The requirements of Islamic microfinance

MOINUDDIN MALIM looks at the basic framework for setting up an effective and successful Islamic microfinance model.

Over 500 industry experts, practitioners and stakeholders from 20 countries participated in the international Islamic microfinance conference in June last year in Islamabad, Pakistan. While the participants discussed the challenges facing the industry and presented plausible solutions, they agreed that an Islamic microfinance model can only be successful when institutions are duly supported by a legal framework with a clear policy from state-owned regulatory and financial bodies.

While major researches on commercial microfinance showed that the growth of microfinance has far outstripped its effective alleviation of poverty, the participants agreed that microfinance should be provided at a high financial cost considering that micro businesses are more profitable than other commercial businesses.

While Islamic microfinance is relatively new and there are few models available to study, we need to draw from the success of the conventional microfinance industry.

Microfinance models

There are a handful of successful conventional microfinance models which have different variants and a few of these are also being emulated by Islamic microfinance.

1. **Grameen Bank model**
   This popular model requires careful targeting of poor female groups of five to 10 women in the community through a 'means' tests. This requires intensive fieldwork and supervision by microfinance staff to keep the 'borrowing' groups motivated. The group members guarantee each other's financing. A key feature of the model is group-based and graduated financing that substitute collateral as a tool to mitigate default and delinquency risk.

2. **Village bank model**
   Under this model, individual village banks are established through any agency with about 30-50 members who provide 'external' capital for onward financing to individual members. Individuals are required to repay the loans at weekly intervals over an agreed period, usually three to four months, at which time the village bank returns the principal with interest/profits to the agency. A bank who has repaid in full is eligible for subsequent loans, with loan sizes linked to the performance of village bank members in accumulating savings with the bank. The idea is to make the bank accumulate sufficient capital internally to become an autonomous and self-sustaining institution (in three to four years).

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3. **Credit union model**
   A credit union model is based on the concept of mutuality. Its membership owns and controls the credit union and operates it on a non-profit basis. It brings members together on a common ground that mobilizes savings and provides loans for productive and provident purposes. Credit unions generally have a primary promoter or a regulator that provides guidelines, training and monitors the financial performance.

4. **Self-help group model**
   When a group of people with relatively equivalent income streams come together they can establish a self-help group model where members pool their savings and use them for lending to each other. The group can also seek external funding to supplement internal resources. The terms and conditions of loans differ among groups depending on the democratic decisions of members. Self-help groups are usually established through the direct assistance and promotion of NGOs, who guide them on how to become self-sustaining.

While all of the above models are conventional, there are no limitations to them being developed and used on a Shariah compliant platform. On the contrary, the essentials of the models are very close to Shariah principles and can be easily molded to make them fully Shariah compliant.

Microfinance best practice

The Consultative Group to Assist the Poor has come up with a set of key principles of microfinance that together constitute the essence of 'best-practice' microfinance; and these have been slightly modified in light of Shariah principals.

1. Islamic microfinance can uplift the social fabric of the society. To assist someone with the tools for them to earn their living is much better than giving charity for buying food only.
2. Teaching the poor and assisting them to become self-sufficient requires a support system to ensure that their productivity generates enough for their sustenance.
3. A variety of financial services including loans, savings, insurance and money transfer services should be offered under the microfinance model to the poor.
4. Microfinance builds the financial systems that serve the poor but will reach its full potential only when it is fully integrated into the country's mainstream financial system.
5. Risk participation also means the share of profits which may work out to be a higher rate of return for the Islamic microfinance which is fine so long as it is fair.
6. Microfinance is about building permanent local financial institutions that can attract domestic deposits, recycle them into Islamic financing, and provide other financial services.
7. The government should set up policies to encourage Islamic

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microfinance to grow and become institutionalized rather than philanthropic endeavors by a selected few.

8. Microfinance should be able to tap into the deposit market, i.e. private capital that can be also supplemented through donor funds where both must not compete with each other.
9. Performance measurement, disclosure and reporting of microfinance should be mandatory for all the right reasons as well as demonstrating social performance.
10. Zakat and Sadqa may work better for people who are so destitute that they are without income or means of repayment. Hence microfinance may not be for everyone.

Types of microfinance

A successful microfinance industry should be able to cater for different types of financial outlays required by lifecycle events, emergencies and opportunities. The poor not only need credit but they have other financial needs as well. The current offerings are as follows:

1. **Microcredit**
   A few Muslim countries offer microcredit through conventional microfinance institutions but this violates the fundamental prohibition of Riba. Microcredit may be offered using a variety of mechanisms that do not violate the Shariah. There are a range of Shariah compliant structures such as Qard Hasan, Murabahah with Bai Bithaman Ajil, Ijarah and Bai Salam, which can be used to create a 'debt obligation' on the participant.

2. **Microequity**
   A preferred way of extending microfinance is through investing in a microenterprise through equity types of funding. In an Islamic economy, several partnership-based modes of equity financing exist: such as trustee financing (Mudarabah), joint venture (Musharakah), share-cropping (Mudarah) and distributorship (Wakalah).

3. **Microsavings**
   Saving should be inculcated in all segments of the society including the poor. However they may be constrained due to multiple demands on their low income and lack of the appropriate saving instruments which fit their needs. They too want a secure, convenient deposit that allows smaller balances and offers easy access to their funds in addition to deposit and the return being Shariah permissible (Halal) even though they may be using interest rates as a benchmark for comparison.

4. **Microtransfers**
   The poor may have relatives living and earning money in distant places. They need services relating to sending and receiving money in addition to borrowing from their relatives at times of urgency. Hence money transfers encompass more than just remittances as they also cover the portion of migrant worker earnings sent to family members or other individuals in their place of origin. Such remittances can include both domestic and international transfers.

5. **Micro-insurance**
   The variety of risks and uncertainties, such as death, sickness of the bread-winner, loss of crops, livestock or housing due to natural calamities etc. are faced by poor people more than any other segment of society. Micro-insurance is the protection of low-income individuals against specific perils in exchange for regular monetary payments (premiums) proportionate to the likelihood and cost of the risk involved. According to most Shariah scholars, insurance in the Islamic framework is ideally not-for-profit and takes the form of mutual guarantee by members in a cooperative venture called Takaful-Tawuni. As with all insurance, risk pooling allows many individuals or groups to share the costs of a risky event.

Requirements for Islamic microfinance

1. To become an effective provider, Islamic microfinance needs to segment its activities based on market subsectors where it should target a specific product, i.e., simple and easy to use and understand.
2. Islamic microfinance providers should always think like pure equity investors who are willing to take on risk in a similar fashion to an angel investor or venture capital firm. This means even getting involved in the business hands-on at any level.
3. Developing an understanding of the market including social and cultural aspects which may affect behavior needs to be thoroughly researched and will help microfinance to better understand the size, segment and opportunity set for it to develop the right product offering.
4. Microfinance, Islamic or otherwise, can only realize its full potential when it has the capacity to tap into the wider geography which requires trained personnel. Hence, developing human capital and training them to think differently is also critical as these types of staff are not typical banking professionals who are used to credit analysis.
5. In addition to the capacity of the Islamic microfinance itself, there is also the need to train the participant to be successful in setting up, organizing, managing and monitoring the business as well as attaining the basic tools of financial acumen.
6. Micro-insurance on an Islamic Takaful basis insures the enterprise assets against basic calamities and incidents. For the participant, their cattle and other livestock, their storage facilities, etc. may be their only assets which need protection and insurance.
7. Islamic financial reporting standards need to be developed for Islamic microfinance and this should be taken up seriously by Islamic standard setters like AAOIFI and IFSB.

Conclusion

Islamic microfinance favors equity-based and cooperative models in contrast to mechanisms that create and perpetuate debt. There are Shariah compliant debt-based modes; however, equity-based modes are clearly preferred. 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 with empathy for the poorest of the poor.

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