Islamic Microfinance at the Crossroads

Islamic finance can only truly succeed if it encompasses all segments of society. Failure to offer robust services to the poor in order to help them climb out of poverty will bode unfavourably for the intents and purposes of Islamic finance. In this new section of ISFIRE, we explore the contribution of Islamic finance to poverty alleviation and social responsibility. Dr. Mohammed Kroessin assesses Islamic microfinance and the work of microfinance organisations in poor countries.

Living in the hot and dusty planes of southern Mali, all that small business women like Kadia Samaki wanted was a small amount of funds to help her out of the poverty trap. But banks did not want to lend to her because she didn't have any collateral. The village moneylender was more than happy to oblige, yet he charged extortionate interest rates on the principal.

Ten years on, Kadia runs a busy co-operative with 74 other women, nurturing, harvesting and processing shea tree nuts. "It's all down to a small loan that Islamic Relief gave me, of course interest-free", she smiles. "It's Islamic after all."

The microfinance sector

Microfinance, which is the provision of small loans without collateral to poor people who cannot access banks, is a powerful tool. Due to barriers in accessing development and poverty reduction finance, many consider microfinance programmes as a key strategy for alleviating poverty in low-income countries and helping to achieve the Millennium Development Goals (MDGs). Indeed, the United Nations designated 2005 as the 'Year of Microcredit'. Evidence has shown that microfinance programmes can be financially and operationally sustainable and in most cases are reported to have had a significant positive impact on poor people's social and economic empowerment, with women being the majority of borrowers worldwide.

It is likely that microfinance programmes will continue to grow in the future as they diversify their activities to provide additional financial services such as savings, insurance and money transfer facilities in addition to loans. Many microfinance programmes originally began as civil society initiatives, such as the famous Grameen programme in Bangladesh initiated by Prof. Muhammad Yunus in 1976, and have evolved into formal microfinance institutions. Many of these in turn have evolved into large commercial financial service providers with social objectives.

Why Islamic microfinance?

Similarly, Islamic microfinance, although still in its infancy, seeks to provide an economic empowerment tool for poor or disadvantaged people. Based on Islamic financing methods that avoid interest, deemed exploitive according to the Shari'a, there is a focus on trade and investment in productive activities, which is consolidated by the ethical teachings of the Qur'an and Sunna.

Islamic microfinance entails a wide range of Shari'a-compliant financing modes such as mark-up sales (murabaha), equity investments (mudaraba or musharaka) or leasing (ijara). Similar to conventional microfinance, Islamic microfinance targets a sector that is usually regarded by the mainstream finance industry as 'unbankable' due to the absolute or relative lack of collateral to secure loans against. Islamic microfinance is at the heart of the microfinance movement, breaking down the barriers to broader access to development finance. In many countries with a significant Muslim population, however, it is not just access barriers such as the lack of collateral but the very fact that loans are interest-bearing, which excludes Muslim borrowers from finance and microfinance.

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Despite the proliferation of institutions providing credit and loan services to poor or disadvantaged populations, very few microfinance initiatives adhere to Islamic financing principles even when their work is undertaken in largely Muslim countries. Currently, Islamic microfinance is concentrated in a few countries: Indonesia, Malaysia, Bangladesh, Pakistan and Afghanistan. According to the 2008 Consultative Group to Assist the Poor (CGAP) survey, Islamic microfinance accounts for less then 0.5% of global microfinance despite a global Muslim population of over 1.6 billion.

This is an interesting phenomenon, given that the mainstream Islamic finance industry has grown tremendously over the last 30 years to an estimated $1 trillion (The Economist, 2009), although more recent estimates peg the industry at $1.357 trillion with growth rates well above 20% per annum (Global Islamic Finance Report 2012).

Due to this growth, it is likely that Islamic microfinance alternatives will become increasingly important in the future with mainstream Islamic banks seeking to diversify their investment portfolio. This would allow investors and poor clients alike to follow their Islamic ethical compass and mutually benefit. More so, since Islamic principles are not antithetical to the general microfinance ethos of access to the 'unbankable', Shari'a compliant finance interventions should make a welcome addition to the development sector.

Nonetheless, there are specific challenges to overcome in developing sustainable Shari'a compliant microfinance programmes in addition to the challenges that all microfinance programmes face such as the lack of capital before Islamic microfinance can become a more widespread and effective tool for poverty alleviation.

To overcome access barriers most microfinancing, both conventional and Islamic, utilises social collateral in which clients are organised in groups who have a shared responsibility for the repayment of all outstanding funds. Other types of security might be attained through personal guarantors, credit guarantee schemes, or zakat-funded guarantees against default or the like. However, some group lending approaches have more recently attracted criticism due to the pressure that commercial microfinance institutions put on communities, who in effect have become debt collection agents in pursuit of profit rather than mitigating moral hazard. This practice is also in contravention with Islamic injunctions to be merciful to the debtor.

Whilst Islamic microfinance is currently a growing sector both within the NGO and banking industry, best practice models are still being developed. International standards for Islamic finance such as those published by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB) are still not customised to micro-financial applications, nor are standards globally agreed upon amongst the different stakeholders.

Greater understanding is also needed on the impact of Islamic microfinance in order to influence donors and institutions to engage with it. This is a particular challenge not just for the Islamic microfinance sector but also for conventional providers as the body of evidence for the poverty reduction impact of such lending is mixed. For Islamic microfinance institutions, relying heavily on murabaha represents a further challenge since it can be argued that even Shari'a compliant mark-up finance imitates the economic function of interest. This dilemma makes it difficult for Islamic financiers to argue that their products are actually stronger in terms of poverty reduction. The overreliance on murabaha also stifles product development since commercial Islamic bankers and NGOs prefer the simplicity of mark-up finance to mudarabah and musharaka, given the potentially increased moral hazard and the lack of a quasi guaranteed return on investment.

These challenges are underpinned by the relative lack of Islamic finance professionals, which is more pronounced in the not-for-profit sector, where qualified and experienced staff managing microfinance programmes in the field are more attracted by the remuneration that can be found in the commercial Islamic finance industry.

Islamic Relief's microfinance programme

Islamic Relief Worldwide (IRW) has been providing Islamic microfinance to poor people in over 20 countries during the last 15 years, disbursing loans (qard hassan), facilitating mark-up sales (murabaha) and investing in microenterprises (mudaraba, musharaka) to currently over 10,000 beneficiaries with a loan portfolio in the region of over £10m.

As a humanitarian relief agency, Islamic Relief has established a reputation for being one of the leading non-specialist NGOs in the area of Islamic microfinance. Specialist microfinance institutions might have considerably larger client numbers, such as Al Amal Microfinance Bank of Yemen, the winner of the Islamic Microfinance Challenge 2010. The Challenge was sponsored by CGAP, Deutsche Bank, IDB and Grameen-Jameel Microfinance Award. Al Amal has recruited over 20,000 clients in the 2 years since coming into existence.

However, Islamic Relief's strength is the breadth and depth of its service provision. Usually microfinance programmes are differentiated in terms of sole credit provision and as 'credit-plus' which includes training for various trades that entrepreneurs might want to specialize in. Islamic Relief's microfinancing programme also carries out extensive social mobilization work, entrepreneurship, accounting and technical skills training prior to financing and is providing business and marketing support after. Moreover, often clients are graduating from more basic economic recovery programmes such as cash for work which are extensively utilized in humanitarian post-disaster relief work that IRW has carried out in the wake of, for example, the Indian Ocean Tsunami of 2005 in Aceh. By taking an integrated development approach, Islamic Relief also seeks to ensure that microfinance addresses a range of factors that contribute to the economic vulnerability of poor people whilst also building sustainable livelihood opportunities for the poor and reducing the incidence of hand-outs.

There are long standing microfinance programmes that Islamic Relief runs in several countries including Pakistan, Bangladesh, Kosovo, Bosnia and Herzegovina, Palestine, Sudan and Mali. More recently IRW has received increasing interest from traditional humanitarian donors and funding agencies in promoting Islamic microfinance initiatives. Islamic Development Bank, the Department for International Development, (DFID) the Scottish government and HSBC Amanah have provided funding for Islamic microfinance programmes.

In some countries, IRW has implemented microfinance services through separate registered microfinance institutions (such as 'First Islamic' in Bosnia and 'START' in Kosova) whose activities are supervised by the regulatory authorities and can successfully compete with other semi-commercial MFIs in the marketplace without losing sight of Islamic Relief's social development objectives.

As Kadia's success story illustrates microfinance has clearly had a positive impact on poverty alleviation, primarily through providing poor people with access to ethical Islamic finance for income and employment generation as well as improving standards of living through improved housing, healthcare, nutrition and education for clients, their families and the wider community.

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