A SHARIAH-COMPLIANT MICROFINANCE FUND:

A MUCH NEEDED TOOL FOR THE ACCOMPLISHMENT OF ISLAMIC ECONOMIC'S GOALS

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" Money is none of the wheels of trade: it is the oil which renders the motions of the wheels more smooth and easy. "

DAVID HUME

Poverty can bring someone to a state of disbelief.
Hadith of the Prophet (PBUH).

BACKGROUND ISSUES

ISLAMIC FINANCE IS CURRENTLY EXPERIENCING A critical developmental issue with the growing divergence between the aspirations of Islamic economics and the realities of the industry. Rather than being part of the Islamic political economic thought, Islamic finance has been pursuing policies away from the theoretical underpinnings of Islamic economics and has located a surrogate financial framework in neo-classical economics. Islamic finance institutions aiming at efficiency have ignored and relegated the importance of social dimension and failed to internalise social justice into their own operational function. In that predicament, Islamic finance is perhaps best described as heterogeneous financial products deprived of their value systems and is nowadays suffering from the perception that it is simply a rebranding of conventional finance and not truly reflective of Islamic principles.

On the one hand, Islamic economics provides axioms and values that propose an ethical system of economics and finance based on the ontological and epistemological sources of Islam: the Qur'an and the hadiths. Its foundational claims are social justice, poverty alleviation and prevention of exploitation while at the same time emphasising social justice, needs' fulfilment, wealth redistribution and postulating sociotropic individuals. On the other hand, a critical analysis of today's IF institutions indicates that the pragmatic approach adopted by the industry has lead to the non-implementation of these values. The emerging wealth in the Muslim world and the staggering rate of growth of the Islamic finance institutions assets-base coupled with the weak development of the contemporary discourse of Islamic economics has forced Islamic finance to blindly adhere to the well-known precepts of a neo-classical paradigm of managing wealth. By doing so, it has weakened the entire social justice discourse of Islamic economics and has not made any significant contribution to the betterment of the lives of common Muslim individuals.

Nowhere this issue has become apparent as in the microfinance sector with the notable absence of Shariah-compliant products aiming at poverty alleviation and the empowerment of micro-entrepreneurs. Microfinance products have indeed been quite successful in Muslim majority countries with large microfinance banks operating in Indonesia, Bangladesh, Pakistan, Morocco, Egypt and India but few of them are Shariah-compliant. Though 44% of conventional microfinance clients worldwide reside in Muslim countries, the overall penetration of microfinance in these countries is indeed irrelevant. Conventional products do not fulfil the needs of many Muslim clients as Shariah compliance in some societies may be less a religious principle than a cultural one with even the less religiously observant preferring Shariah-compliant products. All available evidence hints indeed at the existence of a market of poor clients who strictly engage in Islamic transactions but also at a category of Muslim clients who reluctantly use conventional products but prefer Islamic ones and would switch over once they become available. Unlocking this potential could be the key to providing financial access to millions of Muslim poor who currently reject microfinance products that do not comply with the Shariah.

From the Islamic perspective the concern about conventional microfinance rests upon the fact that all the conventional models are interest-based which makes their application unacceptable. Interest rates, high or low, are rejected by Muslims as tantamount to *ribà*, something that is prohibited in no uncertain terms by the Shariah. Indeed, one can say that financial exclusion is exacerbated in Muslim societies by the abhorrence to interest-based microfinance that prevents the access to banking or financial services. Amongst other lacunas caused by the interest rate system there are problems of adverse selection and moral hazards.

According to the 2007 CGAP's report, *Islamic Microfinance: An Emerging Market Niche*, Islamic microfinance has a total estimated global outreach of 380,000 customers accounting for a meagre 0.5% of the total estimated microfinance outreach of 77 million. Islamic microfinance institutions reach roughly 300.000 clients through 126 institutions operating in 14 countries plus an estimated 80,000 clients through a network of Indonesian cooperatives. In all Muslim countries, Islamic microfinance is still in its infancy and accounts for a very small portion of the country's total microfinance outreach never exceeding 3% of outstanding microfinance loans. With 80% of its supply concentrated in Indonesia, Bangladesh and Afghanistan, in other countries Islamic microfinance has no scalable institutions reaching clients on a regional and national level. The average outreach of the 126 institutions is only 2,400 clients with none with more than 50,000 clients.

THE CASE FOR A FOR-PROFIT APPROACH IN ISLAMIC MICROFINANCE

Challenges in reaching a sustainable scale are mainly due to the 'not-for-profit culture' nature of the Islamic microfinance institutions that are featuring an over-dependence on grants coupled with a lack of operational efficiency and proper risk management. This, and a want of product diversification, has resulted in an industry that is overall struggling, with most institutions not economically viable and largely dependent on the availability of external funds. In this respect it should be noted that NGOs are the dominant players with 14 institutions reaching 42% and just two commercial banks reaching 29% of the market. Other players are rural, village and cooperatives banks.

The overdependence on grants obliges Islamic microfinance institutions to constantly look for injection of funds to keep running less their capital is used to cover the operating costs. In addition, they have to ration their funds and thereby limit the access of financial services to some people and geographical areas. Furthermore, as a result of this grants' addiction, Islamic microfinance institutions do not strive to collect extra saving which in turn is another reason that prevents them from attaining self reliance and growth. Microfinance should indeed aims at building permanent local financial institutions that can attract domestic deposits, recycle them into loans, and provide other financial services. The UN Capital Development Fund estimated in a recent study that there is potential for 7 million borrowers and 19 million savers, so it appears that the availability of microsavings products may be more important than microfinancing, a fact recognised only recently.

Grants should be temporary start-up support, designed to get an institution to the point where it can tap private funding sources (investor with equity/loans and deposits). External funds are needed particularly during the initial stages of operation, when the savings of members are small but with the passage of time as savings of beneficiaries accumulate and get recycled, the dependence on external funds should reduce. Though voluntary contributions to the greater public welfare are a long standing and important aspect of the Muslim culture, current Muslim philanthropy needs to become more focused and utilise the available resources to tackle the underlying causes of important social problems without confining itself to assuage the effects of social issues. Unprecedented wealth creation and gentrification should drive a new generation of actors to channel their private giving into new institutional forms such as capacity building in microfinance at the macro, micro and institutional level with the key bottleneck remaining the shortage of managers. In this respect, an innovative approach should perhaps be considered with particular reference of the obligatory *zakat*.

To be sustainable the industry must shift from a charity-based donor-dependent approach to a market-based for-profits approach and clearly separate the role of donors' funds from that of private capital. Traditionally, the private sector was viewed as a potential source of funds that would contribute to development efforts from a desire to meet corporate social responsibility objectives. More recently, it is recognised that the private sector can make a significant contribution to achieving the Islamic microfinance institutions goals when its core business focuses on profitably (=sustainably) providing quality services at reasonable price.

This for-profit approach will help addressing the issues of operational efficiency, risk management, transparency, product diversification and authenticity. It will also help establishing much needed performance benchmarks. Islamic microfinance must pay for itself if it is to reach a large numbers of people and unless microfinance providers cover their costs, they will always be limited by the scarce and uncertain supply of subsidies from governments and donors.

CONVENTIONAL MICROFINANCE AND ISLAMIC FINANCE

Available evidence shows that the conventional microfinance recipients better the quality of their lives, generate more income for their households, create job opportunities within their own communities and improve general living standards including nutrition, health, housing and education.

In spite of the current divide, conventional microfinance institutions can find Islamic finance a natural fit in their programmes, debt and equity-based alike. Microfinance the Islamic way has indeed the potential not only to respond to unmet demand but also to combine the Islamic social principle of caring for the less fortunate with microfinance's power to provide financial access to the poor. Microfinance and Islamic finance have much in common. Both emphasise the good of society as a whole. Both advocate entrepreneurship and risk sharing and believe that the poor should take part in such activities. Both focus on developmental and social goals and advocate financial inclusion. Both involve participation by the poor.

In the light of the above arguments, the need of a Shariah-compliant microfinance fund – or microfinance investment vehicle (MIV) – structured along the lines of the existent 103 funds with total assets of USD 6.6 billion, becomes apparent by the day. This vehicle should target funds looking initially at Islamic microfinance as an alternative investment, in which participants might like to engage, and subsequently as an asset class on its own, in which participants might like to invest. In this regard, the fund should appeal to Islamic investors because it will provide a convenient method of acquiring a position in a new class of assets that combine the objective of having a social impact and providing a return to the investors.

The final outcome will contribute towards the inclusiveness and integration of Islamic microfinance into the Islamic finance and conventional microfinance systems and it will initiate the journey towards the pooling of the USD21 billion needed to provide micro finance facilities to the world's poorest 100 million families.