

# ***Session IV***

## ***Islamic Microfinance: Challenges and Prospects***



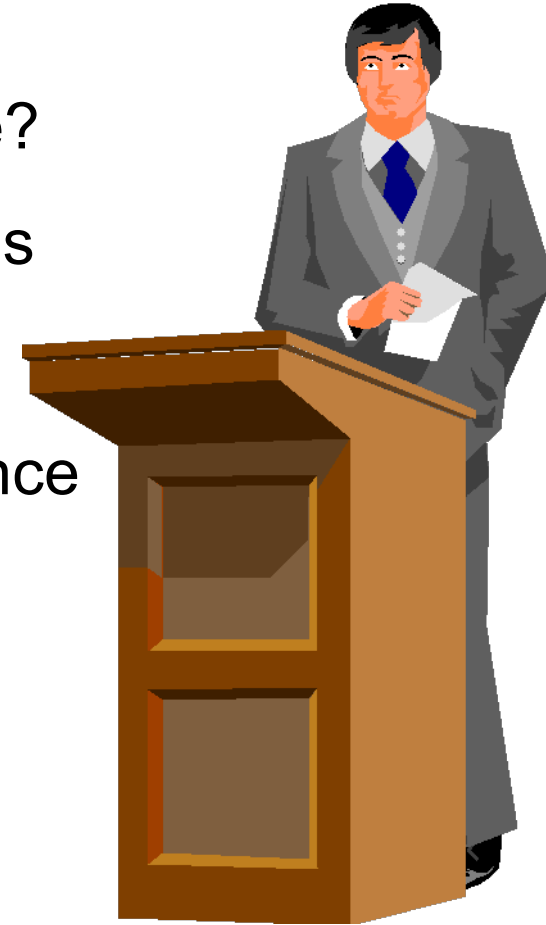
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# Agenda

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1. Is there a demand for Islamic Microfinance?
2. What does Islamic Microfinance offer that is different and innovative?
3. Shariah Compliance vs Shariah Performance
4. What is the Main Challenge and Solution?



1.

## Is there a Demand for Islamic Microfinance?

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## Is there a demand for Islamic microfinance?

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- Strong demand from Muslim population
- 72% of people living in Muslim majority countries do not use formal financial services (Honohan 2007)
- Strong demand from non-Muslims too
  - Participatory Finance in Benin, Cameroon etc

**Key is to demonstrate Value Proposition of  
Islamic Microfinance**

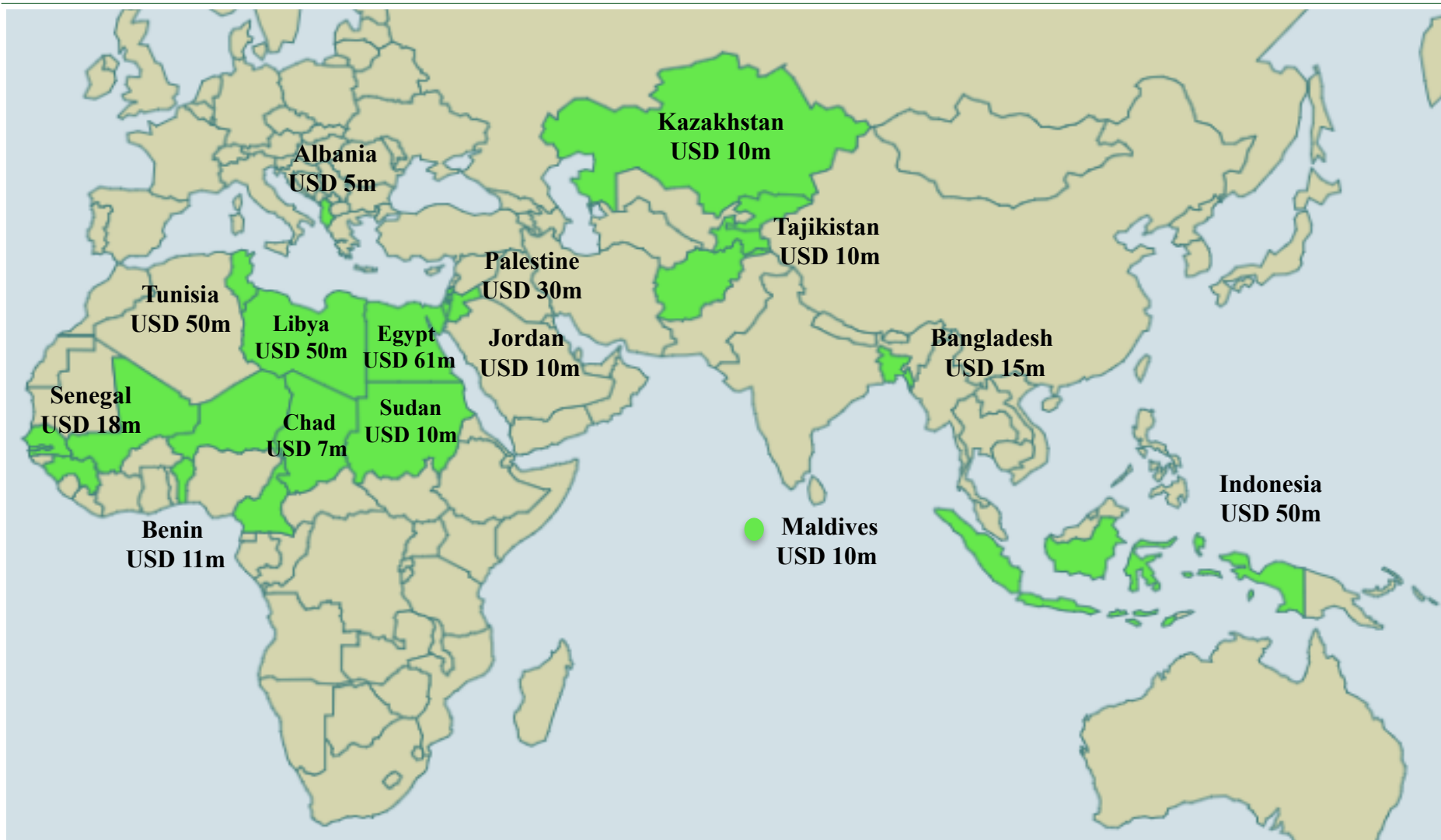
# IDB Involvement in Islamic Microfinance

Type Of Operation	No of Projects Supported	Approved Financing Participation (US\$)
Full-Fledged Micro – Very Small Finance Projects	25	221,231,200
Vocational Literacy Programs with Microfinance Component	4	42,463,237
Integrated Community Development Projects with Microfinance Component	17	46,460,235
Grand Total	45	310,154,672





# IsDB's Flagship Islamic Microfinance Operations



2.

**What does Islamic Microfinance offer that is different and innovative?**

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# Islamic Microfinance- 3<sup>rd</sup> Wave of Innovation

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## 1<sup>st</sup> Wave of innovation (Year 1983) :

- Professor Mohammad Yunus established the Grameen Bank
- Innovation: Replaced physical collateral with social collateral
- Achievement
  - Won Nobel Peace Prize in 2006
  - Practiced in more than 100 countries





# Islamic Microfinance- 3<sup>rd</sup> Wave of Innovation

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## 2<sup>nd</sup> Wave of innovation (Year 2012) :

- Safaricom riding on the success of Mpesa, started MShwari
- Innovation: Allowed people to borrow money without physical or social collateral
- Achievement in 2 years
  - Has 6.9 million customers in Kenya
  - Disbursed USD 276 million of loans in Kenya
  - Similar loan products being replicated in other parts of the World



# Islamic Microfinance- 3<sup>rd</sup> Wave of Innovation

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## 3<sup>rd</sup> Wave of innovation (Current) :

- Islamic microfinance – Providing Finance +
- Innovation: Empowering microfinance institutions to go beyond their role as the financial intermediary
- Achievement (winners of Ethical Finance Innovation Challenge Awards 2014)
  - More than 300 Shariah compliant microfinance institutions in 32 countries (CGAP 2012)
  - Akhwat: Providing interest free microfinance
  - Bank of Khartoum: Group Value Chain Microfinance



## Why is Islamic microfinance different?

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- Not just about Access to Finance but also Access to Markets, Access to Knowhow, Access to Technology etc: FINANCE ++
- Doing Business with clients- Buying, selling and investing with clients and value chain stakeholders
- Negotiate with Suppliers on behalf of clients
- Negotiate with Buyers on behalf of clients
- Treat Clients as Business Partners and not as Debtors



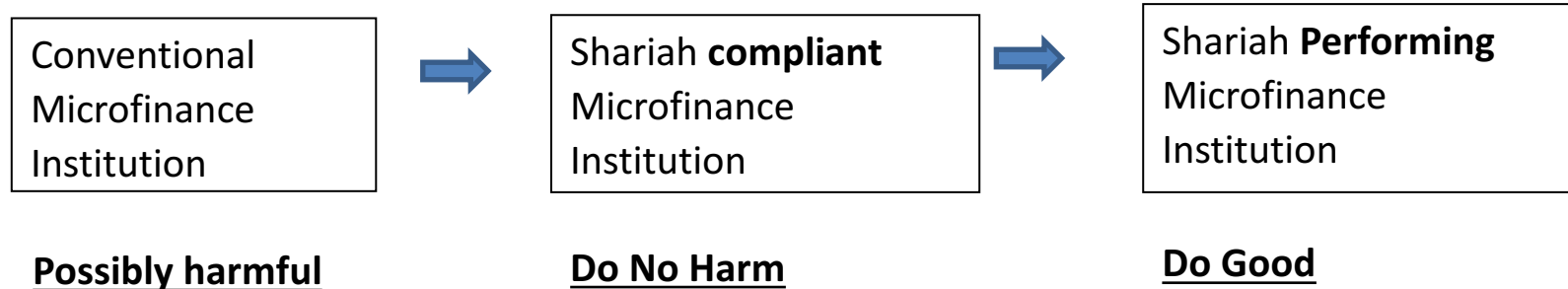
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## Shariah Compliance vs Shariah Performance

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# Shariah Complaine vs Shariah Performance



1. Islamic microfinance is about achieving Shariah performance and not just compliance
2. Shariah compliance – Putting in place some measures prescribed by the Shariah to prevent the harmful effects of debt. DO NO HARM APPROACH.
3. Shariah performance- Active involvement in value chain in order to generate a win- win scenario between MFI and client. DO GOOD APPROACH.

# A Comparison

## Conventional Microfinance

- Client needs \$500 to buy fertilizer and seeds
- Borrows from MFI at 30% interest per annum over 1 year
- Pays \$650 after 12 months (\$500 principle, \$150 interest)
- If delayed by another 12 months, pays \$195 additional interest (\$150 additional on the principle and \$45 additional interest on the interest)
- Penalty fines may be incurred as income

## Shariah Compliant Microfinance (Murabaha Financing)

- Client needs \$500 (purchase price) to buy fertilizer and seeds
- Borrows from MFI at 30% profit per annum over 1 year
- Pays \$650 (selling price) after 12 months (\$500 principle, \$150 profit)
- If delayed by another 12 month, not additional profit is due
- Penalty payments allowed but must be given to charity





## A Comparison

### Shariah Performing Microfinance (Murabaha Financing)

- Client needs \$500 to buy fertilizer and seeds
- MFI negotiates with supplier at retailer or wholesaler level, gets 30% discount
- Negotiated purchase price \$350 (purchase price)
- Borrows from MFI at 30% profit per annum over 1 year
- Pays \$455 (selling price) after 12 months (\$350 principle, \$105 profit)
- If delayed by another 12 month, not additional profit is due
- Penalty payments allowed but must be given to charity

	Paid by client	
Method	Due After 12 months	Due After 24 months
Conventional Microfinance	\$650	\$845
Shariah Compliant Microfinance	\$650	\$650
Shariah Performing Microfinance	\$455	\$455

## A Comparison

### Shariah Performing Microfinance (Salam Financing)

- Client needs \$500 to buy fertilizer and seeds to sell \$1000 of tomatoes
- Since target profit rate is 30%, it contracts the tomatoes for \$769 (\$1000/1.3)
- MFI negotiates with buyer for 30% higher price selling at \$1300
- MFI receives tomatoes from client and sells to buyer at \$1300
- Returns 50% of the additional profit of \$300 to client (ie \$150)

Method	Profit of Client from the transaction	Profit/Interest of MFI from the transaction
Conventional Microfinance	$\$1000 - \$650 = \$350$	$\$650 - \$500 = \$150$
Shariah Compliant Microfinance	$\$769 - \$500 = \$269$	$\$1000 - \$769 = \$231$
Shariah Performing Microfinance	$\$769 - \$500 + \$150 = \$419$	$\$1000 - \$769 + \$150 = \$381$

# Equity Oriented Investment – Abu Halima Greenhouses using Mudaraba Financing

## The IDEA

- A group of Agricultural Graduates wanted to supply to the market tomatoes during summer when prices are 5 to 6 times the price in winter.
- Although the weather in Sudan is too hot in Summer to grow tomatoes, greenhouses can reduce the temperature and make it conducive to grow tomatoes
- Greenhouses can reduce temperatures during winter even further to grow high value vegetables and fruits that are often found in temperate countries

## The PROCESS

- ▶ Idea developed into a business plan in collaboration with IRADA and the graduates
- ▶ Feasibility Study commissioned
- ▶ IRADA approved maximum SDG 15.00 million (USD 4.50 million) Mudaraba investment

## The VALUE ADD/ SMART Financing

- ▶ IRADA helps graduates earn twice their expected market salary
- ▶ IRADA targets 30% IRR (IRR currently at 22%)
- ▶ IRADA controls the venture during the 5 year implementation period to ensure that it is profitable
- ▶ Graduates are trained to manage the venture during this period
- ▶ IRADA cedes control of the project assets to the Agriculture Graduates Cooperative to manage the project after 5 years



4.

## What is the Main Challenge and Solution?

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# Main Challenge of Islamic Microfinance Institutions

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## To be Shariah Compliant but not achieve Shariah Performance

- Mindset Shift from Creditor to Business Partner MFIs
- Capacity Building in managing business risks not just credit risks

**Creditor  
MFIs**



**Business Partner  
MFIs**

# Solution: IMPACT Program

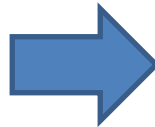
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## The goal of the program is to create

- a) a platform for experts to share and deepen the understanding on the Islamic Microfinance models; as well as to
- b) create tools and infrastructure in order to share best practices, governance and standards.

## 5 IMPACT Pillars

- 1) Operations
- 2) Monitoring & Evaluation
- 3) Policy & Standards
- 4) Technology
- 5) Advocacy



## Output

- Toolkits
- Research on what works
- Implementation standards
- Capacity Building
- Technology systems

**By Working with partners and stakeholders**





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