TOWARD INCLUSIVE ISLAMIC FINANCE

Insights from GIZ

On behalf of

Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH

Federal Ministry for Economic Cooperation and Development

Published by
Deutsche Gesellschaft für
Internationale Zusammenarbeit (GIZ) GmbH

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Layout: Elena Panizza

Supported by: MINO Sector Network

Printed and distributed by: Digitaldruckerei Top Kopie
Printed on 100% recycled paper, certified to FSC standards

Eschborn, June 2014

FOREWORD

The revolution of Islamic Microfinance is pending. In recent years, the discussion on Microfinance has made significant leaps. Following the 2007 crisis, the industry has reflected on potential areas of poverty reduction and employment creation, the importance of its double bottom line of profit and social impact and, by extension, the need of putting consumer protection principles at the center of attention. The shift from quantity towards quality in supplying access to financial services is vital, especially given the significant proportion of people left without access to finance who will need to be taken into consideration.

How Islamic Finance can play a part in this change remains unclear. The demand for Islamic financial services is manifold. Its demands call for a general wider range of products, for products suitable for start-up finance on a micro-level, for higher levels of transparency and last but not least the demand for products which are in line with the 'clients' religious beliefs', conviction. Despite this increasing interest, this part of the industry has been largely neglected both academically and in practice until 2004 when the first research papers emerged and international cooperation projects entered existing, emotionally driven discussions.

This discussion paper aims to summarize the experiences and lessons learned by Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH and other international organizations over the past 10 years. It identifies hindrances, dares to look forward and, in addition, suggests interventions for much needed support in order for the revolution to finally take off. Targeting colleagues from donor organizations and implementing agencies as well as Government and Non-Government organizations, it provides a basic understanding of the principles and products available.

Finally, this paper outlines the obstacles regarding further development and details some successful cases. This paper also attempts to show how Islamic Microfinance and conventional microfinance overlap. This paper is not, however, based on any professional evaluation, and provides the view of GIZ only; even though several up-front interviews with leading experts of the industry have influenced the outcome.

The authors are grateful to colleagues from CGAP, the Islamic Development Bank, the Islamic Financial Services Board, the KfW, Finance in Motion, USAID, Bank Indonesia and Bank of Pakistan, and the many freelancers and GIZ colleagues for the input and feedback they have provided.

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ABBREVIATIONS

AAOIFI	*Accounting and Auditing Organisation for Islamic Financial Institutions*
BCE	*Before Common Era*
BMZ	*German Federal Ministry for Economic Cooperation and Development*
CAGR	*Compound Annual Growth Rate*
CAR	*Capital Adequacy Ratio*
CGAP	*Consultative Group to Assist the Poor*
GCC	*Gulf Cooperation Council*
GIZ	*Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH*
IDB	*Islamic Development Bank*
IFSB	*Islamic Financial Services Board*
KfW	*formerly KfW Bankengruppe*
MFI	*Microfinance Institution*
MSME	*Micro, Small and Medium sized Enterprises*
NABARD	*National Bank for Agriculture and Rural Development*
NBKR	*National Bank of the Kyrgyz Republic*
PSBC	*Postal Savings Bank of China*
PPP	*Public Private Partnership*
SAB	*Sharia Advisory Board*
SFD	*Social Fund for Development*
TA	*Technical Assistance*
UAE	*United Arab Emirates*
UK	*United Kingdom*

ISLAMIC TERMS

Arabic Term	*Description*
Gharar	*Any element of uncertainty in any business or a contract which is otherwise preventable or avoidable. Does not apply to business risk.*
Halal	*Permissible*
Haram	*Prohibited*
Ijara	*Leasing*
Istisna	*Commission to manufacture*
Mudaraba	*Silent Partnership, equity financing*
Murabaha	*Cost plus sale, or trade credit*
Musharaka	*Partnership or venture capital*
Qard hassanah	*(Benevolent) Loan*
Riba	*Interest*
Riba al-Fadl	*Excess compensation without any consideration, (e.g. Monies passing between the parties) resulting from an exchange of sale of goods.*
Riba al-Naseeyah	*Excess resulting from predetermined interest in which a lender receives over and above the principal amount it has lent out. Primary form of riba. It is the addition of a premium paid to the lender in return for waiting for his money (Time value of Money).*
Sadaqat	*Voluntary charitable contribution, guided by the goodwill of the donor.*
Salam	*Forward Contract*
Sarf	*Currency Exchange*
Sharia	*Ethical framework of Islam, often referred to as Islamic Law*
Sukuk	*Plural of Sakk. Represents a partial ownership in assets. Sukuk are technically neither shares nor bonds but have characteristics of both. Profit is based on the performance of the underlying assets or projects.*
Tabarru	*Voluntary donation*
Takaful	*Islamic insurance comparable to mutual insurance.*
Wa'd	*Promise*
Wakala	*Agency contract*
Zakat	*Obligatory donation to charity for those who can afford it. Calculated as 2.5% of wealth when based on a lunar calendar year, 2.5775% for a solar calendar year.*

Executive Summary

An estimated 2.5 billion people, which is more than half of the world's adult population, does not have access to formal financial services which is due in part to lack of collateral and credit history. Access to finance and financial stability is important for economic development and poverty reduction. In this context, the ability to offer poor households access to financial services that are in line with their abilities and convictions is critical. The global Islamic financial market has seen significant growth in the past few decades, mainly in the increase of retail and investment banking. In addition, micro-finance clients have also started to show significant interest in Islamic financial services. The perceived demand, however, has not yet been fully materialised. The reason for this is highly associated with the additional operational cost involved, with the different product structures, additional financial skills (including financial literacy), and the cost related to achieving and maintaining compliance with Islamic Law (Sharia).

The principles of Sharia in relation to finance are similar to its ethical and social responsibilities with the exception of the prohibition of interest which is a central tenet in Islam. Although interest is prohibited, the creation of wealth through means of trade or investment is permitted. As a result, the structures of financial products differ between Islamic and conventional finance. The transaction types that are most currently used, murabaha and, to a much lesser extent, musharaka, are however not wholly suitable for the purpose as they do not fully reflect client requirements. In order to enhance the industry, a number of areas needing immediate attention have been identified and can be summarised as follows:

Identified Needs For Action

- Regulatory Environment – *Development and enhancement of regulatory frameworks and centralised Sharia Boards is critical in the administering of Islamic microfinance (be consistent either micro finance or microfinance), but should not hinder innovation and should leave room for self-regulation.*

- Standardisation of transactions – *In order to enhance transparency and efficiency, reduce cost and provide investment security, standardisation of the Islamic financial services, is of utmost importance.*

- Capacity Building – *Additional skills, including financial and entrepreneurial know how and financial literacy training are important for the development of the sector.*

- Product Development – *Currently the products supplied are typically an adaptation of conventional products and generally limited to murabaha and, to a much lesser extent, musharaka, which keeps the potential of the industry confined. Demand driven innovation is limited and the supply is generally donor driven.*

For each of these areas, GIZ has identified the main challenges and the essential subsequent steps which involve a multilevel approach targeting law makers, regulators, the infrastructure of financial markets, local financial institutions, and consumers to ensure outreach to the poor and enhance financial inclusion.

MISSION

"Similar to other microfinance clients, many poor Muslim households often do not have access to financial services due to lack of collateral and credit history. Although some may have access to conventional microfinance solutions, many of these clients would prefer the opportunity to undertake their financing in line with their belief system. Any basic discussion on financial inclusion should, therefore, include the development of products that are not in contradiction with fundamental values. However, standardisation on the one hand and innovation on the other are the bottlenecks to make those products an interesting alternative to Muslims and, possibly Non-Muslims alike."

Wolfgang Buecker, Head of Competence Center Financial Systems Development, GIZ

FINANCIAL INCLUSION

Evidence shows that access to financial services including loans, current and savings accounts, and insurance, plays a crucial role in enabling households with a low income to enhance their circumstances by investing in, among others, education, homes, and small businesses. In addition, this allows them to withstand the impact of economic shocks, irregular cash flows, and seasonal variations in income levels. Nevertheless, an estimated 2.5 billion people – or more than half the world's adult population — do not have access to formal financial services, resulting in significant potential for economic and social development. Financial stability is important for economic development, but equally has a significant role in poverty reduction. One of the side effects of the recent financial and economic crisis has been a renewed focus on financial stability and customer protection. In its proposals for financial sector reform, the G-20 has emphasized that access to finance and financial stability go hand in hand.

2.1 GIZ and Financial Inclusion

Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH is a strong proponent of financial inclusion and has a long tradition of actively promoting the provision of a full range of financial services to low-income households as well as to the enhancement of the regulatory framework.

Working on behalf of the German Federal Ministry for Economic Cooperation and Development (BMZ), GIZ, by means of their financial systems development competence centre, is currently active with 52 projects in more than 30 countries. They provide support in this field by advising policy makers, central banks, regulators, microfinance associations and a wide range of other financial service providers. GIZ's activities in financial systems development are above all characterized by a holistic, multilevel approach. By strengthening the capacity of actors at all levels of the financial system, ranging from clients to supervisory authorities, GIZ seeks to expand the frontiers of financial access and to improve the stability and crisis-resilience of the financial sector as a whole.

Financial systems development is a challenging and rapidly evolving field where policy makers seek to conform to the latest international standards. Innovations such as mobile phone banking and micro insurance provide new opportunities for access to financial services. In order to remain at the forefront of these dynamic processes, GIZ places significant emphasis on capacity building, organisational learning and knowledge management. These efforts were
rewarded in recent external evaluations, including the Smart Aid evaluation conducted by the multi-donor consortium CGAP (Consultative Group to Assist the Poor) in 2009.

Promoting Financial Access through Microfinance

Microfinance is typically defined as the provision of a broad range of financial services to low-income households, who are otherwise excluded from the financial system, and includes small and micro enterprises. These services can be provided by different types of institutions including banks, Microfinance institutions (MFIs), cooperatives, or informal groups; each having their own strengths and weaknesses. In their support of microfinance, GIZ does not favour a particular delivery channel since the most efficient way of providing these services is often dependent on the local environment.

Approach and Experience

GIZ employs a financial system-based approach to microfinance encompassing both the microfinance institutions (MFIs) and the legal and institutional environment they work in. On the macro level, GIZ assists countries and their financial supervisory authorities (central banks or government agencies in charge of supervision of the microfinance sector) in the development of appropriate regulatory frameworks for microfinance covering both prudential and non-prudential regulation.

A professional infrastructure of the financial market (meso level) is an essential part of the enabling environment for microfinance. MFI associations and networks, credit information bureaus, training institutions, and rating agencies provide services that help MFIs to extend their reach and reduce costs. GIZ can bring different stakeholders together and provide technical assistance, such as in in the institutional setup phase.

On the micro level, GIZ assists MFIs in their effort to become financially, legally and institutionally viable financial intermediaries. On-site technical assistance can, for example, help MFIs with a credit focus to expand into savings mobilization and improve their operational and financial management. Postal banks and (former) state banks may also be able to offer a highly effective method of providing microfinance due to the fact that they typically have a large branch network that can be used to mobilise savings and provide credit in underserved areas.

Cases

The Postal Savings Bank of China (PSBC) has 270 million depositors, half of whom are from poor rural households, and operates a network of 36,000 branches. As part of a nation-wide financial systems development programme commissioned by BMZ, GIZ strengthened the capacity of the PSBC in order to introduce credit products specifically tailored to the needs of rural households.

Linkage banking can provide a means to boost penetration of the microfinance sector. Up until 2008, BMZ supported a programme in India that links self-help groups to the formal financial sector. To date, NABARD's (National Bank for Agriculture and Rural Development) Self-Help-Group Bank Linkage Programme has reached more than 50 million group members, of whom 90 % are women.

2.2 Islamic Microfinance and Financial Inclusion

The global Muslim population is estimated to have reached 1.6bn at the end of 2012.[1] with approximately 25% of them living on less than USD 1.25 per day.[2]

It is therefore reasonable to assume that an excess of 0.4bn Muslims have limited or no access to any formal form of finance. A recent analysis by the World Bank in 2013 has found that Muslims are significantly less likely than non-Muslims to have a formal current account or savings at a formal financial institution.[3] The ability to reach a significant part of the population without access to financial services is without doubt one of the most compelling reasons to support the development of Islamic microfinance. However, the potential is not limited to Muslims alone. The underlying principles of fairness, honesty, and openness appeal to a large proportion of the population regardless of their religious beliefs.

Experiences

Religious community leaders are well versed in aspects of Sharia when it comes to family matters, but often not when it comes to finance. For the majority, any mention of a percentage in a transaction equates to riba and the only acceptable way to finance business is by entering into a profit and loss sharing partnership.

Juan M. Estrada-Valle – ACE/ADF

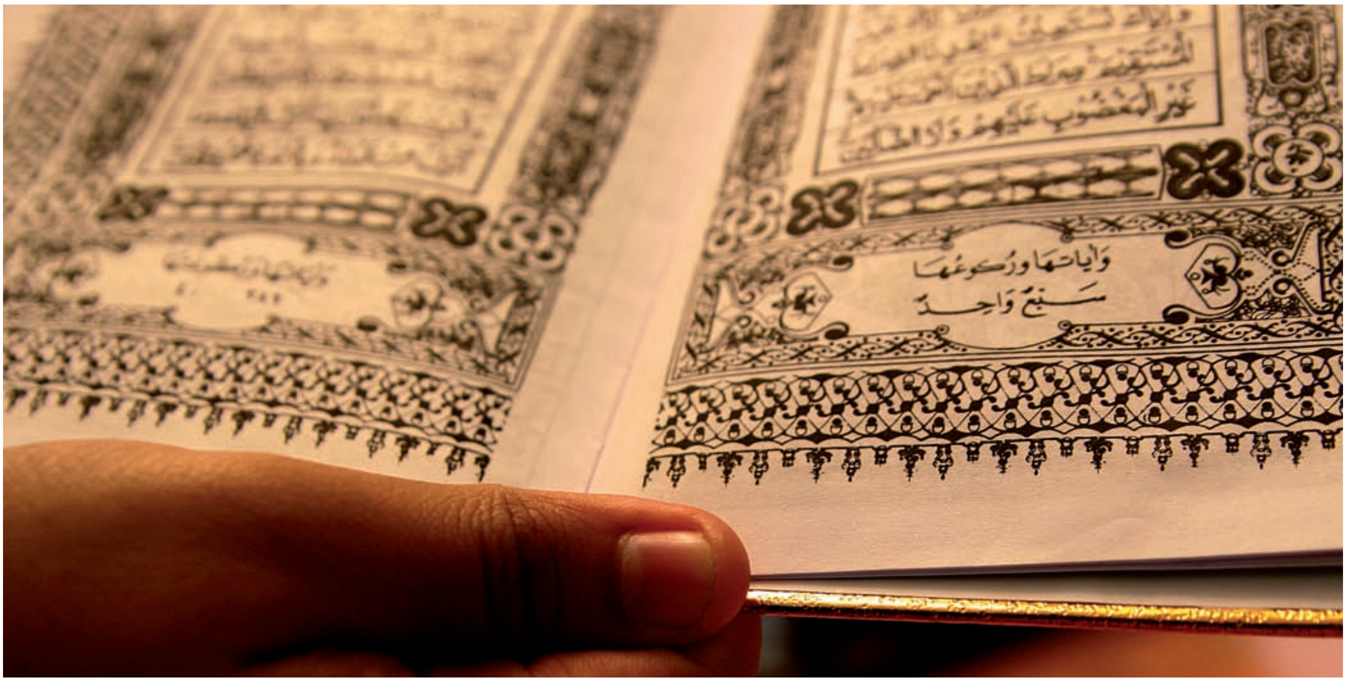
Similar to other microfinance users, economically active Muslims typically do not have access to conventional financial services due to lack of collateral and credit history. Although they may have access to conventional microfinance solutions, many of these borrowers would prefer the opportunity to undertake their financing in line with their belief system. These borrowers are among the most vulnerable and are easily taken advantage of by credit providers such as traders, lenders, and loan sharks that charge extortionate fees. Any basic discussion on financial inclusion should, therefore, include the development of products tailored to this part of the population.

1 The Pew Project (2012) The Global Religious Landscape http://www.pewforum.org/2012/12/18/global-religious-landscape-muslim/
2 As calculated by IRIN based on 2011 HDI
3 Demeriguc-Kunt, A, L. Klapper, D. Randall (2013) Islamic Finance and Financial Inclusion; Measuring Use of and Demand for Formal Financial Services among Muslim Adults, The World Bank: Working Paper 6642

BASICS OF ISLAMIC FINANCE

Sharia provides a set of ethical principles which derive from the teachings of the Islamic faith and, which governs every aspect of a Muslim's life and dealings with others. This encompasses commerce and is most accurately described as the ethical framework that provides legal, moral, and spiritual guidance aimed at achieving the goals of Islam. These principles and values, many of which are universally applicable, equally apply to Islamic financial services, and are similar to the norms and values associated with the strong business ethics often advocated by professional industry bodies and the generally accepted view of social responsibility and consumer protection.

One of the overarching principles in Sharia is justice, which defines how different parties should accordingly behave with each other. This applies to how parties conduct their business relations, but also, perhaps more importantly, to the way people treat each other in a larger social context. The justice principle contains guidelines concerning conduct, such as the principles of fairness, justice between parties in a contract, and the prohibition of deceit. The emphasis is on relativity rather than objectivity in justice, which means that although criterion may be considered when it comes to justice, individual circumstances take precedence.



3.1 Economic History

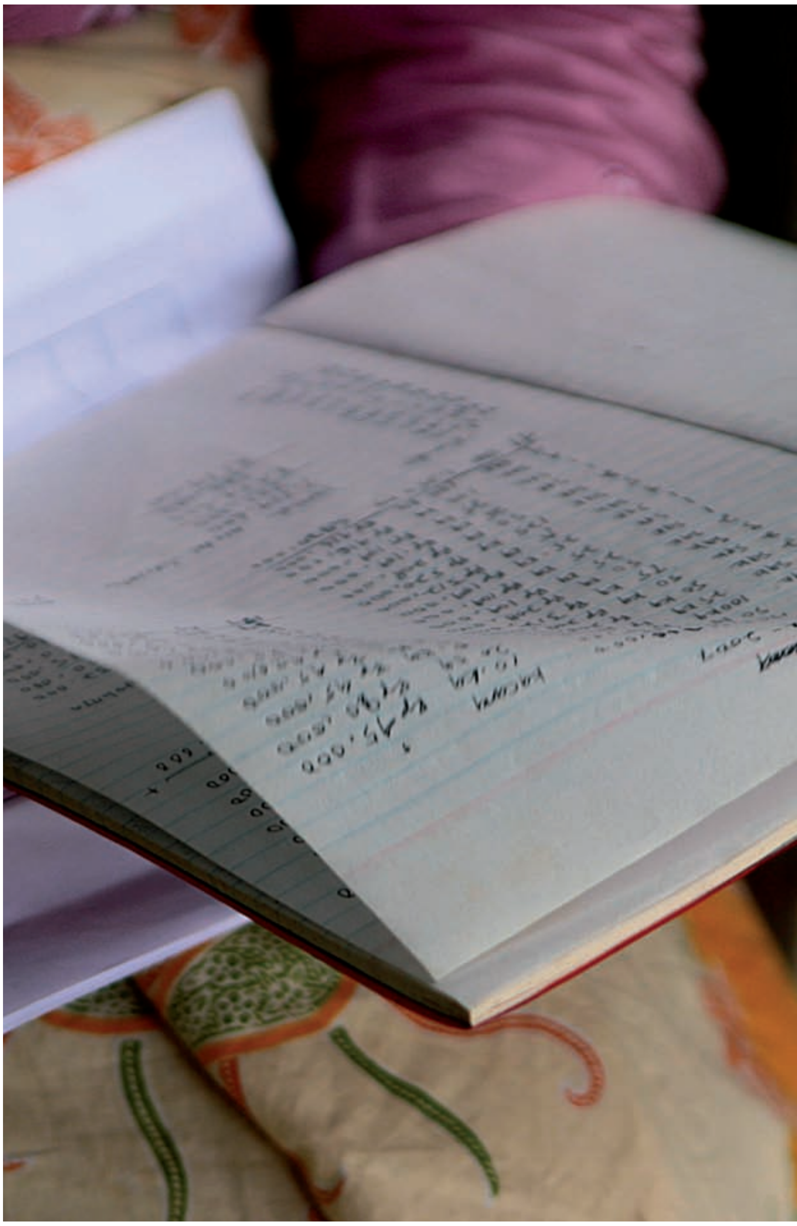
The basis for Islamic economics and the associated principles dates back to the development of early civilisations in Mesopotamia at around 3500 BCE.[4] Investment in trade and enterprises was often undertaken by the King or the temple, either directly or via their agents, giving rise to an early form of one of the main economic theories, the "principal – agent" problem.

This problem is concerned with aligning the diametrically opposed interests of the principal and the agent by devising compensation schemes that induce the agent to act in the best interest of the principal. This is of particular importance in many Islamic (financial) transactions where partnerships (musharaka and mudaraba) and agency agreements (wakala) are commonly used.

4 See Appendix for further reading.

3.2 Islamic Economics

Islamic economics are not all that dissimilar from general economic theory and strongly believe in the incorporation of demand and supply as factors for determining a just price, and the workings of the market economy in which labour, land, and capital are seen as factors of production. The notion of stewardship.[5] is central to Islam, as is the prohibition on usury. Within the context of Islamic economics it is believed that money has no utility and no intrinsic value of its own. The ban on usury is related to all interest payments, whether money or in kind, and is absolute and unqualified. Profits and wealth generation are permissible since money and other assets should be used to invest to the benefit of the owner as well as other participants in the wider economy.



3.3 Underlying Principles

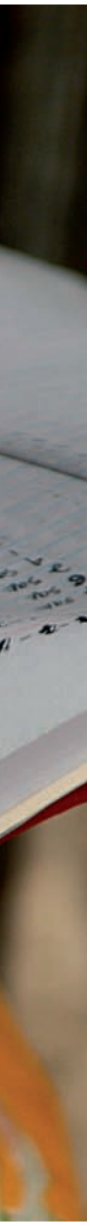
Sharia is derived from primary sources: the Quran (the word of God), Sunnah (words, acts, and approvals of the prophet), as well as three secondary sources including consensus by independent jurists, and analogy or case law. The final source is known as ijtihad which is the interpretation of all other sources (both primary and secondary) by individual Sharia scholars.

Sharia provides the basis for a framework of business ethics. This framework reflects a set of behavioural norms and values comprising honesty and fair trade, avoidance of misrepresentation, the sale of goods in the open market, and the avoidance of taking advantage of another party in a transaction. Wealth creation and trade are permissible, but strongly linked to social values. As such, the rules concerning business relationships can be viewed as a combination of open market with strong social principles. On the one hand prices are determined based on demand and supply and the bargaining between trading parties while, on the other hand, great emphasis is placed on striving for greater equality, and social improvement.

In addition to the guiding principles outlined above, Sharia defines three major prohibitions: Riba (interest), gharar (unnecessary uncertainty).[6], and maysir (speculation).

5 Within Islam, the notion of stewardship is related to the key obligation that man is left in charge of looking after the earth on behalf of Allah. It typically extends to the obligation to care for family.

6 Gharar typically occurs when a party enters into a transaction that is subject to a level of uncertainty that should be avoided. An example of this type of uncertainty is when a person agrees to sell a tractor for the equivalent



3.4 Charitable Giving

Within the framework of Sharia there are a number of specific stipulations regarding charitable giving and wealth creation. As mentioned previously, Sharia promotes wealth creation as an economic stimulant. In addition, anyone with a certain level of wealth is required to give some of it away for charitable distribution. Charitable giving comes in different forms:

- *Zakat - Mandatory charitable giving of 2.5% per annum of average wealth generally paid during the month of Ramadan.*

- *Sadaqat – Contrary to zakat, sadaqat is voluntary and at the discretion of the donor.*

Donors are typically free to donate to any charitable cause, either directly to individuals or to a charitable organisation, as long as they are non-discriminatory in the assistance they provide. Waqf, a charitable trust originally designed to provide social services within the community, can equally be applied as a conduit for zakat and sadaqat funds. Once funds or goods have been placed in a waqf, they cease to be owned by the donor. The waqf funds need to be managed in accordance with its mandate.

Islamic MFIs could benefit from funds that are distributed by a waqf, as well as direct sadaqat donations, provided they have a non-profit status. For the same reasons, zakat funds may also be applied to Islamic microfinance. The view on acceptability might vary per school of thought, however, with the majority currently agreeing that it is not suitable.

3.5 The Global Islamic Financial Industry

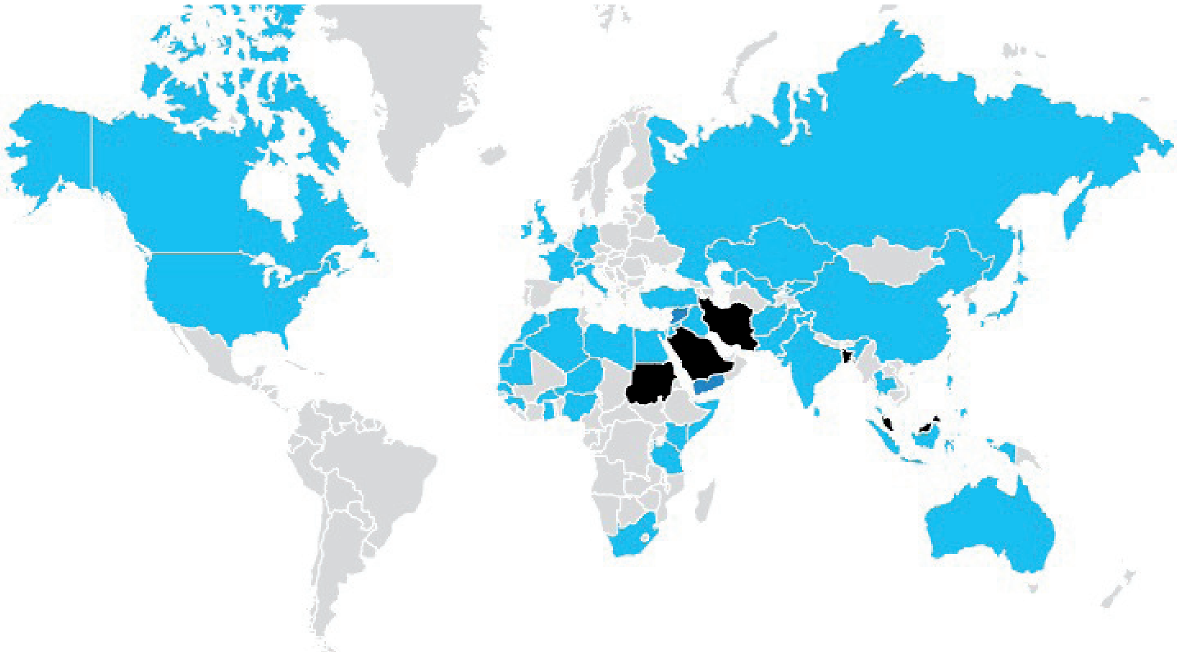
Currently estimated at between USD 1.1 and USD 1.5trn, the global Islamic Financial Industry has shown remarkable growth.. With a market share well below 2%, however, it remains a relatively small, albeit viable, part of the overall financial industry.

The vast majority of Islamic financial institutions are based in the Gulf Cooperation Countries (GCC) and Asian regions (see map), notably in the United Arab Emirates (UAE), Saudi Arabia, Bahrain, Iran, and Malaysia, followed by Sudan and the Yemen. In the representation above, large parts of Asia and Africa are deemed to be of minimal systemic importance for the growth of the Islamic financial services industry. Although this may be correct from the point of view of Islamic capital markets and commercial Islamic financial institutions, this may not apply in the same way to SME and microfinance. In this context, geographical areas with higher systemic importance are those jurisdictions where the Islamic financial industry is, or is expected to be, a significant part of the national financial services industry.

The 2013 Islamic Financial Services Industry Stability Report.[7] reveals that between 2004 and 2011 the Islamic banking industry showed a compound annual growth rate (CAGR) of 38.5%, which includes a period of slower growth following 2008. Islamic capital markets, e.g. the issuance of Islamic Bonds (sukuk), and the development of Islamic funds and indices, have continued to outperform most similar asset classes in the conventional sector.

of half of the annual profits for the year of the buyer. In this case, the amount of the purchase is unknown and could be well below the actual price of the good. Gharar does not occur when taking business risks since the investor is supposed to be fully informed of the risks he is taking.
7 http://ifsb.org/docs/IFSB%20-%20IFSI%20Stability%20Report%20TEXT%20FINAL%20%28OUTPUT%29.pdf

Islamic Finance Markets by Systemic Significance



source: KFRH

Systemic Importance

Potential Systemic Importance over Mid-term Given Current Growth

Minimal Systemic Importance

One of the main causes for the resilience of Islamic banks during the crisis is related to their relatively high capital adequacy ratios[8], which has in part been caused by a general absence of liquid instruments. Although profitability has been relatively higher during the post crisis period, many Islamic financial institutions are exposed to concentration risk in relation to real estate investments and large exposures to single borrowers. The majority of the players in the Islamic financial industry are commercial entities working in competition with conventional institutions offering financial services to private wealth and institutional clients with the remainder of them serving the retail and mass affluent markets.

Self-regulatory institutions such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) as well as the Islamic Development Bank (IDB) are well established and their guidelines are respected throughout the industry. Established in 1975 in Jeddah, the role of the IDB is to foster the economic development and social progress of member countries and Muslim communities using techniques that respect the principles of Sharia.

In addition, Islamic financial institutions are subject to the regulations and supervision in their jurisdiction of incorporation. The latter may cause challenges related to the fact that regulations, as well as taxation rules, are generally not suited to the way Islamic financial transactions are conducted. Many global financial centres have amended or extended their rules and regulations to allow for Islamic financial services to be offered from their jurisdiction.

Pertaining to countries without a majority Muslim population, another main challenge is associated with the direct link to religion. This results in many potential beneficiaries to stay away from Islamic financial institutions.

8 The Banker; Top Islamic Financial Institutions

ISLAMIC MICROFINANCE

Aimed at individuals, groups, villages, or micro, small and medium size enterprises (MSME), GIZ strongly believes that financial institutions provide a stimulus for the local economy and economic growth in the local area. Not only does it meet the requirements for stewardship on earth, but it also enhances financial inclusion with all the associated benefits that have long been recognised. The norms and values underpinning Islam strongly advocate investing in the (local) economy without charging interest on loans.

In line with Sharia, Islamic microfinance is inclusive in nature and is not restricted to Muslims. Regardless of religion, the nature of Sharia compliant instruments is of interest to both borrowers and lenders. Although financial institutions typically shy away from profit and loss sharing instruments, such as mudaraba and musharaka, they can be attractive to all potential clients who are willing to give up more of their profits in order to reduce their risk. Making the principles and the intricacies of these products transparent and easy to understand will assist borrowers and lenders in their decision making process.

In general, Islamic microfinance is no different from microfinance i when it comes to the operational and credit risks involved. Default rates are typically low as a result of careful selection, enhanced monitoring, and peer pressure within the community. Islamic microfinance does, however, face a principal-agent.[9] risk when the product structure chosen is in the form of a partnership or profit and loss sharing transaction in which the financier provides equity-like capital. Although monitoring efforts for these transactions are more cumbersome due to, among others, accounting information, this would be similar to an equity type form of lending in conventional finance. It is the relationship between financier and client, which typically includes regular on-site visits, in combination with the alignment with the principles of justice, fairness, and economic growth, which make Islamic Finance well suited to microfinance. Similar to conventional microfinance, Islamic microfinance has what is known as a double bottom line, meaning that they wish to achieve profitability, but also want to do good.

9 The principal-agent problem deals with aligning the diametrically opposed interests of the principal and the agent by devising compensation schemes that induce the agent to act in the best interest of the principal.

4.1 Products

Within Islam money is considered to be a means of exchange and cannot reproduce itself. Therefore it is prohibited to make money purely from the passage of time. Wealth can only be generated via trade or investments. As a result, Islamic financial transactions are structured either as trade, leasing, or investments. Islamic microfinance services are typically based on one of two types of transactions: trade based transactions (e.g. murabaha) and equity financing (e.g. musharaka and mudaraba). In addition to financing, mudaraba transactions can also be applied as a means to attract deposits. Other Islamic financial products such as wakala, ijara, istisna, and salam have so far generally not been well developed enough for Islamic microfinance purposes, despite appearing to be on the rise.

Trade transactions - murabaha

A murabaha transaction is a trade transaction in which a good is sold for its original price plus a profit margin or mark-up agreed between the parties. In the context of Islamic microfinance, the financial institution purchases the goods and immediately sells these goods to the client. The client will pay the original purchase price plus an agreed mark-up at a pre-arranged future date or in instalments. In the contract between the buyer and the seller all components – i.e. the goods, the mark-up, the delivery date, the original price, and the payment date – is available knowledge to both parties. Within the context of financial services, the payment is often deferred to a later date.

Experiences

Although not desirable, in practice the purpose of microfinance loans is typically two-fold. On the one hand there is the business, but on the other hand the loan is typically used to partially cover living expenses such as food, medication, or clothing. Offering financial services using a murabaha transaction does not provide the same flexibility as a conventional loan. No matter what the purpose of the loan is, it must be taken into consideration that the poor don't always have the luxury to pay for their beliefs.

Junior Gyamfi – Oxus Afghanistan

In a conventional loan, the MFI typically provides the funds to the client, who then applies the funds as required. In a murabaha transaction, the MFI purchases the goods and sells them to the client. The underlying asset can, for example, be raw materials, part-finished goods, tools, or goods for resale. Generally, it is maintained that this additional process causes additional cost to be incurred. However, it is not unlikely that the MFI may be in a better position to negotiate prices and, provided the MFI has the right expertise, assist the client in identifying the most appropriate good.

Direct Investments – musharaka and mudaraba

Musharaka and mudaraba transactions have the characteristics of direct equity investments in which profits and losses are shared between the investors and the entrepreneur. The main difference between the two types is that in a musharaka transaction the entrepreneur also provides capital, whereas in a mudaraba transaction the investor provides all capital and the entrepreneur manages the business without any interference from the investor.

Musharaka

all partners provide capital as well as skills and expertise to the partnership. Capital can be either cash or in kind, e.g. land, buildings, or other capital assets. Skills and expertise range from technical expertise to labour and management. Profits are shared between the partners as agreed in the contract. Losses, to the contrary, are always distributed to the partners in proportion to their capital provided. Each of the partners is called musharik. Any partner can be exempted from being involved in the day-to-day operations and thus become a sleeping partner.

A special form of the musharaka transaction is the diminishing musharaka (musharaka mutanaqisah) in which it is agreed from the outset that one of the partners will, over time, purchase units in the musharaka venture from one of the other partners. The sale price of the units should be based on the market value as determined by an independent source. As the purchasing party to the project accumulates more units, his proportionate share of the capital increases and hence his liability for any loss. Profit ratios will be revised either with each purchase or on a periodic basis depending on the agreement between the partners.

Mudaraba

One of the partners provides the capital (rab al mal) with the other partner (mudarib) providing the skills to run the business. Similar to the musharaka transaction, profits are shared between the partners as agreed in the contract, with the losses being distributed in proportion to the capital provided. Due to the fact that there is only one party providing capital, all losses are fully absorbed by the investor.

From a MFI's point of view, a musharaka based investment attracts less risk due to the fact that the business manager also has a financial interest in the undertaking. Any form of direct equity investment has a significant potential to suffer from information asymmetry between the managing partner and the financier. The resulting principal-agent problem can be resolved by providing the right incentives such as profit shares and performance bonuses.

Experiences

Musharaka and mudaraba transactions are equity investment transactions and as such are assumed have a higher on-going cost for the financier in ensuring books and records are accurate, the business is well run and progressing in line with expectations set-out in the business plan. In instances where musharaka products have been offered, this was typically donor driven, and based on limited client demand.

Michael Tarazi – CGAP

Benevolent loan – Qard Hassan

The qard hassan transaction is a benevolent loan in which the amount lent is paid back at an agreed time in the future without any compensation. For example, if the borrower receives $10 he repays $100 at the agreed time.

Although largely associated with charity, this transaction type can have its place in an overall structure targeting the poorest of the poor, and may assist in covering some of the consumption requirements as long as it is not conditional on any other transaction.

Agriculture Finance

Although each industry has its own peculiar issues that need to be addressed, the agricultural sector is of particular interest in relation to microfinance. Many microfinance clients can be considered agricultural or agribusinesses (enterprises closely linked to agriculture). Unlike other sectors, the agriculture industry is strongly subject to seasonal fluctuations and natural disasters. This requires specific attention in the structuring of the financial instruments. Within Islamic finance, salam transactions are used when one party forward purchases the produce to be delivered after the harvest. In other words, salam transactions can be applied to pre-harvest financing. In this case, the borrower has free use of the funds against future delivery of the goods. This can also be used for short-term production financing and although the financial institution runs the risk of price fluctuation, the borrower has often already arranged a buyer for the goods, thus significantly reducing this risk.

Case Study – USAID's Agricultural Development Fund, Afghanistan

The Agricultural Development Fund (ADF), an U.S. Agency of International Development (USAID) funded initiative focussing on agricultural lending, has seen significant traction for Islamic finance in the SME market in the agricultural sector, such as commercial farmers, cooperatives and agribusinesses, with a minimum loan amount of USD 100,000. Expanding agricultural businesses beyond just sustenance farming into SME sized enterprises enhances the economy, provides food security, and alleviates poverty. Financing cooperatives and agribusinesses will, for example, enable discounted purchases of raw materials and enhance market efficiency thus resulting in fairer pricing of produce for both producers and processors, or traders.

During the first year of operations, ADF experienced a significant unmet demand for Islamic financial services, which was then subsequently addressed by the development of a range of Islamic financial products specifically designed to meet the requirements for agricultural finance. The ADF offers a combination of murabaha, wakala, qard hassan, ijara, and salam structures, which are accompanied by operational procedures, standardised product documentation, and intensive staff training. Currently around 50% of the portfolio is Sharia compliant. In the initial stages, there was some opposition due to clients' lack of knowledge about Islam in terms of financial services. Approval of the structures by the ADF's Sharia Advisory Board and direct engagement with the client and their religious leaders enhanced the legitimacy of the offering. An ongoing challenge is that a considerable number of borrowers expect the ADF to be significantly more lenient if a default situation arises, when taking out Islamic financial services.

Juan M. Estrada-Valle – ACE/ADF

Other potential Products

Generally, the current products offered are largely restricted to murabaha and, to a lesser extent, musharaka transactions, with neither of them appearing to attract significant demand. As outlined before, it is generally believed that besides awareness and financial literacy, the main reasons for the lack of traction are the reduction in flexibility and increase in cost in comparison with conventional microfinance. The cost component can be addressed by a combination of standardization and operational efficiency which has to date been lacking. Naturally, once borrowers will start to use Islamic financial solutions, the marginal cost will be reduced as economies of scale develop. In the offering, flexibility can be enhanced by applying different product types or combination of products, specifically during the product penetration phase. The following product types can, for example, be amended to suit Islamic microfinance:

Agency agreement – wakala

A wakala agreement is the agreement that governs the relationship between two parties where one party is requesting another to act on its behalf. The application of the wakala agreement is varied and can range from appointing an agent (wakil) to purchase or sell an asset, to undertake a business, or to investment funds.

The agent or wakil is entitled to a fee for his services which could either be a fixed fee, a share of profits, or any profits in excess from a pre-agreed amount. The financial institution would appoint the client as their agent to undertake a specific service. The wakala can be subject to restrictions and penalty clauses.

Short Term Production Finance – Salam

A salam contract is a purchase contract comparable to a conventional futures transaction in which payment is made now against future delivery of an asset. In other words, it is a contract between a buyer and a seller for which payment of the full transaction amount occurs today for goods to be delivered in the future.

The salam transaction is often used for agricultural finance and allows the salam seller (the borrower) to purchase, for example, tools, fertiliser, and seeds, but also allows him to pay for labour during the period. Salam transactions can also be applied to short-term production finance.

Ijara – Leasing

An ijara transaction is related to the lease of an asset against a periodic rental payment. The asset remains in the ownership of the financial institution for the duration of the transaction. There are 2 generic types of leasing transactions: the operating lease in which the client gives the asset back to the financial institution at the end of the transaction period, and the finance lease (ijara wa Iqtina) in which the client becomes the owner of the asset at the end of the transaction period. The first is normally not in the interest of small financial institutions, unless they specialise in leasing transactions.

Deposits

Deposits are typically offered using qard hassan (benevolent loan), wadia or amanah (safe keeping). Due to its charitable nature, the use of qard hassan is declining in favour for the use of wadia and amanah products. Under these products, the bank makes a promise to keep the funds safe and is responsible for returning them to the client on request. In order to be able to use the funds in its day-to-day operations, the bank needs to obtain explicit permission from the client. This could be obtained as part of the account opening process by means of a tick box. Alternatively, deposits can be offered on the basis of a profit and loss sharing scheme in which the client receives a return based on the profitability of the bank. The disadvantage of this structure is that the client could technically lose part or all of his capital in the event the bank incurs a loss. Regulators, however, typically have rules in place to prevent a situation like this.

Islamic Insurance

Takaful, or Islamic insurance, is based on the principles of mutuality and solidarity and could be offered by MFI as microinsurance. Instead of transferring risk by paying a premium for an uncertain benefit, risk is mitigated by the creation of risk pools. Participants voluntarily donate (tabarru) an amount of money to a general fund to support those who may suffer a loss from a predefined cause, for example, a car accident. The preferred model would be for the members to manage the operations and investments themselves, but despite this, in practice, the management is typically delegated to a third party, the takaful operator. In this structure, a takaful operation consists of two parts. The management of the underwriting and investments is outsourced to the takaful operator, which is a commercial entity owned by external shareholders, while the member's funds are institutionalised as a co-operative. The operator is paid for his services either by receiving a proportion of the returns from investments (mudaraba model), a fee for his management services (wakala model), or a combination of both. The accounts and assets of the two entities are strictly separated.

Any underwriting surpluses are attributed to the fund and can either be repaid at the end of the period or used to reduce future donations. Any deficits will temporarily be covered by the takaful operator, for example via the provision of a benevolent loan to the fund.

The structures elucidated upon in the last section reveal how it is possible to create frameworks suitable for Islamic finance. Instead of trying to copy conventional financial services and forcibly apply these structures to the framework of Islamic finance, the industry would, first and foremost, do well to consider the principles of Sharia compliant financing in combination with the borrower category (retail, SME, etc) when designing Islamic financial instruments.

Experience - The Islamic Microfinance Challenge 2013

Costs and risks associated with Sharia compliant products can be extensive, even more so for microfinance clients. The Islamic Microfinance Challenge, supported and sponsored by CGAP, the Islamic Development Bank, and Al Baraka Banking Group, as well as Triple Jump and BMZ (via GIZ), seeks to assist institutions with their costs by supporting innovative models for Islamic microfinance, which have demonstrated potential for sustainability and scalability. The Challenge invites financial institutions to submit applications for non-murabaha products on offer. Any model submitted must have demonstrated its ability to meet the financial needs of poor and economically vulnerable parts of the population. By means of an extensive media strategy the sponsors aim to attract innovative solutions which will then be made obtainable to a larger public.

The Challenge aims to uncover more evidence concerning the viability and reach of these products and, in doing so, encourage wider adoption and scaling up. In order to achieve these goals, the Challenge has implemented a robust strategy incorporating communications at every phase from judging to awarding and implementation.

Actions needed

Product development – Provide assistance to local institutions, regulators, and other interested parties in order to develop a set of sustainable products that are Sharia compliant, cost neutral, and easy to understand. Technical Assistance can be provided in relation to training and to raise awareness about creative product development.

Standardisation of documentation – Standardisation and uniformity of documentation supports the products and the industry for further development.

4.2 Demand

Reliable data on the demand for Islamic microfinance is not readily available, but the observable differences between the desired financial products as recorded in survey responses and the actual use of financial instruments clearly show that the services provided do not meet demand. Although surveys find a seemingly robust demand for Sharia compliant products, actual demand appears negligible in comparison with traditional microfinance products. A CGAP study from 2013 concludes that, despite a significant increase of an estimated 1.28 million in poor clients using Sharia compliant microfinance, the sector continues to struggle to find sustainable business models and products.[10]

Islamic microfinance largely conveys the impression of only developing in countries where the relevant legislative framework is already available. Surveys from Jordan, West Bank and Syria, for example, conclude that 20-60% of respondents do not access conventional microfinance for religious reasons.[11]

Anecdotal evidence, however, shows that actual demand is significantly lower than the identified demand. The most recent analysis was done by Gallup Inc. on behalf of the World Bank and covered a dataset of 65,000 adults in 64 countries, representing 75 % of the world's adult Muslim population (excluding countries with less than 1 % or more than 99 % Muslim populations).

The results, when controlling for other individual- and country-level characteristics, found that Muslims are significantly less likely than non-Muslims to own a formal account or save at a formal financial institution. However, no evidence could be found that Muslims in the sample are less likely than non-Muslims to report formal borrowing or indeed any form of borrowing. The data shows that Muslims are more likely than non-Muslims to report religion as a barrier to account ownership. These results appears to be, however, mainly driven by respondents in Sub-Saharan Africa.

Worldwide, just 7 % of unbanked Muslims and unbanked non-Muslims cite religion as a barrier to account ownership.

Similar to non-Muslims, Muslims are more likely to cite cost, distance, and documentation as barriers to account ownership.[12] It should be becoming clear that the data available so far is not sufficient. In addition, it is not always clear to the respondents of these existing surveys what is meant by the term Islamic finance. Further, it must be taken into consideration that there is a lack of standardised survey methodologies, and demand studies in behavioural (such as religious) contexts are generally more difficult to design. With this in mind, the results should therefore be considered carefully.

10 CGAP, March 2013, Trends in Sharia Compliant Financial Inclusion.
11 CGAP, August 2008, Islamic Microfinance: An Emerging Market Niche, PlaNet Finance, 2011, Naser, Jamal, and al-Khatib (1999), IFC 2006
12 Demeriguc-Kunt, A, L. Klapper, D. Randall (2013) Islamic Finance and Financial Inclusion; Measuring Use of and Demand for Formal Financial Services among Muslim Adults, The World Bank: Working Paper 6642

Practitioners in the field agree that an increase in demand will strongly depend on a reduction in cost and enhanced flexibility of the instruments. Based on data collected in 2012 in Algeria, Egypt, Morocco, Tunisia, and Yemen, the World Bank finds that there is a hypothetical preference for sharia-compliant products among respondents despite higher costs. However, 37 percent of respondents.[13] reported that they would prefer a cheaper conventional loan or that they have no preference either way.

Based on GIZ's own experience, there is reason to believe that an increase in demand also hinges on other factors as well, such as the development of the regulatory and legal environment, awareness, education, and capacity building. In addition, research has shown that customers respond to non-monetary factors when considering a loan such as branding and advertising.

Actions needed

Research – Support the development of the industry with higher quality data on demand and supply in order to enable the alignment of both sides by tailoring products to meet the requirements of the target groups.

Templates – Provide the tools and capacity to capture the demand on Islamic Financial Products on an institutional level.

13 Demeriguc-Kunt, A, L. Klapper, D. Randall (2013) Islamic Finance and Financial Inclusion; Measuring Use of and Demand for Formal Financial Services among Muslim Adults, The World Bank: Working Paper 6642

Experiences

An additional challenge in meeting the demand is that the borrower's decision making process associated with Sharia compliance is unknown. Low financial literacy also plays a role in this process.

How a borrower decides whether a product is Sharia compliant is unclear. It is likely that the main source of information in this respect is their local imam who may or may not be educated in finance.

Michael Tarazi – CGAP

Initiatives – Demand Study

GIZ, CGAP and Yale University researchers are currently undertaking a study to improve the understanding of the market demand for sharia-compliant microfinance products.

The proposed study which is conducted on behalf of BMZ aims to undertake a field experiment that will identify some of the reasons for the differences in demand between conventional and shariacompliant #micro-finance loans. One of the components of the study will be to run an advertising experiment in Egypt with the aim to estimate the relative value of different aspects of a loan in a large credit market in a Muslim country.

The experiment relies on the ability to randomly assign potential borrowers different types of loans using different types of advertising. If possible, the study will randomize over 5 dimensions: (1) the cost of the loan, (2) the way the cost is presented, (3) the sharia compliance of the loan, (4) the type of sharia compliance being advertised (Azhar vs. Bank Board vs. Local Imam), and (5) the logistics of the loan (normal vs in-kind, etc). With these five dimensions, the outcome should be able to estimate how much value clients put on the different characteristics of the loan, thus resulting in a better understanding of why conventional loans seem to be in much greater demand than sharia- compliant products.

4.3 Pricing

An often heard remark is that Islamic financial services are more cost intensive and thus more expensive to the client and consequently less attractive. What needs to be considered is that the demand for Islamic financial services is unlikely to pick up if the price is significantly higher than a comparable conventional microfinance offering. Understanding the cost drivers will enable institutions to assess where potential cost efficiency can be achieved in order to reduce the cost to the level of comparable conventional instruments.

Generally costs of MFI offering Islamic financial services are associated with primary initial internal training, additional training for clients and related parties in relation to Islamic financial services, marketing, product development, and Sharia approval. Additionally, depending on the type of instruments offered, the skill set for monitoring of transactions can be potentially different and could include technical knowledge of the clients' business and the ability to carry out financial analysis. These skills are scarce and either have to be brought in at a higher price or will require additional training, which in turn will make staff more attractive to other financial institutions.

Besides common cost drivers in micro financing such as credit worthiness and time to maturity, there are two main cost areas: set-up cost and operational cost. From the perspective of the institution, operational costs are, in addition to standard running cost such as salaries and office space, associated with continuing education of staff, financial literacy of clients and other related parties, and intensive monitoring of clients once they have received their financing. These costs are to a degree similar whether the offering is based on conventional or Islamic finance, although there are specific costs associated with some of the Islamic financial services. It is important to note that these costs are caused by different transaction structures. These are not specifically Islamic and would be comparable while offering the same structure in conventional microfinance.

Murabaha transactions: The client typically identifies the goods required which are subsequently purchased by the MFI and sold to the client. This l0eads to an additional processing cost associated with the purchase and sale of the goods. On the other hand, the MFI is likely in a position to negotiate a discount on the goods and this saving that is obtained can thus be used to off-set the additional cost.

Musharaka and mudaraba transactions: Equity type transactions require additional monitoring of the enterprise, particularly in regards to its profitability and current performance. These are similar to the costs associated with conventional direct investments.

Ijara transactions: In Ijara (leasing) transactions, the financial institution becomes the owner of the asset. This transaction runs the risk that the asset will become damaged or destroyed and will therefore become useless before the client has fully paid for the asset and taken ownership of it. In order to cover this risk, the institution will charge the client a higher price for the duration of the transaction, which is standard practice for any leasing product.

Salam: In this transaction the institution is exposed to fluctuations in the price of the finished good between the start and end date of the transaction. This risk, resembling other forward products, will be included into the price charged to the client.

Profit and loss sharing transactions are preferred by Sharia scholars due to the fact that they closely reflect the Sharia principles. However, these are the instruments that are least widely offered and used. Much the same to conventional direct investments, musharaka and mudaraba instruments require particularly vigilant reporting and a high level of transparency in order to ensure that profits and losses are distributed fairly between the partners. In general, the operational costs associated with direct investments are higher than for instruments with a more predictable return structure, for example, leasing. Direct investments are based on the assessed viability of the enterprise, not on the strength of the collateral or the credit rating of the borrower.

The already existing higher costs associated with monitoring and reporting are further exacerbated by the fact that micro and small enterprises are not accustomed to formal accounting, thus requiring more monitoring efforts from the MFI in comparison with conventional products.

As a result, overall outreach of these instruments remains low, with an estimated 9,300 global clients, of which approximately 7,500 are based in Indonesia.

Another driver is **Business Development**. Wherever Islamic microfinance is offered in the form of Musharaka or mudaraba, the lending staff will need to be able to assist in the development and review of business plans as well as on-going monitoring of the enterprises. This is done to ensure that the microfinance institution is paid the appropriate profits, or has attributed the correct loss amount. This can be outsourced or the staff will need to be trained.

As mentioned previously, a further set-up cost driver is the required approval of a new Islamic financial product by an Islamic scholar with knowledge of finance as well as Islamic jurisprudence in this area.

Internationally operating scholars can charge significant fees. The use of local scholars for microfinance operations would, therefore, result in a reduction of their costs, provided the required knowledge is available or can be attained. Furthermore, introducing a highly standardised product offering that can be fine tuned per jurisdiction would reduce costs significantly. There are different approaches to obtaining Sharia approval as outlined in the section on regulation.

Initiatives – Implementation of Sharia compliant profit and loss sharing

A number of (financial) institutions are currently researching the possibilities of implementing Sharia compliant profit and loss sharing transactions. However, with insufficient cost analysis it is relatively impossible to obtain a thorough understanding of long-term viability. In order to bridge this gap, GIZ and CGAP are undertaking a cost analysis study based on several schemes that are currently in operation. This will assist the sector in increasing their understanding of the different cost components as well as identifying how cost reductions can be achieved conducive to providing a sustainable offering.

There is an additional cost associated with Islamic windows, where a conventional financial institution also offers Islamic financial services, whereby capital and accounts need to be segregated into conventional and Islamic financial offerings. A discussion on Islamic Windows will follow on page 31.

In order to succeed, Islamic microfinance will eventually have to be cost neutral in comparison with conventional alternatives. Capacity building in combination with high levels of standardisation will assist in keeping costs low.

Actions needed

Technical Solutions – Assist the industry with the development of other instruments, Management Information Systems and innovations to reduce operating costs.

Standardisation– Standardisation bodies should be supported to provide approved, cost efficient product structure with optional tailoring.

Scale – Scale must be reached without compromising the value of customers within the products.

4.4 Financial Literacy

Potential beneficiaries and staff of Islamic microfinance, akin to conventional microfinance, often lack financial literacy skills. In addition, there is a general lack of awareness, skills and expertise regarding the Islamic financial services by not only potential beneficiaries and the MFI staff, but also among shareholders and scholars.

Experiences

Financial services products should appeal from an ethical perspective and the focus should be on the underlying principles, not religion.

Shehab Marzban – Shekra

Islamic microfinance is often perceived as a charitable contribution by clients, NGOs, investors and donors. This is in part due to the fact that Islamic MFIs are in some cases registered as non-profit organisations or fall under NGO laws. Correspondingly, it is not always easy to distinguish between financing and charity modes when undertaking Islamic microfinance.

From the viewpoint of financial literacy, there are a number of basic requirements for clients and staff that need to be assessed such as the concepts of Islam on financial services, the higher complexity of the product structures, the different roles of the stakeholders and overall smart handling of financial services.

Experience

In addition to the perception of non-Muslims, there is also a lack of understanding among Muslims in relation to Sharia compliant financing. Non-interest bearing is generally equated with free of charge, any percentage mentioned in a transaction is deemed to be interest, and beyond riba and gharar most people are unaware of the principles underlying Islamic finance, the types of instruments, their structures, and how they are permitted. This lack of knowledge is not just limited to borrowers, but extends to their religious leaders, financial institutions, and regulators. The key to resolving this is capacity building in which the right skills are offered using workshops and longer training sessions in combination with financial literacy instruments including simplified marketing materials, standardised instruments, and client focussed structure descriptions including background on their permissibility in Islam. Each of these can either be used on a stand-alone basis, incorporated in curricula in schools, or used in public awareness sessions.

Shehab Marzban – Shekra

Local scholars are typically not skilled in the interpretation of the principles of financial services in Sharia, which may hinder running a profitable, non-charity based Islamic banking institution.

Specific attention needs to be paid to the shareholders of the financial institution who invest in microfinance with charitable intent. This implies that they are not expecting profitability or sustainability from the institution, and are often against establishing a sustainable approach. Although this in itself is a generous position, creating sustainable institutions will be more beneficial for the borrowers in the long run. Sustainability in this case should not be confused with profitability. An institution can be non-profit in which case the returns on loans pay for the operational cost of the organisation and provide a modest additional amount for future growth.

Case – GIZ in Aceh

As part of the Economic Recovery and Microfinance program in the Indonesian province Aceh, GIZ worked between 2006 and 2009 to enhance the practical knowledge of Islamic MFIs and to create good practice standards. As part of the program, GIZ supported the establishment of Islamic cooperatives (Baitul Qiradh) that offer Islamic microfinance services to poor clients and small businesses. A team of international and local experts was mobilised to assist cooperatives during the start-up phase and to develop training modules with local service providers and the local university, covering a wide range of subjects including product development, governance, and ethics. Focussing on the business of Islamic microfinance instead of its charitable nature positively impacted the sustainability and outreach of the cooperatives.

Rural banks, another important provider of microfinancial services in Indonesia, faced similar challenges with staff, shareholders, and directors, who had only a limited understanding of Islamic financial products and about how rural banks can play a significant role in financial inclusion. GIZ worked with rural banks in Indonesia to reduce costs by providing effective training, developing of marketing tools, and through the development of a new management information system complying with Islamic Banking Principles. This proved to be essential for effective decision-making and allowed the banks to scale-up their business, as well as building client trust.

In the context of Islamic financial services, one of the challenges pertains to the incorporation of the word Islamic. In certain environments this has negative connotations because it may be associated with extremism. Although these are strongly related to a lack of understanding, it causes potential beneficiaries of financial services to shy away from the offering. When marketing the offering the word Islamic can be avoided, as is the practice in Turkey, and may alleviate these concerns somewhat. Many concerns can be overcome, however, by providing the appropriate training (including financial literacy) and marketing focussing on the underlying principles, thus taking the focus away from religion. On the other hand, there is a part of the population who will automatically opt for an Islamic product due to the fact that it correlates to their belief system.

Actions needed

Enhance skills – *Develop training material for Islamic finance aimed at different job roles within MFIs. This could be taught as a specialised, in-house, training course, offered via technical service providers, or as a course at Universities.*

Financial Literacy – *Develop training material focussing on the Islamic financial principles, prohibitions and product types provided to clients and their religious advisers in the form of workshops, campaigns and media, or in schools.*

Business Development – *Wherever Islamic microfinance is offered in the form of Musharaka or mudaraba, the lending staff will need to be able to assist in the development and review of business plans as well as on-going monitoring of the enterprises. This will ensure that the microfinance institution will pay the appropriate profits, or will attribute the correct loss amount.*

4.5 Regulation and Risk

Similar to conventional financial institutions, regulation and supervision of Islamic financial institutions is typically undertaken by the Central Bank or Financial Supervisory Authority. In most jurisdictions, Islamic financial institutions are regulated under the same rules as conventional banks. In countries with a predominantly conventional financial system, however, where a significant part of the financial industry is Sharia compliant, so-called dual regulation is often in place. In this case a separate set of laws and regulations governs the licensing and supervision of Islamic and conventional financial institutions.

For Islamic financial transactions regulatory requirements may differ from conventional regulations and may even include elements usually associated with contract law. In comparison with conventional loan transactions, Sharia compliant transactions may result in either party being subject to a broader set of duties and obligations. The absence of generally accepted industry standards for Sharia compliant transactions and experienced legal support, results in (local) court decisions having a significant impact on the regulatory environment. In addition to having to abide by conventional regulatory standards, the main regulatory body within an Islamic Financial institution is the Sharia Advisory Board. Legal advisers in this field are often affiliated with international legal firms and the regulator only occasionally provides a set of (mandatory) standard contracts. There are a number of reasons for increased regulation of Islamic financial institutions including, but not restricted to:

- Increased concern for client protection due to a lack of transparency and the presence of information asymmetry;
- Compulsory integration of core Islamic principles in all activities, transactions, sourcing and operations;
- The perception of unfair practices by Islamic financial institutions regarding penalties, fees, redemptions, and responsibilities in case of loss;
- Improved on- and off site supervision;
- Enhanced risk management; and
- Fairness of marketing and information.

A recent example of regulation can be found in the Kyrgyz Republic where they have introduced a way of staying in accord with the Islamic Principles of financing by providing additional minimum requirements for standard contracts. In this case the National Bank of the Kyrgyz Republic specifies a number of mandatory issues to be integrated into contract clauses (see also Case – GIZ in Kyrgyzstan, page 32).

Whether regulated under the same regulatory framework or under a separate set of regulations, reporting requirements for Islamic financial institutions should differ from conventional financial institutions due to the differences in assets, liabilities, and income generation.

Differences between the operations and balance sheet structures of Islamic and conventional financial institutions have consequences for the types of risks faced by Islamic financial institutions. Although not subject to interest rate risk, there are three generic risk types specific to Islamic financial institutions:

Displaced commercial risk – Related to the common practice among Islamic banks to "smooth" the financial returns to investment account holders (IAH) by varying the percentage of profit taken as the mudarib share (profits due to the bank), which can be compared to an arrangement or agency fee. The practice of profit smoothing is typically the result of commercial and regulatory pressure, and occurs when the bank is not able to pay competitive rates of return in comparison to other institutions that operate in the same market.

Withdrawal or rate of return risk - Arises due to a mismatch between the rate that is earned on funds invested by the bank and the rate that has to be paid out to investment account holders. Banks typically hold a larger proportion of fixed yielding assets and a smaller proportion of floating assets, and generally shorter term deposits. General movements in profit rates may introduce a rate of return risk when the bank earns less on their assets than it has to pay out to investors or account holders.

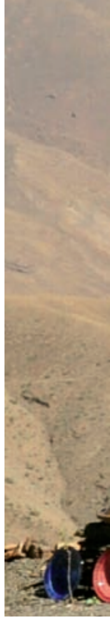
Profit Rate Risk - Profit Rate risk is a subset of market risk and can be considered to be the equivalent of interest rate risk for conventional banks. Profit rate risk refers to the risk that the expected profit or implied volatility may change resulting in potential losses or lower than expected returns. The nature of murabaha, the most used Islamic financial transaction, is such that in some cases the mark-up is fixed for the duration of the contract. This exposes the bank to a potential mismatch between what it earns on the fixed mark up contract and what it is expect to pay on its liabilities, thereby exposing the bank to a potential loss.

Regulatory standards including transparency, market discipline, and guarantees offered to depositors in the event of commodity, equity or return-on-investments losses, are essential for the development of the Islamic financial industry. In addition, capital adequacy standards, such as those issued by the IFSB, need to ensure that Islamic financial institutions hold sufficient capital to absorb a reasonable level of losses before becoming insolvent, to provide deposit protection for profit sharing account holders, and to promote the stability and efficiency of the Islamic financial system.

Experience – Regulatory Guidance

The sound functioning of a financial system depends, inter alia, on the users of the system having confidence in the quality of the conduct of business and that there are adequate systems of control over the conduct of business. A framework of the principles and rules that effectively govern the conduct of business of Islamic financial services industry (IFSI) participants, whether mandatory or voluntary, can play a significant role in supporting the growth of the IFSI. Such a framework would not only promote a climate of confidence and a supportive environment that upholds t ransparency and fair dealing comparable to the conventional frameworks, but would also strengthen the relevant moral, social and religious dimensions in conducting business.

Jaseem Ahmed – IFSB



Islamic finance is based on the absence (or diminishing) of asymmetric information, in other words, the prohibition of gharar (see above). This principle is embedded in profit and loss arrangements. However, full information symmetry would assume that an Islamic investor knows an investee company as well as the Islamic financial institution. It becomes apparent, that there is a specific interest in protecting the interest of the investor/depositor which calls for industry specific standards in transparency and market discipline. These standards would as well apply in properly guaranteeing what an Islamic financial institution can offer depositors in the event of commodity, equity or return-on-investments losses. This in turns leads to the main concerns regarding regulation of Islamic financial institutions: appropriate capital adequacy standards and loss provisioning as an answer to potentially larger exposure to fluctuations in asset prices due to the direct involvement with the purchase and sale of assets and investment in enterprises.

Islamic Financial institutions therefore must:

- *Provide enough capital to absorb a reasonable level of losses before becoming insolvent;*

- *Protect depositors/investors and/ or profit sharing investment accounts (PSIA) from undue loss (respecting nevertheless risk symmetry between all parties); and*

- *Promote stability and efficiency of the Islamic financial system.*

Experience – Regulatory Guidance

Experience – Regulatory Guidance
From a regulatory perspective, there are a number of major challenges that can be identified which include, but are not restricted to:

- *Identifying the appropriate level of regulation;*
- *Lack of education, awareness, knowledge and expertise, and product reach;*
- *Lack of operational efficiency;*
- *Insufficient funding; and*
- *Lack of capacity building.*

The involvement of IFSB, IDB, local regulatory authorities, governments and other bodies is crucial in further development and growth of the sector.

Pak Nawawi – Bank of Indonesia

The way in which regulations are implemented can have an impact on the achievement of goals such as financial inclusion. This is of particular relevance to microfinance institutions since increased regulation associated with Sharia compliance may indirectly reduce acceptance by potential clients due to higher cost.

Examples of financial inclusion initiatives are:

Structure – Islamic financial services can either be offered by fully fledged Islamic financial institutions, or by institutions that also offer conventional microfinance, which is typically referred to as an Islamic window. In the latter case, the financial institution keeps operations, accounts, and capital of the two types of financial services segregated. From a regulatory perspective, Islamic windows are faced with two instead of one types of exposure to default each with an unpredictable influence on the overall risk profile of the institution. In addition, an Islamic window may be subject to two different sets of regulations and may require two different supervisory bodies. The main concern of the Central Bank of Qatar, for example, dealt with issues related to the supervision of the segregation of capital, operations, and accounting in these institutions. Islamic windows require regulatory consistency between conventional and Islamic financial regulation, as well as a dual supervisory approach. Islamic windows may provide a first step towards a broader availability of Islamic financial services in an environment where the effective demand for Islamic financial services is considered to be limited but growing.

New regulation – Generally speaking, microfinance institutions are regulated under the same regulations as other financial institutions, allowing regulations to be amended as required. However, the impact of the stand-alone regulation has not yet been evaluated.

Regulating for Sharia compliance – There are two different views on the regulation of Sharia compliance. On the one hand there is the view that regulators should apply Sharia compliance to the institution as well as to the instruments in their supervisory practice. On the other hand, there is the view that Sharia compliance is not a regulatory concern in the same way as ethical finance is not regulated for its adherence with ethical principles. Although fully fledged Islamic financial institutions would generally be viewed as compliant with Sharia principles, Islamic windows are generally considered to be less trust worthy.

Deposit protections schemes – They ensure that depositors with a regulated financial institution will be able to recoup some or all of their funds in case of default by the institution. The presence of deposit protection schemes will enhance the willingness of individuals to save with a financial institution and is typically part of financial regulation. A solution for Islamic microfinance institutions could not as of yet be identified.

Sharia compliance of product types – Approval of products for Sharia compliance is generally the responsibility of individual institutions and their Sharia Advisory Board (SAB). An exception to this is Malaysia, where the SAB of the Central Bank approves all Islamic financial instruments that will be allowed to be offered in the country. A SAB can be appointed at the level of the individual FI, regional or at country level depending on where aggregate data reveals the impact of standardisation would be the greatest.

Alternatively, global institutions such as the IFSB or AAOIFI could be the conduit in providing a set of international standards for Islamic microfinance institutions. The discussion has been ongoing, with both advantages and disadvantages being addressed. However, the role of the SAB is to ensure Sharia compliance of the Islamic microfinance institution and its offering. Commercial decisions fall outside their responsibility.

Case – GIZ in Kyrgyzstan

Kyrgyzstan was the first country in Central Asia to join the Islamic Development Bank (IDB) in 2006 and had by mid 2012 already received IDB investments totalling USD 159 million. As part of a pilot project in 2006, regulations were introduced under the title "On the implementation of Islamic finance principles in the Kyrgyz Republic in the framework of the pilot project". In addition, the National Bank of the Kyrgyz Republic (NBKR) approved the establishment of the EkoBank. Renamed EcoIslamicBank in 2010, the bank is fully Islamic with its own Sharia Advisory Board (SAB). In the absence of regulatory experience, EcoIslamicBank's Shariah Board was also mandated to advise on the further development of the regulatory framework for Islamic finance in the country. Since 2006, 17 regulatory acts have been issued by the NBKR.

According to NBKR the regulatory challenges are mainly concerned with capital adequacy standards (in applying the respective IFSB standards), various aspects of risk management, and client awareness. In response to a growing interest from microfinance institutions, NBKR has issued a regulation respecting the minimum requirements for standard Sharia complaint contracts for microfinance institutions and credit unions. The regulation sets standards for mudaraba and murabaha contracts and has been developed in close cooperation with EcoIslamicBank and the International Shari'ah Research Academy for Islamic Finance (ISRA) in Kuala Lumpur.

Regulations need to address a number of issues including whether or not the application of Islamic principles should be regulated, prudential standards, capital adequacy, and governance standards.

Actions needed

Appropriate levels of regulations - *The regulatory initiatives of the IFSB show that regulation is mostly a combined approach of direct regulatory instructions (a supervisory process with a firm enforcement power by the regulator), market discipline (disclosure requirements, fair competition), internal risk-management, a broad consensus of industry principles and finally a code of conduct (self-regulation of the industry). The effective mix of these approaches will vary on a country-by-country basis, although in practice, most countries have a few direct regulations focussing on capital adequacy and profit-and-loss sharing. In addition, regulators rely on on-site consultations to understand the activities and risk profiles of the institution. Lastly, appropriate regulation ultimately depends on industry specific contracts and risks which require the regulator to have an in-depth knowledge of business as well as Islamic finance contracts. Bank supervisors, supervisory agencies, or Central Banks do not necessarily possess these skills. Continuous monitoring and evaluation of risk profiles, based on supervised institutions' business strategies and exposures is necessary. It is therefore of the utmost importance to extend capacity building to supervisors.*

Education, awareness, knowledge and expertise, and product reach - *Islamic financial institutions need to invest in building knowledge of their (potential) clients' business. Clients require more accurate information about Islamic financial principles, contract profiles and inherent risks as well as rights and obligations in the framework of those contracts. Those measures, if simultaneously implemented, might result in increased product reach, acceptance, demand and finally in Islamic financial market stability. The same is true for Islamic scholars offering their services in an SAB.*

Operational efficiency - *Microfinance organisations in particular have become increasingly driven in taking efficiency in their operations into consideration, with loans per loan officer ratios becoming a key indicator of efficiency and profitability of the organisation. In Islamic micro finance this is not possible to the same extent due to lack of standardisation. Some of the non-financial services could be launched by affiliated organisations, in cooperation with the MFI. Defining new and innovative institutional arrangements between a MFI and a technical services provider is a major area of technical assistance and results in the increase of operational efficiency of the financial institution.*

Insufficient funding - *Similar to conventional financial markets, Islamic financial markets need a financial infrastructure as a vital prerequisite for institutions to survive. Problems related to insufficient funding at local and national levels cannot be resolved if the local market for Sharia compliant funding is underdeveloped. However, national regulation can provide a framework for Islamic financial institutions to acquire funding from international investors, very much like conventional financial institutions. This is a particular problem for Islamic microfinance organisations if regulatory provisions prevent them from international sources of funds or certain types of available funding sources, which are mentioned in section 4.6*

Lack of capacity building. - Only in larger Islamic financial markets, specialised service providers, such as Islamic Finance training institutes, finance academies, consultancies, specialised auditors, etc. can develop. In small countries, even those with a predominantly Muslim population, only very few Islamic financial institutions exist, causing specialised service providers to not develop. Thus, the only way to overcome a lack of local capacity is via international cooperation. Regulators can (in)directly contribute to the networking efforts of Islamic financial institutions in their countries via cooperation between regulatory agencies dealing with Islamic financial institutions and international capacity building activities offered by a number of central banks (for example Bank Negara Malaysia). This can provide networking opportunities, especially for small Islamic financial institutions with little international networking. In addition, conventional financial sector industry associations can play a significant role in raising awareness and providing information about Islamic financial services among their members and to their members' clients through supporting financial education initiatives.

Deposit Protection – In order to enhance the mobilisation of savings, deposit protection is a key part of regulations that needs to be included.

Regulation involves several levels of the financial system; from the policy level to the individual transaction. At the policy level, the decision needs to be made concerning to what extent the financial system should include Islamic principles. Prudential standards need to be risk-adjusted to the degree that Islamic contracts may carry different, although not necessarily higher, risks. Sharia standards and associated risks need to be addressed at the contract level. An emerging industry code of conduct would assist in building stability in the Islamic financial industry. Regulatory challenges may reside in a number of still prevailing weaknesses such as those addressed above.

4.6 Funding Sources

Currently the supply of Islamic microfinance services is generally donor driven, but there are a number of other sources of funds that can be applied within the framework of Sharia:

Savings – An important component of financial inclusion is access to strictly regulated saving products. From a financial institution's perspective savings are important as they form a key component of capital. In addition, other saving mobilisation techniques such as the introduction of 'Savings Day' or participation at the Global Money Week.[14] can be applied.

Corporate funds – In order for microfinance institutions to be successful their funding should be sustainable. The organisations should be commercially viable, with moderate profits that are sufficient enough to cover the operational costs as well as moderate future growth. Commercially viable initiatives could attract corporate funds on an investment basis.

Individual shareholders –Although generally attracted by commercial viability and profitability, investing in microfinance institutions will also meet investors' ethical requirements.

Crowd Funding – The concept of crowd funding is one in which individuals and corporations pledge funds to one or more entrepreneurs who publish their business plan on a platform. It is new, but shows potential.

Charitable giving – An estimated USD 200 billion to USD 1 trillion has been given in mandatory alms giving (zakat) and voluntary charitable donations (sadaqat) by Muslims globally. Some of these funds will be donated to charitable institutions, with others being vested in waqf or donated directly. Mixing charitable funds with other funding sources can cause conflict of interest between donors and investors due to differences in expectation when it comes to profitability. Although waqf and sadaqat funds can be applied to Islamic microfinance, since they are distributed at the discretion of the donor, most scholars disagree with funds raised using zakat being used for micro financial purposes, particularly when the institutions are profit driven.

Case – Crowd Funding

Crowd Funding is a relatively new concept and provides a complementary funding channel alongside the use of traditional intermediaries. It can, for example, be implemented in collaboration with banks or MFIs. There is evidence of international crowd funding platforms partnering with local financial intermediaries, or being located in the target countries, trying to attract local, regional or international investors.

The Islamic crowd-investing platform Shekra based in Egypt, for instance, attracts Musharakah investments by domestic and foreign investors, and finances musharaka based financing for small enterprises. By facilitating the transfer of information along with finance, Shekra enables financial and investor inclusion. An incentive-compatible remuneration scheme enables capacity building in enterprises. It can advance microfinance where traditional sources are unable to do so because of, on the one hand, transaction costs and limited resources and an information gap for smaller enterprises on the other. By complementing the capacity-building infrastructure alongside facilitating funding, such a platform can „help build a pipeline of ‚investment ready' firms to narrow the gap between [impact] investors' appetite and absorption capacity.[15]"

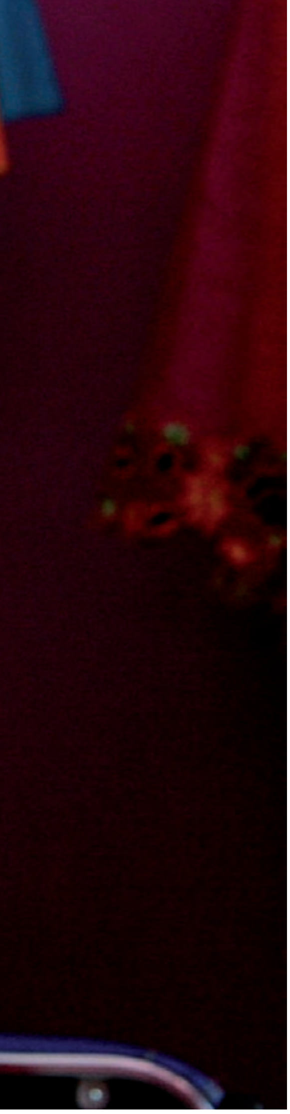
14 http://globalmoneyweek.org/
15 El-Zoghbi/Gonzalez (2013), p. 3.

Experiences

The 2012 UK Charities Commission Report shows that in the UK alone, 1,373 Muslim charities are registered with a combined income of £218.5 million. Of these, 379 have been registered for the past 5 years, displaying a distinct growth in Islamic charities in Western jurisdictions .[16]

As a result of their charitable nature, it is reasonable to say that the last source (sadaqa) is less concerned with the stability of the offering. In order to attract savings, corporate funds, individual investors, and crowd funding, however, the MFI needs to be sustainable in the long run. This does not mean significant profits, but the institutions need to generate sufficient enough profits from Islamic microfinance to cover its cost, have a provision for any expected defaults, and still have some profits left to provide for future growth.

16 www.charitycommission.gov.uk/



Case Study – KfW's Sharia Compliant Refinancing, Yemen

In Yemen, the German government-owned development bank, Kreditanstalt für Wiederaufbau (KfW), provides refinancing funds to the Social Fund for Development (SFD) which serves as a refinancing agent to the local MFIs. Historically, the MFIs have generally requested conventional, interest-bearing funds. More recently, however, the demand for Sharia compliant financing has increased significantly. SFD offers Sharia compliant refinancing in the following ways:

- *Diminishing Musharaka – SFD obtains an equity share in the MFI in return for an amount of financing. Over the course of the agreement, the MFI purchases the equity stake back from SFD as agreed in a "Share Selling Agreement". The agreement typically specifies equal instalments over a 24 – 36 month period. The instalment encompasses a repayment component as well as profit sharing.*

- *Musharaka – SFD funds the MFI in the form of a joint venture in which profits at the end of the year are returned. When the principal is returned to SFD, the profits shared are as follows: 50% for the MFI, 25% to the NGO and 25% to SFD.*

Currently all but one of SFD's recipients (Hadhramout) are receiving funds under a diminishing musharaka structure.

Actions needed

Funding mix – Assessment of the most optimum funding mix and the potential to include funds from charitable sources needs to be determined. The use of sadaqat and waqf type funds may assist in ensuring that the capital is Sharia compliant

Savings mobilisation – Introduction of concepts such as savings day and deposit insurance has the potential to increase awareness and willingness to save with Islamic MFIs.

THE WAY FORWARD

GIZ's work in Islamic microfinance builds on more than thirty years of experience in financial systems development. GIZ works with public and private institutions to develop inclusive, sustainable financial systems to provide access to responsible financial services that meet the needs of low-income households. In relation to Islamic microfinance, GIZ's involvement has generally been at three different levels: products and business models, supportive infrastructure and enabling environment.

Similar to conventional microfinance, GIZ works with policy-makers and regulators to create an enabling environment for Islamic microfinance. GIZ partners with internationally accepted standardsetters such as the Islamic Financial Services Board in Malaysia or Multilateral Development banks, such as the IDB, to address these challenges. In order to advance the Islamic micro finance industry, there are four main areas needing immediate attention which have been summarised as follows:

Regulatory Environment – The current political environment in GIZ's partner countries is not necessarily conducive for Islamic financial services. Not only does the word Islamic have negative connotations in certain areas, but there is also a strong feeling that fatwa are issued for the furthering of an individual's political agenda. Although this is outside of GIZ's sphere of influence, GIZ perceives the strong role central banks and other regulatory bodies can play in broadening their regulatory frameworks. Centralised Sharia Boards also share a role and should enable innovation and leave room for self-regulation. In order to develop a tailored approach in each partner country, the dialogue between stakeholders is vital for the provision of demand oriented services including customer protection.

Standardisation of transactions – In order to enhance transparency and efficiency, as well as reduce cost and provide investment security, standardisation of the Islamic financial services offering is of the utmost importance. GIZ feels an immediate requirement is necessary to strengthen self-regulatory bodies such as the IFSB and AAOIFI. This requirement would increase the corporation with them and including them in GIZ's programs.

Capacity Building – There is a general misconception about many elements of Islamic finance including the fact that it is inclusive to all religions, the structures, and the underlying ethical principles. This is not restricted to non-Muslims, but equally includes Muslims, local scholars, finance professionals, clients, regulators, donors, and TA agencies. In addition to a significant need for financial literacy at all levels, GIZ is convinced of a further need to strengthen the infrastructure in terms of training material, IT solutions, process optimisation, and apex organisations.

Product Development – Currently the products supplied are typically an adaptation of conventional products and generally limited to murabaha and musharaka, which confines the potential of the industry. Demand driven innovation is limited and the supply is generally donor driven. GIZ considers this to be the biggest bottleneck in increasing the outreach of these products. Activities to spark innovation such as the Islamic Microfinance Challenge and the south-south exchange, should be combined with private sector cooperation in the form of public-private partnership (PPP), the engagement of technology companies and research institutes, and the set-up of think tanks to further Islamic microfinance.

APPENDIX – BACKGROUND ON ECONOMIC HISTORY

The basis for Islamic economics and the associated principles dates back to the development of early civilisations in Mesopotamia at around 3500 BCE. At this time in history commercial activity was not a public pursuit but rather one that rulers and other members of the elite, such as temple and palace officials, were actively engaged in. Their place in society and the accompanying extensive network provided access to information regarding economic opportunities in local and distant markets and, more importantly, access to the capital required to invest in trade and enterprise.

The independent merchants that existed at the time often acted as agents for the King or the temple, thus giving rise to an early form of one of the main economic theories, the principal –agent problem. The principal-agent problem deals with aligning the diametrically opposed interests of the principal and the agent by devising compensation schemes that induce the agent to act in the best interest of the principal. This is of particular importance in many Islamic transactions, including financial transactions, where partnerships (musharaka and mudaraba) and agency agreements (wakala) are commonly used (see section 4.1 for further details on these instruments).

Money and Usury – Aristotle argued that money was a medium of exchange without an intrinsic value of its own, and is a view that is supported by scholars of all main religions. Christian scholars at the time, claimed that lending at a fixed rate of interest was unholy. Lending at interest was typically done for the purpose of consumption, not production which was deemed immoral. In addition, compound interest resulted in a large social cost leading to enhanced social inequality. The extension of the ban on interest for the general public in the 12th Century AD did not eradicate debt finance. Instead, it simply made it more complicated and resulted in the application of different structures that had the same economic effect. The ban on interest was re-evaluated when society began to change. It became more urbanised, international trade developed, and a separation

The expansion of trade routes resulted in the development of ways to finance and insure trade. The concept of insurance dates back to the 13th century BCE in Hittite Anatolia and Syria. Any party who killed a travelling merchant would be obliged to pay compensation and to replace the goods the merchant had had with him. Neighbouring countries worked on the basis of partnerships and as a result, trade flourished, economies grew, and economic concepts such as demand and supply and the right to fair prices were established.

Notions of money and usury, justice in economic exchange, and private property have been debated and researched by Greek philosophers and scholars from different faiths over the past millennia.

of State and Religion occurred. By the middle of the 17th Century AD, the ban on interest was generally abolished in Western Europe and usury was redefined from pertaining to all interest to only excessive interest. With the onset of the industrial revolution, it was argued that capital should be seen as a factor of production just like land, labour and building and should therefore also be subjected to costs or rent.

Private Property – Private property has always been a contentious issue within the context of religion. Within the Abrahamic faiths, property is typically deemed to be owned by God with man having "stewardship" and all property should be made available for public use.

Although Christians turned against this notion in the early 5th century AD and began to accumulate significant amounts of property, the attitude towards stewardship is still upheld by Islamic scholars who believe that property should be applied to enhance economic activity.

Justice in Economic Exchange– The notion of justice in economic exchange is concerned with questions such as: "Is it appropriate to make a profit purely from a difference in price?" and "How large can this difference be before it becomes unreasonable?" Generally making a profit has always been deemed acceptable as long as the entrepreneur is not motivated by pure gain and the profit is meant to cover the cost of his labour. Aristotle advocated that "a just exchange ratio of goods would be where the ratio (or price) would be in proportion to the intrinsic worth of each of the goods in the transaction", without any consideration to demand and supply factors. The Romans, on the other hand, held the opinion that a just price is any price agreed between the contracting parties without heed for intrinsic value. During the 12th and 13th century, Christian theologians concluded that intrinsic value is determined by the "usefulness" of a good to one of the contracting parties. By further adding that "one should not charge for a good more than what he would be willing to pay for it himself", factors of supply and demand were allowed to influence the price. Eventually, it was accepted that the just price is the natural, exchange-established price, since in a competitive market, buyers and sellers will not make transactions at a price that is not satisfactory to either one of the parties.

UNDERLYING PRINCIPLES AND PROHIBITIONS

The principles underpinning Islam are not dissimilar to the norms and values associated with strong business ethics often advocated by professional industry bodies as well as the generally accepted view of social responsibility as advocated by religion and society as a whole. One of the main overarching principles is justice governing social as well as business relations, which emphasises relativity rather than objectivity. As such Sharia considers justice in the individual situation and, although precedents may be considered, the individual circumstances are of more importance?. Sharia provides the basis for a framework of business ethics which are reflected in a set of behavioural norms and values that can be summarised as follows.[17]:

Honesty and fair trade. Trades have to be conducted in a fair and honest way and traders should not engage in practices such as weight manipulation, hiding of defects, or cheating.

Disclosure and Transparency. All characteristics including any potential faults, quality, and other relevant specifics need to be disclosed by the seller. All components of the transaction have to be completely transparent to all parties. Although the emphasis here is on the seller, the buyer has some responsibility and needs to ensure that he is aware of what is being sold to him.

Misrepresentation. False declarations regarding the goods, the trader's own standing, or ownership of the asset should not occur.

Selling over and above the sale of another. Although bargaining is permitted, once a transaction is concluded, another party should not attempt to interfere in the transaction by offering his own goods at a better price.

Forbidden items. Only goods and assets that are deemed to have a value in the eyes of Sharia can be traded. Any unlawful (haram) goods such as alcohol, weaponry, pornography, and other haram investments are prohibited.

Hoarding. Notwithstanding that trade is encouraged, hoarding as well as excessive love of wealth is condemned. The emphasis is on balance, reasonableness and fairness.

17 Schoon, N (2010) Islamic Asset Management, an asset class on its own? Edinburgh: Edinburgh University Press

Sale of goods and assets in the open market.
Competition is encouraged and transactions should take place in the open market. All parties have to ensure that they are aware of general market conditions and pricing prior to concluding a transaction. Neither the buyer nor the seller should take advantage of the fact that the other party is unaware of market price and conditions.

Avoid taking advantage of a seller's helplessness.
Taking advantage of an individual who, under pressure, is forced to sell an item must at all times be avoided. Instead of taking undue advantage, the buyer should offer assistance to the seller during his plight. Writing off debt, revising repayment structures, or exploring other ways to assist a debtor suffering hardship is encouraged.

All the above mentioned rules are part of the ethical framework represented in Sharia. It allows for wealth creation and trade, but strongly incorporates social values. As such, the rules concerning business relationships can be viewed as a combination of open market and socialist economy. On the one hand prices are determined based on demand and supply and the bargaining between trading parties, whilst also striving for greater equality, and improvement for all.

In addition to the guiding principles outlined above, Sharia defines three major prohibitions: Riba (usury), gharar (unnecessary uncertainty), and maysir (speculation).[18]

Riba – The literal definition of riba is excess or usury and is generally interpreted as the predetermined interest collected by a lender. That is, the interest which the lender receives over and above the principal amount it has lent out. The Quranic ban on riba is absolute and without qualification. Although it comes in various guises, two main forms of riba are distinguished:

- *Excess compensation from pre-determined interest (riba al naseeyah). Equivalent to interest paid on loans, this form of riba is linked to the amount and the duration of the loan. It is defined as any monetary compensation for an amount provided to a borrower.*

- *Excess compensation without consideration, (riba al fadl). This occurs when there is an inequality in the counter value of exchanged goods or services such as, for example, the exchange of 100 gram 9ct gold for 100 gram 18ct gold.*

18 Schoon, N. (2008) Islamic Banking and Finance, London: Spiramus Press, pp 20 – 23

Any compensation should be justified based on either a specific activity or a specific risk, and neither party should be compensated in excess of the value, activity and risk. Riba applies to money as well as commodities that have a money-like function, i.e. gold, silver, wheat, barley, dates and salt. One of the main reasons underlying the prohibition of riba is that it creates an unfair balance towards either the lender or the borrower, or even the economy.

Gharar and Maysir – Both unnecessary uncertainty (gharar) and gambling (maysir) are prohibited by Sharia due to their affiliation with excessive risk taking. The lexical meaning of gharar is to deceive, cheat, delude, lure, entice, and overall uncertainty, and is in some cases defined as unknowingly putting oneself or one's property into jeopardy. The most commonly accepted interpretation is that gharar covers both the unknown and the doubtful and occurs "where consequences of a contract are not known". In a commercial transaction, uncertainty regarding the asset, the price and the delivery date all result in gharar. Consider, for example, a transaction in which one person offers to buy another person's car for an amount equivalent to a month's salary.

There are two areas that would cause concern in this transaction. Firstly, the seller does not know how much the buyer's income is and secondly, the buyer appears unaware of the car's condition.

Maysir or speculation occurs when there is a possibility for total loss to one party in the contract and is associated with games of chance or gambling. It has elements of gharar, but not every gharar is maysir.

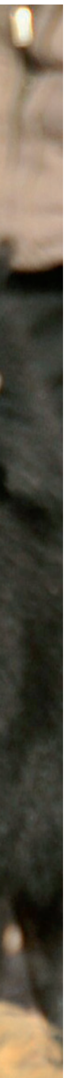
Entrepreneurial risk, and risk associated with natural disasters can occur and are deemed to be normal in the course of business and are permitted.

THE IFSB STANDARDS THAT MAY BE ADAPTED FOR FINANCIAL INCLUSION

Concrete institutional arrangements, standards and guidance notes that work in those directions, are, among others:

• The IFSB capital adequacy standard (IFSB 2, renewed IFSB 15, as of December 2013): Largely based on the Capital Adequacy Ratio?(CAR) standard of the Basel Committee on Banking Supervision (BCBS), capital requirements arising from an Islamic financial institution's contracts, assets are risk-weighted according to the different risk categories proper to Islamic financial contracts.

• FSB Guidance Note GN 3 (December 2010): PSIA, commonly referred to as "investment accounts", are a pool of investment funds placed within an Islamic financial institution, usually on a murabaha basis. In accordance with the murabaha contract, investors share profits of successful investments, but are exposed to the loss of part or all of their funds. However, if negligence, misconduct, fraud or breach of contract can be proven, the Islamic financial institution would be rendered liable for the entire capital of the investor. Therefore, in the absence of negligence or misconduct, which is dealt with under operational risk, the Islamic financial institution is not liable for the risks arising from IAH funds. This is because the commercial risks (market and credit risks) of assets funded by the IAH are borne by the IAH themselves, whereas operational risk is borne solely by the IIFS.



IFSB 9: Promoting stability and efficiency of the financial system IFSB 9: Provides for 7 guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services:

- *Principle 1: Truthfulness, Honesty and Fairness*
- *Principle 2: Due Care and Diligence*
- *Principle 3: Capabilities*
- *Principle 4: Information about Clients*
- *Principle 5: Information to Clients*
- *Principle 6: Conflicts of Interest and of Duty*
- *Principle 7: Sharia Compliant*

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