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Financing the Poor: Towards Islamic Microfinance

This symposium held at Harvard University brought together a diverse group of international speakers and a number of noted individuals from the microfinance and Islamic finance sectors. Nazim Ali, director of the Islamic Finance Project (IFP) at Harvard Law School, gave the opening address, and reports on the event for NewHorizon.

Microfinance is not reaching the poorest of the poor, even though this is its purpose, and loans are going to activities unrelated to entrepreneurship. Islamic finance could, in principle and in practice, correct these defects.

The Islamic finance sector has for some time focused on the development of its business, including the standardisation and consolidation of the industry. This approach has marginalised a large number of 'unbankable' members of society. Microfinance is one such area that has been neglected by the industry, and many financial institutions around the world are working to address this – not just for philanthropic reasons, but because this is a vast sector on which they can capitalise. The Islamic International Ratings Agency (IIRA) is currently involved in discussions with the Islamic Development Bank as to how to promote microfinance in Muslim countries. Financial institutions such as Deutsche Bank and the Islamic Bank of Thailand have also decided to venture into Shari'ah-compliant microfinance. Other efforts are under way on an experimental basis, although it is more difficult to provide a detailed account of these.

While Islamic finance aspires to create an equitable economy, it has in the eyes of many become a banking system for the rich. Conventional microfinance, meanwhile, has demonstrated success as a tool to help reduce poverty and encourage economic growth in neglected, rural parts of the world, but the flip side of this coin reveals criticism of the industry's tendency to charge the poor exorbitant interest rates and fees. These are often necessitated by the high transaction costs incurred in microfinance, including the provision of services to monitor and supervise entrepreneurial endeavours, health insurance, and so on. With the two industries sharing the common goal of social justice, the aim of the IFP symposium was to bring together representatives from both, so that each party could learn from the other and move towards a viable system of Shari'ah-compliant microfinance.

The IFP symposium wanted to explore the role of the Islamic finance industry as a source of funding for microfinancing initiatives and to serve as a medium to promote alternative financial instruments within the Islamic finance industry. With many microfinance services offered on a not-for-profit basis, the viability of harnessing traditional Islamic financial institutions that use zakat and waqf as a source of funding was discussed. Also considered was the potential collaboration between industry and academia to provide better tailored microfinance models which would serve the needs of increasingly sophisticated microfinance institutions, while simultaneously creating alternatives, with lower service costs and increased accountability and transparency, for borrowers on the ground.

Misconceptions about intangible hurdles which have to be overcome within the Islamic finance industry, as well as microfinance, were aired within the symposium. Many suggestions were offered as means of overcoming sources of mutual misunderstanding, with a view to better serving the poor, particularly in Muslim economies. Communication is key.

Baber Johansen, acting director of the Islamic Legal Studies Program and affiliated professor at Harvard Law School, chaired the symposium. He opened the session by commenting on the burgeoning interest in financing the poor and the Islamic finance industry's long-standing desire to promote equitable economic development. In his opinion, this offers a strategic approach towards a charitable goal.

Robert Annibale, global director of microfinance for Citigroup, was the first keynote speaker. He shared his insights into both Islamic finance and microfinance. He described microfinance institutions as self-styled 'bankers of the poor', originally rooted in domestic, local markets but increasingly expanding into larger markets and offering a broader range of services. He noted that the high operating costs, passed on to the customer in the form of high interest rates, are a hurdle for the poor. Annibale encouraged institutions to try to make their operations more cost-effective, because the customer inevitably pays for any inefficiencies. He felt that this was where there is potential for Islamic finance to make a difference.

Under conventional microfinance, risk is borne by borrowers and rarely held by the institutions. Non-governmental organisations (NGOs) and other non-profit institutions offer efficient services to supplement their lending, but these services add to the cost base. Islamic finance focuses on interest-free methods of providing capital, because the Shari'ah holds lending to be a purely charitable exercise, rather than a means of making a profit. Islamic finance is also accustomed to methods of risk–reward sharing between the institution and the borrower.

Taking a step back, Annibale then reviewed the market, highlighting the work of the Microfinance Information Exchange and its transparent analysis of microfinance groups. He noted that there were only small-scale microfinance offerings across North Africa and Pakistan and that competition in this part of the world would be beneficial. Indonesia and Bangladesh, on the other hand, have more developed microfinance markets. In fact, microfinance institutions enjoy greater penetration than traditional commercial banks in Bangladesh.

Microfinance has grown significantly in India, but the industry there faces a number of restrictions, imposed to protect customers from very high interest rates, as well as objections raised against usury and exploitation from religious leaders. In his closing remarks, Annibale stressed that the industry is in need of competition and innovation if it is ultimately to be of benefit to its customers.

Aamir Rehman, former global head of strategy at HSBC Amanah, presented the second keynote address on behalf of Iqbal Khan, HSBC Amanah's founding CEO. Rehman considered the extent to which the Islamic finance ethos is compatible with the spirit of microfinance. From the perspective of the Shari'ah, Islamic finance should focus on ethics and values that encourage community-based, alternative programmes to promote genuine economic activity. As a nascent industry, however, it still faces a number of challenges to its credibility in the finance world. As a result, it has focused less on the alleviation of poverty in the past because it has been working to meet world-class banking standards and to serve its clients in a Shari'ah-compliant way. At the same time as being seen as a viable system of financing, it has had to prove itself to be profitable as well. While the social goals of the Shari'ah are important, Rehman stressed that Islamic finance has to meet commercial standards first. He added that the industry has had to move from a consumer-debt industry to a savings industry, dovetailed by microfinance, because it assists business development and economic activity.

If Islamic finance and microfinance could converge, the industry could reach a three billion person market. Trade, Rehman reminded the audience, has played an integral part in the spread of Islam and Islam has a long history of valuing trade and entrepreneurship. Moving on, Rehman described how traditional banks seek growth through the expansion of customer debts while Islamic banks have tried to move away from this debt-based approach. He could envisage a paradigm shift in Islamic finance away from a 'Shari'ah-compliant' to a 'Shari'ah-based' industry, which uses its commercial services to partner with microfinance institutions with access to rural and poor communities.

Following these two keynote speeches, proposals for, and case studies of, Islamic microfinance were presented in the symposium's first panel session. The session was moderated by Asim Khwaja, associate professor of public policy for the JFK School of Government, Harvard University.

Opening with an alternative view of microfinance, Samer Badawi of the Consultative Group to Assist the Poor (CGAP) expressed the view that, while there is evidence to support the value of microfinance, there is also alarming evidence to the contrary. Microfinance is not reaching the poorest of the poor, even though this is its purpose, and loans are going to activities unrelated to entrepreneurship. Islamic finance could, in principle and in practice, correct these defects.

Professor Hans Dieter Seibel from the University of Cologne, Germany, presented a case study on Indonesia, the largest Muslim country in the world, with a mixed history of Islamic microfinance. Seibel noted that Islamic microfinance banks have statistically not done well compared with their conventional counterparts. Absentee ownership, together with a lack of competence in Islamic finance, have been partly responsible for this, but mudarabah savings and fixed deposits have still been successful. Seibel also emphasised that a proper legal framework and regulation of interest rates are important factors in the success of Islamic microfinance.

Contrasting Afghanistan with Indonesia, Siraj Sait, a senior lecturer in law at the University of East London, talked about the Global Land Tool Network (GLTN), which uses Islamic land tools as a means of empowering the poor. The goal is to create pro-poor, scalable, and replicable tools; to cross-fertilise generic tools with Islamic tools; and to define stakeholders. He also highlighted end-user scepticism over Shari'ah compatibility and lack of state regulation as representing challenges for the industry.

Taha Abdul Basser, a Ph.D. candidate at Harvard University, presented a paper by Dr Muhammad Anas Zarqa, advisor to the International Investor company. Basser explained that, as a young industry, Islamic finance still has to focus on social justice. In order to do so, it has to be more convincing to its clients and it needs to hone managerial talent. Basser discussed the viability of the Islamic instrument of monetary waqf (cash trust) as a means of financing Shari'ah-compliant microfinance. In addition to initial donations, a monetary waqf further mobilises temporary funds that can be extended to the productive poor as microcredits. Basser presented Dr Zarqa's opinion that there should additionally be two tiers of philanthropic guarantors for a monetary waqf to strengthen its security standing: guarantors of liquidity and guarantors of losses. Not only would this help to increase the credit standing of a waqf, but it would also attract a considerable quantity of temporary funds.

Saif I Shah Mohammed, from the Columbia University School of Law, spoke next. He agreed with Badawi that microfinance had been over-hyped. Mohammed was of the view that a partnership between Islamic finance and microfinance would offer the best approach, especially in the case of Bangladesh. He pointed out, however, that Islamic microfinance institutions need to overcome distrust in the microfinance market and clarify terms that have in the past caused confusion. Mohammed also appealed to Shari'ah scholars to take a proactive role in clarifying these terms for the population.

The second session was moderated by Samuel L Hayes, III, Jacob Schiff professor emeritus of the Harvard Business School. The panellists spoke of the challenges of integrating Islamic finance with microfinance. Shari'ah scholar Sheikh Nizam Yaquby noted that the fight against poverty is an important one for Islam and for microfinance. But he pointed out that, unlike conventional microfinance, Islam does not allow exploitation with higher returns. Nadeem Hussain, president and CEO of Tameer Microfinance Bank, expressed his reservations that the lack of fundamental assets make it difficult to apply microfinance to Islamic finance.

The speakers also contended, however, that these issues could be resolved if people from the Islamic finance and microfinance sectors were to work together. Aamir Rehman and Robert Annibale reiterated that a hybrid model, integrating philanthropic and commercial goals, or a not-for-profit model using charitable sources such as zakat, offer a relationship between the Islamic finance and microfinance industries.

Michael Ainley of the UK Financial Services Authority (FSA) compared the current development of microfinance with Europe's transition from credit unions and community banks to its contemporary economic system. Ainley also noted the importance of effective government regulation and supervision of the industries in this process. Aqil Abdus Sabur, interim president of the Philadelphia Commercial Development Corporation, linked the discussion through microfinance as practised by the Prophet Muhammad's (PBUH) companions over a thousand years ago.

The panellists offered closing remarks, reminding the audience of Islam's history in finance and the scope of potential for Islamic microfinance. This is a project that is growing in the US and the UK, as well as in the rest of Europe, the Middle East, and Asia. As Sheikh Nizam Yaquby advised the session, however, it is important to bear in mind that the goal is to eliminate poverty, not to cloak goals to exploit people.

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