

DRAFT – NOT FOR CITATION

Meeting the Demand for Sustainable, Shari’a-Compliant Microfinance

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Abstract

Although Islamic finance has grown and continues to grow rapidly, it has yet to reach the vast majority of Muslims, many of whom live in the poorest countries on Earth. Reaching these unbanked Muslims with financial services will in many cases require the development of Shari’a-compliant products that are at once affordable for microfinance clients and profitable for the institutions that deliver them. Established Islamic banks may be well-placed to develop these products, but they would do well to draw upon the experience of a highly professionalized microfinance industry. This paper seeks to provide an overview of the current microfinance landscape, including its challenges, and explore potential synergies with the Islamic finance industry. The aim is to create a common framework for an exchange between microfinance practitioners and Islamic finance practitioners, an exchange that can lead to the joint development of affordable, profitable, and Shari’a-compliant microfinance products and the deepening of access to financial services in the Muslim world.

Introduction

Despite its popularity in predominantly Muslim countries like Bangladesh, microfinance has few champions in the burgeoning Islamic banking industry. Although some microfinance programs have attempted to introduce Shari’a-compliant financial products, these have had only limited success. In many cases, the cost of maintaining an Islamic window at a microfinance institution has been much higher than expected. Moreover, the development and delivery of these products have generally been highly subsidized by donor or government funds. As such, current Islamic microfinance programs, even if they show limited success, do not appear capable of expanding to reach the tens of millions of unbanked Muslims. To do that, they would need to become profitable and represent a viable business proposition for Muslim and non-Muslim investors.

Islamic banks, with their wide range of well-developed and successful Shari’a-compliant instruments and strong capital base, may be well-positioned to adapt these instruments for poorer customers. The prospect is exciting because such an effort could lead to the development of an Islamic microfinance industry that is profitable from the outset and potentially able to reach scale quickly. Although there may be no turn-key solutions for Islamic financial services directed to poorer customers, Islamic banks can draw upon the experience of a highly professionalized microfinance industry to reach the unbanked who demand Shari’a-compliant financial services. Such an effort could ultimately strengthen the outreach of the entire microfinance industry and possibly contribute to innovations that would improve, not only breadth and depth of outreach, but also the overall transparency and efficiency of microfinance services.

The Current Microfinance Landscape

Once a niche market essentially about the single product of micro-enterprise credit, microfinance now signifies a wide range of financial services for the poor as well as diverse institutions and delivery channels. Sustained growth and stability have contributed to greater investment in microfinance, which in turn has helped further the professionalization of the industry’s services and standards.

Diverse services and institutions

Safe places to save, old-age pensions, reliable money transfers, insurance—all are now recognized microfinance services that help people heretofore excluded from access to financial services build assets, plan for the future, and cope with the present. Along with diversification of products, the number of microfinance service providers and resources channeled through them has expanded. Commercial, postal, and agricultural banks are all

part of the vision of “scaling up” microfinance, of providing access to financial services for more and more poor people. Indeed, a recent CGAP study suggests that poor people may have as many as 750 million credit and savings accounts in such Alternative Financial Institutions.¹

Diverse delivery channels

Some microfinance providers are overcoming the lack of infrastructure among poor populations by using technology to deliver financial services. South Africa’s Wizzit has no branches of its own but reaches the unbanked through their cell phones and a debit card instead. Other banks have followed, and now 400,000 South Africans are making one million cell phone banking transactions every month. The Philippines’ two biggest cell phone companies, Globe Telecom and SMART, both offer a service that allows customers to send money, pay for goods with their phones, and more. Some 4.5 million Filipinos have signed up in just four years. Even Vodafone, one of the world’s largest mobile telecommunications firms, is piloting a link between cell phones and financial services for the poor in Kenya.

Growth

The microfinance industry is growing fast, adding nearly 15 percent more borrowers each year since 1999. The number of self-sustainable institutions is growing, too. Today, there are at least 400 sustainable institutions reporting to the Microfinance Information eXchange, or MIX, the industry’s most trusted source for market data. All told, these institutions have helped microfinance mature into one of the most successful and fastest-growing industries in the world; worldwide, the leading microfinance institutions are nearly twice as profitable as the leading commercial banks.

Stability

In the last decade in emerging markets, microfinance has been a more stable business than commercial banking. During Indonesia’s 1997 financial crisis, for example, commercial bank portfolios imploded, but loan repayment among Bank Rakyat Indonesia’s more than three million micro-borrowers barely declined at all. During the more recent Bolivian and Colombian banking crises, microfinance portfolios suffered slightly, but remained substantially healthier than commercial bank portfolios, and the microfinance institutions remained more profitable.

Investment

Microfinance funds’ investment in MFIs tripled in two years to \$2 billion in 2006, and CGAP estimates that foreign capital investment in microfinance has reached \$5 billion. Moreover, some of the world’s largest commercial investors are putting millions into microfinance. Institutional investors such as pension fund TIAA CREF have 17 percent of the market share in microfinance funds, up from 5 percent in 2004. In addition, equity fund Sequoia Capital -- which provided venture capital funding to Google, Yahoo!, and YouTube -- recently invested \$11.5 million in India’s SKS Microfinance, making it the largest for-profit microfinance institution in the world.²

Professionalization

Microfinance is today widely understood and practiced as retail banking for low-income people, with standards and services that draw upon the professionalism of the larger banking sector. The services are the same: loans, deposit facilities, money transfers. Moreover, the standards are increasingly the same: more than 100 recipients of the CGAP Financial Transparency Award comply with International Financial Reporting Standards, for example, and core performance indicators for microfinance have been widely adopted.³ Microfinance is serious business and, with its huge untapped market, may be shaping the future of retail banking.

Developing Practical Models for an Islamic Microfinance

Islamic financial institutions have the potential to play an even greater role in the future of retail banking than they currently do by catering to a mostly overlooked segment of the poor -- Muslims who demand Shari’a-compliant products. With few donor-funded NGOs offering Shari’a-compliant microfinance, there is an opportunity for well-

¹ See *Financial Institutions with a Double Bottom Line: Implications for the Future of Microfinance*, CGAP Occasional Paper No. 8, July 2004.

² See *Sequoia Invests \$11.5 Million in Microfinance Fund*, CNBC.com, March 27, 2007, <http://www.cnbc.com/id/17844093>.

³ For a full discussion of these indicators, see *Core Performance Indicators for Microfinance*, CGAP, April 2006.

capitalized Islamic banks to develop practical models that rely not on donor funds, but on well-known principles that emphasize profitability while offering the potential to be highly transparent as well as impact-driven. These principles, notably, are: the materiality of products, as represented in the *murabaha* and *ijara* instruments; and risk-sharing, as represented in the *musharaka* instrument. These instruments, and the principles which underlie them, can not only support the development of Islamic financial services for the poor; they can also potentially contribute to the development of the broader microfinance industry. The following discussion explores both opportunities, offering possible ways forward drawn from the broader microfinance industry.

The Materiality Model: *Murabaha* and *Ijara*

In a *murabaha* or *ijara* transaction, the provider of funds purchases a commodity and resells or leases it to the user with a mark-up against installments or delayed payment. In other words, the materiality of a *murabaha* or *ijara* transaction essentially objectifies transparency in the form of a commodity -- a sewing machine sold or leased to a micro-entrepreneur, for example. In this case, the retail "price" of a microfinance transaction is actually set by a competitive market for sewing machines.

The client in such a transaction benefits from competition on the wholesale market, but the costs to a microfinance provider associated with purchasing, maintaining, selling or leasing, and then tracking a commodity raise questions about the efficiency of a *murabaha* or *ijara* transaction. Will these added costs, though perhaps more transparent, actually result in higher prices for microfinance clients?

More practical experience is needed to address the question of efficiency. Still, the experience of conventional microfinance to date may be instructive. The average Operating Expense Ratio (OER) of microfinance providers reporting to *The MicroBanking Bulletin*, published by the MIX, is approximately 30 percent. Although this figure probably represents considerable inefficiency (commercial banks typically report OERs of well below five percent), the higher cost is mostly a function of servicing many more -- and much smaller -- loans than larger lenders.

Islamic financial institutions must come to terms with the true cost of microfinance and the implications of serving poorer customers profitably and sustainably. One clear implication is around pricing. To cover their costs, conventional microfinance providers charge higher interest rates than those of larger commercial banks. These rates are usually significantly lower than those charged by informal moneylenders, however, boosting the demand for microfinance services where they are available. Indeed, most MFIs report repayment rates approaching 100 percent among their clients.

This argument carries the assumption that demand for micro-credit and continuous external financing is highly inelastic around initial accessibility amounts. Still, the persistence of high interest rates, even in highly active and competitive markets like Bangladesh, has led policymakers especially to question whether the price of financial services for the poor is too high. Although many in the microfinance field see this as political grandstanding -- in some cases, a legitimate claim -- there is little doubt that greater attention is being paid to the price of microfinance. In addition, questions are being raised about the accessibility of microfinance services for especially poor populations and, as a corollary, to whether MFIs are by necessity serving higher-income customers.

Islamic financial institutions would not be immune to these questions. To deal effectively with them, Islamic microfinance providers, regardless of the instruments they utilize, must: 1) be realistic about the cost of serving poorer customers, especially in remote rural areas; 2) engage policymakers and others to educate them about the true cost of microfinance; and 3) explore innovative ways to reduce the cost of microfinance transactions.

Much thinking has already been done and substantial investment has been channeled to adapting existing technologies that can be used for banking the poor more cost-effectively. By accessing an automated teller machine, the Internet or, increasingly, a mobile phone, clients of large commercial banks can assume much of the cost burden (i.e., maintaining bank branches) of delivering financial services. Recent efforts at extending these "branchless banking" services to poorer populations show great promise.⁴

However, the vast majority of microfinance programs still rely on loan officers to collect or disburse payments. The potential to avoid such costly activities is seen most clearly in the meteoric increase of mobile phone usage in the developing world. The number of mobile phone subscribers worldwide has doubled -- to two billion -- in just over two years, with more than 80 percent of that growth coming from developing countries, according to the

⁴ See *Using Technology to Build Inclusive Financial Systems*, CGAP Focus Note No. 32, January 2006. For further background, see also www.cgap.org/technology.

GSM Association. This bodes well for the replication of successful models like those of Wizzit,⁵ Globe Telecom, and SMART.

Besides mobile phones, technology may offer two other ways to further reduce the costs of a *murabaha* or *ijara* transactions. The first, and more obvious, is by utilizing microchip technology to track assets. The second involves leveraging point-of-sale (POS) devices to extend outreach through banking agents.

Banking agents are retail vendors, lottery outlets, post offices—any trusted local establishment that can double as a kind of bank branch for their customers, processing everything from bill and pension payments to deposits, withdrawals, and money transfers. In Brazil, for example, these agents are known as *correspondentes bancarios*, and their long track record of delivering reliable financial services to the previously unbanked points to an exciting opportunity for other microfinance markets.⁶

Banking agents process transactions with POS card readers, barcode scanners, and sometimes personal computers that connect with the bank's server using a dial-up or other data connection. The clerk at the retail or postal outlet collects and disburses cash and, in some cases, opens bank accounts for new clients and fills in credit applications. The retail outlets earn a portion of the transaction fee, and some generate so much business from handling these transactions that they dedicate an employee to operating the POS device.

Of course, the problems with this model revolve around the risk of fraud. The risk is so pronounced that some banks use management companies to not only identify, equip, train, and support banking agents, but to assume all liabilities for the cash they handle. The risk involved in a *murabaha* or *ijara* transaction, however, could be far less. In other words, an "Islamic banking agent" could be made to transact an actual commodity, not simply cash. Since these agents are typically local vendors, the link is a natural one and again leverages the competition of the wholesale market to offer lower, more transparent prices for poor clients.

By emphasizing materiality, *murabaha* and *ijara* instruments offer the potential to bank the poor through highly transparent transactions that leverage the economies of scale of wholesale markets. Still, many of the challenges of managing these transactions efficiently will remain the same as those of conventional microfinance. The prices associated with delivering financial services to the poor must not be underestimated by Islamic financial providers. Recognizing this, they must make efforts to educate policymakers and others about the value of their services to poor clients, even as they support the search for innovative solutions that can dramatically reduce the cost of these services. Many of the solutions today being explored in conventional microfinance can contribute to the more efficient and transparent delivery of *murabaha* and *ijara* transactions for the poor.

The Risk-Sharing Model: *Musharaka*

In a *musharaka* transaction, the financier enters into an equity participation agreement with other partners to jointly finance an investment project and participate in its management. Profits (and losses) are shared among partners based on their respective contributions to capital. A *musharaka* transaction gives the microfinance provider an equal stake in its clients' success and could potentially help address a critical development need in much of the Islamic world -- creating jobs.

However, a *musharaka* transaction carries significant risks and associated costs for the microfinance provider. In practice, an Islamic microfinance provider would need to offer business development and capacity-building services through a separate window than that of the financial transaction. Some conventional microfinance providers do offer training and other services to their clients. In many cases, however, these services rely on donor funds or cross-subsidization from other segments of a microfinance provider's business. A similar approach could be taken by Islamic financial institutions offering microfinance -- for example, these institutions could draw upon *zakat* contributions, or alms, to fund training opportunities through a *qard hasan* (or profit-free) model -- but Islamic microfinance providers must take great care not to allow such activities to undermine the profitability of their financial services.

Addressing this challenge, some microfinance institutions (MFIs) are finding ways to link with existing safety net programs to "graduate" the poorest from reliance on grants and into access to financial services. There are two basic models for linking grant-based programs with sustainable microfinance programs.

⁵ For more on Wizzit, see *Mobile Phone Banking and Low-Income Customers: Evidence from South Africa*, CGAP, UN Foundation, and Vodafone Group Foundation, 2006.

⁶ Part of the excitement comes from the sheer scale of banking agents' services in Brazil. An estimated US\$1 trillion in transactions were processed through Brazil's 58,000 agents in 2005, and about six million current accounts were opened across this network in the past three years, according to Banco Central do Brasil. Already, the model has spread to Mexico, Peru, Colombia, and Chile.

In the first model, safety net programs themselves develop basic financial services for their clients to help them better manage their livelihoods. The MFI's engagement with the safety net program is limited: the MFI simply coordinates with the safety net program to recruit successful "graduates" as customers. The advantage for the MFI is that the safety net program generates information about participants' behavior that can later help the MFI make better decisions about the likelihood these participants will repay loans. For example, an MFI would consider a safety net participant with a track record of showing up for work, saving regularly, or even repaying a loan offered by the safety net program to be a less risky borrower when she eventually approaches the MFI for regular micro-credit. An MFI with access to such information can make safer loans to poorer clients than an MFI without this information. The relationship also benefits safety net participants, because it gives them a long-term path forward and motivates good performance while they are with the safety net program. This win-win situation creates little extra cost or risk for either the program or the MFI. Even a weak MFI can use this strategy to pursue its social mission to sign up promising clients without jeopardizing its ability to achieve sustainability.

The second model involves a more intense collaboration between an MFI and a safety net program. In this model, the MFI establishes a separate subsidiary or affiliate that works directly with safety net participants. In cooperation with the safety net program, the MFI subsidiary provides non-financial services and, perhaps, some subsidized savings or credit. Successful graduates gain access to the MFI's regular programs. The MFI subsidiary will need access to soft money to be able to offer its services to participants, until participants are able to join the mainstream microfinance program. This second model entails high costs and risks for the MFI, including the risk that handing out "grants" as part of the safety net program could undermine the culture of strict repayment discipline that is an essential part of the MFI's micro-credit operation. As such, there needs to be a clear distinction between the safety net and MFI components. This is typically accomplished by using separate staff working in a separate subsidiary. This direct engagement model would work well only for a mature, exceptionally strong MFI whose core business is operating so solidly and sustainably that it can afford to have its management and staff resources diluted.⁷

Islamic banks, which boast strong systems and management capacity as well as a wide range of instruments -- including, for example, *qard hasan* -- have the potential to implement the second model above as part of a *musharaka* transaction. This would require the careful sequencing of grants, training programs, and financial services so as not to compromise the sustainability of the microfinance operation, on the one hand, and, on the other hand, to create the best conditions for the client's success.

Envisioning Islamic Financial Services for the Poor

Islamic financial institutions can offer valuable products and services to microfinance clients. At the same time, the intent and design as well as the challenges of Islamic finance for the poor must be clear. With respect to intent and design, the asset-backed nature of Islamic finance (e.g. in a *murabaha* or *ijara* transaction) provides for an arguably different business relationship with clients than that of conventional microfinance, which views uncollateralized loans as essential to creating *access* to finance. This access can -- and often does -- support more than micro-entrepreneurship: for farmers and itinerant workers, it helps "smooth consumption" during months without income; and for victims of natural or man-made disaster, it can help rebuild homes or pay for emergency medical bills. The *musharaka* transaction also presupposes some sort of business activity for the microfinance client.

To the extent that microfinance is a development intervention, however, with the aim of lifting poor people out of poverty, Islamic financial services, while addressing the significant demand for Shariah-compliant products, may also offer practical models for conventional microfinance. In particular, models based on materiality and risk-sharing offer opportunities to build on current microfinance experience and to develop synergies around the development of new technology-driven delivery channels as well as "graduation" programs that can help develop and sustain the capacity of microfinance clients.

Any model for Islamic microfinance, if it is to attain the scale necessary to reach the tens of millions of unbanked in the Muslim world, must become profitable for microfinance providers and affordable for microfinance clients. Getting there will take the investment, commitment, and bold leadership of Islamic financial institutions themselves. It will also take a practical approach that acknowledges the challenges of delivering affordable and profitable financial services to the poor and builds on the successes of the larger microfinance industry.

⁷ For more on the different models for "graduation" programs, see *Graduating the Poorest into Microfinance: Linking Safety Nets and Financial Services*, CGAP Focus Note No. 34, February 2006.