Session IV

Islamic Microfinance: Challenges and Prospects

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Agenda

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?
Is there a demand for Islamic microfinance?

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

Key is to demonstrate Value Preposition of Islamic Microfinance
## IDB Involvement in Islamic Microfinance

<table>
<thead>
<tr>
<th>Type Of Operation</th>
<th>No of Projects Supported</th>
<th>Approved Financing Participation (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full-Fledged Micro – Very Small Finance Projects</td>
<td>25</td>
<td>221,231,200</td>
</tr>
<tr>
<td>Vocational Literacy Programs with Microfinance Component</td>
<td>4</td>
<td>42,463,237</td>
</tr>
<tr>
<td>Integrated Community Development Projects with Microfinance Component</td>
<td>17</td>
<td>46,460,235</td>
</tr>
<tr>
<td>Grand Total</td>
<td>45</td>
<td>310,154,672</td>
</tr>
</tbody>
</table>
IsDB's Flagship Islamic Microfinance Operations

- Tajikistan USD 10m
- Palestine USD 30m
- Jordan USD 10m
- Egypt USD 61m
- Bangladesh USD 15m
- Indonesia USD 50m
- Libya USD 50m
- Tunisia USD 50m
- Senegal USD 18m
- Benin USD 11m
- Chad USD 7m
- Sudan USD 10m
- Kazakhstan USD 10m
- Maldives USD 10m
- Libya USD 50m
- Tunisia USD 50m
- Senegal USD 18m
- Benin USD 11m
- Chad USD 7m
- Sudan USD 10m
- Kazakhstan USD 10m
- Maldives USD 10m
What does Islamic Microfinance offer that is different and innovative?
Islamic Microfinance- 3rd Wave of Innovation

<table>
<thead>
<tr>
<th>1st Wave of innovation (Year 1983) :</th>
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<tbody>
<tr>
<td>- Professor Mohammad Yunus established the Grameen Bank</td>
</tr>
<tr>
<td>- Innovation: Replaced physical collateral with social collateral</td>
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<tr>
<td>- Achievement</td>
</tr>
<tr>
<td>- Won Nobel Peace Prize in 2006</td>
</tr>
<tr>
<td>- Practiced in more than 100 countries</td>
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</tbody>
</table>
Islamic Microfinance- 3\textsuperscript{rd} Wave of Innovation

2\textsuperscript{nd} 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 - 3rd Wave of Innovation

3rd 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?

- 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
3. Shariah Compliance 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

<table>
<thead>
<tr>
<th>Method</th>
<th>Due After 12 months</th>
<th>Due After 24 months</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conventional Microfinance</td>
<td>$650</td>
<td>$845</td>
</tr>
<tr>
<td>Shariah Compliant Microfinance</td>
<td>$650</td>
<td>$650</td>
</tr>
<tr>
<td>Shariah Performing Microfinance</td>
<td>$455</td>
<td>$455</td>
</tr>
</tbody>
</table>
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 (i.e., $150).

<table>
<thead>
<tr>
<th>Method</th>
<th>Profit of Client from the transaction</th>
<th>Profit/Interest of MFI from the transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conventional Microfinance</td>
<td>$1000 - $650 = $350</td>
<td>$650 - $500 = $150</td>
</tr>
<tr>
<td>Shariah Compliant Microfinance</td>
<td>$769 - $500 = $269</td>
<td>$1000 - $769 = $231</td>
</tr>
<tr>
<td>Shariah Performing Microfinance</td>
<td>$769 - $500 + $150 = $419</td>
<td>$1000 - $769 + $150 = $381</td>
</tr>
</tbody>
</table>
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.
What is the Main Challenge and Solution?
Main Challenge of Islamic Microfinance Institutions

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
Solution: IMPACT Program

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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Together We Build a Better Future