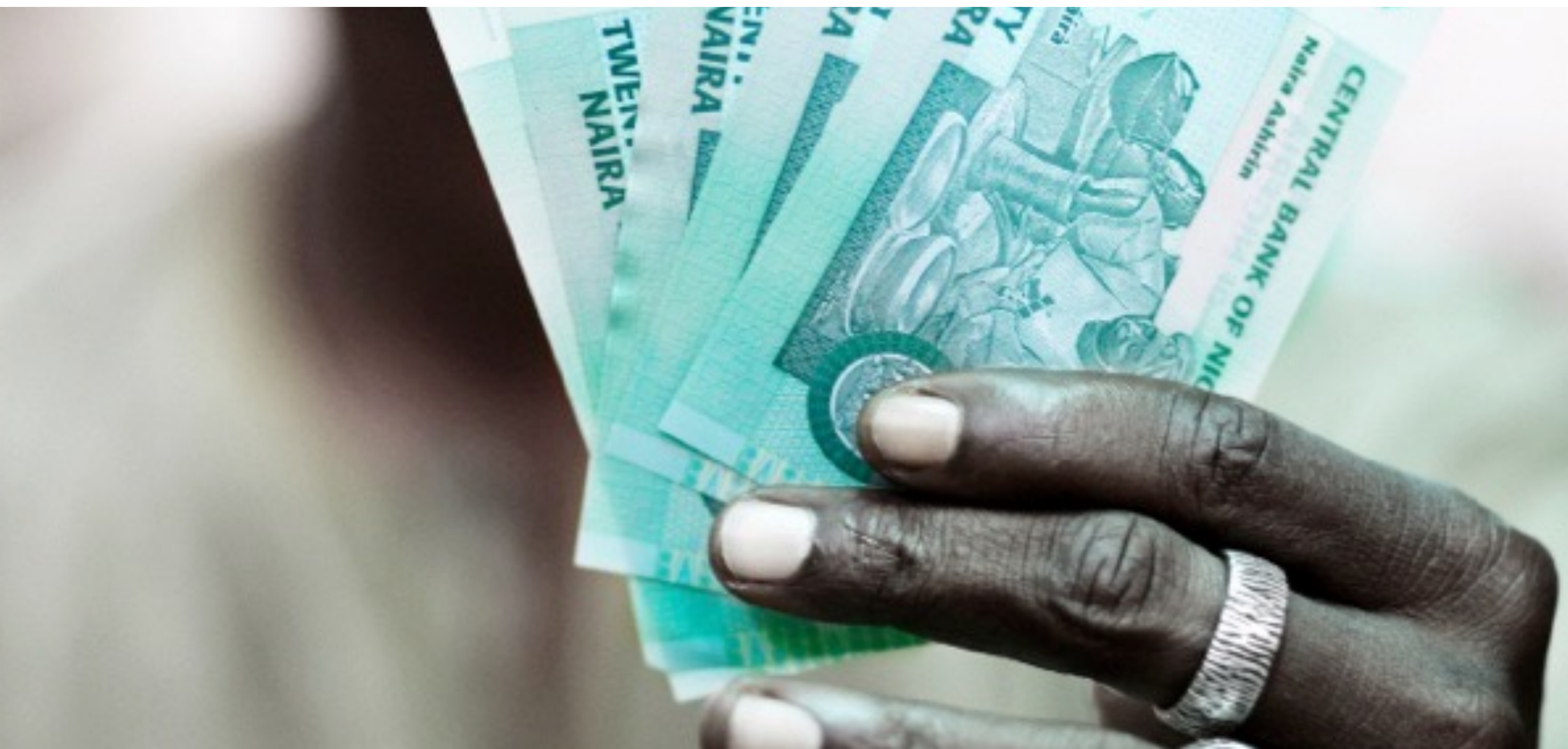
POVERTY TO PROFIT: USING ISLAMIC MICROFINANCE TO ALLEVIATE POVERTY

Poverty alleviation has traditionally been the domain of the interest-based development agency, and profit generation has always been the mainstay of the corporation. Rarely have the two overlapped: corporate shareholders have no interest in giving money away and development banks have little to offer profit-oriented investors.

Note: Before implementing any Islamic finance product, including the structures described in this article, get the approval of a qualified Islamic finance scholar.

Microfinance is a financing tool that sustainably provides very small loans to the working poor. A handful of borrowers, usually 5 to 20 individuals, assemble themselves into groups. The first set of loans are extended to an initial subset of individuals within the group, for instance 2 out of the group's 5 individuals, and once these loans are repaid, a second subset of individuals receive their loans. This continues through the entire group, circulating until a final loan is extended to a designated group leader.



Variations of this general theme abound but the basic underlying principle remains the same: a borrower is much more likely to repay on time if not doing so affects one's selected group partner, usually an acquaintance. The fear of a faceless bank is replaced with the mercy for one's own neighbor. This non-traditional concept of "social collateral" banking allows the poor to break out of the poverty cycle: the provision of capital allows for greater business investment, which leads to increased income, resulting in higher household savings and eventual financial independence.

The Origins of Conventional Microfinance

Microfinance grew out of the failure of cooperative movements and government-sponsored initiatives for concessional individual lending. With some of these heavily subsidized programs yielding repayment rates as low as 40%, there is little wonder they were short-lived.

In the 1970s, Bangladesh's Grameen Bank revolutionized the development world by extending small, interest-based loans to the extreme poor, an economic group commercial banks refused to lend to and development banks found difficult to sustain acceptable repayment rates with. But by assembling individuals into self-selected borrowing groups, particularly in homogeneous settings, peer pressure and peer assistance lead to a form of informal monitoring that paved the way for continued success.

What began as a $26 loan to 42 village women is now a major industry in Bangladesh, with 4 million Grameen borrowers and over $4 billion in disbursed loans, of which over $300 million is currently outstanding. All collateral-free.

…Its Problems…

But critics of Grameen and other conventional microfinanciers cite Draconian interest rate levels as a major impediment to many borrowers becoming truly self-sufficient; an astronomical 22% interest rate charge at Grameen (measured on a declining basis), and as high as 50% elsewhere. Anathema to Muslims, for whom taking even the smallest amount of interest is forbidden, evidenced by a number of Quranic verses (2:275-279, 3:130, 4:160-161, 30:39), numerous rigorously authentic traditions of the Prophet (Allah bless him and give him peace), the consensus of the four schools of jurisprudence, and the ravaging effects of decades of low-interest development loans to poor countries.

The single biggest problem with conventional microfinance, and for that matter all interest-based finance, is that the borrower has to make his interest payments even if he is unable to meet them. If his business succeeds, he pays; if his business fails, he still pays.

At a time when a young business should be concerned with innovation and expansion, an interest payment looms unavoidably large at the end of the month. Putting it off only exacerbates the problem, as interest payments often become larger than the original loan principal with the passage of time. It makes little sense for small, undercapitalized microentrepreneurs with nothing to fall back on to assume debt instead of equity. In a protracted market downturn, when large groups of borrowers are unable to meet their repayment requirements, this precipitates heightened levels of market volatility. End game: debt forgiveness on the lender's part or increased impoverishment on the borrower's, meaning bonded labor in some countries.

Further, interest-based transactions tend to focus attentions on the process-oriented task of repayment rather than on the result-oriented task of increasing profit. And because no direct causality exists in an interest-based transaction between the size of the payout and the profitability of the business (since interest payments are already fixed), conventional microfinance requires additional technical intervention on the part of the lender in order to promote business efficiency. Equity-based investments, on the other hand, already assume an effort toward business efficiency because both the investor and the worker share the same goal: increasing profit.

…And Its Islamic Alternative

Islamic microfinance provides an innovative interest-free alternative to conventional microfinance. Perhaps not so innovative since interest-free, equity-based investing has already proven itself as the predominant corporate financing tool for decades, from Wall Street investment banks to Silicon Valley venture capitalists. And while the players may change, the transaction dynamics remain largely the same, whether the transaction is worth billions of euros or hundreds of rupees: an investor takes a stake in a business for a share of the business's profits, undertaking commensurate levels of risks.

Based primarily on the profit-sharing principles of equity-based finance, Islamic microfinance offers greater resilience than conventional microfinance. If a business fails, nothing is paid; if a business succeeds, profits are shared. Risks and rewards are always proportionate to equity shares. So while any return on capital in the form of interest is completely prohibited in Islam, there is no objection to getting a return on capital if the provider of capital enters into a partnership with a worker or entrepreneur and is prepared to share in the risks of the business.

The key dynamics of conventional microfinance arrangements are, however, still retained in Islamic microfinance, with small groups of self-selected individuals providing each other with emotional, technical, and financial support. By assembling themselves into their own groups, clients choose as partners only those individuals they trust most, filtering out to a large extent poorer credits.

How Islamic Microfinance Works

One Islamic microfinance arrangement is done using a mudarabah structure, a participative agreement in which one party provides capital (the principal) and the other (the worker) utilizes it for business purposes in which profit from the business is shared according to an agreed upon proportion, and loss, if any, unless caused by negligence or violation of contract by the worker, is borne by the principal. Some considerations include the following:

- The bank as the principal should not interfere in the routine transactions of the business of the worker, though the bank is permitted to provide general technical advice. The worker should provide regular periodical reports to the bank on the state of the business;
- The worker may choose to also employ his own capital in the mudarabah business, taking commensurate increases in profit and loss;
- Profit earned from a mudarabah business is distributed between principal and worker on the basis of proportions settled in advance;
-

- No fixed amount, whether as profit, wage, or commission, may be settled in favor of either party beforehand; Islam permits the fixing of profits in percentage terms (e.g. "share 10% of your profits with me every month"), but forbids fixing profits in absolute terms (e.g. "give me $100 of your profits every month"), the obvious difference being that the former is linked to the performance of the business, whereas the latter is linked to nothing;

- In a running business, losses may be offset by business earnings until the business comes to a close and accounts are settled;

A Shariah-compliant version of the Grameen model resembles the following, the particulars of which should be approved by a qualified AAOIFI-versed scholar:

1) A group of 5 clients approach an Islamic microfinance bank for investment capital for 5 separate projects;

2) After assessing feasibility for each of the 5 projects, the bank draws up separate contracts, explaining repayment schedules and profit-sharing percentages, and underscoring the possibility of larger investments in future depending on their individual performances;

3) The bank first invests in 2 individuals;

4) These first 2 individuals repay one-fourth of each of their original investments each week for four weeks (clawing profits back into the business each week) until at the end of the month the entire original investment is repaid, and 75% of all profits remain with the individual and 25% of profits return to the bank (primarily to fund the bank's future operations and growth); in the event of losses, only what remains of the investment is repaid;

5) In the second month, the bank then assesses the performance of these first 2 individuals and decides whether to reinvest; increasing investment sizes for those individuals with rates of return higher than 10%; maintaining existing investment sizes for those individuals with rates of return between 0% and 10%; and reducing investment sizes for loss-making individuals, where a second round of losses would disqualify them from any future investment, forcing the remaining group to find another group partner;

6) Also in the second month, the bank commences investment in the next 2 individuals, using the same repayment schedule and profit-sharing agreement as for the first 2 individuals;

7) In the third month, the bank assesses the performance of the existing 4 clients and decides whether to reinvest, using the same criteria as before;

8) Also in the third month, the bank invests in the fifth and final individual of the group, using the same repayment schedule and profit-sharing agreement as for the previous 4 individuals;

9) The bank continues this transaction cycle, using the same repayment schedule, profit-sharing agreement, and reinvestment criteria for all future investments;

These simple steps are as effective in a rural village in a Muslim country as they are in an urban ghetto in a non-Muslim one, whether the client is male or female, young or old, Muslim or not. Group sizes, repayment schedules, profitability targets, reinvestment criteria, investment duration, and other integrals of the transaction may be tailored to suit client needs as necessary.

It is critical that at the outset, clients are explained that profitability (and, implicitly, declaring profits honestly) translates into larger investments in future. Islamic Law does not permit parties to contractually condition future investment sizes on past investment performances, but parties are permitted to enter into unenforceable pledges whereby the investor agrees, as a matter of policy at his own discretion, to increase or decrease future investment sizes on the basis of historical performance, perhaps according to the investor's own internal investment matrix. The parallel subtext obviously being that theft only hurts the client. And because original investment sizes are sufficiently small, suiting only the extreme poor of the locality, the bank filters out free-riders and other untargeted individuals.

One might wonder why simply giving money away to the poor, as opposed to investing in their businesses, might not be the most effective poverty alleviation tool. Zakat and charity come to mind. But in Islam believers are also encouraged to keep their money circulating throughout the community, as zakat and charity indeed, but also complementarily as risk capital. Now more than ever, with large capital inflows entering the Islamic banking industry and the possibility of securitizing microfinance contracts a proven reality, we stand at the beginning of a second microfinance revolution, in which Islamic microfinanciers alleviate poverty with sustainable, replicable, and inexpensive transactions, without the problems associated with conventional microfinance.