Islamic Microfinance: Outreach and Sustainability

Muhammad Khaleequzzaman
Room No. C - 015
Department of Islamic Banking & Finance
Academic Block-11, New Campus
International Islamic University
H-10 Sector, Islamabad
Pakistan
mkhaleequzzaman@yahoo.com

ABSTRACT

This paper, focusing outreach and sustainability being the most significant factors of success in microfinance, compares the effectiveness of Islamic principles with the secular practices and suggests the operational framework for Islamic microfinance. Despite vital prospects of reaching out, especially the Muslim populations, the Islamic MFIs are at greater disadvantage suffering from resource and outreach constraint. Piecemeal efforts; based on low capitalization, product concentration, and absence of Shariah advisory, to undertake Islamic microfinance suggest coordinated efforts and public policy perception linked with Islamic social capital, to fetch excellence in quality and commitment. Mainstreaming and commercial approach can bring the actual difference.

Introduction:

Sustainability is crucial for the success of microfinance programmes and their ability to alleviate poverty. However, evidence depicts that many programmes do not fulfill this criterion. That is why the role of microfinance in poverty alleviation and uplift of poor has not been confirmed. Social collateral, a necessary tool believed to benefit the Microfinance Institutions (MFIs) by establishing trust relationship, lowering transaction costs, and imparting greater coherence of actions, is failing to deliver, therefore adversely affecting the sustainable operation. Microfinance affects the Muslim population differently. A significant proportion of Muslim poor have excluded themselves from these programmes as they believe in *Shariah* prohibition of interest. But, these programmes have ignored to tap the opportunity of extending outreach by offering *Shariah* compliant products and services. The Islamic microfinance could address this deficiency with convenience of perception and inherent value loaded social capital. However, very few initiatives could be taken owing to resource and policy constraints. The paper attempts to suggest guidelines to establish sustainable Islamic microfinance programmes. The inferences drawn from a survey conducted in respect of an MFI in Pakistan have helped framing recommendations.

The state of poverty alleviation in Muslim countries is not encouraging. Characterized by widespread inequality and narrow access to socio economic opportunities, none of the Muslim countries has entered the developed world. The statistics compiled from WDR, HDR, and IDB Annual Report[1] reveals that aggregate per capita GNI at current and PPP US$ of IDB member countries was 20% and 38% of the world aggregate and 86% and 71% of the average of middle and low income countries, respectively. With the exception of a few high income countries[2], the rest illustrate medium and low human development[3]. It has been reported that poverty in Muslim countries was among the highest in the world[4].

The low economic and financial opportunity, central to the incidence of poverty in any society, limits capacity of the poor to utilize their skills for income generation. Access to affordable financial services; credit, savings, and insurance, integrated with business development support, can therefore empower them to change their lives and those around them. Perception of commercial banks about servicing small clients a costlier business and high credit risk resulted in emergence of microfinancial services in 1980s. Introduced by Grameen bank, microfinance is understood as successful programme impacting poverty alleviation. Social collateral of microfinance groups, known as Grameen innovation, is considered much stronger commitment than collateralized transactions where the local groups provide cost effective peer monitoring and screening to ensure repayment and overcome enforcement problems (Prescot, 1997)[5]. However, the inability of such programmes to be consistent with cultural and religious values limits their scope to a considerable extent, and requires the microfinance initiative to align with such grounds.

The paper, discussing outreach and sustainability problem, reviews selected literature in microfinance and social capital in both Islamic and secular frameworks. The review of literature on social capital has been particularly included to help suggest social norms in Islamic perspective which could increase effectiveness of such programmes. The conceptual framework of Islamic social capital has been developed to facilitate infusing Islamic values among all the stakeholders involved in microfinance programmes. A limited survey of an Islamic microfinance programme in Pakistan helps to assess potential for product diversification and building social capital based on Islamic values. Finally, the recommendations suggest the Islamic microfinance alternatives.

[1] The World Bank, "World Development Report 2006", Oxford University Press, New York NY, USA; United Nations Development Programme, "Human Development Report 2006", Palgrave Macmillan, New York, NY, USA; and Islamic Development Bank, IDB Annual Report 1426H (2005-2006)", Jeddah, Saudi Arabia.
[2] Bahrain, Brunei, Kuwait, Malaysia, Oman, Qatar, and UAE.
[3] They rank 64 or above in terms of Human Development Index out of 177 countries; 56% in medium human development and 44% in low human development category.
[4] Salih, S. A., 1999, p.33

[5] Prescot, E.S 1997, p.23

Outreach and Sustainability Problem:

Extended outreach, repayment performance and permanence of services are the most vital factors ensuring sustainability. Although, microfinance operations have reached many millions of poor people[6], the poorest have rarely been looked after, hence excluded[7]. Otherwise too, the outreach is restricted owing to the under-capitalization problem of MFIs, mistargeting and low public policy concern, which leaves the demand for microfinance largely unmet. According to the estimates, the outreach of microfinance programmes around the world could not go beyond 7% to 12% by 2001-02[8]. In the North Africa and Middle East region represented mostly by the Muslim countries, the microfinance reaches only to less than 0.2% of the poor[9]. In Pakistan, the microfinance could meet demand of only 10% of the poor people[10].

While the microfinance programmes, generally compatible with Islamic finance, have missed the opportunity of diversifying their operations, the number of Muslim countries practicing Islamic microfinance is very few, the programmes even fewer. These efforts, too, are affected by unsustainable operations due to paucity of funds and very limited outreach causing scale problem. Their efficiency is further restricted by product concentration, weak social mobilization, Shariah advisory, and conceptual misunderstanding. Relatively longer term financing for capital equipment which can help introduce technology and innovation is generally not available, neither the microfinance programmes have explored such prospect in non-trading modes like leasing and partnership financing. At the same time, the Islamic banks, keeping short term liquidity[11], have ignored to diversify their assets in microfinance. They have not paid any heed to this profit generating and welfare oriented objective. Thus the outreach has not only been affected by insufficient/piecemeal and inefficient operations of microfinance programmes but also due to lack of commercial orientation helpful to gain operational scale.

---

[6] "MicroBanking Bulletin", 2006. p.24 According to MBB, 446 participating MFIs represented by Eastern Europe & Central Asia, Latin America & the Caribbean, Middle East & North Africa, and Asia, served 33 million borrowers with 13 billion US$ in loans in 2005, and raised over nine billion US$ in deposits from 48 million depositors.

[7] Hashemi, S, and Rosenberg, R 2006, p.1 states that the poorest of the poor either exclude themselves fearing default on account of business failure or inability to earn the trust of group members to guarantee their loans.

[8] UNCDF, estimates that out of the total 400 to 500 million households around 30 million had access to microfinance services in 2002.
Yunus, M., 2003, p.1, quotes that more that 54 million families around the world benefited from microcredit by the end of 2001.

[9] Talal, B. In North Africa and Middle East alone, out of 60 million poor people, only 112,000 have access to financial services.

[10] "Performance Indicators Report 2005", 2006. p.2

[11] Din, B. Ibrahim, A, and Vijaykumar, K. C., P.20

Review of Literature:

Social capital: Social collateral developed in microfinance programmes represents social capital. It makes the members responsible for paying default of fellow members to save from disqualification from future access to credit. It prescribes various dimensions; including trust, solidarity, collective action and cooperation, which help reaching the economic opportunity, also improving governance and accountability through exclusion of vested interest, moral hazard, and mistrust[12]. The literature points towards failure of social capital in microfinance. The trust is breaking and MFIs have started experiencing multiple borrowing by their clients and frequent right offs. Dropouts are excessive[13]. The social collateral has produced tension among household members and a new form of dominance over women has escalated violence in the society[14]. Even the loans have been diverted to the people not targeted by the programmes[15] and the very sense of social collateral has been violated by the lenders[16].

Islamic values carry significance in framing organizational and participatory approaches. The concept of unity, as directed through Divine revelation, can be instrumental in gathering momentum for collective action and social transformation[17]. The people desist violating contractual obligations. Such belief is developed in anticipation of better life in another world[18]. Extending a proposal of establishing *Musharakah* for small fishermen in Malaysia, Al-Harran[19] suggests observance of Divine injunctions to induce change in motivation and attitude of stakeholders. Such values are also being considered by globalizing banks in their insight to initiate microfinance[20]. The aforementioned literature prescribes the role of religious values for better achievement, but does not state as to how these values would be integrated in the programmes. The paper as such prescribes the plan of developing Islamic social capital for effective implementation of microfinance.

Microfinance; secular vs. Islamic approaches: Operations of Islamic microfinance are deficient than those of conventional microfinance in many respects: let

---

[12] "World Bank's Social Capital Implementation Framework" can be accessed at: http://web.worldbank.org/wbsite/external/topics/extsocialdevelopment/exttsocialcapital

[13] Kashangaki, J. 1999. p.7 – The study reports that dropouts doubled in only one year, from 1997 to 1998. Most of the dropouts were due to business failure, followed by inconsistent programme policies and indiscipline/loan diversion, reflecting weak interaction and mistrust among MFIs and their clients.

[14] Rahman, A. 1999. p.71-72 - The anthropological research on Grameen Bank points out the hidden transcript of the programme that some women borrowers committed suicide under repayment pressure from peers and loan officers.

[15] Baker, J. L, 2000. p.103-104 - An impact study of flagship programmes (Grameen Bank, BRAC, and BRDB) in Bangladesh concludes loan mistargeting where the programme officers bent the rules in an unobservable way and leaving conflicting conclusions about reducing income and consumption variation between programme participants and non-participants. Rather the impact on education was reverse after correcting for selection bias.

[16] Bastelaer, T.V, 2000 – The paper records that the joint liability and contingent renewals were often enforced imperfectly by lenders, hence damaging the credibility of the system with the borrowers.

[17] Choudhury, M.A2002.

[18] Nienhaus, V. and Brauksiepe, R1997.

[19] Al-Harran, S. 1995.

[20] Ferro, N. 2005. p.1
http://www.feem.it/Feem/Pub/Publications/WPapers/default.htm]

it be the political will, initiative, experience, resources, outreach, product development, commercialization/transformation, moral/religious obligation, etc. The gap is expected to grow further if the situation is not taken up with serious commitment. It also necessitates to check the dangers of interest in the religious forbiddance and to end coercion. Hassan and Alamgir[21] have invited attention to this state of affairs and the comments on the paper point out the marginal impact of conventional microfinance in poverty alleviation, as well as, adverse effects on family system. This particular situation similar to the earlier mentioned hidden transcript calls for the attention of the governments, NGOs, and banks to come forward and save the society from these harms.

Most of the Islamic MFIs follow *Murabaha* or *Bai Muajjal*. The other modes which could build confidence of the poor through risk sharing and business development support are not very common. However, the Sudanese Islamic Bank has successfully implemented *Musharakah* in microfinance[22] suggesting a high degree of trust between MFI and the operating partners and low cost monitoring of the business and profitability. The Hodeihdah Microfinance Program in Yemen[23] applies diminishing *Mudarabah* which transfers ownership through sale of shares out of dividends earned by the clients. The programme could not achieve sustainability as it was suffering from lack of diversity and default problems.

Sustainability: Known generally in financial terms, it in fact covers broader dimensions. The institutional sustainability refers to the programme's endurance when clients perceive the services they receive are of significance and value and are willing to assume responsibility and ownership for them. The financial sustainability[24] implies MFIs ability to cover all of its operating and financial costs adjusted for subsidies and grants, provision for expected default, and an appropriate capitalization rate. Market sustainability addresses meeting various needs of clients by offering them the range of products and services of their choice. Finally, the sustainability of clients is judged from the impact on their living standards and long term and permanent access to the socio economic opportunities.

The financial self sufficiency has been recorded below 100% in case of 38% MFIs in various regions around the world[25]. MFIs in Pakistan exhibit operational and financial self sufficiency as low as 15.4%[26]. MFIs prefer to capture the market share

---

[21] Hassan, M. K. and Alamgir, D.A.H in Iqbal, Munawar (Ed) 2002. The paper states that pattern of microfinance in Bangladesh has allowed *Riba* to penetrate in the whole society and it requires the Islamic NGOs to fulfill their obligation by replacing the current interest based system with the Shariah compliant modes. The comments on the paper point out that women empowerment brought through secular microfinance programmes has infact yielded adverse effects disturbing the family system. Despite wide coverage, the impact on poverty alleviation was stated only marginal. The paper also discovers that some NGOs funded by foreign donors have induced the hardcore poor to convert to Christianity.

[22] Harper, Malcolm (ed)," 1997.

[23] Al-Arhabi, A1998.

[24] Long term delivery of services requires an MFI to achieve financially self-sufficiency more than 100% implying its ability to cover all of its operating costs, financial costs adjusted for subsidies and grants and provision for expected default.

[25] MicroBanking Bulletin. ibid. p.43

[26] "Performance Indicators Report 2005",Pakistan, 2006. p.2

instead of evaluating business productivity and market feasibility. High operating cost covered by high effective interest rates eat up sustainability of borrowers rendering those transitory poor, yet disguisedly managing to sustain the MFIs. Large subsidy indexes have been developed through donor driven practices. Even Grameen bank had to increase interest rate from 20% to 33% per annum in order to eliminate subsidies[27], which definitely would cut into the net return of borrowers, ultimately increasing the rate of default.

Commercialization of microfinance is essential to enhance scale, imparting corporate norms and reaping economies. Therefore, integration of mainstream banking into poverty alleviation effort looks crucial. The banks can either intervene directly or they can use MFIs as intermediaries to facilitate savings mobilization and enhance outreach and sustainability[28].

Conceptual Framework for Social Capital and Islamic Microfinance

Most of the microfinance programmes operate through solidarity groups. Although it is seen as a Grameen invention, but the concept is older than this and was formalized when cooperatives were given legal cover in many counties in 19th and 20th century. By definition, the cooperatives are the corporate bodies based on voluntary associations of people of limited means combined to achieve an improvement in their social and economic conditions through common ownership and democratic management of their wealth[29]. The urban based cooperatives having large membership exercise limited liability whereas village based smaller cooperatives are organized with unlimited liability. The difference between the two liabilities arises obviously owing to the opportunity of participation in the business of cooperative.

Conceptually, the solidarity groups are informal and involuntary associations of the members of the microfinance programmes, serving through joint liability of unlimited nature which works via peer pressure and peer support. Known as social collateral, the liability helps reducing loan transaction and administrative costs by shifting the burden of screening and monitoring to the group. The group serves more than one purpose. Most transactions take place in front of the group and vested interest is kept away. A number of benefits like economic uplift, socio-political empowerment, bargaining capability, human development are spilled over.

Demonstrating high repayments, however, the social collateral do not account for the cost of psychological shocks sustained by the poor clients because of the problem of cultural and religious compatibility. Many from Muslim communities do not benefit because of the interest based transactions. As such, there is need to address this issue. The social capital built up on the injunctions of *Shaiah* is expected to effectively serve the Muslim populations and ensure sustainability of microfinance programmes supported by excellence in quality and commitment of staff of MFIs and their clients. The following Islamic values can become instrumental in organizing coherent actions of all social

[27] Morduch, J. 1999. p.245
[28] Seibel, H. D. 1985. p.4
http://www.uni-koeln.de/ew-fak/aef/PDFnew/S_A05_%20Working%20Paper%20-%20Outreach%20&%20Sustainably.pdf
[29] Awan, I.M.1989, p.2.

agents ie. Clients and their Islamic Microfinance Groups (IMFGs), MFIs and Islamic banks:

i. Solidarity among clients, IMFGs, and MFIs so that each unit represents the whole (Principle of Unity).
ii. Relationship among the group members (trust, joint/unlimited liability, cooperation).
iii. Nature of relation between MFI and IMFG (trust, cooperation).
iv. Motivational force for programmes (*fard al kafayah*, *falah*, *adl* , *Ihsan, and ta'awun* –cooperation).
v. Payment behavior (Necessity of repaymentand prohibition of willful default, respite)
vi. Mutual Responsibility / Risk Sharing (*kafalah, takaful*)
vii. Help for poor and destitude by wealthy (*Zaka*, *Infaq*)

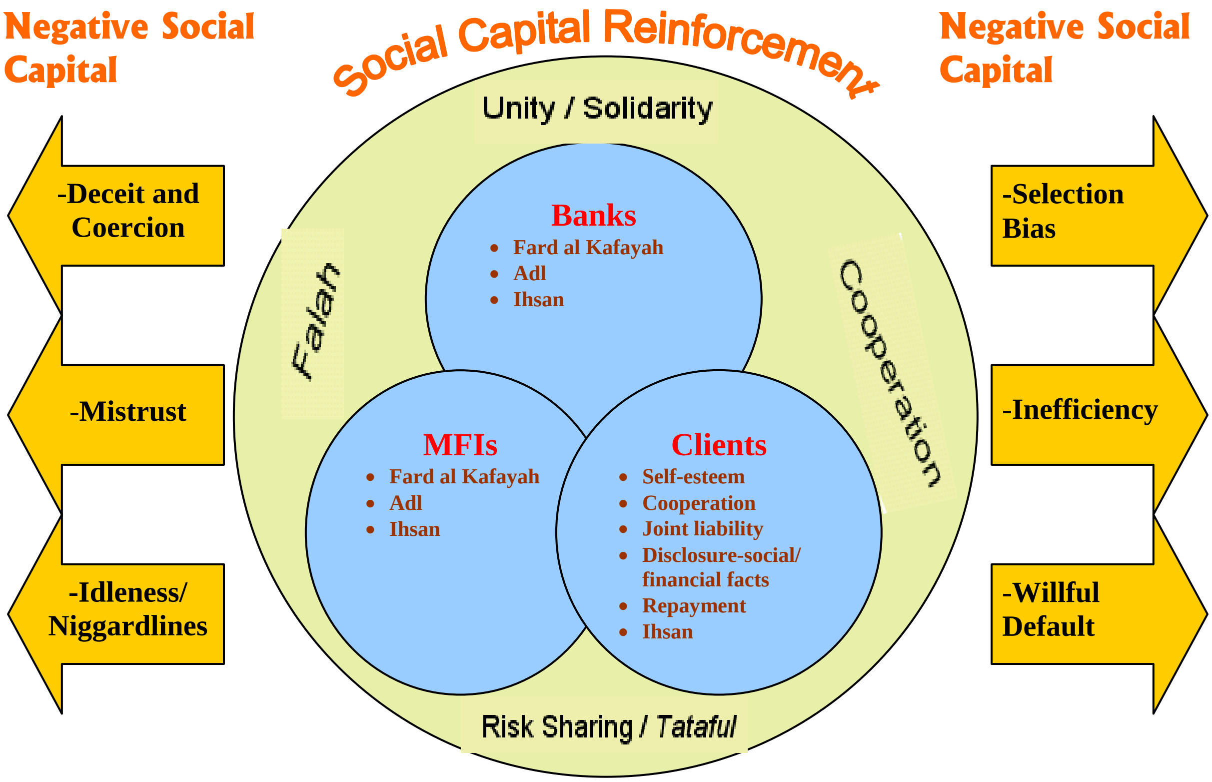
Cooperation is the core of Islamic society which targets human wellbeing. Distributive justice through equality in opportunity and access to material and social resources is the right of every individual. Sharing of one's wealth for the greater cause of community and looking at neighborhood (*adl* and *Ihsan*) are the prime pursuits for Muslim. Whereas self reliance is the key for self esteem, *Fard al Kifayah* calls for social obligation to provide ways and means to help develop the income earning opportunities for destitute who cannot afford at their own. These particular objectives require to develop social capital according to the Islamic principles.

Such social capital can help sustain the microfinance operations by building greater confidence between MFIs and their clients, either in group or individual capacity. The groups should be preferred to intensify the principles of cooperation among the poor. Establishing trust can help access to information disclosure, evaluation of entrepreneurship and feasibility of businesses, thereby excluding selection bias and deceit. The principles of *Fard al Kifayahand Infaq* can help build resources of microfinance programmes, inducing banks, funds, and rich people to share their wealth and expertise with those MFIs who are prepared to follow the Islamic modes in their operations. Peer support can be developed among members of MFIs/groups out of cooperation and unity. Injunctions pertaining to contractual obligations can ensure quality membership and commitment. To meet the damages of clients for reasons beyond their control and consequent loss of MFIs, cooperative insurance (*Takaful*) can be operated by the clients and the MFIs.

The proposed environment of Islamic social capital has been demonstrated in Exhibit-1 showing positive social capital being reinforced among the social agents and negative capital pushed out.

Exhibit-1

Islamic Social Capital Environment



Any Parameter of Islamic Social Capital can be present in respect of more than one social agent. The outer circle reflects the social environment common to all agents while the inner circles reflect the parameters specific to each of them or not common to all. The Negative Social Capital has been arrowed out.

Survey of Small Scale Enterprises Development Programme of Islamic Relief Pakistan:

A survey of clients of the Small Scale Enterprises Development (SSED) Programme of Islamic Relief Pakistan (IRP)[30] was conducted in the month of December 2006 to assess the potential for diversification of products and services and to determine the endowment of social capital based on some of the parameters suggested by World Bank's Social Capital Implementation Framework[31]. SSED is the first Islamic microfinance programme in Pakistan and was chosen on the basis of longest experience

[30] The Islamic Relief, established in UK in 1984, started its operations in Pakistan in 1992 primarily to alleviate poverty and provide resources to the disadvantaged people. The IRP initiated interest free micro credit in urban part of Rawalpindi sub-district in 2001. Recently the program has been extended to earthquake-hit Azad Kashmir and hilly areas of the Frontier Province of Pakistan.
[31] World Bank's Social Capital Implementation Framework, ibid.

of five years as against two other MFIs Akhuat and Human Development Foundation operating for less than one year with very small number of clients. The programme practices *Murabaha* and has served on an average 380 clients per year during the last three years (2004-2006), 83% male and 7% female. The profit is charged at 12% of the cost and *Murabaha* price is repaid in 12 monthly installments. The individuals are financed against personal surety of two people living in the same area. There is no permanent arrangement for Shariah advisory; however the contracts have been approved by a Shariah scholar of Pakistan. The payment rate has ranged from 95% to 97% of the due finance for the last three years and the average portfolio per credit officer per year works to Rs. 752, 997 ($12, 344). The productivity of the credit officer is quite low i.e. 63 active clients per credit officer. The entire financing till to date concentrates on Murabaha.

A random sample of 50 clients (40 male and 10 female) of SSED Programme in Nasirabad area of Rawalpindi sub-district (urban) was selected. An equal number of non-clients (50 respondents) were also randomly selected from operating area of the Programme. The professions of the respondents[32] included petty trades, from selling merchandise to manufacturing and services.

The results of the survey depict that 56% of the interviewed clients were saving on an average of Rs.377 ($6.18) per week, 87% of them were keeping saving at home as they never considered to keep the small amounts in a bank and also that these savings were to be spent soon on their business or other domestic need. The proportion is expected to be higher in case of rural areas. Although most of the client respondents kept their savings at home as they were not aware of the advantage of depositing in a bank. Therefore, saving services matching their saving pattern can improve their investment capacity and provide assurance to meet emergencies. The Murabaha facility ranging from Rs. 8,000 ($131) to 25,000 ($410) could not fulfill the investment needs of clients. Therefore, the additional requirements for expansion of their businesses which could, in their view, bring optimum returns were also assessed. Similarly, the non-client respondents, already in business, were in need of more finance. A comparison of such requirements between client and non-client respondents is given in Table-1:

Table-1: Financial Requirements vide type of requirements

Particulars of requirement	**Proportion of respondents and corresponding demand vide type of requirement**			
	Clients		**Non-Clients**	
	%	**Amount (Rs)**	**%**	**Amount (Rs)**
working capital/raw material	73	10,000 -100,000	70	3,000 - 150,000
furniture and fixture	10	2,000 - 20,000	9	5,000 - 15,000
utilities and rent	20	1,000 -10,000	31	800 - 15,000

[32] The professions included bakery item suppliers, hawkers, tea shops/small restaurant operators, public call office operators, Tailors, auto mechanics, grocery, cloth, and stationery store operators, taxi/rickshaw drivers, fruit sellers, second hand clothes sellers, steel workers, painters, carpenters, weavers, women industrial homes and stitching schools.

sewing and weaving machines	12	4,000 -15,000	22	2,000 - 100,000
used taxi or motorcycle rickshaw	17	75,000 -150,000	24	40,000 - 200,000
renovation of house	7	20,000 -30,000	0	-
consumption	2	2,000	4	3,000 - 20,000

Note: US$ = Pakistani Rs.61. It may be noted that the respondents required financing for more than one purpose, eg. working capital, utilities, rent, furniture and fixture, were demanded together.

As regards willingness to share in the equity of business, 4% clients did not agree while the rest were ready to share equity, reflecting their perception about larger amount of investment and risk sharing[33]. There was ample opportunity to diversify the products. Equity participation in working capital/raw material, utilities, rentals, etc., diminishing *Musharakah* in home financing/machinery and micro *Ijarah* in small transport vehicles (motorcycle rickshaw and used taxi), *Istisna'* in manufacturing, require designing of new products. In case of small farmers, *Salam* can have great utility. These products not only will help diversify the asset base of the program but also work for risk management and economy in transaction cost.

As regards social capital, current endowment was assessed to know the potential for developing it on the Islamic principles. The parameters used for assessment included trust, collective action & cooperation, and social cohesion. Although the programme does not follow the solidarity group approach nor prepares its clients through any formal process, the unconscious preference regarding cooperation and care for others was present. The results in this respect are given in Table-2:

Table-2: Respondents vide Social Value

Social Value	**Determinant**	**Respondents vide social value**	
		Client %	**Non-Client %**
Trust	Most people living in vicinity can be trusted.	86	70
Group Work	Already worked with others in the past 12 months.	73	80
Collective action & cooperation	Up to 4 people would be ready to help in case of sudden need of small amount of money.	68	52
	5 or more people would be ready …..	24	29
	None would be ready …..		
	It would be very likely that people get together to help the grieved at some unfortunate happening	46	51
	It would be very unlikely that people …..	7	0
	It would be somewhat likely to somewhat unlikely that people ….. Or respondents remained neutral.	47	49
Social Cohesion (Closeness among people)	Respondents felt that they were at great distance from each other.	15	21
	Respondents felt that they were very close to each other.	24	33
	Respondents felt that they were from somewhat distant to somewhat close to each other. Or remained neutral.	61	66

Most of the respondents trusted others and had experience of working together for the common cause in their communities. Half or more of them were helpful to each other and expected that other people from the community would come up to help them in case

[33] the team of enumerators explained to the clients the features of Musharakah and Mudarabah

of exigencies. However, different clients brought different view regarding social cohesion. Only about quarter of them felt very close to each other, while about one fifth felt at a great distance.

The conclusion therefore can be drawn that the social capital has already been endowed in these communities. No significant difference could be observed between clients and non-clients as SSED did not work much for social mobilization. The ground being fertile, the need only is to bring these parameters in conformity with the principles of Shariah. The injunctions drawn from *Quraan* and *Sunnah* very clearly require to intensify Islamic values among the stakeholders and strive for exclusion of negative pursuits like deceit, mistrust, coercion, inefficiency and idleness. The analysis requires that groups be preferred for effective development of Islamic social capital. The specific guidelines have been suggested in recommendations.

Recommendations:

There are five types of recommendations offered in the light of above discussions:

A. Integrating Islamic banks with Islamic microfinance-Downscaling of Islamic banks.
B. Strengthening existing MFIs to effectively deliver Shariah compliant Microfinance.
C. Providing risk mitigation through Islamic insurance.
D. Developing social capital to improve the quality and commitment of all Stakeholders.
E. General recommendations.

A. Integrating Islamic banks with Islamic microfinance: There are two alternatives which can ensure sustainable microfinance operations with extended outreach; (i) Islamic banks downscale their operations and provide services directly to the microfinance clients or (ii) Intermediate through MFIs or Microfinance NGOs[34]:

I. Integration of Islamic banks to undertake Islamic microfinance:
The Islamic banks should look at microfinance as both moral obligation and business opportunity. Most of them are characterized by short term liquidity, hence face the problem to fetch long term assets and rely only on limited range of products. Keeping this in view and absence of inter-Islamic bank market, they can diversify their portfolios and invest their resources profitably in microfinance in following ways:

1. **Operation through Islamic Microfinance Division:** Islamic banks can establish Islamic microfinance divisions in Head Office and open dedicated branches or microfinance windows in the existing branch network with control in Head Office. However, it would be appropriate to

[34] Both MFIs and NGOs not recognized to collect and recycle savings are termed as informal institutions although they are registered under certain law of the country allowing them to provide social and financial services.

open separate branch network considering the culture and environment of microfinance business different than of commercial bank, like social mobilization, participatory evaluation of financing request, short maturities and small amount of savings, consumption loans, un-collateralized transactions, etc. Similarly, the manpower trained in these expertise, as well as, business development services is required to be developed/hired. This option will contain following features:

i. The Islamic Microfinance Division (IMFD) will be financed initially by an appropriate amount on the basis of *Mudarabah*. The base of fund will further be strengthened with the savings of microfinance clients. The pool of Islamic bank's fund and savings will create *Musharakah* among the providers of resources. The pool of funds and IMFD will share the profits as per agreed ratio once the operating expense of IMFD is deducted. The part of the profit allocated to the pool will be shared by the Islamic banks and the saving holders. There is no possibility of receiving Musharakah profits by IMFD in addition to service fee as in case of usual Islamic banking operation since their will be no retained earnings kept by IMFD.

ii. The Profit and Loss Account of IMFD will be drawn separately, passing on each time the net profit to the Islamic bank. However, the Balance Sheet of Islamic bank will show the business of its IMFD.

iii. The Islamic bank, if needed, will request the concerned quarters (the government and the central bank) to relax the rules enabling to render services compatible with microfinance environment.

iv. The Islamic banks will utilize their experience of financing *Musharakah*, Diminishing *Musharakah*, *Mudarabah*, *Salam, Istisna*, and *Ijarah* to bring diversification in microfinancial products, affording opportunity of financing capital equipment, which at present is rarely available, exception to a few examples.

v. Shariah Advisors of Islamic bank can serve two purposes; helping to develop microfinance products/contracts and services and building Shariah compliant social capital/collateral in social mobilization. They will also be responsible for Shariah audit of IMFD. Shariah advisory, the most important aspect, is completely missing in case of most of Islamic MFIs at present.

vi. Islamic banks can even cross subsidize microfinance operations with the mainstream business either by agreeing on smaller proportion in profits or by returning part of their profit to IMFD under the principle of *Hibbah*, whose benefit passes on to the clients.

2. Creation of Microfinance Subsidiaries of Islamic banks: In case the Islamic banks do not want to involve directly in microfinance, they can establish Microfinance Subsidiaries. The subsidiary will have advantages which the banking norms and regulations usually do not permit. It will be in a position to undertake trade, arrange supplies and provide marketing facility. It will have the following features:

i. Islamic bank will provide capital to the subsidiary. If the capital meets the requirement of the regulating authority (ie. The central bank), the subsidiary will have the advantage of being regulated by the central bank and achieve the status of formal MFI eligible to collect and use savings (Pakistan's Law: Microfinance Institutions Ordinance 2001 refers).

ii. It may have the departments which the Islamic banks may not be allowed to keep. The following departments are suggested to be the part of the subsidiary:

- **Supplies and Marketing Department** will arrange acquisition of raw material/inputs, merchandise, technical services, etc. and arrange for procurement and marketing of produce.
- **Training and Business Development Department** will train the manpower of subsidiary in developing social capital amoung the clients and provide support in their business development.
- **Shariah Advisory and Social Mobilization Department** will perform the most important function and develop Shariah compliant products and parameters on which the social capital will be built up.
- **Microfinance Operations Department** will manage all the micro financial services; financing, savings, insurance, and payment services.

iii. Till the time the subsidiary has not achieved the status of a formal MFI, it will channel savings to the parent company or hold/invest on behalf of the parent company, subject to the laws of the respective country.

B. Strengthening existing structure of NGOs/MFIs to effectively deliver microfinancial services in Shariah compliant manner:

i. As another alternative, Islamic banks can opt a business approach of equity financing of the Islamic NGOs/MFIs, which would strengthen the equity base of NGOs/MFIs and provide leverage to the internal resources. Banks can also purchase equity in those MFIs which intend converting to Islamic Framework.

ii. The equity providing banks will have the opportunity of supervising the operations of MFIs, ensuring better utilization of funds, introducing the norms of corporate governance, and sharing the results of MFI business on the basis of *Musharakah*.

iii. The limitation of using savings can be removed by directing these savings towards participating Islamic banks through their branches operating in the area of MFI. The alternative can also help upscale NGOs/MFIs into formal institutions by proving minimum capital required for this purpose, enabling them to carry the benefits of central bank supervision, building confidence of the clients and equity providers, as well as empowering to collect savings and use them as sustainable resource.

iv. The services of Islamic bank's Shariah advisors will be available to such MFIs to save on cost on the one hand and providing support in development of products and services on the other.

C. Risk Mitigation through Islamic Insurance (Takaful):

Waqf model is being suggested to provide life and general insurance to the clients and their businesses. Main parameters are given below while the modalities can be worked out.

I. General insurance:

i. MFI creates Waqf fund and manages the fund on Wakalah basis.
ii. Policy holders (clients) contribute premium to the Waqf fund.
iii. MFI invests Waqf fund in different avenues as Mudarib.
iv. The profits of Mudarabah business are shared by the MFI and the Waqf fund in pre-determined ratio.
v. Waqf fund, after deducting compensations, receives the remaining profit and continue to grow.
vi. The Shariah scholars may decide if a part of the profits is to be paid to the policy holders.
vii. MFI, after deducting its management cost, distributes the balance of profit amoung shareholders.
viii. The compensations are paid according to the value of the asset developed out of the MFI financing and the equity (if any) of the client.

II. Life insurance:

i. The Waqf model is followed, with the following change.
ii. Two funds are developed instead of one; ie. The Waqf fund and the Investment fund.
iii. The premium of policy holders is contributed in each of the two funds; the larger proportion in Waqf fund and smaller proportion in investment fund, based on actuarial calculation.
iv. The compensation is paid in case of physical disability and the loss of life. The compensation should necessarily compensate the financial obligation towards MFI and expenses towards medical treatment/ funeral etc.
v. The profits on account of investment funds are paid to the policy holders.
vi. The MFI gets pre-determined share in profit from both funds as Mudarib.
vii. The other income of MFI will be on account of Wakalah.

D. Development of Social Capital:

i. The social capital environment, as given in Exhibit-1 suggests reinforcement of Islamic values to bring excellence in quality and commitment of all stakeholders, ensuring sustainability.

ii. Well trained and dedicated manpower is required for social mobilization.
iii. The framework of social mobilization in respect of scheduling and training/orientation of MFI staff and clients is given in Exhibits-2&3, covering necessary modules. The staff would be trained in modules given in Exhibit-2 regarding philosophy of Islamic finance, product and services, book keeping, and monitoring. Formation of IMFGs will be carried out through modules given in Exhibit-3 regarding area selection, sensitization, client assessment, accreditation, registration, and initial financing.

E. General Recommendations:

i. Range of products need to be expanded to fulfill diversified requirements of the clients. The MFIs need necessarily to introduce financing of capital investment of the micro enterprises.
ii. The MFIs have to leave the minimalist approach and focus the integrated approach by instituting Islamic injunctions in their programmes through building Islamic social capital and providing business development support as part and parcel of financial services.
iii. Zakat fund and various kinds of donations should be available to MFIs to strengthen their financial base.
iv. Above all, the public policy declaration carrying political commitment is needed.

Conclusions:

It can be concluded that both conventional and Islamic MFIs suffer from resource and outreach constraints which restrict sustainable operations, Islamic MFIs even at greater disadvantage. The commercial banks, particularly, the Islamic banks on whose shoulders the responsibility lays the most, have not considered microfinance a viable business opportunity. Piecemeal and individual efforts; based on low capitalization, product concentration, and absence of *Shariah* advisory, to introduce Islamic microfinance suggest for effective coordination and public policy perception. Developing Islamic social capital to fetch excellence in quality and commitment can provide the prime force for coordinated action. However, Mainstreaming and commercial approach can bring the actual difference.

References:

Al-Arhabi, A., “Approach of Micro-Credit and Income-Generating Projects Financed by the Social Fund for Development in Yemen”, Social Fund for Development, San’aa, Yemen, Paper presented at Economic Development And Poverty Reduction Workshop, Mediterranean Development Forum, September 3 - 6, 1998, Marrakech, Morocco.

Al-Harran, S., “Proposal for an integrated marketing model of Musharakah financing to help disadvantaged fishing people in Malaysia”, a paper presented at workshop jointly organized by Cranfield University, School of Management, The Enterprise Development Centre, England, and the Arab Foundation for Enterprise Development, Cairo, July 10-13, 1995.

Awan, I. M., “The Manual of Cooperative Societies Laws” Mansoor Book House, Lahore, Pakistan, 1989.

Baker, J. L, “Evaluating the Impact of Development Projects on Poverty-A Handbook of Practitioners”, The World Bank, Washington DC., 2000.

Bastelaer, T. V., “Does Social Capital Facilitate the Poor’s Access to Credit? A Review of the Microeconomic Literature”, Social Capital Initiative Working Paper No. 8, The World Bank Social Development Department, Washington, USA.

Choudhury, M. A., “Microenterprise Development Using Islamic Financing and Organizational Instruments; Modality and Practicum”, International Journal of Social Economics, 29(1/2)119, 2002.

Din, B., Ibrahim, A, and Vijaykumar, K. C., “Some Aspects of Liquidity in Islamic Banks (ISBS)-A Case Study of Selected Banks in the MENA Region”, Research Report No. 0422, ERF Research Project, Economic Research Forum, Cairo, Egypt.

Ferro, N., “Value Through Diversity: Microfinance and Islamic Finance and Global Banking”, The Fondazione Eni EnricoMatteiNote di LavoroSeriesIndfex: Milano, Italy, 2005. http://www.feem.it/Feem/Pub/Publications/WPapers/default.htm

Harper, M. (ed),”Partnership Financing For Small Enterprise-Some lessons from Islamic Credit System”, Papers presented at the meeting jointly organized by Arab Foundation for Enterprise Development Cairo, and Small Enterprise Development Centre of the Cranfield University, England, Intermediate Technology Publications, London, 1997.

Hashemi, S, and Rosenberg, R. ”Graduating the poorest into Microfinance: Linking Safety Nets and Financial Services”, Focus Note No. 34, February 2006, The Consultative Group to Assist the Poor, Washington DC, USA.

Hassan, M. K and Alamgir, D.A.H., ”Microfinancial Services and Poverty Alleviation in Bangladesh: a Comparative Analysis of Secular and Islamic NGOs”, in Iqbal, Munawar (Ed), “Islamic Economic Institutions and the Elimination of Poverty”, The Islamic foundation, Leicester, UK, 2002.

http://www.uni-koeln.de/ew- fak/aef/PDFnew/S_A05_%20Working%20Paper%20-%20Outreach%20&%20Sustainably.pdf

Islamic Development Bank, “IDB Annual Report 1426H (2005-2006)”, Jeddah, S. Arabia, 2006.

Kashangaki, J., “Dropouts Amoung Kenyan Microfinance Institutions”, MicroSave-Africa-Centre for Microfinance, Kampala, Uganda, 1999.

MIeX, “MicroBanking Bulletin”, Issue No. 13-Autumn, Microfinance Information Exchange, Inc., Washington, DC, USA, 2006. www.mixmbb.org

Morduch, J., “The Role of Subsidies in Microfinance: Evidence from the Grameen Bank”, Journal of Development Economics, Vol. 60, 1999, Princeton University, Princeton, NJ, USA.

Nienhaus, V. and Brauksiepe, R., “Explaining the Success of Community and Informal Economies-Shared Altruistic Values or Effective Social Control?”, International Journal of Social Economics, Vol. 24, No. 14, MBC University Press, Birmingham, Al, USA, 1997.

PMN, “Performance Indicators Report 2005”,Pakistan Microfinance Network, Islamabad, Pakistan, 2006.

Prescot, E.S. “Group handing and Financial Intermediation: An Example”, Federal Reserve Bank of Richmond Economic Quarterly, Vol.83/4 Fall 1997, USA

Rahman, A., “Micro Credit Initiatives for Equitable and Sustainable Development: Who Pays?”, World Development, Volume 27, No.1, 1999.

Salih, S. A., “The Challenges of Poverty Alleviation in IDB Member Countries”, Islamic Development Bank, Jeddah, 1999, quoting Al-Abdin, A.Z. (1997).

Seibel, H.D., “Saving for Development - A Linkage Model for Informal and Formal Financial Markets - Outreach and Sustainability of Rural Microfinance in Asia: Observations and Recommendations”, University of Cologne Development Research Center, appeared in Quarterly Journal of International Agriculture, Vol. 24, No. 4, Oct. - Dec. 1985.

Talal, B. “Microfinance Offers the Poor a Way Out of Poverty”, International Fund for Agricultural Development (IFAD) http://www.ifad.org/events/yom/basma.htm

The World Bank, “World Development Report 2006”, Oxford University Press, New York NY, USA, 2006

UNCDF, “Basic Facts About Microfinance”, United Nations Capital Development Fund, New York, NY, USA, http://www.uncdf.org/english/microfinance/facts.php

UNDP, “Human Development Report 2006”, Palgrave Macmillan, New York, NY, USA, 2006

United Nations Human Settlements Programme (Un-Habitat), “Islamic Credit and Microfinance: Islam, Land & Property Research Series Paper 8”, UN-HABITAT, Nairobi, Kenya, 2005.

World Bank’s Social Capital Implementation Framework, http://web.worldbank.org/wbsite/external/topics/extsocialdevelopment/exttsocialcapital

Yunus, M., “Expanding Microcredit Outreach to Reach: The Millennium Development Goal - Some Issues for Attention”, Palli Karma-Sahayak Foundation, Dhaka, Bangladesh, 2003.

Exhibit-2

Process Flow-Development of Cadre of MFI Staff

Developing Cadre of MFI Staff

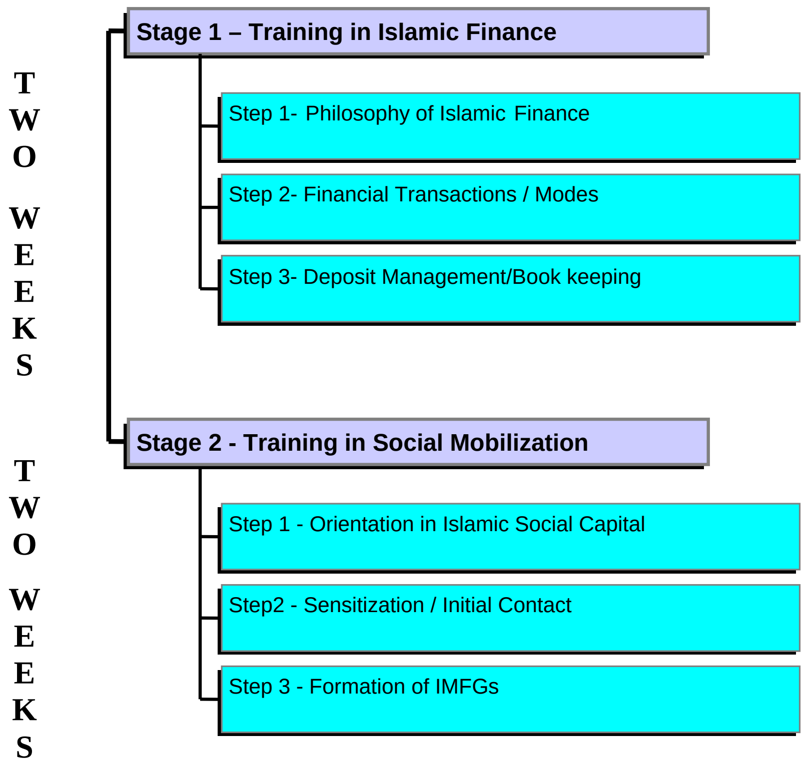


Exhibit-3

Process Flow-Development of Islamic Social Capital

Formation of IMFG

TWO WEEKS

- **Stage 1 – Initiating Social Mobilization**
  - Step 1-Area mapping and Zoning
  - Step 2- Area Coordination, Consultation & Promotion
  - Step 3- Conduct of prospective Client Evaluation through client assessment forms
  - Step 4- Consolidation & Analysis of Evaluation Results

ONE WEEK

- **Stage 2 - IMFG Training and Formation**
  - Step 1 - Conduct of Orientation Training on parameters of Islamic Social Capital
  - Step2 - Conduct of oral IMFG Qualification Test to become quality and committed member
  - Step 3 - Registration of members, IMFG Formation and creation of bond etc.

TWO WEEKS

- **Stage 3 - Financing and Monitoring**
  - Step 1 - Finance Application, evaluation, Sanction, Release and Utilization
  - Step 2 - Monitoring of IMFG Operations
  - Step 3 – Realization of receivables, distribution of profits/sharing of losses
  - Step 4 – Redemption and next cycle of financing where applicable