Managing microfinance

The present situation of the Islamic microfinance industry highlights some of the challenges that have created a gap between demand and supply, writes **Alberto Brugnoni**

IN ALL Muslim countries, Islamic microfinance accounts for a very small portion of the country's total microfinance outreach, never exceeding 3% of the outstanding loans. Conventional microfinance products command in the same countries a market share of around 44%.

Of the conservatively estimated 77 million microcredit clients worldwide, only 380,000 adhere to Islamic microfinance—300,000 are reached by 126 institutions operating in 14 countries and 80,000 by a network of Indonesian cooperatives. Its supply is concentrated within a few players, with Indonesia, Bangladesh and Afghanistan accounting for 80% of global outreach. In all other countries, Islamic microfinance is still in its infancy. No scalable institutions are reaching clients on a regional and national level. The average outreach of the 126 institutions is 2,400 clients—none has more than 50,000 clients and the average Islamic micro loan is similar to a conventional micro loan.

Efficiency lags behind its conventional cousin. A loan-to-deposit ratio of more than 110% indicates the need to improve the deposit-gathering process. The average operational efficiency ratio at 20% compares with the more affordable 15% of conventional Asian institutions and shows the need to work on the average loan size, cost structure and staff productivity.

The average portfolio at risk at 30 days of approximately 9% is well above the 5% as reported by the 1,200 conventional microfinance institutions surveyed by the Microfinance Information Exchange. This lack of efficiency translates into an average return on assets at 1.5%—below the 2.2% of conventional institutions.

In spite of this low penetration and efficiency, studies suggest that a sizeable pent-up demand for Shariah-compliant microfinance products does exist. In Jordan, 25% and 32% respectively of those interviewed by USAID (2002) and IFC/FINCA (2006) cited religious reasons for not seeking conventional loans.

In Algeria, a 2006 study conducted by the Frankfurt School of Finance and Management revealed that 21% of microenterprise owners did not apply for loans, primarily because of religious reasons. In Yemen, an estimated 40% of the poor demanded Islamic financial services, regardless of price. In Syria, an International Finance Corporation (2007) survey revealed that 43% of respondents considered religious reasons to be the largest obstacle to obtaining microcredit.

In the West Bank and Gaza, more than 60% of low-income respondents to a survey conducted by Planet Finance (2007) claimed a preference for Islamic products over conventional products. A 2000 Bank Indonesia report indicated that 49% of the rural population of East Java considers interest prohibited and would prefer to bank with Shariah-compliant financial institutions.

Business model

To take advantage of this opportunity, expand access to finance throughout the Muslim world and ease financial exclusion exacerbated by the abhorrence to interest-based products, Islamic microfinance needs to develop an original business model based on its

authentic principles of equity financing. Islamic microfinance also needs to adopt a performance-minded culture with a clear separation between the roles of donors and capital providers and introduce proper risk management techniques and benchmarking methodologies.

The industry still lacks product diversification to serve the financial needs of the microentrepreneur. Access, rather than cost, should be the main focus in designing and implementing an Islamic microfinance programme. The definition of microfinance needs to broaden from microcredit to the provision of a variety of financial services, such as savings, insurance and remittance.

Equity-based products through *musharakah* are unique to Islamic microfinance and may account for its superiority over conventional microfinance on the grounds of ethics, efficiency and resiliency of the cost of capital. But the present Islamic microfinance industry mimics the conventional version and relies—for more than 70% of its products offering—on asset financing through Shariah-compliant debt (*murabahah*).

Although the creation of debt does not require the client to maintain written records and reduce the opportunity for abuse through inaccurate record-keeping, the implementation of *murabahah* is costly. The checks and balances of adequate documentation showing ownership and constructive possession are extremely difficult, as microfinance involves the disbursement of small amounts in large frequencies. The costs associated with purchasing, maintaining, selling or leasing a commodity are also expensive and are often passed on to clients.

Another problem associated with debt-financing involves the possibility of wilful default by clients, because Islamic modes do not admit the possibility to sanction this behaviour with payments in excess of the original amount of debt. A growing number of Shariah scholars do not approve of it—especially in the *tawarruq* structure—on the basis that it is merely disguised lending, where the participants have no interest in acquiring the underlying commodities. This particularly applies to providing microfinance to start-ups and small companies whose businesses do not involve the sale and purchase of commodities and do not have sufficient surplus funds to be credibly investing in commodities.

Criticism

If, in spite of all these shortcomings, the Islamic microfinance industry still focuses on debt-financing. It exposes itself to the criticism that *murabahah* products are offered with the sole intent of disguising interest as a cost mark-up or administration fee and that Islamic finance is simply a rebranding of conventional finance and not truly reflective of Islamic principles. Consequently, low-income populations, which often rely on financially uneducated local religious leaders to address questions of religion, will tend to shy away from Islamic microfinancial products.

As for *musharakah*, agency problems with prof-

it-loss-sharing are cited as the key reason behind the preference for debt-based products. Reporting and transparency requirements surrounding the profit-loss-sharing mechanisms need long-term involvement by microfinance institutions in the form of technical and business assistance.

This in turn raises the cost of implementation and can result—at least at the beginning—in substantial operating burdens and costs on small enterprises unaccustomed to formal accounting. The uncertainty about profits is a major drawback of profit-loss-sharing models.

To address these issues, a group financing methodology can be used to fix the principal-agent problem. Each member monitors other members' businesses and the profit reporting and profit-sharing payments are made available to the other group members—the latter may then report them to the microfinance institution if they systematically understate profits.

Performance-minded culture

In contrast with its conventional cousin, Islamic microfinance is permeated by a not-for-profit culture that relies on donor funds and focuses mainly on social goals. In Asia, non-government organisations are the dominant players, with 14 institutions reaching 42% of clients and just two commercial banks reaching 29% (Yemen's Tadhamon Islamic Bank and Bangladesh's Islamic Bank Bangladesh).

In the Gulf, donor institutions are the key players. The Arab Fund for Economic and Social Development, a US$2bn fund, includes a microfinance programme. The Arab Gulf Fund for United Nations Development Organisations supports the establishment of banks for the poor across several Arab countries, including the Republic of Yemen, Jordan and Lebanon.

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In Saudi Arabia, the Abdul Latif Jameel Community Service Programme aims, through an interest-free loans micro-retail strategy, to empower low-income women. Its Bab Rizq Jameel Centre focuses on job creation and offers interest-free loans to owners of new or existing projects of a service, industrial or production nature.

Commercial banks are now timidly downscaling and offering Islamic microfinance services. The Saudi Credit Bank extends interest-free loans for marriage, home repair, vocational pursuits and other social endeavours, including family loans. The most well-known venture is the Noor Islamic Bank and Emirates Post Holding Group plan, with aims to establish a company providing an array of Islamic microfinance products, including microcredit and insurance, to the low income and unbanked segment of the UAE population.

To expand and be sustainable, the industry should shift from a charity-based donor-dependent approach to one that reflects the mechanics of the free market. It should emphasise systemic efficiency and transparency and restrict the use of donor funds to capacity building, the key bottleneck being the shortage of strong institutions and managers. Donor subsidies should be temporary start-up supports designed to get an institution to the point where it can tap private funding sources. They should complement private capital, not compete with it.

Capacity building is needed at all levels to realise the full potential of Islamic microfinance. At the macro level, the Islamic Development Bank and Islamic financial standard setters, such as IFSB and AAOIFI, should consider developing global financial reporting standards adapted to microfinance to build the infrastructure for transparency in the global Islamic microfinance sector. This infrastructure would entail comprehensive disclosure guidelines on Islamic microfinance accounting principles, pricing methodologies, financial audits and, eventually, rating services.

At the micro and institutional levels, international donor agencies can play a major role by helping existing institutions reach scale, and funding pilot projects testing various business models.

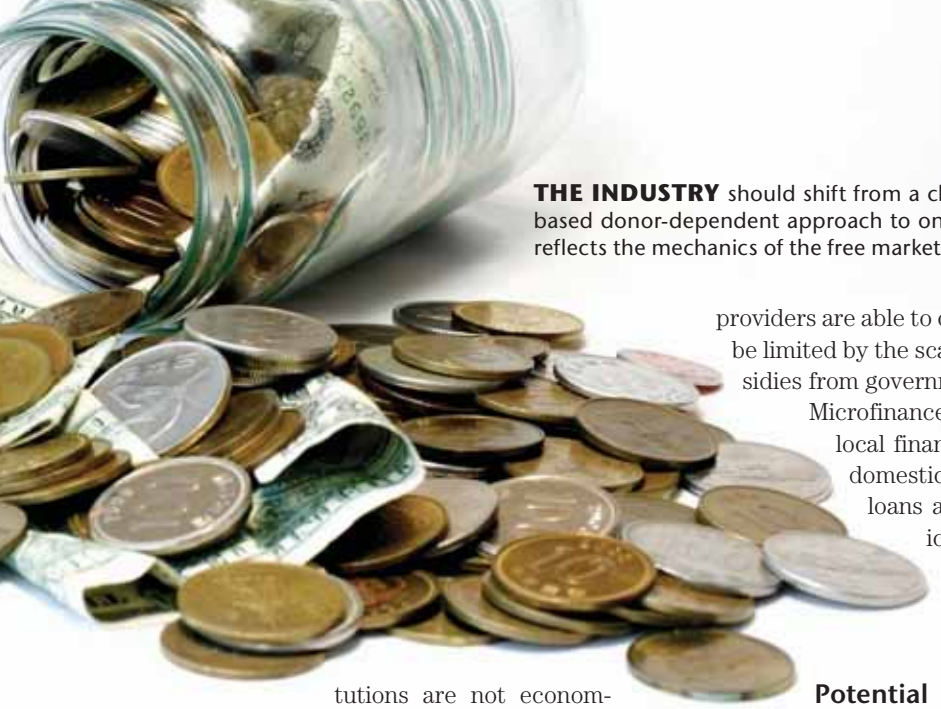
More effort should be made to train Islamic microfinance institutions managers and staff through, for example, the development of operational tools and manuals such as those developed by Deutsche Gesellschaft für Technische Zusammenarbeit for use in Indonesia. Governments should set a supporting policy environment and legal and regulatory framework to enable financial services.

As for private funding, this should finance Islamic microfinance initially as an alternative business model in which participants might like to engage, and subsequently as an alternative asset class in which participants might like to invest.

Sources

But where does one find the necessary funds? The UN Capital Development Fund estimates that there is potential for seven million borrowers and 19 million savers. It appears that the availability of microsavings products may be more important than microfinancing.

The lack of fund mobilisation and high administrative cost means that most Islamic microfinance insti-



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tutions are not economically viable and their growth and sustainability largely depend on the availability of external funds and efficiency of operations. External funds are needed, particularly during the initial stages of operation—members' savings are small but as savings of beneficiaries accumulate and get recycled, the dependence on external funds should reduce.

Risk management techniques

This for-profit approach should help to address the issues related to the implementation of *musharakah* and enable the industry to provide affordable financial services in a cost-effective manner with the introduction of risk management techniques.

As the conventional microfinance industry has developed a set of good practices to manage credit risk and boasts an excellent portfolio quality, Islamic microfinance should take peer pressure and strict discipline into account for collection in accordance with principles embedded in Islam. For example, pressure from the religious community and appeals to a sense of religious duty should complement reliance on peer pressure. A number of ready instruments in Shariah are available to address extra-financial issues.

One example is the *kafalah,* where the group members are guarantors for repayment. Members in the group can agree to help each other in case any are unable to pay the instalment. One way to do this is to provide *qard-hasan* (interest-free loans) to the person facing problems in paying the instalments. The Islamic social development programme builds the social capital, such as a feeling of brotherhood and comradeship and obligation to repay debt, which helps the regular repayment of instalments.

This approach will foster the establishment of benchmarks with Islamic microfinance institutions, producing accurate and comparable reporting on financial performance (for example, loan repayment and cost recovery) as well as social performance, such as number and poverty level of clients being served.

Reporting not only helps stakeholders judge costs and benefits but also improves performance. Islamic microfinance can pay for itself, and must do so if it is to reach large numbers of people. Unless microfinance providers are able to cover their costs, they will always be limited by the scarce and uncertain supply of subsidies from governments and donors.

Microfinance is about building permanent local financial institutions that can attract domestic deposits, recycle them into loans and provide other financial services. Inclusiveness and integration of Islamic microfinance with the Islamic financial system is required.

Potential

The emergence of microfinance—conventional and Islamic alike—is a testimony to the fact that all is not well with our world. There are a number of known and unknown lacunas with prevailing systems of commercial banking, financing and resource allocation. Among the known lacunas, there are problems of adverse selection and moral hazards like interest rates.

As for conventional microfinance, it is already structurally aligned to applying Islamic equity financing structures. Microfinance programmes are based on group sharing of risk and personal guarantee, while maintenance of trust and honesty is tied to the availability of future funds. This should allow for the inclusion of a *musharakah*-based model or at least a model of collective guarantee.

Microfinance institutions looking to implement Islamic finance in their programmes can develop *mudarabah*-based programmes. Microfinance institutions can find Islamic finance a natural fit in their programmes—both debt and equity-based.

Interest rates—high or low—are rejected by Muslims as tantamount to *riba*—something that is prohibited in no uncertain terms by Shariah. Islamic microfinance has the potential to respond not only to unmet demand but also to combine the Islamic social principle of caring for the less fortunate with microfinance's power to provide financial access to the poor.

Microfinance and Islamic finance have much in common. Both emphasise the good of society as a whole. Both advocate entrepreneurship and risk sharing and believe that the poor should take part in such activities. Both focus on developmental and social goals and advocate financial inclusion and both involve participation by the poor.

Unlocking this potential could be the key to providing financial access to millions of poor Muslims who currently reject microfinance products that do not comply with Islamic law. It has been estimated that it would require only US$21bn to provide microfinance facilities to the world's poorest 100 million families. ■

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