non-bank microfinance institutions, expansion of branch network for existing institutions, possible restructuring of existing banks to serve as rural specialized microfinance banks and allow for banks wholesaling to non-bank microfinance institutions and using the non-profit organizations with social agenda to reach out to poor.

The limited provision of bank finance to micro-enterprises is mainly attributed, among other factors, to the absence of a legal, policy and regulatory framework for collaterals and guarantees appropriate for microfinance. The new framework should therefore allow for greater flexibility in determining the type of non-conventional collateral that is more appropriate for micro credit. It should require

that microfinance institutions, in general, and banks, in particular, change their procedures and branch structures to accommodate such changes.

It also requires more reliance on reputational collateral that can be generated by credit bureaus through the provision of clients' repayment history that could aid in assessment of risks. The different nature of the procedures with microfinance also requires a change in mindset of physical-collateral-inclined traditional banker community.

A strategic response to increase the attractiveness of microfinance to commercial banks is establishment of **credit guarantee schemes** with the purpose of sharing credit risk with banks. Realizing the need for this product, some recent MFIs have opted to specialize in this product. A case in point is the Grameen-Jamil Initiative for development of microfinance in the MENA region. (see Box V). As indicated earlier, this product can be made Shariah-compliant in the framework of *al-kafalah*. According to accepted *fiqhi* opinion of scholars, the guarantor is allowed to receive a fee for the guarantee provided (according to some, the fee should neither be too high, nor in proportion to quantum of debt guaranteed). Another alternative form of a credit guarantee scheme is possible via a *zakah* fund (since *zakah* may legitimately be used to pay-off unpaid debt of the poor). However, care must be taken to ensure that the coverage of such a scheme is restricted to the extremely poor and the destitute only.

#### **Box V: A Guarantee Product by Grameen-Jameel Initiative**

The Grameen-Jameel Initiative, an innovative collaboration between Grameen Foundation and the Abdul Latif Jameel Group to fight poverty in the Arab World through microfinance as its first transaction provided a \$2 million guarantee to Dakahly Businessmen Association for Community Development (DBACD), a leading microfinance institution (MFI) enabling it to secure a local currency loan of \$2.5 million from BNP Paribas. With this new funding, DBACD can provide much-needed loans to 16,000 poor Egyptians. This deal negotiated by the Grameen-Jameel Initiative utilizes a \$1 million guarantee from Grameen Foundation's Growth Guarantee Program. The other \$1 million guarantee comes from the Mohammad Jameel Guarantee Fund, established in favor of the Grameen-Jameel Pan Arab Initiative. Both the Grameen Foundation Growth Guarantees Program and the Jameel Fund provide guarantees for MFIs to receive local currency financing from local commercial banks. The guarantees of \$1 million each were issued by Citibank and Banque Saudi Fransi. In another first, this transaction is the only one to date where an Egyptian MFI has received leveraged funding from a commercial bank. Historically, banks in Egypt have required a 100 percent guarantee. By providing credit enhancement and with the partial guarantee, Grameen-Jameel was able to interest international banks in lending to DBACD for its microfinance programs.

#### 4.4.4. Capital Market Participation

In an ideal world with inclusive financial systems, domestic capital markets in addition to the banking sector would supply the bulk of the funding for microfinance. Financial service providers would rely on savings from the public, loans from the commercial banking sector, bond issues, and domestic stock markets. A capital market product that has facilitated flow of funds to MFIs is a micro-finance fund. The number of such funds that invest in bond, equities and quasi-equities or convertibles of conventional MFIs are on the rise. These include equity funds, funds associated with MF networks, and the socially-responsible funds. In a similar manner, dedicated funds could be established to invest in Islamic MFIs. The creation of such funds would involve a mechanism similar to that of the Islamic mutual funds in the framework of *mudarabah* or *wakalah*.

##### **Box VI: World's First Micro-Credit Securitization**

BRAC one of the world's largest NGOs with over 5mm borrowers and 100,000 employees, has closed World's first micro-credit securitization structured by RSA Capital, Citigroup, FMO and KfW. This groundbreaking transaction, denominated in Bangladesh Taka (BDT), will provide an aggregate of BDT 12.6 BN (US\$180mm equivalent) of financing for BRAC over a period of six years. Under the program, BDT 1 BN (US\$15mm equivalent) will be disbursed every six months to BRAC, with a maturity of one year. The transaction is a securitization of receivables arising from micro-credits extended to low-income individuals by BRAC, primarily in rural communities not reached by Bangladesh's commercial banks. The structure involves the creation of a special purpose trust which purchases the receivables from BRAC and issues certificates to investors representing beneficial interest in such receivables. The securitization will allow BRAC, to diversify its funding sources, reduce its on-balance assets and also disburse more funds to a larger number of micro entrepreneurs. The transaction brings the global financial markets to the doorsteps of nearly 1.2mm households in Bangladesh. It will also help in the development of Bangladesh's local capital markets, as it marks the first such securitization in the market and also the first AAA rated local certificates issue in Bangladesh, rated by the Credit Rating Agency of Bangladesh. The transaction was very well received by the local investors. BRAC will be the Originator as well as the Service Provider for the transaction. The Trustee for this transaction will be Eastern Bank Limited of Bangladesh. Citibank, N.A. Bangladesh is the Account Bank for the trust. The transaction required the creation of a software to track a dynamic pool of receivables, which was created by MF Analytics. Clifford Chance, and Lee Khan and Partners are acting as legal advisors.

A process opposite to that of establishment of a Fund is securitization. Microfinance institutions that are liquidity-starved may explore approaching the capital market and raise capital through Islamic securitization. For example it should be conceptually possible to establish an SPV (Special Purpose Vehicle) as a *mudarabah* or on the basis of *wakalah* that would purchase small *ijarah* portfolios

of microfinance providers and create a large enough portfolio against which securities could be issued in the capital market. Practical implementation of this is certainly a challenge, given that it is yet to be attempted. Indeed much of the challenge to Islamic microfinance emanates from the fact that it is untried and unproven. A beginning has already been made in securitization of micro-credit in the domain of conventional microfinance by BRAC, Bangladesh. (see Box VI).





## **5. ISLAMIC MF INFRASTRUCTURE: MESO LEVEL**

The meso level of the financial system includes the basic financial infrastructure and the range of services required to reduce transaction costs, increase outreach, build skills, and foster transparency among IsMF providers. It includes a wide range of players and activities, such as, auditors, rating agencies, professional networks, trade associations, credit bureaus, transfer and payment systems, information technology, technical service providers and trainers. These entities obviously can transcend national boundaries and include regional and global organizations.

### **5.1. Landscape**

The frenetic pace of growth of Islamic finance has witnessed several landmark developments, such as, the establishment of the Islamic Financial Services Board (IFSB), the Accounting and Auditing Organization of Islamic Financial Institution (AAOIFI), the International Islamic Rating Agency (IIRA), the General Council of Islamic Banks and Financial Institutions (GCIBIFI) at the international level and many other agencies at regional levels to provide meso-level services to IFIs. However, presently these do not provide services specific to the Islamic MF sector. With entry of more and more IFIs into MF, the scenario is expected to change however. As far as the MFIs in Muslim countries are concerned, presently there are a handful of regional networks. In the MENA region, SANABEL among other things (see Box VII), is seeking to develop a resource center with documents and training material in Arabic language. In Indonesia, the ASBISINDO, Asosiasi Bank Syariah Indonesia is an association of rural Islamic banks (BPRS) and also Islamic commercial banks. Its objective is the development of Islamic banking in Indonesia through human resource development, technical assistance, operational standardization and financial product development, facilitation of vertical and horizontal communication among Islamic financial institutions, advocacy and participation in policy dialogue.

The most important player providing meso-level services, such as, financial and technical assistance to its member countries is the Islamic Development Bank. The IsDB has in the recent past undertaken a number of financial and technical assistance programs in member countries, such as, Palestine, Sudan and Yemen among others. The Islamic Research and Training Institute, a member of the IsDB Group has undertaken a number of research and training programs relating to the field and has several ambitious plans currently in this regard.

## **5.2. Challenges**

### **5.2.1. Payment Systems**

Payments systems allow the transfer of money among participating financial institutions, usually banks. Though safe, efficient, and reliable payments systems are critical to the effective functioning of the financial system most of Islamic MFIs or their conventional counterparts do not have access to such systems. In the IsDB member countries, only some top Islamic banks have access to systems such as, electronic funds transfer and real time gross settlement system. The smaller microfinance institutions working for the poor may not be in a position to institute the systems themselves.

### **5.2.2. Transparency and Information Infrastructure**

Financial transparency is defined as the widespread availability of relevant, accurate, timely, and comparable information about the performance of financial institutions. Transparency also attracts funders. Accurate, standardized information allows private investors and public donors to make informed funding decisions. Finally, transparency also better informs clients, which could lead to increased competition among financial service providers as clients gain knowledge and comparison shop among their options. Transparency and its benefits depend critically on the availability of a suite of related services and tools, ranging from reliable information software to high-quality auditors and rating agencies, to credit bureaus that capture clients' credit histories. Unfortunately, these services are scarcely available to Islamic microfinance institutions.

### **5.2.3. Education and Training**

Lack of education and training among clients and organization personnel constitutes a major challenge for the Islamic microfinance sector. Lack of trained manpower is a major constraint for its growth, expansion and consolidation. Presently there are only a handful of resource centers; and fewer training programs in native languages. There is an urgent need to develop resource centers and training material in native languages.

### **5.2.4. Networking**

Lack of effective networking is another challenge. Networks are important because a large number of activities that cannot be undertaken individually can be done collectively by a network due to economies of scale and scope - such as, initiating dialogue on legal frameworks, regulations and taxes; creating and updating information base; conducting training programs etc. The Islamic world does not have an apex coordinating body in the area of Islamic microfinance. There

are a few regional networks though. Compared to the size of the Islamic world, however, their number is quite small, and there is little coordination between them, resulting in duplication and lack of effectiveness.

**Box VII: Arab Microfinance Gateway by CGAP, Sanabel and Grameen-A LJ Initiative**

Arabic speakers now have a portal for information on microfinance. The Consultative Group to Assist the Poor (CGAP), the Grameen-Abdul Latif Jameel Initiative, and Sanabel recently launched the Arabic Microfinance Gateway: [www.arabic.microfinancegateway.org](http://www.arabic.microfinancegateway.org), which is the first major online resource for microfinance in the Arab world. More than a hundred specialized microfinance documents were translated into Arabic for the launch of the site. With this new access to resources and information, microfinance institutions in the Arab World will be better able to reach more clients and provide a better and wider range of services. In addition, potential donors and other interested in microfinance in the region will develop a deeper understanding of the industry. The Arabic Microfinance Gateway will be a one-stop shop for microfinance in the Middle East. With news and opinion, and a significant library of microfinance documents in Arabic, the Arabic Microfinance Gateway will become a key resource for anyone seeking to learn more about microfinance. Following the model of the English and French versions of the Microfinance Gateway, it is also intended to become a community portal, offering discussion groups and a job bank for consultants.

### 5.3. Strategic Response

In formulating a strategic response to the challenges, an important question needs to be answered - whether infrastructure and services should be microfinance-specific or whether microfinance skills should be absorbed by existing mainstream providers, that work more broadly with mainstream IFIs - institutions like IFSB, AAOIFI, GCIBIFI and IIRA. As conventional microfinance markets mature and begin to integrate into the financial system, the mainstream service providers (rating agencies, auditors, management consultants, and bank training institutes, among others) are starting to adapt to meet the needs of financial institutions that serve poor clients. A similar development in the Islamic finance sector should take care of the meso-level requirements of Islamic MF sector. The need for specialized microfinance support services should also be carefully assessed, particularly when microfinance is not as well integrated into the financial system.

#### 5.3.1. Payment Systems

As noted earlier, in the IsDB member countries, some top Islamic banks have access to systems such as, electronic funds transfer and real time gross settlement

system. Though the smaller microfinance institutions working for the poor may not be in a position to institute the systems themselves, they may work through the larger Islamic FIs by forging alliances with them.

### **5.3.2. Transparency and Information**

An important meso-level initiative would be to provide for rating services specific to Islamic microfinance. Presently a number of conventional rating agencies undertake rating of credit quality, such as, CRISIL, JCR-VIS in South Asia. There are other agencies which take up overall risk assessment, such as, M-CRIL, Microfinanza, Micro Rate and Planet Rating in South Asia, South East Asia, MENA and Sub-Saharan Africa. It is important that such agencies develop rating methodology for Islamic microfinance instruments. In order to encourage such agencies institutions like Islamic Development Bank can play a proactive role and establish a rating fund similar to one established by CGAP, Inter-American Development Bank and EU. (see Box VIII). This fund could initially reimburse to Islamic MFIs the entire cost of getting themselves rated by an Islamic rating agency, such as, IIRA. Subsequently the share of the cost of rating borne by the Fund could be reduced with an increasing share passed on the MFIs concerned. The ratings would substantially reduce information costs and help Islamic MFIs to obtain financing from the market.

### **5.3.3. Education and Training**

Education and training are imperatives for an effective strategy for the growth and rejuvenation the Islamic microfinance sector. Since traditional banking is ill-suited for collateral-free entrepreneurship-oriented microfinance, there is a need to create a cadre of microfinance experts by imparting training to persons with diverse experiences such as, in banking, finance, investments, entrepreneurship development and community development. Even there is a need for education for the clients in subjects like basic accounting and management; accounting is important because of the unavoidable need to calculate profits in case of participatory financing methods, such as, *mudarabah* and *musharakah*.

### **Box VIII: Microfinance Rating and Assessment Fund**

This is a joint initiative of the Inter-American Development Bank (IsDB), the Consultative Group to Assist the Poor (CGAP) and the European Union. The primary objectives of the Rating Fund are:

1. Market-building for MFI rating and assessment services by encouraging greater demand from MFIs for professional external evaluations, as well as strengthening the quality of supply.
2. Improved transparency of MFI financial performance, as a basis for improved performance and increased flow of commercial funding to MFIs.

To this end, the Rating Fund is based on the following principles:

1. **Transparency:** Promote and facilitate the public disclosure of MFI performance information through the increased use of ratings and assessments.
2. **Availability of Information:** Promote information-sharing to increase the amount of reliable information on MFI performance, for example, through the Rating Fund and MIX Market ([www.mixmarket.org](http://www.mixmarket.org)) web sites. (The MIX Market is a website that links MFIs with investors.)
3. **Quality of Information:** Ensure that ratings and assessments financed by the Rating Fund contain enough information to enable investors to make informed decisions about MFI performance.
4. **Cost-Sharing/Value Realized:** Require MFIs to bear an increasing portion of the cost of a rating or assessment so that they recognize the benefits of undertaking a rating exercise and build it into their normal business costs.

Source: [www.cgap.org](http://www.cgap.org)

#### **5.3.4. Networking**

Since coordination between institutions offering microfinance services and those with different mandates (banks, NGOs, social funds, and rural development projects) is extremely limited, there is strategic need for a coordinating body dedicated to development of the Islamic microfinance sector. As pointed out earlier, networks are important because a large number of activities that cannot be undertaken individually can be done collectively by a network due to economies of scale and scope. Such regional networks and associations should further be networked at a global level. The global network and its regional member-networks can perform a variety of functions, such as, (i) initiating dialogue on legal frameworks, regulations, taxes (ii) resolution of divergence of views on Shariah compliance; (iii) providing exposure to worldwide microfinance good practices through development of resource center; (iv) designing and conducting training programs in microfinance facilitation and management; (v) development and maintenance of information base for use by member organizations; (vi) creation of infrastructure, such as, credit rating facility for microfinance etc. It can play a major role in development of financially sustainable microfinance institutions by

promoting efficiency, self-sufficiency and sustainability goals for them by building both financial and managerial capacities.

### **5.3.5. Technical Assistance through *Awqaf* and *Zakah* Funds**

As a strategic meso-level initiative to develop Islamic microfinance, it is important to institutionalize voluntary giving in order to guarantee sustainability of assets and their income generating abilities. While the primary purpose of the institutions of *awqaf* and *zakah* is poverty alleviation and improvement in the quality of life, there is a need to ensure that the benefits realized from any such activity are sustainable.

In the context of *awqaf*, it is important to preserve and develop assets under *waqf* to add to productive capacity and create capabilities for wealth creation. *Awqaf* may also be created specifically to impart knowledge and skills in entrepreneurship development among the poor as microfinance alone cannot create wealth unless combined with entrepreneurial skills. Indeed all technical assistance programs can be organized as *awqaf*.

While *zakah* funds must be distributed to the destitute and poorest of poor, this institution could be integrated with microfinance. This may be attempted by seeking to push such individuals through *zakah* distribution out of dire poverty to levels, where they are not longer regarded as “unbankable” by MFIs. Therefore, Islamic MFIs and *zakah* funds would be performing two distinct roles which supplement each other. A scheme of proper integration of the two types of institutions would do away with issues related to the desirability or otherwise of *zakah* funds being invested in speculative wealth-creating assets in stead of getting spent on immediate needs of the poorest of the poor, or issues of ethics - of Islamic microfinance institutions seeking profits and ignoring the “unbankable”.

## 6. ISLAMIC MF REGULATORY AND POLICY FRAMEWORK: MACRO LEVEL

The government has a positive role to play in building inclusive financial systems. Some governments see a major role for them in credit delivery itself. Experience has shown that government credit schemes for the poor are usually heavily subsidized. They could be in the nature of direct credit delivery by state-owned banks or indirectly through wholesale “apex” funds that pass on those resources to retail financial institutions. The following concerns usually go with these subsidized lending schemes. One, they are vulnerable to political patronage, often diverting credit to better-off (and more politically connected) borrowers. Two, borrowers often view soft government money as grants or gifts and are less likely to repay loans from subsidized programs. This is especially true in countries with a history of forgiveness programs for agricultural or other lending. Low interest rates in government programs mean that lending institutions cannot cover their costs and thus require continuous government or donor subsidies to survive. Also, government credit programs are often limited to specific, preferred sectors, regions, or populations. This targeting means that credit does not necessarily reach the most dynamic sectors of the economy. Even worse, directed credit does not always reach the intended beneficiaries.<sup>11</sup> In short, governments are not good at offering credit directly to poor people, even while government-owned banks, such as, postal banks are fairly successful in savings mobilization or money transfer.

There is a growing consensus that the government’s best role is to offer a policy environment that allows competitive and diverse financial service providers to flourish. A good policy environment allows a range of financial service providers to coexist and compete to offer higher-quality and lower-cost services to large numbers of poor clients. Some IsDB member countries, such as, Bangladesh, Jordan and Uganda, have developed microfinance strategies that clearly demonstrate what the appropriate role of government should be relative to the private sector.

Government *sets policies* that affect the financial system. These policies include ensuring macroeconomic stability, liberalizing interest rates, and establishing banking regulation and supervision that make viable microfinance possible. Other policies have an impact on microfinance, but their exact relationship is not as well known. These policies include establishing a favorable legal environment related to issues like contract enforcement, business registry, collateral confiscation, property rights, and taxation. More recently, the rules against money laundering and countering the financing of terrorism have also come under increasing focus.

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<sup>11</sup> Caprio and Honohan, *Finance for Growth, CGAP*.

### **6.1. Macroeconomic Stability**

Probably the most important single thing that governments can do to facilitate microfinance is to make sure inflation remains low. Additionally, regulators and policy makers should ensure that volatility in financial markets – bonds, equity, exchange rates, and other prices in the economy, remains in check. Though Islamic MFs during the South East Asian crisis fared far better than their conventional counterparts in withstanding the shocks, every effort should be made to keep speculative forces in check.

### **6.2. Liberalized Financial Market Rates**

In the era of dual banking, interest rates are used as benchmarks for setting rates of *murabahah*, *ijarah* and other Islamic instruments. A powerful case is often made in favor of doing away with any cap or limit on the level of interest rates that financial service providers can charge on loans.<sup>12</sup> The purpose of these limits, or ceilings, existing in some IsDB member countries, such as, Algeria Armenia, Libya, Syrian Arab Rep, Tunisia, UEAC and UMOA countries, is to protect consumers from unscrupulous lenders and excessively high interest rates. It is pointed out that interest rate ceilings unintentionally hurt poor people in the end by making small transaction financial services unattractive to NGOs and financial institutions. It costs much more to make many small loans than a few large loans, and governments normally set ceilings with mainstream commercial banks in mind, not the more costly microcredit. These ceilings can make it difficult for micro-lenders to cover their costs, driving them out of the market (or keeping them from entering in the first place). Poor clients are either left with no access to financial services or must revert to informal credit markets, such as local moneylenders, which are even more costly. These arguments are relevant for *murabahah* and *ijarah* rates too. In an Islamic economy, these rates should be freely determined by forces of demand and supply. However, this does not rule out concerns about the high costs of microfinance and predatory lending practices. Competition, is the single most effective way to reduce both microcredit costs and the debt market rates. Policies to promote competition among credit providers, combined with relevant consumer protection measures are imperatives.

### **6.3. Banking Sector Regulation and Supervision**

The growing maturity of microfinance across the globe has kept the issue of regulation and supervision of MFIs in the front burner. It is generally felt that MFIs like the mainstream FIs should also be licensed and supervised by the central bank

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<sup>12</sup> Helms and Reille, *Interest Rate Ceilings and Microfinance: The Story So Far*, CGAP



and other financial authorities. In most countries, this shift requires some adjustment of existing banking regulations.

A country-wise analysis of IsDB Member countries and the status of microfinance and Islamic finance in them has some interesting revelations. Arguably, the existence or otherwise of a sector-specific regulatory framework is a reliable indicator of the status accorded to that sector by policy makers and regulators in a given country. The results for micro-finance institutions (MFIs) and Islamic financial institutions (IFIs) are presented in Annexure III. There are as many as 25 member countries that have enacted laws and regulations specifically to govern MFIs and there are as many as 13 member countries that have enacted laws and regulations specific to IFIs. While Islamic MF requires both sets of laws, only one country Pakistan fulfills this requirement. The State Bank of Pakistan has also recently issued guidelines pertaining specifically to Islamic MF.

In the matter of Islamic finance, there are as many as 13 member countries that have enacted laws and regulations specific to IFIs. While some of these countries have witnessed a growing IF sector (e.g. UAE, Bahrain, Kuwait, Qatar), they are fortunate enough not to experience pervasive poverty among their populace and therefore, the need for Islamic microfinance has not been felt.

### **6.3.1. Issues in Prudential Regulation and Supervision**

Prudential regulation aims to ensure the financial soundness of regulated institutions to prevent system-wide financial instability and protect depositors from losing their money. When a deposit-taking institution collapses, it cannot repay its depositors, which could undermine public confidence and stimulate a run on deposits causing even previously solvent institutions to fail. Examples of prudential regulation include capital adequacy norms and reserve and liquidity requirements. However, prudential regulation means little without effective prudential supervision.

Supervision involves monitoring to verify compliance with prudential regulations and taking steps to shore up the solvency of a regulated institution when compliance becomes doubtful. Prudential regulation and supervision are generally complex, difficult, expensive, and invasive. They require a specialized financial authority for their implementation. For those financial institutions that capture deposits from the public (and thus would generally be subject to prudential regulation), some standard banking regulations need to be adjusted to accommodate microfinance. Governments should apply the more burdensome prudential regulation only when the financial system and depositor's money is potentially at risk. Otherwise non-prudential norms and regulatory approaches should be sufficient. Non-prudential regulations include measures like registration with some authority for transparency purposes, keeping adequate accounts,

prevention of fraud and financial crimes, and various types of consumer protection measures.

It is asserted by some that specialized microcredit institutions that do not take retail deposits should not be subjected to prudential regulation. Some countries, prohibit unlicensed non-bank institutions (including NGOs) from lending. This is an unnecessary restriction that can stifle experimentation with microcredit. In these cases, reforms subjecting those that offer microcredit to non-prudential regulation may be a relatively simple and effective means of freeing up the development of large-scale micro-lending.

Some commentators caution against the “rush to regulate” microfinance through the introduction of laws creating new regulatory categories of depository financial institutions. They point to the more successful microfinance markets in Bangladesh, and Indonesia, where microfinance was born and matured without special microfinance regulation.<sup>13</sup>

### 6.3.2. Issues Related to Dual System

Some regulatory issues arise because of the existence of a dual system in most Islamic countries – an Islamic financial system co-existing with a conventional system. In such a scenario, the need for transparency and disclosure and the need to maintain a wall of segregation between the two subsystems is crucial. The following is a list of essential concerns and components that need to be addressed by such a framework. It should be noted here that most of these would involve further debate on their desirability or otherwise.

1. Define products and scope of activities clearly ensuring Shariah-compatibility, free from interest (*riba*) and complexity (*gharar*); enable institutions to engage in fee-based activities;
2. Ensure transparency and disclosure; importance increases many-fold for PLS-based financings;
3. Monitor end-use of financing;
4. Ensure clear choice by market participant between Islamic and conventional techniques;
5. Free of *murabahah* and *ijarah* rates or linking them to a Shariah-acceptable benchmark;
6. Require institutions to clarify goals - single or multiple social goals other than microfinance;
7. Standardize Shariah compliant financing norms and procedures;

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<sup>13</sup> The preceding discussion is based on Christen, Lyman, and Rosenberg, *Guiding Principles on Regulation and Supervision of Microfinance*, CGAP.

8. Standardize *Fiqh* rulings
9. Prescribe ways to dealing with default and delinquency in debt repayment in a Shariah compliant manner;
10. Permit mature and larger institutions only to invite deposits; and
11. Require compulsory *takaful* for members and family members etc.
12. Require MF Providers to create and maintain reserves such as profit-equalization-reserve to minimize depositor risk arising out of profit volatility.

#### **6.4. Strategic Response**

The regulatory and policy framework governing Islamic MF is in urgent need of development. The orientation towards considering microfinance as an integral part of mainstream finance and recent developments in the regulation of Islamic finance can provide guidance in developing the regulatory framework for IsMF. Specifically, the developments brought about by the activities of the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) are worth mentioning. The former, an international self regulatory organization, issues accounting standards and 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.

In a number of countries, authorities remain concerned with the possible diversion of resources mobilized at the grass root level. Accordingly they hesitate 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 should provide guidance in the matter of selecting the downstream organizations, such as, NGOs that function as retailers of microfinance.

An idea that needs further examination is to consider development of a regulatory system for the Islamic microfinance sector in three stages. Stage one - to make the Islamic microfinance institutions appreciate the need for certain common performance standards; stage two - making it mandatory for the Islamic microfinance institutions to get registered with identified or designated institutions and stage three - to encourage development of network of Islamic microfinance institutions which could function as quasi Self-Regulatory Organizations (SROs) at a later date or identifying a suitable organization to handle the regulatory arrangements.



## **7. ROLE OF DONORS AND DEVELOPMENT FINANCIAL INSTITUTIONS**

Donor institutions with a social mission to alleviate poverty have played and continue to play a significant role in shaping the microfinance industry through their policy, technical and financial support at macro, meso and micro levels. According to a recent survey of CGAP member donors, the World Bank, the Asian Development Bank, the Inter-American Development Bank, and the European Commission are among the largest public funders of microfinance. In the domain of Islamic microfinance, the Islamic Development Bank is perceived to be the most important player. A few other international organizations, such as, the United Nations Development Program (UNDP), KfW (Kreditanstalt für Wiederaufbau), FINCA have been instrumental in initiating Islamic microfinance programs (in Syria and Palestine, Northern Mali and Afghanistan respectively).

Donor agencies support microfinance using a variety of tools, such as, policy support, technical assistance, grants, loans, quasi-equity, equity investments and guarantees. Using these mechanisms, donors assume the role of enablers through funding credit and investment portfolios of MFIs; providing guarantees and safety nets to MFIs, capacity building; facilitating MFI's access to domestic capital markets; building the skill sets of technical service providers, rating agencies, consulting firms, training facilities; and supporting the operations of networks and associations. In the context of Islamic microfinance, the tools are not-only Shariah-compliant, but also are more diverse and inclusive of those directed at the extremely poor and the destitute.

Many donors, particularly the multilateral development banks, are able to work only with governments, usually with soft loans. While this instrument might be valid for traditional aid activities like building roads, hospitals, and schools, it is less suitable for supporting the financial system in the private-sector domain. Governments, as pointed out earlier, often have a poor track record in the matter of offering financial services. As the CGAP Donor Guidelines<sup>14</sup> assert, such programs are often characterized by lack of accountability and distort markets by displacing domestic commercial initiatives with cheap or free money.

Donor agencies have a significant role to play, particularly in regions characterized by large-scale conflicts and crises. A mission-based approach replaces market –based approach to microfinance under such abnormal conditions wherein poverty levels keep rising along with increasing business and operational

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<sup>14</sup> Building Inclusive Financial Systems: Donor Guidelines on Good Practice in Microfinance, CGAP

risks for the micro-enterprises as well as for the MFIs. A case in point is the DEEP Initiative in Palestine by the Islamic Development Bank and the UNDP. (See Box IX).

**Box IX. The DEEP Initiative**

The Deprived Families Economic Empowerment Program (DEEP) aims to develop a comprehensive package of financial and non-financial services to meet the needs of the poor and very poor families of Palestine, who are the target group. The program aims to transform the target beneficiaries from being recipients of humanitarian assistance to providers of income for their own families, thus enabling them to sustain their livelihoods. The program will provide financial and technical support to intermediaries, including microfinance institutions and Business Development Service (BDS) providers, who will in turn provide financial and promotional safety net services to the target group.

The program is financed by the Islamic Development Bank and the United Nations Development Program and will initially operate as a pilot project for 30 months before being transformed into a legal entity that will operate as an autonomous organization on a sustainable basis.

The DEEP program will have three main components, as follows:

- Delivery of financial and promotional safety net interventions;
- Capacity building of intermediary organizations; and
- Development of the program management unit into a sustainable organization.

Financial services will be delivered by microfinance institutions. The program will promote international best practices in its work with MFIs. Promotional safety net interventions, which will include enterprise development and livelihood activities, will be delivered by partner intermediaries. In both cases, the Program Management will consider poverty targeting, outreach, institutional experience and track record, etc., as main factors for selecting partner intermediaries.

Funding to MFIs will be in the form of loans, and grants and a credit guarantee scheme would be established at a later stage to guarantee loans from commercial banks to MFIs. Funding will cover the loan portfolio, operational deficits and capacity building for MFIs. Funding to promotional safety net intermediaries will be in form of grants for capacity building, program activities and operational costs.

MFIs will use their usual methods of selecting clients to lend to. However, the DEEP funds will be used to finance loan products that target the poor and very poor clients, such as solidarity group lending. In the case of promotional safety net interventions, targeting and selection of beneficiaries will be done with utmost care and objectivity in order to ensure that the people benefiting from the program are only the poor and very poor.

Contd...

The package of interventions for the target group would include the following:

1. Protective Social Safety Net Intervention: Maintenance of current livelihood assistance; provision of health insurance and savings products;
2. Promotional Social Safety Net Intervention: Provision of a wide array of non-financial services critical to the entry, survival, productivity, competitiveness, and growth of micro and small scale enterprises run and owned by the poor and very poor;
3. Financial Services Intervention: Maximizing the outreach of the lending activities to the Palestinian poor and very poor people, contributing to the MFIs' capacity building; introducing Islamic lending Products; maximizing the outreach of savings activities to the poor; introducing micro insurance products

The program would also seek to provide capacity building interventions aimed to strengthen the various intermediaries that will provide financial and promotional safety net interventions to the targeted poor and very poor households. Other Capacity building activities will be directed to the government staff to improve their knowledge and capacity in areas related to the DEEP program.

The unique feature of this program is the introduction of Islamic lending products, based on *murabahah*, *musharakah*, *mudarabah*, *ijarah-to-own* and *wakalah*.





## 8. RECOMMENDATIONS

Access of the public to financial services enables it to participate in the development process and benefit from it. Islamic finance makes financial services relevant for a large segment of the world population. However, despite progress in different segments of the Islamic financial services industry, Islamic microfinance institutions have an extremely limited presence and outreach. In order to enhance the reach and richness of Islamic microfinance it is imperative to examine the major challenges confronting this sector in a holistic manner and find in partnership with the various stakeholders strategic solutions to redress the challenges.

The primary aim of the present document is to develop a framework for organized dialogue and facilitate formulation of effective policies supporting the delivery of a diverse range of financial services that are widely available, client responsive, reasonably priced and Shariah compliant. The products and services are not limited to credit but also include savings, cash transfers and insurance. The overall goal of the strategy is to develop a microfinance industry that is institutionally and financially sustainable, and integrated within the broader formal financial sector and that respects the cultural and religious sensitivities of a Muslim society. This strategy views Islamic microfinance as an essential tool of intervention within the broader approach for poverty alleviation and socio-economic development in Muslim societies.

An effective strategy for development of microfinance would require concerted efforts by all stakeholders - the poor, the cooperatives/ NGOs, the Islamic banks, the *awqaf* / *zakah* funds, the apex bodies, IsDB and IsDB-sponsored institutions as well as the government agencies, such as, Ministries of Finance, Cooperation, the monetary authority and the capital market authority. The dialogue shall effectively address the need for change of perceptions, strategies and policies at the level of the various stakeholders:

1. As far as the poor are concerned, they should perceive formal savings, credit and financial services as safer and more attractive; develop entrepreneurial abilities and acquire relevant education and skills and consider charity as temporary support only.
2. The cooperatives/ NGOs should act as catalysts of change involving community assets; combine social and economic agenda with synergized effect; recognize sustainability as the core factor in development and develop linkages with banks and capital markets.
3. The Islamic banks should develop linkages with non-profit organizations for reaching out to poor, recognize microfinance as an additional segment with

its distinct risk-return and other features and engage in direct and indirect finance, facilitate participation of microfinance providers in capital markets, initiate and participate in dialogue with policy makers and regulators.

4. The *awqaf / zakah* funds should institutionalize voluntary giving in order to guarantee sustainability of assets and their income generating abilities, preserve and develop assets under *waqf* to add to productive capacity and create capabilities for wealth creation and distribute *zakah* funds to destitute and poorest of poor who are not bankable.
5. The apex bodies, IsDB and IsDB-sponsored institutions should enhance mutual cooperation and coordination in matters of common interest and initiate and participate in dialogue with policy makers and regulators.
6. Finally, the government agencies, such as, Ministries of Finance, Cooperation, the monetary authority and the capital market authority should formulate supportive policy and regulatory environment and create supportive infrastructure.

Multilateral institutions like IsDB can play an effective role in improving services to the Islamic MFI sector at all levels. Some specific initiative that would go a long way in strengthening the Islamic MF sector are:

#### **At a micro-level**

- Participate in equity of Islamic financial institutions with a view to creating specialized MF Divisions;
- Create *Qard al-Hasan*-specific Funds to support various *qard al-hasan* based microfinance institutions across the globe;
- Create refinance facility to act as a whole-seller of Islamic microfinance products for a chain of Islamic and conventional microfinance retailers;
- Participate in equity of commercial *takaful* companies with a view to developing micro-*takaful* products services; also of *retakaful* companies.
- Design a Credit Guarantee Scheme for Islamic microfinance providers;
- Promote dialogue among Shariah scholars for collective resolution of *fiqhi* issues related to microfinance

#### **At a meso level**

- Develop knowledge base through research in issues pertaining to building Islamic inclusive financial systems;
- Document, collate and translate best-practices from across the world of microfinance; Undertake training and education programs to impart microfinance related special skills to bankers;
- Undertake training of trainers to impart managerial and accounting skills to users of microfinance

- Encourage formation of apex and regional industry associations whose objective is the development of Islamic microfinance through human resource development, technical assistance, operational standardization and financial product development, facilitation of vertical and horizontal communication among Islamic financial institutions, advocacy and participation in policy dialogue;
- Create *Zakah* and *Awqaf* Funds at a global level dedicated exclusively for poverty alleviation and linked to microfinance institutions downstream; and
- Help create rating mechanism in member countries for Islamic microfinance institutions.

**At a macro level**

- Assist member countries to develop a regulatory framework for Islamic microfinance;
- Support policy makers to ensure an enabling policy framework conducive to the development of Islamic microfinance,
- Support and facilitate the integration of *zakah* and *awqaf* in financial sector reforms and
- Build an effective alliance and forum of Islamic microfinance providers and other stakeholders.

**Annexure I: Poverty Levels in IsDB Member Countries**

	Name of Member Country	Human Poverty Index Rank	Income Poverty Index Population Below			Population In Millions	No of Poor in Millions
			\$1 a day (%)	\$2 a day (%)	National Poverty Line		
1	Islamic Republic of Afghanistan				53	31.06	16.5
2	Republic of Albania				25	3.58	0.9
3	Democratic and Popular Republic of Algeria	46	2	15.1	25	32.93	5.0
4	Azerbaijan Republic				49	7.96	3.9
5	Kingdom of Bahrain					0.7	
6	People's Republic of Bangladesh	85	36	82.8	45	147.37	122.0
7	Republic of Benin	90	30.9	73.7	33	7.86	5.8
8	Brunei Darussalam					0.38	
9	Burkina Faso	101	27.2	71.8	45	13.9	10.0
10	Republic of Cameroon	61	17.7	50.6	48	17.34	8.8
11	Republic of Chad	100			80	9.94	8.0
12	Union of Comoros	56			60	0.7	0.4
13	Republic of Côte d'Ivoire	82	14.8	48.8	37	17.65	6.5
14	Republic of Djibouti	52			50	0.49	0.2
15	Arab Republic of	44	3.1	43.9	20	78.89	34.6

	Name of Member Country	Human Poverty Index Rank	Income Poverty Index Population Below			Population In Millions	No of Poor in Millions
			\$1 a day (%)	\$2 a day (%)	National Poverty Line		
	Egypt						
16	Republic of Gabon	50				1.42	
17	Republic of the Gambia	86	59.3	82.9		1.64	1.4
18	Republic of Guinea	96			40	9.69	3.9
19	Republic of Guinea Bissau	92				1.44	
20	Republic of Indonesia	41	7.5	52.4	17.8	245.45	128.6
21	Islamic Republic of Iran	35	2	7.3	40	68.69	5.0
22	Republic of Iraq					26.78	
23	Hashemite Kingdom of Jordan	11	2	7	30	5.91	0.4
24	Republic of Kazakhstan				19	15.23	2.9
25	State of Kuwait					2.42	
26	Kyrgyz Republic				40	5.2	2.1
27	Republic of Lebanon	20			28	3.8	1.1
28	Great Socialist People's Libyan Arab Jamahiriyah				7.4	5.9	0.4
29	Malaysia	15	2	9.3	8	24.39	2.3

	Name of Member Country	Human Poverty Index Rank	Income Poverty Index Population Below			Population In Millions	No of Poor in Millions
			\$1 a day (%)	\$2 a day (%)	National Poverty Line		
30	Republic of Maldives	36			21	0.36	0.1
31	Republic of Mali	102	72.3	90.6	64	11.72	10.6
32	Islamic Republic of Mauritania	81	25.9	63.1	40	3.18	2.0
33	Kingdom of Morocco	59	2	14.3	19	33.24	4.8
34	Republic of Mozambique	94	37.8	78.4	70	19.69	15.4
35	Republic of Niger	99	60.6	85.8	63	12.53	10.8
36	Republic of Nigeria	76	70.8	92.4	60	131.5	121.5
37	Sultanate of Oman					3.1	
38	Islamic Republic of Pakistan	65	17	73.6	24	165.8	122.0
39	State of Palestine	8			45.7	3.8	1.7
40	State of Qatar	13				0.89	
41	Kingdom of Saudi Arabia					27.02	
42	Republic of Senegal	84	22.3	63	54	11.99	7.6
43	Republic of Sierra Leone	95		74.5	68	6.01	4.5
44	Republic of Somalia					8.86	
45	Republic of Sudan	54			40	41.24	16.5
46	Republic of Suriname	23			70	0.44	0.3

	Name of Member Country	Human Poverty Index Rank	Income Poverty Index Population Below			Population In Millions	No of Poor in Millions
			\$1 a day (%)	\$2 a day (%)	National Poverty Line		
47	Syrian Arab Republic	29			11	18.88	2.1
48	Republic of Tajikistan				64	7.32	4.7
49	Republic of Togo	72			32	5.55	1.8
50	Republic of Tunisia	39	2	6.6	7.4	10.18	0.7
51	Republic of Turkey	21	3.4	18.7	20	70.41	13.2
52	Republic of Turkmenistan				58	5.04	2.9
53	Republic of Uganda				35	28.2	9.9
54	United Arab Emirates	34				2.6	
55	Republic of Uzbekistan				28	27.31	7.6
56	Republic of Yemen	77	15.7	45.2	45.2	21.46	9.7

## Notes:

1. HDI Ranks are based on UNDP Human Development Report for 120 developing countries;
2. Data on Income is extracted from SSERTC Database and refer to the most recent year available during 1990-2004
3. Data on Population and estimates of the percentage of the population falling below the national poverty line are extracted from CIA Fact Book. Definitions of poverty vary considerably among nations. For example, rich nations generally employ more generous standards of poverty than poor nations.
4. No of beneficiaries is estimated by multiplying the percentage of population below \$2 a day with the population figures. Where the former values are not present, percentage below national poverty lines are used.

**Annexure II: Access to Financial Services in IsDB Member Countries**

Serial #	Name of Country	Access Percentage	Serial #	Name of Country	Access Percentage
1	Islamic Republic of Afghanistan		32	Islamic Republic of Mauritania	16
2	Republic of Albania	34	33	Kingdom of Morocco	39
3	Democratic and Popular Republic of Algeria	31	34	Republic of Mozambique	12
4	Azerbaijan Republic	17	35	Republic of Niger	31
5	Kingdom of Bahrain		36	Republic of Nigeria	15
6	People's Republic of Bangladesh	32	37	Sultanate of Oman	33
7	Republic of Benin	32	38	Islamic Republic of Pakistan	12
8	Brunei Darussalam		39	State of Palestine	14
9	Burkina Faso	26	40	State of Qatar	
10	Republic of Cameroon	24	41	Kingdom of Saudi Arabia	62
11	Republic of Chad		42	Republic of Senegal	27
12	Union of Comoros	20	43	Republic of Sierra Leone	13
13	Republic of Côte d'Ivoire	25	44	Republic of Somalia	
14	Republic of Djibouti		45	Republic of Sudan	15
15	Arab Republic of Egypt	41	46	Republic of Suriname	32
16	Republic of Gabon	39	47	Syrian Arab Republic	17
17	Republic of the Gambia	21	48	Republic of Tajikistan	16



18	Republic of Guinea	20	49	Republic of Togo	28
19	Republic of Guinea Bissau		50	Republic of Tunisia	42
20	Republic of Indonesia	40	51	Republic of Turkey	49
21	Islamic Republic of Iran	31	52	Republic of Turkmenistan	
22	Republic of Iraq	17	53	Republic of Uganda	20
23	Hashemite Kingdom of Jordan	37	54	United Arab Emirates	
24	Republic of Kazakhstan	48	55	Republic of Uzbekistan	16
25	State of Kuwait		56	Republic of Yemen	14
26	Kyrgyz Republic	01			
27	Republic of Lebanon	79	1	India	48
28	Great Socialist People's Libyan Arab Jamahiriyah	27	2	Russia	69
29	Malaysia	57	3	Netherlands	100
30	Republic of Maldives		4	USA	91
31	Republic of Mali	22	5	UK	91

Adapted from: Patrick Honohan, Cross-Country Variations in Household Access to Financial Services, World Bank Conference on *Access to Finance*, March 15-16, 2007

**Annexure III: Regulatory Framework for MFIs and IFIs in IsDB Member Countries**

<b>Name of Member Country</b>	<b>MFIs</b>	<b>IFIs</b>	<b>Status</b>
Islamic Republic of Afghanistan	<p>Law of Banking in Afghanistan Includes Regulations for Deposit-taking MFIs</p> <p>Ministry of Rural Reconstruction and Development Coordinates Micro-Lending by International Donors</p>		<p>Conventional MF through international donor agencies;</p> <p>New experiment in Islamic microfinance</p> <p>No IFIs</p>
Republic of Albania	<p>Law on the Bank of Albania 1997; Banking Law 1998; Regulation on the Licensing of the Financial Activity of the Non-banking Institutions, 1999 Regulation on Cooperative Banks 2000;</p> <p>Law on Cooperative Associations 1996; Law on Credit Savings Associations 2001; Law for Not-for-profit Organizations 2001</p>		<p>Conventional MF by banks and NGOs</p> <p>No IFIs</p>
Democratic and Popular Republic of Algeria	<p>Order 03-11 on Currency and Credit (OMC 03-11) of the Currency and Credit Council (CMC)</p> <p>Law Covers MF as Any Other Financing Activity</p>		<p>A few MF programs linked to Government-run social service programs</p> <p>No IFIs</p>

Name of Member Country	MFIs	IFIs	Status
Azerbaijan Republic	Law About the National Bank 1996; Law About Banks and Banking Activity 1996, 1998, 1999 Banking Law Covers MF as Any Other Financing Activity		New experiment in Islamic finance  No IFIs
Kingdom of Bahrain	Central Bank of Bahrain Rule Book; No Specific Rules for MF	Central Bank of Bahrain Rule Book for Islamic Banks	A mature IFI sector
People's Republic of Bangladesh	Bank Companies Act 1991; Prudential Regulations for Banks; Financial Institutions Act 1993; Cooperative Societies Ordinance 1984 and Rules 1987; Micro Credit Regulatory Authority Act 2006 and Rules 2007	Banking Regulations Cover IFIs	Leader in micro finance sector with IFIs practicing MF
Republic of Benin	Law to Govern MFIs in Member Countries of West Africa Monetary Union (UMOA) called the <u>PARMEC Law 1997</u>		No IFIs
Brunei Darussalam	Banking Act 1995 Finance Companies Act 1995 Pawn Brokers Act Banking Law Covers MF as Any Other Financing Activity	Emergency (Islamic Bank) Order, 1992 Emergency (Islamic Trust Fund), Order 1991	

Name of Member Country	MFIs	IFIs	Status
Burkina Faso	Law to Govern MFIs in Member Countries of West Africa Monetary Union (UMOA) called the PARMEC Law 1997		No IFIs
Republic of Cameroon	Microfinance regulations developed by the Commission Bancaire de l'Afrique Centrale (COBAC) of the BEAC (Banque des Etats de l'Afrique Centrale) the Central Bank of Central African Economic and Monetary Community (CEMAC)		No IFIs
Republic of Chad	Microfinance Regulations developed by the Commission Bancaire de l'Afrique Centrale (COBAC) of the BEAC (Banque des Etats de l'Afrique Centrale) the Central Bank of Central African Economic and Monetary Community (CEMAC)		No IFIs
Union of Comoros	Guidelines of the Central Bank, the Banque Centrale des Comores (BCC) Cover MF as Any Other Financing Activity		No IFIs
Republic of Côte d'Ivoire	Law to Govern MFIs in Member Countries of West Africa Monetary Union (UMOA) called the PARMEC Law 1997		No IFIs
Republic of Djibouti	Central Bank of Djibouti (BCD) Regulations Cover MF as Any Other Financing Activity		No IFIs

Name of Member Country	MFIs	IFIs	Status
Arab Republic of Egypt	Law of the Central Bank, the Banking Sector and Money 2003; Executive Regulations of the Law of the Central Bank, the Banking Sector and Money 2003 Law Covers MF as Any Other Financing Activity	Banking Regulation covers IFIs; No IFI-Specific Law	
Republic of Gabon	Microfinance Regulations developed by the Commission Bancaire de l'Afrique Centrale (COBAC) of the BEAC (Banque des Etats de l'Afrique Centrale) the Central Bank of Central African Economic and Monetary Community (CEMAC)		No IFIs
Republic of the Gambia	MF-Specific Rules and Guidelines by Central Bank of Gambia	Banking Regulation covers IFIs; No IFI-Specific Law	New experiment in Islamic finance
Republic of Guinea	The Central Bank of Guinea (BCRG) Guidelines Cover MF as Any Other Financing Activity	Banking Regulation covers IFIs; No IFI-Specific Law	New experiment in Islamic micro finance
Republic of Guinea Bissau	Law to Govern MFIs in Member Countries of West Africa Monetary Union (UMOA) called the PARMEC Law 1997		No IFIs

Name of Member Country	MFIs	IFIs	Status
Republic of Indonesia	Banking Law 1992, 1998; Law Concerning Cooperatives 1992; Law on Cooperatives 1967	Banking Regulation Includes IFI-Specific Laws and Regulations  Mature IFI sector	A Network of Islamic Micro-Finance Institutions
Islamic Republic of Iran	The Monetary and Banking Law of Iran, 1972; The Law for Usury (Interest) Free Banking 1983 Banking Law Covers MF as Any Other Financing Activity	The Law for Usury (Interest) Free Banking 1983 The Law for the Issuance of Participation Papers 1997	Islamic Micro-Finance Projects Governed by IFI-specific Laws
Republic of Iraq			Conflict Zone No IFIs
Hashemite Kingdom of Jordan	Banking Law of 1999; Development and Employment Fund (DEF) is governed by Law No. 33, 1992; Other agencies are governed by their own particular laws.	Banking Law Includes IFI-Specific Regulations	Mature Islamic banking and micro finance sectors; National Microfinance Bank created in 2006

Name of Member Country	MFIs	IFIs	Status
Republic of Kazakhstan	Law on Banks and Banking Activity 2001; Law on Microlending Organizations 2003	Banking Regulation covers IFIs; No IFI- Specific Laws or Regulations	New Islamic finance experiment
State of Kuwait	Banking Law Covers MF as Any Other Financing Activity	Banking Law Includes IFI- Specific Laws and Regulations	
Kyrgyz Republic	Law on Banks and Banking Activity; Law On Microfinance Organizations 2002; Temporary Regulation on Activities of Micro Credit Companies and Micro Credit Agencies; Law on Credit Unions	Banking Regulation covers IFIs; No IFI- Specific Laws or Regulations	New Islamic finance experiment
Republic of Lebanon	Banking Law Covers MF as Any Other Financing Activity	Banking Law Includes IFI- Specific Laws and Regulations	Experiment in Islamic Micro-finance
Great Socialist People's Libyan Arab Jamahiriyah	Banking Law Covers MF as Any Other Financing Activity		No IFIs
Malaysia	Banking Law Covers MF as Any Other Financing Activity	Islamic Banking Act 1983, Takaful Act 1984	Mature IFI sector

Name of Member Country	MFIs	IFIs	Status
Republic of Maldives	Regulations for Banks and Financial Institutions 1981 Covers MF as Any Other Financing Activity		No IFIs
Republic of Mali	Law to Govern MFIs in Member Countries of West Africa Monetary Union (UMOA) called the PARMEC Law 1997		Experiment in Islamic Micro-finance
Islamic Republic of Mauritania	Central Bank of Mauritania (BCM) Guidelines for MF		No IFIs
Kingdom of Morocco	Law Regarding the Activities of Credit Establishments and their Control 1993; Law Relating to Microfinance 1997	Banking Regulation covers IFIs; No IFI-Specific Regulations	New Experiment in Islamic finance
Republic of Mozambique	Banking Law Covers MF as Any Other Financing Activity		No IFIs
Republic of Niger	Law to Govern MFIs in Member Countries of West Africa Monetary Union (UMOA) called the PARMEC Law 1997		No IFIs



Name of Member Country	MFIs	IFIs	Status
Republic of Nigeria	Central Bank of Nigeria Act 1991; Banks and Other Financial Institutions Act 1991; Regulations for Community/ Micro Banks; Cooperative Societies Law 1973; Cooperative Societies Regulation; State Laws Microfinance Policy Framework of CBN	Banking Regulation covers IFIs; No IFI-Specific Regulations	New IF Experiment  New Micro finance Policy Framework for Micro-finance Banks
Sultanate of Oman	Banking Law Covers MF as Any Other Financing Activity		No IFIs
Islamic Republic of Pakistan	Microfinance Institutions Ordinance 2001; Prudential Regulations for Microfinance Banks/Institutions; NGO/RSPs/Cooperatives-Transformation Guidelines Draft, 2005; Societies Registration Act, 1860; Voluntary Social Welfare Agencies Ordinance, 1961; Companies Ordinance 1982 Banking Companies Ordinance, 1962	Banking Regulation Includes IFI-Specific Laws and Regulations  Guidelines for Islamic Banking <u>Draft Guidelines for Islamic Microfinance</u>	Mature IFI and MF sectors with Islamic MF-experiments
State of Palestine	Banking Law Covers MF as Any Other Financing Activity	Banking Regulation Includes IFI-Specific Laws and Regulations	

Name of Member Country	MFIs	IFIs	Status
State of Qatar	Banking Law Covers MF as Any Other Financing Activity	Banking Regulations Include IFI-Specific Provisions	
Kingdom of Saudi Arabia	Banking Law Covers MF as Any Other Financing Activity	Banking Control Law  Banking Regulations Include IFI-Specific Provisions	
Republic of Senegal	Law to Govern MFIs in Member Countries of West Africa Monetary Union (UMOA) called the PARMEC Law 1997		No IFIs
Republic of Sierra Leone	Banking Law Covers MF as Any Other Financing Activity		No IFIs
Republic of Somalia			Conflict Zone No IFIs
Republic of Sudan	Banking Law Covers MF as Any Other Financing Activity	Banking Regulation covers IFIs; No IFI-Specific Regulations	Mature Islamic banking and micro-finance sectors

Name of Member Country	MFIs	IFIs	Status
Republic of Suriname	Bank Act 1956 Covers MF as Any Other Financing Activity		No IFIs
Syrian Arab Republic	Law to create MFIs introduced in 2007	Banking Regulation covers IFIs; No IFI-Specific Regulations	Experiment in both Islamic banking and Islamic MF
Republic of Tajikistan	Law on Banks and Banking Activities, 1998; Law On the National Bank of Tajikistan, 1996 Law On Microfinance Organizations, 2004		No IFIs
Republic of Togo	Law to Govern MFIs in Member Countries of West Africa Monetary Union (UMOA) called the PARMEC Law 1997		No IFIs
Republic of Tunisia	Central Bank of Tunisia (BTS) Micro-Credit Law 1992	Banking Regulation covers IFIs; No IFI-Specific Regulations	New experiment in Islamic banking
Republic of Turkey	Banking Act 1999, 2003 and The Law on The Central Bank of Turkey Covers MF as Any Other Financing Activity	Banking Regulation covers IFIs; No IFI-Specific Regulations	New experiment in Islamic banking

Name of Member Country	MFIs	IFIs	Status
Republic of Turkmenistan	Presidential Decrees		Absence of legal structure No IFIs
Republic of Uganda	Financial Institutions Act 2004; Micro Finance Deposit-Taking Institutions (MDI) Act 2003; Micro Finance Deposit-taking Institutions (MDI) Regulations 2004		No IFIs
United Arab Emirates	Banking Laws Covers MF as Any Other Financing Activity	Federal Law Regarding Islamic Banks, Financial Institutions and Investment Companies 1985	Mature Islamic banking sector
Republic of Uzbekistan	Presidential Decrees		Absence of legal structure No IFIs
Republic of Yemen	Banking Law 1998 Covers MF as Any Other Financing Activity	Banking Regulation covers IFIs; No IFI-Specific Regulations	Experiments in IF, MF and Islamic MF

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### LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization of Islamic Financial Institution
ADB	Asian Development Bank
AIM	Amana Ikhtiar Malaysia
ASBISINDO	Asosiasi Bank Syariah Indonesia
BI	Bank Indonesia
BRAC	Bangladesh Rural Advancement Committee
BMT	Baitul Maal wat Tamweel
BPRS	Bank Perkreditan Rakyat Syria
CIBAFI	General Council of Islamic Banks and Financial Institutions
CGAP	Consultative Group to Assist the Poor
CU	Credit Union
DEEP	Deprived Families Economic Empowerment Program
IIRA	International Islamic Rating Agency
IsDB	Islamic Development Bank
IFI	Islamic Financial Institutions
IFSB	Islamic Financial Services Board
IsMF	Islamic Microfinance
MDG	Millennium Development Goals
MFI	Microfinance Institution
NBFI	Non-Banking Financial Institution
SHG	Self-Help Groups
SSB	Shariah Supervisory Board
NGO	Non Governmental Organization
ROSCA	Rotating Savings and Credit Associations
UNDP	United Nations Development Program

## GLOSSARY OF ARABIC TERMS

<b>Word</b>	<b>Definition</b>
<i>Akhuwat</i>	Brotherhood.
<i>Al-rahn</i>	Collateral
<i>Awqaf</i>	Plural of <i>waqf</i> . For meaning, see below.
<i>Bait-ul-Maal</i>	Public treasury, Also used for a charitable institution meant to help the poor and needy.
<i>Bay mu'ajjal</i>	Sale on credit, i.e. a sale in which goods are delivered immediately but payment is deferred.
<i>Bay salam</i>	A sale in which payment is made in advance by the buyer and the delivery of the goods is deferred by the seller.
<i>Bay-bithaman-ajil</i>	Another term used for <i>bay mu'ajjal</i> .
<i>Bay-istijrar</i>	Recurring sale or purchase
<i>Damanah</i>	Guarantee, security.
<i>Darar</i>	Damage, harm, injury.
<i>Fiqhi</i>	Refers to the whole corpus of Islamic jurisprudence. In contrast with conventional law, <i>fiqh</i> covers all aspects of life, religious, political, social, commercial or economic. The whole corpus of <i>fiqh</i> is based primarily on interpretations of the Qur'an and the <i>sunnah</i> and secondarily on <i>ijma</i> (consensus) and <i>ijtihad</i> (individual judgement). While the Qur'an and the <i>sunnah</i> are immutable, <i>fiqhi</i> verdicts may change due to changing circumstances.
<i>Gharar</i>	Literally, it means deception, danger, risk and uncertainty. Technically it means exposing oneself to excessive risk and danger in a business transaction as a result of uncertainty about the price, the quality and the quantity of the counter-value, the date of delivery, the ability of either the buyer or the seller to fulfil his commitment, or ambiguity in the terms of the deal; thereby, exposing either of the two parties to unnecessary risks.
<i>Hadith</i>	Sayings, deeds and endorsements of the Prophet Muhammad (peace be upon him) narrated by his Companions.
<i>Halal</i>	Things or activities permitted by the Shariah.

<i>Hiba</i>	Gift.
<i>Ijarah</i>	Leasing. Sale of usufruct of an asset. The lessor retains the ownership of the asset with all the rights and the responsibilities that go with ownership.
<i>Istijrar</i>	Same as <i>Bai-Istijrar</i>
<i>Istisna</i>	Refers to a contract whereby a manufacturer (contractor) agrees to produce (build) and deliver a well-described good (or premise) at a given price on a given date in the future. As against <i>salam</i> , in <i>istisna</i> the price need not be paid in advance. It may be paid in instalments in step with the preferences of the parties or partly at the front end and the balance later on as agreed.
<i>Jahl</i>	Ignorance, lack of knowledge. In contracts, it refers to lack of information with respect to the subject of the contract or the terms and conditions of the contract.
<i>Kafalah</i>	A contract whereby a person accepts to guarantee or take responsibility for a liability or duty of another person.
<i>Mudarabah</i>	A contract between two parties, capital owner(s) or financiers (called <i>rabb al-mal</i> ) and an investment manager (called <i>mudarib</i> ). Profit is distributed between the two parties in accordance with the ratio upon which they agree at the time of the contract. Financial loss is borne only by the financier(s). The entrepreneur's loss lies in not getting any reward for his services.
<i>Mudarib</i>	An investment manager in a <i>mudarabah</i> contract.
<i>Murabahah</i>	Sale at a specified profit margin. The term, however, is now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed time frame, either in instalments or in a lump sum. The seller bears the risk for the goods until they have been delivered to the buyer. <i>Murabahah</i> is also referred to as <i>bay mu'ajjal</i> .

<i>Musharakah</i>	Partnership. A <i>musharakah</i> contract is similar to a <i>mudarabah</i> contract, the difference being that in the former both the partners participate in the management and the provision of capital, and share in the profit and loss. Profits are distributed between the partners in accordance with the ratios initially set, whereas loss is distributed in proportion to each one's share in the capital.
<i>Qard Hasan</i>	A loan extended without interest or any other compensation from the borrower. The lender expects a reward only from God.
<i>Qur'an</i>	The Holy Book of Muslims, consisting of the revelations made by God to the Prophet Muhammad (peace be upon him). The Qur'an lays down the fundamentals of the Islamic faith, including beliefs and all aspects of the Islamic way of life.
<i>Rabb al-Mal</i>	Capital owner (financier) in a <i>mudarabah</i> contract.
<i>Riba</i>	Literally, it means increase or addition or growth. Technically it refers to the 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or an extension in its maturity. Interest as commonly known today is regarded by a predominant majority of <i>fuqaha</i> to be equivalent to <i>riba</i> .
<i>Sadaqah</i>	An act of charity.
<i>Salam</i>	The short form of <i>bay al salam</i> .
<i>Shariah</i>	Refers to the corpus of Islamic law based on Divine guidance as given by the Qur'an and the <i>sunnah</i> and embodies all aspects of the Islamic faith, including beliefs and practices.
<i>Tabarru</i>	Actions/contracts the purpose of which is not commercial but is seeking the pleasure of Allah.
<i>Takaful</i>	An alternative for the contemporary insurance contract. A group of persons agree to share certain risk (for example, damage by fire) by collecting a specified sum from each. In case of loss to anyone of the group, the loss is met from the collected funds.
<i>Ujrat</i>	Fee, remuneration
<i>Ulama</i>	Scholars.



<i>Wadiah</i>	A contract whereby a person leaves valuables with someone for safekeeping. The keeper can charge a fee, even though in Islamic culture it is encouraged to provide this service free of charge or to recover only the costs of safekeeping without any profit.
<i>Wakalah</i>	Contract of agency. In this contract, one person appoints someone else to perform a certain task on his behalf, usually against a fixed fee.
<i>Waqf</i>	Appropriation or tying up a property in perpetuity for specific purposes. No property rights can be exercised over the corpus. Only the usufruct is applied towards the objectives (usually charitable) of the <i>waqf</i> .
<i>Zakah</i>	The amount payable by a Muslim on his net worth as a part of his religious obligations, mainly for the benefit of the poor and the needy. It is an obligatory duty on every adult Muslim who owns more than a threshold wealth.