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MAKING DEVELOPMENT ASSISTANCE SUSTAINABLE THROUGH ISLAMIC MICROFINANCE

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ABSTRACT

Microfinance schemes have been operational since the 1960s, however, they mostly involve conventional finance, whereas many low income Muslims would prefer to have *sharīʿah* compliant finance. The aim of this paper is to explore how microfinance can be provided on a *sharīʿah* compliant basis and what instruments and structures could be used. The implication of this paper is that *sharīʿah* compliant microfinance is best provided by non-banking institutions, which in the case of the *wakālah* model, may have links to the *waqf* and *zakāh* authorities. With *muḍārabah* profit sharing microfinance, there is scope for commercial undertakings, but arguably specialized finance companies rather than banks, even Islamic banks, may be more appropriate institutions to get involved.

JEL classification: G21, Z12

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1. INTRODUCTION

Microfinance involves the provision of financial services for those too poor to have access to banks.[1] Although microfinance schemes have been operational since the 1960s, they mostly involve conventional finance whereas many low income Muslims would prefer to have *sharīʿah* compliant finance. The aim of this paper is to explore how microfinance can be provided on a *sharīʿah* compliant basis and what

instruments and structures could be used. The literature in this area is very limited, but there have been a number of recent notable contributions indicating the increasing interest in the topic.[2] Two key issues have already been addressed, but not resolved. First, would Islamic microfinance be best provided by specialist *shar¥‘ah* compliant financial institutions or by existing Islamic and conventional banks?[3] Second, are credit unions, organized through co-operatives, the way forward, or are commercial institutions such as banks or investment companies preferable?[4]

Microfinance is often approached idealistically, as it is designed to help the poor. This is, of course, a commendable objective, but one that is often difficult to achieve given the complexities of poverty alleviation. In reality there are often social rather than simply financial factors determining poverty. The problem is not primarily a finance gap but rather due to the lack of knowledge and social discriminations that persists from generation to generation. In other words, the problem is not solely the supply of finance, but rather on the demand side. However, making *shar¥‘ah* compliant finance available for legitimate business activity that is perceived as *úal£l,* together with technical assistance, may encourage poor Muslims to think about how they can make better use of their God given talents.[5] The core concept to impart is that of *khil£fah* (vicegerency), and righteous management of resources in terms of being aware of the responsibility to the Creator. The aim should be to reach the stage of *mu‹ma’innah* (a righteous state) by pleasing Allah, including serving fellow believers and by being economically productive.[6]

2. MICROFINANCE MODELS

The history of microfinance predates modern banking as it involved informal financing through moneylenders, pawn shops, loans from friends and relatives and supply of credit from merchants and landlords. Most of this involved debt based credit. This is often exorbitantly priced, possibly reflecting the risks with unsecured lending and the high administrative charges of arranging and managing many small loans. There is also an element of exploitation, since the borrowers were desperate to secure funding to meet immediate needs. They also became easy victims of unscrupulous lenders, to whom the poor were often indebted from generation to generation in a vicious cycle of poverty. Such unfair conditions exist, even today. The poor cannot secure bank

funding as they have no collateral to offer. Consequently they still continue to use informal sources of finance, despite the increasing presence and impact of modern banking in many developing countries.

The socialist critique of such alleged exploitative practices from the mid-twentieth century onward did not result in their abolition, even in countries with left leaning or communist governments. Indeed with the failure of state organizations to meet the credit needs of the poor, informal microfinance often flourished in these societies, as the commercial banking sector is found to be typically weak and seldom innovative. Consequently many put their faith in non-governmental organizations (NGOs) as the alternative providers of microfinance. The funds are often provided through international development assistance to encourage the emergence of institutions serving civil society that could be seen as a way of bypassing corrupt national governments. Many development activists saw microfinance as an important tool in empowering the poor, contributing to the growth of civil society and decentralized decision-taking.

2.1 THE GRAMEEN BANK

The Grameen Bank is an outstanding example of a successful microfinance institution. The award of the Nobel Peace Prize in 2006 to the Grameen Bank and its founder, Muhammad Yunus, brought microfinance to international attention. With 6.91 million borrowers and 2,319 branches throughout Bangladesh, Grameen Bank has achieved remarkable success. It has been able to make small loans of less than $100 viable, by keeping down operating expenses to less than 10 percent of the value of its loans, and has a mere 2.5 percent of its loan portfolio classified as impaired or at risk. Rather than demanding collateral and legally enforceable contracts, the Grameen Bank has developed a system, based in its words on "mutual trust, accountability, participation and creativity."[7]

The key to the Grameen Bank's early success in the late 1970s and 1980s was believed to have been the organization of borrowers into small homogenous groups, initially of five members. There were group loans, with peer pressure from group members, usually women, to repay on time through weekly installments. Although this system worked for a time, there were operational problems, and it was unable to cope with major economic shocks, notably the floods of 1998 when half of Bangladesh was submerged for a ten week period, destroying

much of the country’s infrastructure, as well as crops and livestock. Subsequently the Grameen Bank II model was launched, with three simple products, a basic general purposes loan, a housing loan and a higher education loan. Borrowers would not qualify for the housing or higher education loans unless they had met all their basic loan obligations. If borrowers fail to meet their basic loan obligations, they are provided with a flexi-loan as a rescheduling facility, the advantage being a longer repayment period. But there is a penalty, as the increments to the basic loan ceiling built up over the years with timely repayments get wiped out. Bank assets get written down by fifty percent for the amount of basic loans outstanding, with one hundred percent provisions where borrowers refuse to move to a flexi-loan. Although there is not a formal system of credit scoring, borrowers must have a personal savings and a special savings account with the bank, and a pension’s savings account if they wish to qualify for a larger loan. They must also take out deposit insurance, which repays outstanding loans if a borrower dies.[8]

2.2 *SHARĪʿAH* COMPLIANT MICROFINANCE

Although Bangladesh is a predominately Muslim country, the Grameen Bank is not a *shar¥ah* compliant financial institution as it charges interest on its loans, and pays interest to depositors. Interest for income generating basic loans is 20 percent, whole housing loans are charged at 8 percent and higher, education loans at 5 percent, implying a degree of cross subsidy. Savings rates vary from 8.5 to 12 percent depending on the category and size of deposit. From an Islamic perspective this amounts to *ribŒ’*, and the fact that the Grameen Bank calculates its rates in simple rather than compound terms does not mitigate the *ribŒ’* transactions. Interestingly, an empirical study by Ahmed (2002) revealed there were three small Islamic microfinance institutions in Bangladesh that performed better than the Grameen Bank.[9]

There are also wider concerns with conventional microfinance from a Muslim perspective. Although the provision of alternatives to exploitative lending is applauded, there is the issue of whether these are sustainable if they conflict with the values and beliefs of local Muslim communities. Simply extending materialism and consumerism into poor rural communities and urban shanty town settlements could actually undermine social cohesion, by raising false expectations which could not be fulfilled, resulting in long term frustration and possible social discontent or even economic crime. In so far as microfinance contributes

to the growth of civil society rather than social fragmentation, it is seen as desirable, although there is a worry that the institutions of civil society are secular. Supporters of Islamic alternatives to conventional microfinance have as their aim, the enhancement of Islamic society, rather than with the promotion of values that might be contrary to *shar¥cah*.

Comprehensive microfinance involves not only credit through debt finance, but the provision of equity, savings schemes, money transfers and insurance. The *shar¥cah* compliant equivalents of conventional debt facilities might include *qarè al-úasan* interest free loans, the only type of permissible loan under *shar¥cah* law; *murŒbaúah,* mark-up trade finance; *salam,* forward purchase credit and *isti§nŒ,* project financing, as well as the facilitation of operational leases, *ijŒrah*, which eliminates the need for micro enterprises to tie up their scarce capital resources in equipment or buildings.[10] Muslim-run micro enterprises could choose one of these financing methods, or obtain an assistance package, with a retailer, for example combining *murŒbaúah* for the purchase of stock, with *ijŒrah* for the rental of premises. The role of Islamic microfinance agencies, however, will not simply be to react to client requests, but to be pro-active in advising what methods and combinations of financing are appropriate for particular purposes. This will necessitate detailed knowledge of the micro enterprises being financed.

3. POTENTIAL ISLAMIC MICROFINANCE INSTRUMENTS

Islamic finance is usually provided through *shar¥cah* compliant instruments that have their origins in *fiqh* jurisprudence, but which have been adapted to be viable in the modern world, and in particular, competitive with conventional products. Often these are designed to serve a similar function as their conventional equivalents, as the financing facilities sought by Muslim clients are no different to anyone else. The main difference with *shar¥cah* compliant financing facilities is their legal contracts, especially with respect to the rights and responsibilities of the parties under national law. The substance of the contracts differ as the financing is usually linked to trading in, or the production of, underlying real assets, although this can involve services as well as commodities. The responsibility of the *shar¥cah* board members of Islamic financial institutions is to scrutinize the contracts, which are drafted by conventional law firms and not by the *shar¥cah* scholars.[11]

Traditional informal microfinance can therefore be regarded as inappropriate, as there is no contractual uncertainty, and therefore the potential for misunderstanding and exploitation, or in other words, an element of *gharŒr*. The teaching of the Qur'Œn suggests:

> When you deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing…. It is more just in the sight of God, more suitable as evidence and more convenient to prevent doubts amongst yourselves. (2:282)

Historically many of the recipients of informal microfinance were illiterate, but today, with universal literacy in many Muslim countries and communities even amongst the poor, using this as an argument against formalizing contracts is increasingly untenable. Of course, drawing up legal contracts brings additional costs. However, this can be reduced substantially once contracts become standardized. This is increasingly the case with *shar¥'ah* compliant financial contracts. The purpose of written contracts is not to impose formalization for its own sake, but rather to ensure the contracts are just. Any ambiguity could result in disputes that are likely to be costly for those involved in both financial and emotional terms.

Islamic financial contracts, being linked to real transactions, are usually designed for specific purposes. *MurŒbaúah,* for example, is used for the purchase and resale of commodities, while *ijŒrah* applies to operational leases involving property or equipment. *Isti§nŒ',* on the other hand, covers the manufacture or supply of specific items, and is increasingly used for project finance. All of these instruments can, of course, be structured for microfinance operations. But the clients often want cash which they can use at their discretion, rather than being tied to a particular commodity or transaction. *Shar¥'ah* compliant microfinance cannot include the offer of overdraft facilities, as these usually involve *ribŒ'*. An alternative to this can be *tawarruq*, whereby the acquisition of a commodity is financed through *murŒbaúah*, under which the client is required to sell the commodity for cash to the bank or its agent. The provision of *tawarruq* has proved controversial. Although some *shar¥'ah* scholars stress its legitimacy under *fiqh*, more assert that it is a mere device with little financial substance. There are unresolved issues about whether *tawarruq* should be offered to everyone, or only the more affluent. The latter are less likely to face debt repayments problems and may be more able at managing

discretionary cash. However, a counter argument is that the cash needs of the poor should be given priority which might lend support for microfinance institutions offering *tawarruq*.[12]

Arguably, *qarè úasan* is a better instrument than *tawarruq* for the provision of liquidity. However, the problem with this type of interest free loan is that there is no profit for the financial institution providing the funding. The attraction of *tawarruq* is that a mark-up is charged, as well as transaction fees relating to the re-sale of the commodity. Of course, with *qarè úasan,* an arrangement fee can be charged to cover set-up costs, as well as a management fee to cover the cost of the loan administration. Any charges that exceed costs would amount to *ribŒ*, especially if they were related to the size and duration of the loan. Having flat arrangement and management fees potentially penalizes those who take loans of lesser amounts as the fees will be proportionately higher, the smaller the loan amount.

It has been suggested that *tawarruq* should be confined to business cash advances, while *qarè úasan* should be restricted to personal lending. The basis of such an argument is that businesses can generate profits to cover the *tawarruq* mark-ups, while personal lending, especially to those in need, should be on a "not for profit" basis. With microfinance, however, the distinction between business and personal lending often becomes blurred, making it difficult to have a clear demarcation between where *tawarruq* should end and *qarè al-úasan* should begin. As *qarè úasan* in classical Islamic jurisprudence was designed for those in need, this may be a better criterion as it involves morality, unlike the often arbitrary distinction between what is business and what is personal. Nevertheless, this still begs the question of how to define need. Indeed, all that can be said is that microfinance was geared to those in need.

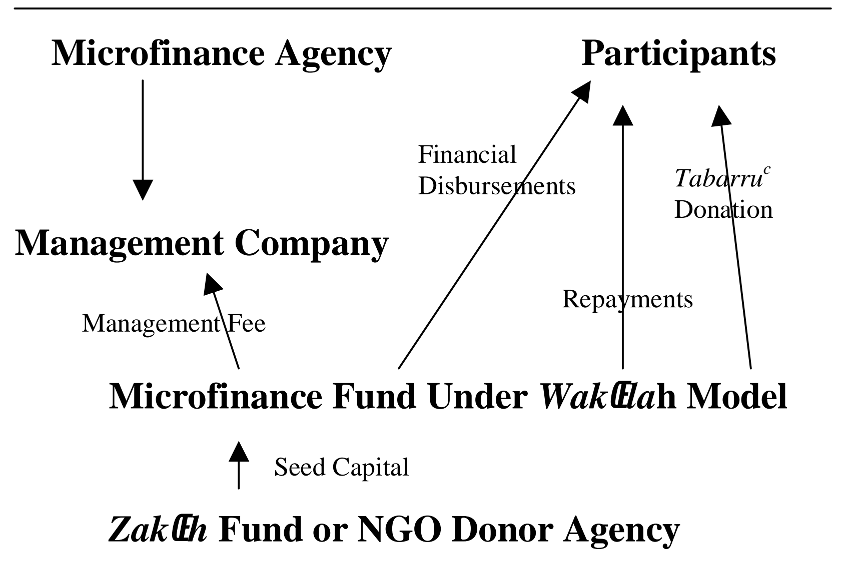
4. A *WAKĀLAH* AGENCY MODEL AS AN ALTERNATIVE TO PREVAILING MICROFINANCE MODELS

As Islamic microfinance finance involves charitable assistance such as *qarè úasan,* interest-free loans which require subsidies or cross subsidies, can grant aid be harnessed and *zakŒh* funding be used for this purpose? Structures that might be appropriate for the inclusion of *zakŒh* or NGO donor funding as the grant element of a financial package are a possible way forward. One potential structure investigated is based on the *wakŒlah* model (sometimes transliterated as *wikŒlah*)

that is widely used for Islamic *takāful* insurance. Such a scheme could ensure that *zakāh* promotes self-sustaining development that helps those with low incomes, rather than creating a dependency culture.

An advantage of the *wakālah* model is that it combines some of the features of a credit union with professional financial management. It ensures that the interests of participants are protected. The concern would be if there was any exploitation of participants by the management, as there is the potential for a conflict of interest, with participants losing out if management remuneration is excessive or not transparent. As the flow chart shows, only the participants are entitled to financial disbursements from the fund, which, of course, have to be repaid as the arrows illustrate. The funding is subsidized by the seed capital inflow from a donor agency, as in the case of conventional microfinance, but for *sharīʿah* compliant microfinance a *zakāh* fund could be involved.

FIGURE 1
The *Wakālah* Model



Source: Flow chart adapted by the author from a *takāful* structure. See Rodney Wilson, "Concerns and misconceptions in the provision of *takāful,*" in Sohail Jaffer, (editor) *Islamic Insurance: Trends, Opportunities and the Future of Takaful,* Euromoney Books, London, 2007, p. 77.

With the *wakālah* model, the management is remunerated by a fixed fee. They do not share in the *wakālah* fund, the sole beneficiaries from which are the participants. The latter make a donation to the fund, which can be regarded as a *tabarruᶜ*, a term that implies solidarity and stewardship.[13]

In the case of a credit union the participants are entitled to draw disbursements from the fund, which can exceed their contributions at any given date. Obviously, not all participants can withdraw funds in excess of their contributions at the same time as there would be insufficient funds to meet the demand. This implies a rationing mechanism is necessary. With conventional lending, this is implemented through the pricing of the funds, i.e., the interest rate, which determines the equilibrium between the demand for and the supply of funds. With *sharīᶜah* compliant microfinance there can, of course, be no interest or *ribā'*, hence the supply of funding being classified as *tabarruᶜ*. The motivation for *tabarruᶜ* is not a price incentive such as an interest payment, but rather to help the fellow participants meet their financial requirements while at the same time building up entitlements to similar help.

4.1 DISBURSEMENT CRITERIA

To prevent a sudden exodus of capital and the depletion of the *wakālah* funds, the rationing mechanism involves prioritizing who can draw their entitlements first. Those that can put together viable business schemes that demonstrate how the funds to cover repayments can be generated will receive priority. Those whose projects are less credible will be rejected in the first instance until they improve their plans sufficiently to justify resubmission.

The management company will be responsible for deciding which applications are supported and which are rejected. In the case of the latter, the aim should be to educate the participant as to how they can improve their proposal and resubmit, or draw up a new proposal that is a more viable business proposition. The objective of the management company is to appraise and reduce risk rather than to price for risk, as there is no interest charge for any funding. Islamic finance concerns justice in financial dealings. In the case of microfinance, this implies transparency by the management company in demonstrating how funds are allocated. There should be consistency in decision taking to ensure none of the participants are penalized unfairly.

4.2 SOURCES OF REVENUE

Revenue coming into the *wakālah* fund originates from five sources. First there are the donations, *tabarru*^{c}, from the participants. As these are donations, they do not necessarily have to be repaid. However they give *wakālah* membership privileges, notably the right to apply for financial assistance. Whether they give any right to the assets in the fund beyond this, such as a benefit from any income earned on fund assets is more debatable. Indeed it can be argued that there should be no financial return from *tabarru*^{c}, rather the return being the knowledge that the fellow participants are being helped.

Secondly when they apply for financial support, there is a modest fee. If they are successful in obtaining funding there is a management fee for the duration of the financing. Such fees are referred to as *ju*^{c}*ālah*, the return for the provision, of legitimate fee based services. These fees do not represent *ribā'* or interest, as they are merely to cover costs, both arrangement costs and the administrative costs of maintaining and sending out balance statements to each of the participants, and of processing repayments from those in receipt of funding.

The third source of funding is from the repayments by those participants who have obtained funds which, of course, get recycled back into the fund with no addition to the principal advanced. These repayments help ensure the fund does not diminish in nominal value, although it might be negatively affected in real terms by inflation and payments defaults.

A fourth source of funding is the subsidy either from a non-government organization (NGO) donor agency, in which case it may be simply a one-off contribution, or from a *zakāh* fund, that may involve recurrent payments. For *zakāh* funds to be utilized it would have to be shown that the funds are providing assistance for the poor and those in need, rather than simply aiding business ventures. *Zakāh,* of course, is not a loan, but a form of alms giving, one of the five pillars of Islam that demonstrates religious devotion and a recognition of obligations to Allah. It should, therefore, not be abused by those who administer the funds. This should be guided by the principle of *khilāfah*, vicegerency, accountability to the Almighty for actions undertaken including those involving finance. Participants in the fund will, of course, be liable for *zakāh* themselves, although their liability will be modest, as microfinance is designed for the poor. They would not, however, have to pay *zakāh*

on the assets in the fund, as these are donated, and held in trust under the *wakŒlah* model, and hence there is no personal liability. *Tabarruc* should not be treated as a substitute for *zakŒh* as the latter, as a religious obligation, brings a spiritual benefit. *Tabarruc* is not a religious obligation, but is rather socially motivated, and brings some individual benefits for those funded, and is therefore very different from *zakŒh*.

The fifth source of funding is any income made on the financial assets held in the fund. These are the responsibility of the management company as its remit extends beyond the credit appraisal and the administration of disbursements. There will always be a time lag between the receipt and disbursement of funds. Hence it is a sensible precaution to maintain reserves. It is possible to manage financial assets to yield a return rather than merely being held as idle cash balances. These should not be regarded as long term asset holdings but rather as treasury holdings which should be relatively liquid and subject to minimal risk. Consequently, although it might be justifiable to hold equities as they are liquid, the capital risk rules out holding such instruments. Bonds and floating rate notes are a preferable alternative, but a *shar¥cah* compliant microfinance fund cannot hold securities paying interest. Hence the choice becomes limited to *§uk´k* securities, with *salam §uk´k* paying fixed rate, and *ijŒrah* and *mushŒrakah suk´k* paying a variable rate.[14]

4.3 TREASURY MANAGEMENT

With treasury, as with any form of asset management, portfolios should be diversified. *êuk´k* should not make up the entire portfolio. Even within the *§uk´k* category there should be diversity between fixed and variable return *§uk´k* and sovereign and corporate *§uk´k*. For immediate transactions purposes the microfinance institution will need to keep bank accounts. In the case of a *shar¥cah* compliant microfinance institution these can either be with an Islamic bank or an Islamic window of a conventional bank.

Some deposits will be held in current accounts, which should be *shar¥cah* compliant. Although current accounts with conventional banks pay no or minimal interest, the funding is used to finance loans involving *ribŒ'*. Clients with *shar¥cah* compliant deposits with conventional banks offering these facilities have the assurance from the *shar¥cah* boards of these banks that their funds are segregated from the other liabilities and assets of the bank, and that they will only be used for financing through *shar¥cah* compliant structures for purposes that are *úalŒl*.

Deposits may also be placed in *murŒbaúah* treasury accounts or *muèŒrabah* investment accounts. Both these type of accounts pay returns, with that on the *murŒbaúah* account being a mark-up related to the underlying commodity transaction that the bank funds, either directly or through an agent or broker. With *muèŒrabah*, the return will be related to the bank's profitability, or in the case of a specified *muèŒrabah* deposit, the profit generated by the project that the funding is used for. These deposits can be indefinite in duration, but subject to a period of notice. The longer period brings a higher proportion of the declared profit rate, or time deposits, with returns also related to the duration of the deposit. Usually with treasury management the aim is to have time deposits maturing to cover anticipated liquidity needs. This methodology should also help Islamic microfinance organizations maximize treasury income. At present there are no *shar¥ah* compliant certificates of deposit, but these could also be developed to facilitate profitable treasury management.

4.4 REGULATION, FINANCIAL REPORTING AND *SHARiCAH* COMPLIANCE

As the microfinance institution itself will not usually be a bank, it will have to rely on banks to provide transactions facilities. A microfinance institution can, of course, apply for a banking license. But this would imply it was regulated as a bank, which would mean there was reduced flexibility over disbursements and less discretion over asset holdings, plus additional costs of developing robust systems for regulatory compliance, including possibly paying to be rated. Although credit unions are not subject to central bank regulation, there may be regulation by other government ministries such as those responsible for social affairs. A case could be argued for making the *shar¥ah* compliant microfinance institution accountable to the *waqf* authorities or the institution responsible for the administration of *zakŒh*, especially if *zakŒh* is a source of funding. The effectiveness of such regulation will, of course, depend on the capacity and capability of the *waqf* or *zakŒh* authorities and their professional competence in the field of financial management. The acquisition of such skills may be a necessary part of the institution building process.

Part of the regulatory skill will relate to accounting knowledge. Any microfinance institution should be obliged to keep accurate records of all transactions, so as to produce an annual report containing income

and expenditure statements as well as tables providing details of all assets and liabilities. A less detailed six monthly interim statement is also desirable. In jurisdictions where it is appropriate to apply to make *wakŒlah* trusts as registered charities, the provision of detailed financial reports will be a legal requirement. There are specific accounting standards for *shar¥ah* compliant institutions issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). This covers issues such as the valuation of *murŒbaúah* and *ijŒrah* assets and the reporting of revenues from such assets. As such it would seem sensible for *shar¥ah* compliant microfinance institutions to adhere to these standards.

Islamic microfinance organizations could either have their own board of *shar¥ah* scholars or rely on scholars who are associated with the *waqf* or *zakŒh* authorities. The priorities of the *shar¥ah* scholars should be to firstly ensure that all contracts issued by the microfinance organization were *shar¥ah* compliant, and secondly that all asset holdings were also *shar¥ah* compliant. As in the case of Islamic bank reports, there should be a formal statement of *shar¥ah* compliance in the financial reports issued by Islamic microfinance organizations, with the statements endorsed by well known scholars. Information should also be provided on the *shar¥ah* scholars' qualifications and experience.

4.5 SCREENING OF FUND USAGE

The disbursements by *shar¥ah* compliant microfinance institutions should only be for *úalŒl* activities. The responsibility for ensuring this will rest with the *shar¥ah* scholars. The sector and financial screens used by the Dow Jones Islamic Indices are of relevance as these restrict the uses of *shar¥ah* compliant funds to ensure no activities are *úarŒm*.[15] Sectoral screens exclude the finance of alcohol production or sales, pork product manufacturing and distribution, media output deemed obscene and *ribŒ*' based financing. In practice, these exclusions make little difference to microfinance institutions, as their members are unlikely to be involved in production of *úarŒm* items. The major concern here is with distribution where the finance is for small retail establishments. While *shar¥ah* scholars agree on the excluded activities, there has been some debate about whether retailers can be funded if their primary business activities are *úalŒl*, but a minor proportion of their business involves *úarŒm* products or services. Not surprisingly, there is unease about the latter, even if it is merely secondary to the business. Most

would prefer to see microfinance used to purify business activity, rather than perpetuate what is *úarŒm*, however insignificant it might appear to be.

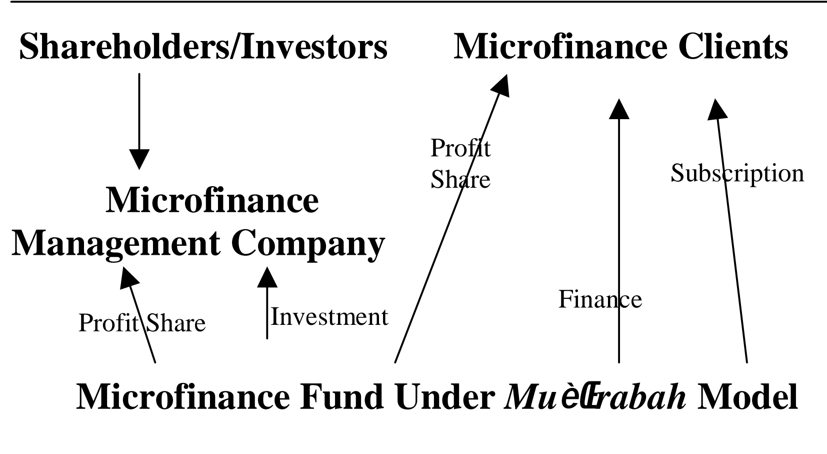
Financial screening is less of an issue with *shar¥ah* compliant microfinance as it is for Islamic banks, *shar¥ah* compliant investment companies and fund managers. Companies are excluded if their outstanding debt exceeds one third of their capitalization, or if interest accounts for more than one third of income because of extensive holdings of conventional savings deposits or bonds.[16] As most of those who approach microfinance institutions lack the collateral and the income to secure a bank loan, they are not involved with conventional interest based institutions.

The only problem that can arise is when small retailers extend significant supplier credits to their clients, and have receivables worth more than the cash value of the items sold. With supplier credits it is normal to charge an additional sum for the deferred payments, but the difficulty with this from a *shar¥ah* perspective is that the retailer or distributor involved extensively in offering such credit is acting like a conventional bank. Under the Dow Jones Islamic Index criteria businesses are excluded if conventional receivables exceed 50 percent of total income. If the receivables were with respect to *murŒbaúah* or *ijŒrah* contracts this would not present a problem as such instruments are *shar¥ah* compliant. However on financial grounds there might be the concern that the business was acting like an unregulated Islamic bank, which would increase risk.

5. *MUËĀRABAH* AS ANOTHER ALTERNATIVE STRUCTURE

Although a *wakŒlah* structure for *shar¥ah* compliant microfinance has many advantages, there is scope for experimentation with alternatives. As with *takŒful* insurance, one obvious alternative is to adopt a *muèŒrabah* structure. This has three notable differences from the *wakŒlah* model, as *muèŒrabah* is a profit and loss sharing contract, not simply an agency agreement. First with a *muèŒrabah* structure the microfinance management company acts as a financier, the *rabb al-mŒl*, and invests directly in the microfinance fund and earns a share of any profits generated by the fund.[17] This contrasts with the management fee earned under the *wakŒlah* model. Arguably earning

FIGURE 1
The *Muḍārabah* Model



Source: Flow chart adapted by the author from a *takāful* structure. See Rodney Wilson, "Concerns and misconceptions in the provision of *takaful,*" in Sohail Jaffer, (editor) *Islamic Insurance: Trends, Opportunities and the Future of Takaful,* Euromoney Books, London, 2007, p. 78.

a profit share acts as an incentive for the management company to ensure the microfinance fund is efficiently run.

The second difference is that the microfinance clients subscribe to the microfinance fund, rather than making a donation or *tabarru*ᶜ contribution. This not only qualifies them as potential applicants for funding, but also entitles them to earn a share in any profits generated by the microfinance fund. The shares of the profit that accrue to the microfinance management and the clients are pre-determined. This share could be equal on a fifty-fifty basis or sixty-forty in favor of either of the parties. There is, in other words, a joint venture arrangement. Hence any profit split between the parties is acceptable, as long as they are in agreement, and that it is not changed during the life of the microfinance undertaking. Although the shares are pre-determined, the profits, of course, are not. As such the actual amount earned by each of the parties will fluctuate from year to year depending on the profitability of the fund and the projects being supported.

The flow chart illustrates how subscriptions from clients and investment from the shareholders are pooled into the microfinance fund and profit shares paid out to each party. Dividends paid to the

shareholders will be determined by the amount of profit paid to the management company in relation to its costs, and all the usual issues involved in agency theory will apply. This is not the case for the microfinance clients however who obtain their profit share directly from the fund without any intermediation.

Under *muèŒrabah,* unlike *mushŒrakah,* the parties to the contract are treated differently. Therefore, it is important to identify who serves as *rabb al-mŒl* and who serves as *muèŒrib*. As the structure discussed here is based on *muèŒrabah* rather than *mushŒrakah*, only the *rabb al-mŒl*, and not the clients, who are regarded as *muèŒrib*, are responsible for any losses. This creates a further incentive for the management company, as the *rabb al-mŒl,* to ensure the fund performs. It is justifiable to designate the microfinance clients as *muèŒrib* rather than *rabb al-mŒl*, as their purpose in seeking funding is to embark on, or further develop their entrepreneurial activity. However by eliminating any possible burden of financial losses from the *muèŒrib*, this reduces their risks, and encourages enterprise.

The third difference between the *muèŒrabah* and the *wakŒlah* model is that with the latter some of the funding came from *zakŒh* or NGOs, but with the former this is not the case. The rationale for this exclusion in the case of *muèŒrabah* is because the venture is more commercial than social in nature, and it would be inappropriate to assign *zakŒh* disbursements to an undertaking that is designed to produce profits for commercial investors. Indeed, the shareholders may hope to exit and realize capital gains if they sell their shares to other investors. Although there is nothing inherently wrong with this, it would be dubious if the value of their shares had been boosted through *zakŒh* disbursements designed to help the poor and needy rather than the relatively affluent investors.

There are often concerns with the moral hazard and asymmetric problems associated with participatory modes of Islamic finance such as *muèŒrabah*, and these arguably could also apply to microfinance. The successful schemes in Bangladesh which Habib Ahmed investigated used *bay*^{c} *mu'ajjal* financing.[18] Like *murŒbaúah*, this involves the client obtaining commodities rather than cash, reducing the likelihood of funds being misappropriated. However, as with *bay*^{c} *mu'ajjal* there is no obligation for the financier to disclose the profit margin, hence, it is not well regarded by many *shar¥*^{c}*ah* scholars. *MuèŒrabah* microfinance can bring conflicts of interest not present in *wakŒlah*, as

with the latter, fees are pre-determined, whereas with *muèŒrabah* profits are not, increasing the incentive for beneficiaries to under-declare as this benefits themselves at the expense of the management company and their peers who will have also paid subscriptions but who may not yet have received financing. In other words with microfinance based on *wakŒlah* there is no agency problem, but this remains a risk with *muèŒrabah*.

6. CONCLUSION

Although this paper is largely conceptual and theoretical, there are a number of existing *shar¥‘ah* compliant microfinance schemes, notably those operated by Bank Simpanan Nasional in Malaysia,[19] the Aceh relief aid schemes in Indonesia,[20] the Hodeidah microfinance program in Yemen[21] and the UNDP *murŒbaúah* based microfinance initiatives at Jabal Al Hoss in Syria.[22] Examination of these schemes could be the basis for a further empirical study.

Guidelines for the provision of Islamic microfinance have been drafted by the State Bank of Pakistan, but these focus on how conventional banks can provide such services, rather than the creation of new institutions.[23] The implication of this present paper is that *shar¥‘ah* compliant microfinance is best provided by non-banking institutions, which in the case of the *wakŒlah* model may have links to the *waqf* and *zakŒh* authorities.[24] With *muèŒrabah* profit sharing microfinance there is scope for commercial undertakings, but arguably specialized finance companies rather than banks, even Islamic banks, may be more appropriate institutions to get involved.

ENDNOTE

1. Access to the most up to date microfinance articles is available through the Microfinance Gateway of the World Bank: ww.microfinancegateway.org

2. Recent papers include Siraj Sait and Hilary Lim, "Islamic Credit and Microfinance," *Islam, Land and Property Research Series,* UN-HABITAT, New York, 2005, Paper 8, pp. 1-21; Chiara Segrado, *Islamic Microfinance and Socially Responsible Investment,* University of Torino MEDA Project, August 2005, pp. 1-20; Dahlia El-Hawary and Wafik Grais, *Islamic Financial Services and Microfinance,* World Bank Paper, Washington, June 2005, pp. 1-5; Dahlia El-Hawary and Wafik Grais, *The Compatibility of Islamic Financial Services and Microfinance,* United Nations Capital Development Fund, New York,

Issue 14, July 2005, pp. 1-4; Nicoletta Ferro, "Value through diversity: microfinance and Islamic finance and global banking," *Fondazione Eni Enrico Mattei Working Paper* No. 87.05, Rome, June 2006. Available at SSRN: http://www.ssrn.com/abstract=755447; Atif Raza Khan, "Poverty to profit," *Islamica Magazine,* Issue 12, Summer 2005, www.islamicmagazine.com/issue12/poverty-to-profit-9.html.

3. Stephanie Nelson, "Microfinance: the opportunity for Islamic Banks," *Islamic Finance News,* Kuala Lumpur, Vol. 3, Issue 43, 1 December 2006, pp. 16-17.4

4. Sajjad Chowdhry, "Creating an Islamic microfinance model: the missing dimension," *Dinar Standard: Business Strategies for the Muslim World,* November 18th 2006. www.dinarstandard.com/finance/MocroFinance111806.htm

5. Abdul Rahim Abdul Rahman, "The Islamic microfinance potential" *New Horizon,* Issue 162, December 2006, London, pp. 9-12.

6. Abbas J. Ali, *Islamic Perspectives on Management and Organisation,* Edward Elgar, Cheltenham, 2005, pp. 28-29.

7. www.grameen-info.org/bank/index.html

8. www.grameen-info.org/bank/bank2.html

9. Habib Ahmed, "Financing micro enterprises: an analytical study of Islamic microfinance institutions," *Islamic Economic Studies,* Vol. 9, No. 2, March 2002, pp. 27-64.

10. There are many useful texts providing an account of these Islamic financing instruments. A good up to date text is Zamir Iqbal and Abbas Mirakhor

11. Mahmoud A. El-Gamal, *Islamic Finance: Law Economics and Practice,* Cambridge University Press, pp. 13-25.

12. Issues regarding *tawarruq* were explored in depth at a workshop in London on 1st February 2007 hosted by the Harvard Law School Islamic Legal Studies Program and the London School of Economics.

13. For a discussion of *tabarru*^{c} see Mervyn K. Lewis, "Wealth creation through *takāful*," in Munnawar Iqbal and Rodney Wilson, (eds.), *Islamic Perspectives on Wealth Creation,* Edinburgh University Press, 2005, p. 176.

14. Rodney Wilson, "Overview of the *suk ´k* market," in Nathif J. Adam and Abdulkader Thomas, (eds.) *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Suk ´k,* Euromoney Books, London, pp. 3-17.

15. *Guide to the Dow Jones Islamic Market Index*, New York, June 2005, pp. 1-12.

16. Rodney Wilson, "Screening criteria for Islamic equity funds," in Sohail affer, (editor), *Islamic Asset Management: Forming the Future for shar¥ah Compliant Investment Strategies,* Euromoney Books, London, 2004, pp. 35-45.

17. Rahul Dhumale and Amela Sapcanin, *An Application of Islamic Banking Principles to Microfinance,* Regional Bureau for Arab States, UNDP in cooperation with MENA division, World Bank, Washington, December 1999, pp. 11-12. (for an account of the advantages and disadvantages of using *mudarabah* for microfinance)

18. Transliterated as *bay^c bithaman Œjil* (BBA) in Malaysia.

19. Secretariat, National SME Development Council, "Strengthening Enabling Infrastructure to Support SME Development," *Bank Negara Press Release*, Kuala Lumpur, August 8 2006.

20. Hans Dieter Seibel and Wahyu Dwi Agung, *Islamic Microfinance in Indonesia,* GTZ, Weisbaden, January 2005, pp. 1-2.

21. Heather Clark, "Islamic banking principles applied to microfinance: case study – Hodeidah Microfinance Programme, Yemen," *United Nations Capital Development Fund,* New York, January 2002, http://www.uncdf.org/english/microfinance/documents-and-reports/thematic-papers/islamic-banking/main-text.php

22. Omar Imady and Hans Dieter Seibel, "Sanduq: a microfinance innovation in Jabal Al-Hoss, Syria," NENARACA Newsletter, Amman, September 2003, pp. 1-12, www.undp-hoss.com

23. Pervez Said, Mahmood Shafqat and Zahid-Ur-Rehman, *Draft Guidelines for Provision of Islamic Microfinance Services and Products by Financial Institutions,* State Bank of Pakistan, Karachi, 2006, pp. 1-11.

24. The involvement of *waqf* and *zakŒh* institutions in the provision of Islamic microfinance was considered at the Islamic Financial Services Sector Development (IFSD) Forum which was held in Dakar, Senegal in May 2007.

Habib Ahmed has written a useful paper, *Waqf-Based Microfinance: Realizing the Social Role of Islamic Finance*, Islamic Research and Training Institute, Islamic Development Bank, Jeddah, March 2007.

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