Making a Dent on Poverty

Islamic Microfinance Principles, Products, Models & Institutions

International Seminar on MF & Financial Inclusion

16th March 2016
**Key Principles of Microfinance**

Search for better options must continue.

| 1. | Poor need a range of financial services, beyond micro-credit |
| 2. | Microfinance must pay for itself. It is about building permanent financial institutions. |
| 3. | Competition will drive down abnormal profits if any; price ceilings choke off supply and hurt poor people. |
| 4. | Microcredit is not always the answer, especially for the destitute. |
| 5. | Donor funds should complement private capital, should not compete with it; should be used for capacity building of MFIs. |
| 6. | Government should have no role as a direct provider; should be an enabler. |
Issues in Microfinance: Six Clusters

Microfinance has lost its moral compass. Microfinance institutions (MFIs) have increasingly focused on financial performance and have neglected, in some cases abandoned, their declared social mission of poverty reduction and empowerment. - David Hulme and Mathilde Maitrot
Product

Like alcohol, a debt boom tends to induce euphoria. Borrowing has been the answer to all economic troubles in the past 25 years. Now debt itself has become the problem – Philip Coggan

Microfinance products:

• Credit-based
• One-size-fits-all
• Hidden costs
Price

I believe the microfinance industry needs to stake out a clear position that we do not make excessive profits.. that we do not charge usurious rates to the poor. To me, responsible practice means we restrain ourselves and make no more than moderate profits – Chuck Waterfield

Cost-plus pricing involves combining:
• operational costs & risk-premium
• cost of funds

How high is too high?
• International evidence
• Some suggested fair-pricing mechanisms
Competition

Over-indebtedness, through formal or informal loan-taking, is the result of a two-party decision (the borrower and the lender)... however, it is the MFIs who should be held accountable for monitoring levels of indebtedness to protect their clients. – David Hulme

Increase in supply of microfinance

• Competition does not drive down profits
• Loan officers resort to aggressive marketing
• Poor now have multiple loans
• Short-term profit maximization
• Caveat emptor (buyer beware)
• Loan officers routinely harass clients (asset confiscation, public humiliation etc)
Client

The typical poor clients juggle their loans as long as they can. As long as the juggling continues, the profits (for MFI) keep rolling in. And the lenders keep pushing more loans on clients they *know* are already juggling multiple loans – Chuck Waterfield

Microfinance clients:

• Vulnerable in the face of unmet needs
• Low level of skill
• Low financial literacy
• Vulnerable to debt-addiction
Model

Greed is good. “Even philanthropy aimed at alleviating poverty can be profitable” – Forbes, 2007; Forbes 2011 and NYT 2010*

Not-for-Profits – Mutuals - Corporations

Diminished role of Philanthropy
• Exclude grants and donations from financial equation
• Only for capacity building
• Unsustainable and erratic nature

*quoted by Hulme et al (2014)
Regulation

The horse is out of the stable, we have no option but to let it run, and to tut-tut or add cautions on the side – Malcolm Harper

Microfinance regulation:

• Self-regulation or self-interested regulation
• Caps on prices/ returns
• Poor governance – insider transaction; compensation; human rights abuses (collection)
• Bail-outs favor small elite
Does Islamic Microfinance Offer Hope?

Search for better options must continue.

1. Do Islamic MFIs offer superior products?

2. Do Islamic MFIs offer financing at affordable prices?

3. Do Islamic microfinance provide healthy competition to their conventional counterparts?

4. Do Islamic MFIs better serve the destitute?

5. Why and how should philanthropy and voluntarism be integrated with Islamic MF?

6. How should Islamic MFIs be regulated and governed?
Do Islamic MFIs offer superior products?

- Freedom from contractual complexity
- A wider range of products: grant-based, credit-based, lease-based and partnership-based
- Sector-specific products: agriculture, manufacturing, trade, housing
- Usually packaged with skill-enhancement, procurement, market and business development services (smart factor)

Example: Wasil, Bank Khartoum Agri-finance
## Product

Complex? Simple? Value-adding?

### Diverse Product Offering by Wasil Pakistan

<table>
<thead>
<tr>
<th>Mode</th>
<th>Target Beneficiary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zakat, Sadqat</td>
<td>Destitute unable to work</td>
</tr>
<tr>
<td>Qard e Hassan</td>
<td>Poorest of the poor with ability to work</td>
</tr>
<tr>
<td>Murabaha</td>
<td>Micro level traders, street hawkers, Small shopkeepers</td>
</tr>
<tr>
<td>Salam</td>
<td>Small Farmers up to 5 acre land holding</td>
</tr>
<tr>
<td>Istisna</td>
<td>Micro manufacturers in different sectors</td>
</tr>
<tr>
<td>Ijara</td>
<td>Farmers without land holding (Rental Land)</td>
</tr>
<tr>
<td>Diminishing Musharaka</td>
<td>Micro entrepreneur in need of assets</td>
</tr>
<tr>
<td>Master Salam (Ijara + Salam)</td>
<td>Farmers in need of land plus money for cultivation</td>
</tr>
</tbody>
</table>
Product
Complex? Simple? Value-adding?

Value-Based Salam Financing by Muslim Aid Sri Lanka

Salam (Value-Based)
Money to farmers as price in advance
Repayment in paddy plus zakah

Mudaraba
Process paddy and sell in market at profit
Recover admin cost + profit + capital

Profit
5 Months
5 Months
The Islamic MFI is involved in each step of the Olive value chain:

- Facilitates Muzaraa agreement between landowners and the poor farmers.
- MFI will provide Salam (advance) Financing for Olive Seeds & fertilizers.
- Olives Collected is sold to the Olive Oil Mill for a profit.
Product
Complex? Simple? Value-adding?

Value Chain Financing by Bank al Khartoum

1. Financial partnership between Ministry of Finance and BoK
2. Nomination of agriculture graduates for the project by Ministry of Social Affairs
3. *Mudaraba* agreement between IRADA (BoK) and the micro entrepreneurs (agriculture graduates)
4. Setting up of Abu Halima greenhouses
5. Technical consultancy to micro entrepreneurs
6. Technical consultancy to greenhouse establishment and operation
7. Provision of fertilizers and other services by Ministry of Agriculture
8. Sale of vegetables output to Sana Hypermarket and others
9. Sharing of profits (40% for 5 years and 100% after that) by micro entrepreneurs
10. Sharing of profits (60%) by IRADA-BoK for 5 years
Price
Can price be reduced to zero?

Do Islamic MFIs offer financing at lower prices?

- Operational costs and risk-premium similar to conventional microfinance; or even higher due to additional costs of Shariah-legal compliance
- Required profit rate on qard funds is zero
- Admin costs may be reduced through institutionalized voluntarism
- Lower admin costs may be absorbed by philanthropic fund flows (zakah, sadaqa and awqaf)

Example: Akhuwat, Islami Bank Bangladesh, Iranian Qard Funds
Price
Can price be reduced to zero?

The Akhuwat, Pakistan

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of loans</td>
<td>44577</td>
<td>65650</td>
<td>99844</td>
<td>125,646</td>
<td>230,000</td>
</tr>
<tr>
<td>Loan disbursed (Rs. million)</td>
<td>488</td>
<td>739</td>
<td>1157</td>
<td>1500</td>
<td>3200</td>
</tr>
<tr>
<td>Percentage of recovery</td>
<td>99.50</td>
<td>99.86</td>
<td>99.85</td>
<td>99.82</td>
<td>99.83</td>
</tr>
<tr>
<td>Cities</td>
<td>15</td>
<td>20</td>
<td>34</td>
<td>45</td>
<td>105</td>
</tr>
<tr>
<td>No. of branches</td>
<td>21</td>
<td>33</td>
<td>53</td>
<td>62</td>
<td>153</td>
</tr>
<tr>
<td>No. of employees</td>
<td>90</td>
<td>181</td>
<td>358</td>
<td>419</td>
<td>785</td>
</tr>
</tbody>
</table>
Price
Can price be reduced to zero?

The Akhuwat, Pakistan

<table>
<thead>
<tr>
<th>Year</th>
<th>Donation from borrowers (Rs Million)</th>
<th>Operating Expenses (Rs Million)</th>
<th>Donations from borrowers as % of OE</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>0.021</td>
<td>8.3</td>
<td>0.25</td>
</tr>
<tr>
<td>2009</td>
<td>0.010</td>
<td>10.4</td>
<td>0.10</td>
</tr>
<tr>
<td>2010</td>
<td>6.1</td>
<td>17.83</td>
<td>34.3</td>
</tr>
<tr>
<td>2011</td>
<td>12.3</td>
<td>36.7</td>
<td>33.4</td>
</tr>
<tr>
<td>2012</td>
<td>23.9</td>
<td>68.2</td>
<td>35</td>
</tr>
<tr>
<td>2013*</td>
<td>29.8</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>No. of Loans Disbursed</th>
<th>Amount of Loan Disbursed (Rs Million)</th>
<th>Operating Expenses (Rs Million)</th>
<th>OE as % of Loan</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>11,388</td>
<td>122.45</td>
<td>8.29</td>
<td>6.75</td>
</tr>
<tr>
<td>2009</td>
<td>13,821</td>
<td>164.23</td>
<td>10.38</td>
<td>6.32</td>
</tr>
<tr>
<td>2010</td>
<td>21,073</td>
<td>251.81</td>
<td>17.82</td>
<td>7.08</td>
</tr>
<tr>
<td>2011</td>
<td>34,194</td>
<td>418.21</td>
<td>36.67</td>
<td>8.77</td>
</tr>
<tr>
<td>2012</td>
<td>67,683</td>
<td>1,137.68</td>
<td>68.16</td>
<td>5.99</td>
</tr>
</tbody>
</table>
3 Competition
Creativity pays

Do Islamic MFIs provide healthy competition to others?

- Space for MFIs funded by grants, not-for-profit and for-profit funds
- Fear of market distortion appears to be largely exaggerated
- Sobering impact on profit-seeking behavior is good for long-term health of the sector

*Example:* Rural Development Scheme of Islamic Bank Bangladesh,
Does Islamic MF better serve the poor?

MFIs are not buyers and sellers of credit, but have a role in economic and social transformation

- Understand the needs of poor, design and offer “smart” products and services
- Involve participation of community
- Ensure cost efficiency through innovative and austere methods
- Establish endowments for provision of safety-nets, non-financial services and absorb specific elements of costs

Example: Dompet Dhuafa, Akhuwat, Islamic Bank Bangladesh, DEEP
ISM is organized as a Legal Regulated Cooperative or Other Institutional Structure.

4 Client

Masyarakat Mandiri, Dompet Duafa

(1) Inception & Growth Stage

- Socialization
- Feasibility Study: Beneficiaries
- Mandatory Group Exercise
- Group Formation
- Financing Productive Business
- Business Mentoring
- Cadre Development
- Completion Systems

(2) Consolidation Stage

- Strengthening Business
  - Strengthening Group-Based and Institutional Business
  - Strengthening Efforts
- Strengthening Organization
  - Independent Admin System
  - Strengthening Financial Reporting and Transparency
  - Strengthening Mgt System of Local Institutions
- Strengthening of Capacities
  - Strengthening Stakeholders Network at Local Level

(3) Self-Reliance Stage

- Self-Reliance & Sustainability Workshop
- Process Evaluation of Independence
- Network & Business Development
- Management of Asset Reform
- Other Required Reinforcement

Autonomy

- Intellectual
- Material
- Managerial
- Time mentoring

Mentoring

Induk

KM

KM

KM

KM

KM
5 Model
Benevolence? Profits?

How do we integrate philanthropy with MF?

- Zakat-funded community-driven-development (CDD)
- Zakat/ waqf-funded credit pool (Mustahiq-2-Muzakki)
- Zakat/ waqf-funded safety net + for-profit MF
- Zakat/ waqf-funded skill-enhancement + for-profit MF
- Zakat-funded guarantee + for-profit MF
- Waqf-funded micro-takaful + MF

Example: Dompet Dhuafa, Akhuwat, Baitul Maal Muamalat, Fae’l Khair, DEEP, Bank Khartoum
Regulation
Too little? Too much?

How should Islamic MFIs be regulated & governed?

- Issues in Shariah compliance while dealing with alternative sources of funds, e.g. zakat, sadaqa, waqf, qard, for-profit funds; Contractual compliance with Shariah
- Transparency, ethics and fairness in dealings – need for maqasid-driven regulatory framework
- Alternative organizational structures that must function under a well-coordinated body of laws and regulations
- Search for new solutions must continue

Example: laws of MF in Indonesia, Bangladesh
References

David Hulme and Mathilde Maitrot, "Has Microfinance Lost its Moral Compass?" BWPI Working Paper 205, August 2014, University of Manchester

Philip Coggan, A Special Report on Debt, Economist, June 24, 2010

Ramesh Arunachalam, An Idea which went Wrong: Commercial Microfinance in India

Maitrot, M. 2013, The Social Performance of Microfinance Institutions in rural Bangladesh, Brooks World Poverty Institute, forthcoming at URL: <http://www.bwpi.manchester.ac.uk>


Thank you

Send your feedback to:
Dr. Mohammed Obaidullah
Senior Economist, Islamic Research and Training Institute
Islamic Development Bank Group, Saudi Arabia
E-mail: mobaidullah@isdb.org