

Financing Microenterprises: Creating a Potential Value-Based Hybrid Model for Islamic Microfinance

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ABSTRACT: The main purpose of this paper is to examine the relevance of Islamic microfinance in the light of ongoing erosion of confidence in the viability of current financial system, full of speculative finance in the prevailing global financial market. For example, the sub-prime crisis of 2007-2008 in the US with its effects all over the world was mainly due to the inadequate market discipline which in turn enhanced more and more lending, high leverage and finally led to bank failures and economic slowdown. The critics of this financial meltdown basically relate it to the interest-based financing mechanism. The paper tries to find the possibility of Islamic (Interest-free) Microfinance as a remedy for this financial instability in this context. The paper mainly focuses the Indian scenario where a large section of Muslim population does not have access to Microcredit due to both religious and political factors. Therefore, at this juncture an attempt is made to find the prospect of microfinance from an Islamic perspective which is imperative for adopting an economic system concerned with fulfilling human needs and creating opportunities for the poor. Besides, the concerned paper suggests a “Potential Value Based Hybrid Model for Islamic Microfinance,” by outlining the features as well as the shortcomings of conventional Microfinance.

Keywords: *Micro-enterprise, Islamic microfinance, India, Andhra Pradesh Microfinance Institutions Act, 2010, Value-based Hybrid Model*

INTRODUCTION

One of the biggest challenges of this century is poverty, where billions of human beings live in abject poverty. It has been observed that Muslim societies fare worse than the rest of the world. A commonly held view among the observers of poverty eradication programmes across the globe is that the provision of Microfinance services to the poor in a sustained manner helps bring down poverty levels (Obaidullah, 2008).

Microfinance is the “programme that extends small loans to very poor for self employment projects that generate income in allowing them to take care of themselves and their families”(Microcredit Summit, 1997)¹. Indeed it has been viewed as an important tool for the empowerment of the poor which contributes to the growth of civil society². The reception of noble prize in 2006 by the Grameen Bank founder, Mohammad Yunis has led to International attention towards Microfinance. At

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1. Microcredit Summit, Position paper by UNESCO (CAB-97/WS/2). The Microcredit Summit was held on February 2-4, 1997 in Washington DC. The Summit was participated by 2,900 people from 137 countries. For more information on Microcredit Summit, see www.microcreditsummit.org.

2. For more details on role of Microfinance in empowerment of poor see, Empowerment and Poverty Reduction, A Source Book, World Bank 1818 H Street, NW Washington DC 20433, 2002.

the same time the latest evidences from the existing studies on the impact of microfinance on the poor provide inclusive as well as exclusive results, ranging from a substantial positive impact in Bangladesh (Khandekar, 2005) to an insignificant impact in Thailand (Coleman, 2006). These results are generally short-term and vary significantly among borrowers, which limits the reach of Microfinance Institutions to poor as well as non-poor but rarely the poorest (Hulme and Moore, 2007; Arun, Arun and Devi, 2011). This means that the poorest borrowers benefit less than the middle and upper poor and even in some cases the impact on the poorest may in fact be negative.

The paper tries to assess the need and targeting of those excluded and attempts to find the potential of Islamic Microfinance as an alternative to the conventional microfinance. Considering the lessons and earlier experiences of microfinance and exploring the innovative ways and other forms of support is a prerequisite for building upon the further success of microfinance. The paper attempts to examine the working of Islamic microfinance through a novel, proposed value-based model. Taking into account the current crisis of conventional microfinance in India, the paper also argues that Islamic Microfinance can play an important role in eradication of poverty, equitable distribution of income (Siddique, 2001), socio-economic development of the poor and small (micro) entrepreneurs without charging interest (riba).

RESEARCH METHOD

The study involves the analytical as well as the comparative research methods. The researcher has collected the data relevant to conventional and Islamic microfinance and on the basis of its analysis the researcher tries to find the potential of Islamic microfinance, as a poverty eradication tool for the down trodden section of the society. An attempt has been made to create a potential value-based hybrid model for Islamic microfinance for the current scenario.

Microfinance: a Critique

Microfinance has really yielded the rewarding results in the past few decades and helped to eradicate the poverty to some extent.

But microfinance as the best way of tackling poverty is still under debate. Microcredit was once extolled by world leaders like Bill Clinton and Tony Blair as a powerful tool that could help eliminate poverty, through loans as small as \$50 to cowherds, basket weavers and other poor people for starting or expanding business (Bajaj, 2011). It began with a noble cause of helping the poor by providing increased economic opportunity to the poor. But, unfortunately the practice of microfinance is far from its original goal. Increased commercialization coupled with very high interest rates only reinforces the working of global economic system to help the rich and hurt the poor. Undoubtedly, it really brought wonders in various developing countries like Bangladesh, Indonesia, India, Pakistan etc., by providing the financial support to the financially excluded section of the society and helped in the poverty eradication to a large extent but in the upcoming scenario, it lost its social mission and moved towards profit maximization like the other prevailing businesses. In the recent era microfinance has also seen the political hostility in Bangladesh, India, Pakistan, Indonesia and other developing countries. Unless fundamental changes are brought in Microfinancing (like no interest) this noble mission will wither away in near future. (Yildirim, 2009).

Issues of Microfinance in Bangladesh, Pakistan and Indonesia

Following the international financial crisis that started in 2007, market growth and even microfinance institutions' performance started to deteriorate. Microfinance experienced its first serious setback at the global level and in some countries faced outright crisis. In Bangladesh which is considered the heart land of Microfinance, the Grameen Bank received criticism on charging unexpectedly high rates of interest from the micro borrowers and the real incidences of default that were found include lack of post-disbursement supervision leading to moral hazard, lack of training on basic business skills and knowledge, lack of health awareness resulting in the need to spend on medical expenses, burdensome immediate repayment schedule, lack of motivation to improve standard of living, multiple borrowings from different Microfinance Institutions (Kassim, Rahman,

F. Jan Sofi

2008). The rate of interest in Grameen Bank is very high and due to high interest rate the poor cannot use the loan in a high profitable business to bear this burden. Fernando (2006) has argued that there have been existing borrowers of Grameen Bank who face obstacles to pay the loan on particular time for having higher interest charges. Recently, Finance Minister AMA Muhith said that complaints of high interest rates and charges are the main problems of microfinance institutions in the country. He said that the borrowers are getting into a debt trap in microfinance. The number of people coming out of poverty level through microfinance is not that much.¹ Interest is the root cause of various problems and similarly in Indonesia, the high interest rate has given rise to two main problems; Commercialization and High delinquency rates of microfinance Institutions. Due to higher interest rates of micro-financing, microfinance institutions have increasingly gained a commercial nature with investment banks obtaining a larger share of the micro-credit sector. But the higher returns to microfinance institutions have come at the expense of poor borrowers. Very high interest rates have made the poor borrowers unable to pay interest in time, never mind the original capital borrowed. This has led to delinquency and liquidity problems for microfinance institutions (Ahmad and Zameer). At the same time, in Pakistan also the rapid commercialization of the microfinance industry has largely contributed to the phenomenon of excessive focus on growth and returns instead of asset quality, misleading contractual information, excessive interest rates, etc., but it is not the only reason. Group lending technologies, which form the basis of many microfinance programs, have also led to severe abuses as a result of their peer pressure mechanism. Examples include aggressive loan collection techniques (e.g., daily harassment, public humiliation, social exclusion, etc.) as well as individual privacy issues.

Microfinance Crisis in India

The great Indian microfinance crisis has shaken the world of microfinance. An industry that grew at 90% on an annual basis from 2002-

03 to 2009-10 was reduced to just 7% of growth in 2010-11.² The Andhra Pradesh crisis is part of chain events which are bringing microfinance a bad name, not just in the hallowed halls of the global development finance industry, but more importantly at the societal level. India suffered from a lot of problems in its microfinance sector particularly in Andhra Pradesh by charging exorbitant rates of interest, restoring to unethical ways of recovering loans by confiscating title deeds, using abusive language, combining multiple products like savings, insurance and loan to ensure prompt recovery and aggressively poaching from government and banks to capture their borrowers (Shylendra, 2006). Finally in October 2010, with no warning or consultation with stakeholders, the Government of Andhra Pradesh issued the Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Act, 2010 effectively shutting down all private sector microfinance operations in the State. The Andhra Pradesh (AP) Act, does not; however, apply to AP's government-backed microfinance business which directly competes with private sector Micro Finance Institutions (MFIs). This was a major blow to the entire microfinance industry as Andhra Pradesh, widely regarded as the birthplace of private sector microfinance, accounts for over 40% of all loans by MFIs across India according to some estimates³, supposedly these practices led to a series of suicides. There has been the situation in Andhra Pradesh, where some big Microfinance Institutions (and many smaller Microfinance Institutions) were increasing client numbers at 5-10% per month in some districts in 2009. This newly recruited trained staff (agents) sought to achieve the financial targets they were set and

1. The Finance Minister, AMA Muhith said while inaugurating a three day international seminar on microfinance at Sonargaon Hotel in the City, *The Daily Star*, 15th March, 2010.

2. What the world can learn from the Indian microfinance crisis, by Sanjay Sinha, *Microfinance Focus*, Jan 3, 2011.

www.creationinvestments.com/news/world-lear-indian-mf-crisis/.

3. The direct effect of the enactment of the AP Act has been to deny millions of India's poorest citizens' access to basic financial services. The impact of the AP Act has the potential to affect 450 million people. Since the AP Act was adopted, MFI disbursements in AP alone have diminished from Rs 5,000 crore (\$1.13 billion) to a mere Rs 8.5 crore (\$1.9 million), creating a severe shortage of much needed finance to the rural poor, India's most vulnerable citizens. The rationale for the AP Act is not to protect the poor, but to protect the uncompetitive government-backed Self- Help Group ("SHG") program run by the Society for the Elimination of Rural Poverty ("SERP"). Source, MICROFINANCE IN INDIA: A CRISIS AT THE BOTTOM OF THE PYRAMID, How the Government of Andhra Pradesh has severely damaged private sector microfinance and put 450 million of India's rural poor at risk. For more discussion visit, <http://www.legatum.org/attachments/MicrofinanceCrisis.pdf>

the credit bubble burst (Hulme and Arun, 2011). These agents were marketing the loans with no heed to borrowers' capacity to repay. It was alleged, too, that coercion was being used to exact repayment, leaving victims with no way out but to end their own lives.

There are undoubtedly lessons to be learned from the Indian experience with microfinance and it is obvious from the above discussion that up to a large extent interest is the root cause of this crisis, in order to overcome this crisis interest free microfinance (Islamic microfinance) can be conceived as an alternative to interest based microfinance. The Interest Free economy aims at equity and justice in economy. India, being the second largest Muslim populated country in the world, may further accelerate the development of an interest free Islamic microfinance system here. In addition Islamic microfinance could be beneficial in other ways like better recovery rates and increased organisational and borrower sustainability, as well as more effectively meeting microfinance's core objective of poverty alleviation, increased production and job creation. Simultaneously, Islamic microfinance can also offer an alternative paradigm for millions of poor people who are currently not served by conventional microfinance. It is time for the Islamic finance industry to adopt innovative and sound practices and prove that its models could work efficiently; that micro entrepreneurs with an appropriate business idea can be helped and hence find a way out of poverty. In this context the paper suggests that Islamic microfinance may be a fruitful initiative towards the main goal of poverty eradication, microenterprise development and may prove to be a positive accelerator of economic growth.

Potential for Islamic (Interest-Free) Microfinance

Recent research findings have shown that even among those who have access to some basic banking services, there is evidence of significant credit constraints (Banerjee and Duflo, 2004). This problem has been mostly found in Middle East, where Muslims are now showing inclination to avoid interest-based financial institutions for borrowing. This is because they are prohibited from taking any kind of interest (riba) as per their Shari'ah rules. So a large section of Muslim population rejects this

interest-based financing which in turn leads to increasing poverty among Muslim populations. Researchers from the Islamic Development Bank estimated that in the six countries with largest Muslim populations (Indonesia, India, Pakistan, Bangladesh, Egypt and Nigeria) the number of people living on less than \$2 per day far exceeds half a billion (estimated to be 628 million) (Obaidullah and Khan, 2008). Recent studies have also included survey results that show Muslims to be highly excluded from access to banking products and services, with exclusion rates reaching as high as 80% in India. Surveys have suggested that up to 40% of Muslims with access to micro-loans reject such loans on religious grounds, (CGAP, 2008, 2009). This gives the Interest-free microfinance a large potential market that is yet to be tapped.

Despite the fact that Islamic Finance is growing at a faster rate, its ability to engage the Muslim poor, who comprise of almost half of all the Muslims in the world, has been meager and thus they need to be addressed with some other initiative that is "Islamic Microfinance". The target group of microfinance is not constituted by the poorest of the poor, who need other interventions such as food and health security, but those poor who live at the border of the so called poverty line.¹ Those who could reach more easily a decent quality of life and who have entrepreneurial ideas but lack access to formal finance.² Microfinance is a very flexible tool that can be adapted in every environment, based on the local needs and economic and financial situation. This flexibility may allow microfinance to get adapted even in those countries where it faces various constraints, such as the countries

1. According to the Consultative Group to Assist the Poor (CGAP), the clients of microfinance- female heads of households, pensioners, displaced persons, retrenched workers, small farmers, and micro-entrepreneurs—fall into four poverty levels: destitute, extreme poor, moderate poor, and vulnerable non-poor. While repayment capacity, collateral availability and data availability vary across these categories, methodologies and operational structures have been developed that meet the financial needs of these client groups in a sustainable manner. The client group for a given financial service provider is primarily determined by its mission, institutional form, and methodology.

2. These people usually do not lack finance in a broad sense: they can borrow money from friends, relatives or local money lenders, but of course they cannot access a wider and safer range of services. They need a formal financial institution to rely on, to ask not only for credit but also saving or insurance services, to deal with on a transparent basis (usury is usually a high risk for these people). Microfinance is filling this vacuum, the gap that until a few decades ago kept these people away from the realization of their own projects.

F. Jan Sofi

inhabited by the Muslim majority and having a serious restriction for interest. With this feature of flexibility, microfinance can easily expand in such countries, giving life to the new hybrid reality of microfinance that is Islamic microfinance (Faruq Ahmad, Rafique Ahmad, 2008). Islamic microfinance holds the ultimate goal of maximization of social benefits as opposed to profit maximization, through the creation of healthier financial institutions that can provide effective financial services at grass roots levels. That is why, some authors (Al Harran, 1996) argue that Islamic finance, if inserted in a new paradigm, could be a viable alternative to the socio – economic crisis lived by the Western paradigm. Even the current economic crisis that spread throughout the world and the problems that occurred with conventional microfinance in various countries like Bangladesh and India assure to look for an alternative that can help to overcome the defects in the existing system and pave a way towards Interest-free financing (Shari'ah-based).

Islamic microfinance is a new area of interest within both the Islamic finance and microfinance research. Theory and practice within this area has been limited, but there appears to be a lot of growing interest in forming an affiliation between the two promising industries. Especially, since both of them appear to share many common characteristics like risk sharing, promoting entrepreneurship and striving for economic justice. Islamic alternatives could replace interest with equity based products and encourage household lending to promote family unity (Siddiqi, 2008). At the same time India with the second largest Muslim population has got a tremendous potential to move towards an Interest-free system, which may heighten the requirement for Islamic Microfinance. Keeping in view the main problems faced by conventional microfinance in India, the Microfinance Industry can take up valuable lessons and pave the way towards interest-free system. In addition to this, India's financial market is moving towards equity culture and the current paper is basically an exposition of variable rate of return based on Profit and Loss sharing system instead of fixed rate of return based on interest-based system. The paper also tries to devise an interest-free hybrid model that may suit better the Indian microentrepreneurs

and entrepreneurs in other Muslim countries, who remain devoid of the micro-financing facilities mainly because of the interest-based nature within this context. It also tries to find its potential as an alternative where conventional microfinance really proved to be havoc and couldn't fulfill the main goal of poverty eradication.

Islamic Microfinance, the Conceptual Issues

Islamic finance is entering into a new pattern. It is deemed that Islamic finance should take initiative to meet the increasing needs of microfinance with aim of alleviating poverty, improving the standard of living, providing the customized products so as to help the poor people in their distress. Concept of Islamic Microfinance is being used to fulfill the demands of microfinance in various developing countries, where its conventional counterpart couldn't yield the fruitful results. Its different models are proposed to be used in microfinance activities to help the poor people for the betterment of their personal life, to provide them the seed capital in order to initiate the small business in order to make them self-sufficient and result in the overall growth of the economy (Saeed, Rehman, Qasim). Despite of the wider concerns with conventional Microfinance from the Muslim perspective, there is an issue of whether conventional microfinance institutions are sustainable if they conflict with the values and beliefs of local Muslim communities. This issue generates the scope for Islamic Microfinance and its potential in the current scenario.

A typical Islamic Microfinance institute should provide credit through debt finance, equity financing via Mudarabah and Musharakah, saving schemes via Wadiah and Mudarabah deposits, money transfers such as through Zakah and Sadaqah, insurance via Takaful, Shari'ah-Complaint bonds (Sukuk) and Shari'ah-Complaint derivatives (Smolo and Ismail, 2010). The key idea here is that all these innovations must be secured with an underlying asset as the core of the transaction¹. This means that Islam doesn't allow gain from a financial activity unless the financial capital is also exposed to the risk of potential loss; and that

1. For more discussion see Principles of Islamic Finance; A focus on Project Finance by Hussein Alasrag, 2011.

interest reinforces the tendency for wealth to accumulate in the hands of few, thereby diminishing man's concern for his fellow man (Lawai, 1994).

Nowadays, Shari'ah-Complaint Micro-credit is offered by using a variety of mechanisms and the most common Shari'ah-complaint modes used by Islamic Microfinance Institutions include Qard hasan (benevolent loan), Murabah (mark up pricing), bai-bithaman-ajil (deferred payment), bai-salam (forwards) and Ijara (leasing). However all these modes create debt but at the same time a micro entrepreneur can also utilize the equity based financing for meeting his/her requirements. The various partnership-based modes of equity for financing include Mudarabah (trustee financing), Musharakah (joint venture) (Dusuki, 2008).

There is no doubt that Islamic Microfinance can be a critical input for the wealth creation and its equitable distribution but the challenge of poverty alleviation through microfinance needs to be achieved through a Joint approach. Here, we explore further and extend the discussion towards Islamic microfinance model, "A Potential Value-Based Hybrid Model of Islamic microfinance for financing Microenterprises"¹ proposed by the researcher. An attempt is made to create a Shari'ah-complaint model for the working of Islamic microfinance. The preceding section will discuss the possibilities.

The Proposed Model

The potential of microenterprises as an alternative to larger, more capital intensive firms is receiving increasing attention in developing countries. In this context, microfinance is seen as a powerful tool for reaching the poor, raising their living standards, creating jobs, boosting demand for other goods and services, contributing to economic growth and alleviating poverty. It has been observed that the formal financial sector has played a very small role in the development of microfinance programs (Dhumale and Sapcanin, 1998). In the past few decades conventional financial institutions have

successfully engineered the innovations to oust the humanity from banking.

But, contrary to it many microfinance initiatives worldwide have proved to be a success by the adoption of group-based lending approach, capitalising on peer monitoring and guarantee mechanism (Obaidullah, 2009). In addition, Shari'ah-Complaint microfinance institutions work on the principle of equitable distribution of income along with equality and fairness in transactions coupled with the sense of a higher purpose to the community (Siddique, 2001). At the same time the innovations in Shari'ah-Complaint microfinance are meant to yield the stable income flows, provide cover or security for financing alternatives for penalty on payment defaults and formulas for pricing Islamic financial products (Obaidullah, 2008). Innovations should lie in the application of a new product or a technology to a specific market opportunity such as lifestyle, explicit socio-economic problem such as the need for small business financing that is Micro-financing.

Most of the entrepreneurs at their initiation stage usually lack the seed capital to set up their small enterprises that demand a proper infrastructure, machinery, input materials, and funds for other variable operating costs. But most often they are not able to fulfil these financial requirements from the existing financial institutions as these financial institutions don't find it economically viable to offer credit to these microenterprises. This leads the microentrepreneurs to drop the opportunity of setting up their own enterprises. Taking into account these problems faced in financing microenterprises and also realising the fact that these enterprises are very important for employment generation, poverty alleviation and economic development, there is a need for social-financial intermediation of funds for microentrepreneurs (Ahmed, 2007). Combining the Islamic social principle of caring for the less fortunate with microfinance's power to provide financial access to the poor has the potential to reach out to millions more people, many of whom have now started to prefer Islamic products over conventional ones (Akhtar and Jaffri, 2009).

Considering this potential of Islamic microfinance, a "Value-Based Hybrid Model" (figure 1) that can be developed and piloted by

1. An innovative model framed from the working of a multistage model of Muslim Aid in Sri Lanka, that provides provision of Finance and other inputs to the farmers. "Innovations in Islamic Microfinance: Lessons from Muslim Aid's Sri Lankan Experiment", by Mohammad Obaidullah and Amjad Mohammad Saleem, Islamic Development Bank, Jeddah, Kingdom of Saudi Arabia.

F. Jan Sofi

the microfinance institutions to overcome the upcoming problems and provide an alternative to the earlier practices of conventional microfinance for micro enterprise development is to be outlined. It is based on a combination of three Shari'ah-based modes; Ijarah wa Iqtina, Bai'al-Istisna and Mudarabah partnership and may be an efficient mechanism to empower the poor microentrepreneurs, who are mostly found non-bankable by the various financial institutions and hence don't get the seed capital to set up their micro-enterprises. This model tries to reduce the dependence and consequent exploitation of the poor entrepreneurs by middlemen through high interest loans and artificially depressed market prices. The proposed model mostly targets the micro entrepreneurs of various Muslim countries with special focus on India (2nd largest Muslim Population) that need to have enterprise development as their immediate objective. It also attempts to lift microenterprises to a qualitatively high level sustainability, setting them on the path to long-term growth and seeking to provide a comprehensive range of services, credit, marketing facilities and technical assistance. India alone has a large potential market for the microenterprises like Handicrafts, Needle Work, Are work, Kaleen Sozi, Shawl Weaving, Batic Print, Bangle Making, Food processing, Apiculture, Pisciculture, Wood carving, Stone and Stone carving, Khadi Gram Udhog, Laces and Embroidery, Ayurved, Knitwear industry, Hosiery, Pottery and Brick, Paper Industry, Bronzes and Brass, Machinery and Part, Rubber and Plastic products, Basic Metal Industry, Papier Mach, Coir Industries, Leather and Leather products, Textile and Readymade Garments, Gem and Jewellery, Handlooms, Khadi and Village industries, Sericulture, etc.¹

Working of a Potential Value-Based Hybrid Model of Islamic Microfinance for Financing Microenterprises

The proposed, "Hybrid model" may be used as a provision of finance and other inputs to the microentrepreneurs. The first stage involves a

creative variant of Ijarah that is "Ijarah wa Iqtina" (Usmani, 2009). Under this mechanism, the Islamic microfinance institution purchases the assets (involving machinery and infrastructure) and leases it to the client. The lessee (client) in turn pays the lease amount during the lease period and the lesser (Islamic microfinance institute) may also enter into a unilateral promise to sell the leased asset to the lessee at the end of lease period.

At the same time in the second stage the Islamic microfinance institute and the microentrepreneurs enter into another contract that is "Bai'al- Istisna". It is a contract of acquisition of goods by specification or order, where the price is paid in advance, but the goods are manufactured and delivered at a later date (Siddiqi and Hrubu, 2008). In this case the Islamic microfinance institutions pay in advance the microentrepreneurs for the specific (customised) goods to be manufactured. This may provide them the working capital required for buying various inputs and managing other costs. Utilizing all these inputs and labour the microentrepreneurs will manufacture the ordered goods and deliver them at a later date.

The third stage begins with the delivery of ordered goods. It involves a partnership between Islamic Microfinance Institutions and marketing firm, where the marketing firm takes the possession of the delivered goods, does the packaging of these goods as per the market demands, promotes them through suitable media and sells the final products in various targeted markets. After the sales the profit is shared between Islamic Microfinance Institute and the marketing firm on the basis of Mudarabah partnership.

It is expected that the profit share of Microfinance Institute would also cover the administrative cost of financing. In order to ensure that the overall model is a "not for Profit" model and that also it is the sustainable one, any surplus of profit share over administrative cost is to be used to create a "Revolving Fund" for these microentrepreneurs (Obaidullah and Saleem, 2008). Microentrepreneurs enjoying incremental income are also expected to make

1. The above list of microenterprises is based on the investigation of the author regarding the microenterprises in various states of India and the author finds the potential for Islamic Microfinance Institutions in targeting these clients.

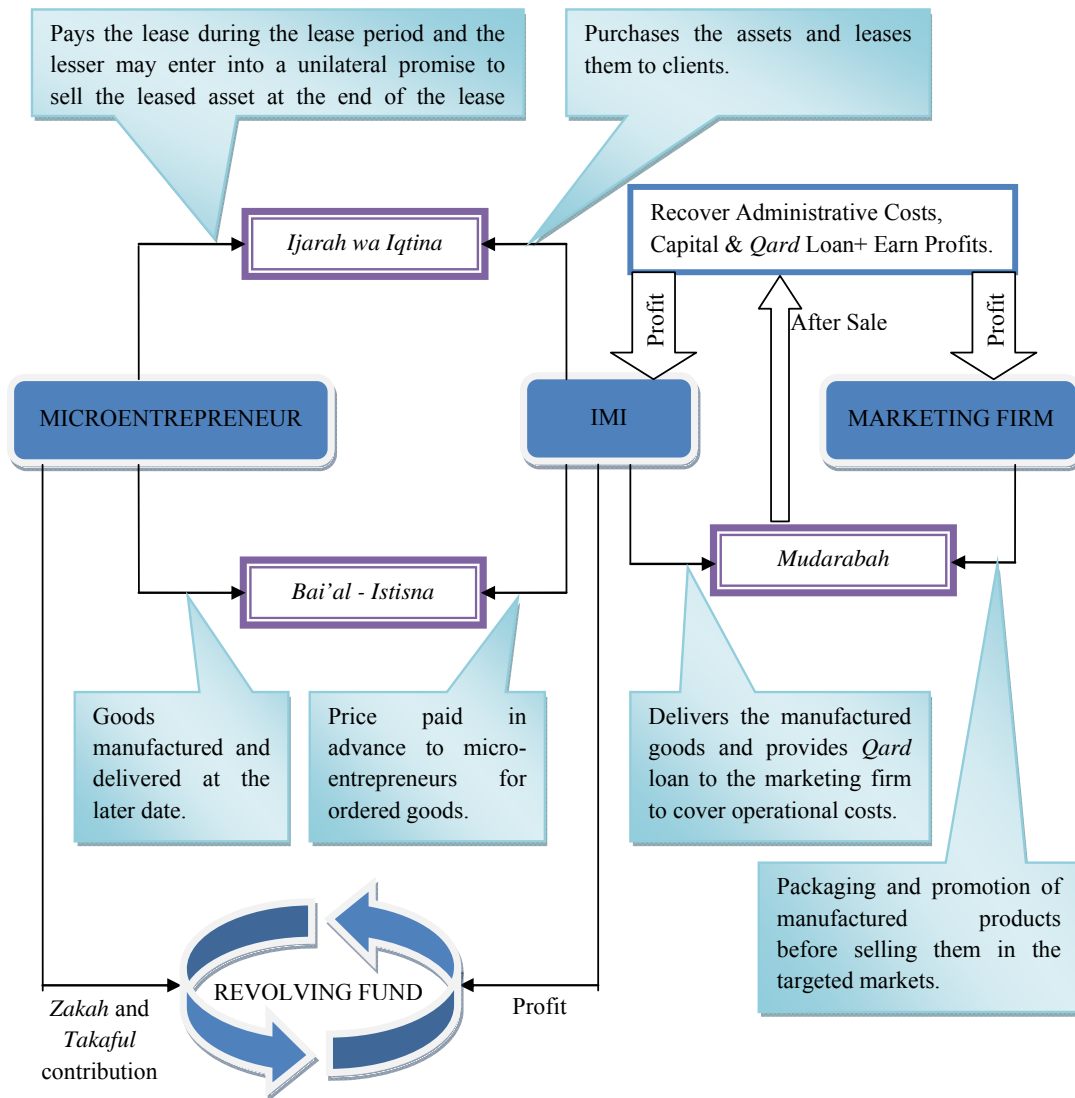


Figure 1: A Potential Value-Based Hybrid Model for Islamic microfinance

Zakah contributions and Takaful contributions to this fund and therefore adding to its size and ability to provide financing to a greater numbers and a safety against the unforeseen conditions. Figure 1 shows the diagrammatic working representation of the Proposed Value-Based Hybrid Model for Islamic Microfinance.

Applications of the Model

This experiment can be conducted in various developing countries especially in an Indian scenario where conventional microfinance has led to disasters to some extent and moved quite far away from its basic goal of poverty eradication by charging unexpectedly high

interest rates moving up to 30%. No doubt the Government of India is helping with the grants and loans for initiating the business and encouraging the microentrepreneurs for setting up their enterprises, but at the same time these grants may increase the “dependency syndrome” as the microentrepreneurs may continue to seek subsidies and grants for carrying out other enterprise activities ((Obaidullah and Saleem, 2008). At the same time, the proposed model helps to generate a “Revolving Fund” that can be a continuous source of financing for the microentrepreneurs with an assured repayment. This may help to empower the microentrepreneurs, to make them self-reliant and to ensure the better returns for their efforts.

This proposed model may also help the microentrepreneurs to get the better returns or enough profits to reinvest, as it enables them to get the better prices for their manufactured goods. This model can also protect the entrepreneurs from the chunks of middlemen who exploit them by purchasing the goods at lower prices from them and then selling at higher prices in the market. The proposed model also saves them from the moneylenders who lend the money at exceptionally higher interest rates. This model to a large extent tries to relieve the microentrepreneurs from searching the markets for their goods, as the marketing firm itself goes for the relevant market segmentation, targeting and positioning. This may help to overcome the major challenges of market segmentation.

But the success of the proposed model demands full cooperation among the various parties involved and an efficient decision making by taking all the favourable factors and suggestions into consideration. This can in turn help the model to achieve a better bargaining power and to become self-sufficient in a short span of time.

Shari’ah Issues

The above discussion shows that the proposed model consists of four distinct components or stages. The first stage that is Ijara wa Iqtina provides the microentrepreneurs with the requisite assets (machinery, infrastructure, technology, etc) they need for establishing their microenterprises. The second stage involves a simultaneous contract along with the first

contract between the Islamic microfinance institute and the microentrepreneurs that is Bai’al Istisna which involves the acquisition of goods by the specification or order. Under this contract the microfinance institutions pay the price in advance to the microentrepreneurs for the ordered goods. In turn the microentrepreneurs start manufacturing the ordered goods and deliver them at the later date. The third stage involves a Mudarabah partnership of the Islamic Microfinance Institute with marketing firm, under which the Rab-ul Mal (Islamic Microfinance Institute) provides the capital in the form of manufactured goods to the marketing firm or Mudarib. Islamic microfinance institution also provides funds for covering the operating costs and other expenses through Qard-Hasan that is recovered before profits are calculated and distributed between both parties as per pre-agreed ratio (Obaidullah and Saleem, 2008). Thus, it leads to value or wealth creation and its equitable distribution between both the parties. In this situation a for-profit mechanism is combined with a not-for-profit financing to provide sustainability to the overall model (Obaidullah and Saleem, 2008). The Islamic microfinance institute also donates its surplus profits to the “Revolving Fund” in order to cater to the basic needs and provide a safety net to its members. With it the microentrepreneurs Zakah and Takaful contribution to this fund also provides micro-takaful to its members against unforeseen adversities on an ongoing basis.

Requirements for Shari’ah Compliance

The first and the foremost requirement of this Hybrid Model to be Shari’ah compliant is that the terms of the contracts must be open ended and all the parties shall be well versed with it. A contract in Islam is a time-bound instrument which stipulates the obligations that each party is expected to fulfil in order to achieve the objectives of the contract (Iqbal and Mirakhor, 2004). The Muslim Jurists also suggest that all the contracts should be fully independent, in terms of rights and obligations of the parties. As mentioned earlier that in the proposed model microentrepreneurs can become the members by contributing a membership amount to the Revolving Fund but all these contracts should be independent of the other contracts that are already being upheld. This contribution is

essential if the microentrepreneurs plan to undertake takaful in future on a cooperative and not-for-profit basis. In the upcoming future when these microentrepreneurs become self sufficient provide, they can also provide the Qard-Hasan Loans to its members but these contracts must be free from any condition such as mandatory payment of Zakah to the Revolving Fund or payment of any other benefit in kind along with the repayment (Obaidullah and Saleem, 2008).

Economics of the Proposed Microfinancing

Initial start-up capital, “C” for the Islamic microfinance institute (table 1) will come from the sponsors, deposits, “D”, cash waqf, “W” (philanthropic waqf) that is waqf endowment donated by the founders, additional waqf funds can be generated by issuing waqf certificates, “WC”, from Qard loans, “Q”, Zakah funds, “ZF” and the deposits “D” from the public by providing opportunities of Shari’ah compatible saving facilities (Ahmed, 2007).

Microfinance institutions need to create some special reserves to ensure against the risks arising from negative shocks. The reserves include Takaful reserves (T) created by small weekly/monthly contributions of the microentrepreneurs. These reserves can be used to cover the losses arising due to some unexpected problems like a natural calamity or death in the family. A profit equalizing reserve will be established by deducting a small percentage of the profit-share of depositors during the relatively profitable periods of operations. These reserves will be used to boost rates of returns on deposits during the periods when the returns get depressed. Similarly, the Microfinance institute would build up a reserve (V) from its surplus that can serve as economic capital. This reserve can be used to cushion any negative shock that may affect the financial position of the institution adversely (Ahmed, 2007).

Probability of Microfinance institutions will depend on the revenues generated and costs incurred. Profit “P” will be the difference between total revenues and total costs.¹

$$P = TR - TC \dots \dots \dots (1)$$

Total costs of Microfinance Institute will include financing costs or borrowing costs (BC) and operating costs (OC). The financing costs depend on the sources of funds. As the Microfinance institutions grow, the savings of microentrepreneurs accumulate, which can then be recycled in financing other microenterprises. However, it may be very long to operate its activities on the savings based solely on microentrepreneurs. Except the external sources of funds (F), Microfinance Institutions can offer interest free deposit facilities that may include the deposits “D” of a large group of Muslims.

If Prf and Prd are the profits earned on external sources and deposits respectively, then borrowing costs equals:-

$$BC = PrfF + PrdD$$

The operating costs comprise a variable component (that is wages to employees) and a fixed component (rent, utilities, etc.). Thus Operating Costs (OC) include variable costs and fixed costs. Thus, total costs of Microfinance Institute equal,

$$TC = OC + PrfF + PrdD \dots \dots \dots (2)$$

Income of Microfinance institute is derived from the profit earned by it in the Mudarabah Contract with the marketing firm. However, the profits in turn depend upon the actual use of borrowed funds in the economic activity. The revenue side can be managed by ensuring the efficient utilization of funds in the manufacturing of ordered goods by the microentrepreneurs and setting up of efficient marketing strategies by the marketing firm. For a given number of clients, (microentrepreneurs) supervision and monitoring improve with more employees at the field level. In other words, as field level employees increase, the quality as well as the quantity of output is expected to rise. This will also ensure the regular/weekly/ monthly flow of income to Microfinance institution. Let “l” be the lease rent to be charged for “n” months of a lease period. Therefore the lease “L” that is paid by the “m” number of clients is given as;

$$L = mnl$$

1. Methodology replicated from a paper written for the International Seminar on “Integrating Awqaf in the Islamic Financial Sector”. Waqf-Based Microfinance: Realizing the Social Role of Islamic Finance by Habib Ahmed, Islamic Research and Training Institute, Islamic Development Bank Group, Jeddah, Saudi Arabia, 2007.

F. Jan Sofi

Table 1: Balance Sheet of a Faith-Based Microfinance Institute (Ahmed, 2007)

ASSET	LIABILITY
Cash (C)	Saving Deposits (D)
Assets (A)	Qard hasan deposits (Q)
Low-Risk Assets (F)	Waqf Certificates (WC)
Micro financing (M)	Capital waqf (W)
✓ Loans-Qard (Q)	Zakah Funds (ZF)
✓ Investments (I)	Takaful Reserves (T)
(Ijarah, Istisna, Mudarabah, Musharakah, Salam, Murabah)	Profit Equalizing Reserves (PER)
Reserves/Economic Capital (V)	

Let “Pmudarabah” be the total profits earned in a Mudarabah contract and “pmf” determines the profit share of a Microfinance Institute. Then the total income of a microfinance institute can be written as;

$$TR = L + pmf.Pmud \dots \dots \dots (3)$$

Using equations (2) and (3) in equation (1) we get, profit of a microfinance as;

$$Pmfi = L + pmf.Pmud - OC - PrfF - PrdD$$

$$Pmfi = mnl + pmfPmud - OC - PrfF - PrdD \dots \dots \dots (4)$$

It implies that the effect of an increase in the number of employees in the field improves the supervision and monitoring of the use of credit and hence increases the income by improving the quality and raising the quantity of manufactured goods.

OPERATIONS ISSUES

On the asset side, let us assume that the Micro finance institute allocates “α”% of its assets “A” into fixed assets “F” that are to be leased to the clients, earning a fixed income “Rf” (L, mnl) from them and the remaining “1-α” for micro financing, M (providing the funds in advance to the micro entrepreneurs for the ordered goods that are to be delivered on a later date and for the Qard loan). Therefore the net income from assets (RA) of the Micro finance institution equals sum of returns from these sources;

$$RA = RM + Rf \dots \dots \dots (5)$$

RM and Rf are net returns from micro financing activities and fixed assets, where

$$Rf = L = mnl$$

Therefore total revenue of a Micro finance Institute from its micro-financing activities includes the returns from its investments “I”

(funds paid to microentrepreneurs in advance) and loan or Qard “Q”, profits from Mudarabah contract “pmfi.Pmud” and qard “cQ” given to the marketing firm. Assuming “r” is the average recovery rate in micro financing activities, then the total revenue, “TR” from its micro financing activities is given as;

$$TR = r(r1I+cQ).....(6)$$

Where “r1” is the rate of return on investments and “c” is the unit cost of providing loan. Since the returns from the investment in this case are in the form of manufactured (ordered) goods that are processed and sold by the marketing firm under a Mudarabah contract with the Microfinance Institute. So the returns from the investment for the Microfinance Institute will depend on the overall profits earned and its profit share in the total profits.

Therefore,

$$TR \text{ of a MFI (from its micro financing activities)} = pmfi.Pmud + r'cQ.....(7)$$

From equations (2) we have;

$$TC = OC + BC$$

Or

$$TC = OC + PrfF + PrdD$$

Assume the “w”% of the micro-financing assets (M) are investments (I), so (1-w) % indicates the proportion given as qard (Q). As costs of microfinance operations are shared between qard “Q” and investments proportionately, let us suppose that “s”% of the OC will be accounted for arriving at the net returns on investment (I). Thus, net income “NIi” of the Islamic microfinance institute from investment activities (I) equals difference between revenue and its share of costs. That is given as;

$$NI I = r'r II - s (OC).....(8)$$

Similarly, (1-s)% of the operating costs will be ascribed to qard. Given that financing charges on Qard can only cover actual cost of services, we get net income of Microfinance Institute from the Qard-loan as;

$$NIQ = r'cQ - (1-s) (OC) = 0.....(9)$$

Or

$$r'cQ = (1-s) (OC)$$

Or

$$c = (1-s) (OC)/r'Q.....(10)$$

While financing of Qard has come from “Waqf Funds”, investments can be financed from deposits, waqf endowments, Zakah funds and other reserves. Assuming “β” to be the proportion of investments, “I” financed by deposits, “γ” be the small proportion of investments financed by Zakah and other and the remaining (1-β-γ)% will be financed by waqf funds. Furthermore, in order to protect the corpus of the waqf endowment from erosion, “y”% of it will be put in low-risk assets (fixed assets), “F” and (1-y)% in micro financing activities.

Hence,

$$F = yw.....(11)$$

$$Q + (1 - \beta - \gamma) I = (1-y) w.....(12)$$

$$\beta I = D.....(13)$$

From equations (11) and (12) we get,

$$W = F + Q + (1 - \beta - \gamma) I$$

The expected loss of the Waqf endowment and other reserves, “ELw” will have two components; the expected loss from Qard operation (ELQ) and from investments, “ELI”. Assuming the uniform recovery rate on all micro financing activities, “r”, irrespective of the modes of financing, giving the expected rate of default as (1-r'), the expected loss due to default or non-recovery of funds in investment and Qard financing will be;

$$ELI = (1-r') r1I.....(14a)$$

$$ELI = (1- r') cQ.....(14b)$$

EL from the fixed assets (α% of fixed assets that are to be leased) is considered to be negligible.

Assume that the Mudarabah deposits stipulate a profit- sharing ratio of “μ”% in favour of depositors and “1- μ”% of profit would go to the Micro finance Institute. From equation (13) we know that “β” proportion of investments are financed by deposits and returns on these are distributed among the depositors and Microfinance Institute at the ratio of μ/1- μ, the expected returns from investments (I) for depositors (Rd) and Micro finance Institute (Rmd) are given by;

F. Jan Sofi

$$Rd = \mu c (NI_i - ELI) \dots \dots \dots (15)$$

(if $NI_i - ELI < 0$, then $1 - \mu$)

$$Rmd = (1 - \mu) \beta (NI_i - ELI) \dots \dots \dots (16)$$

(if $NI_i - ELI < 0$, then $1 - \mu = 0$)

Where NI_i and ELI have been defined in equations (8) and (14) respectively.

Thus in equations (15) and (16) profit-share changes to 1, when there is loss. That is, if $NI_i - ELI < 0$, then $\mu = 1$ and $1 - \mu = 0$. The rate of return on investments for deposits can be estimated as, $rd = Rd/D$

Similarly, as $(1 - \beta - \gamma)$ of the investment, (I) is financed from waqf funds, the returns from this component of financing will be;

$$Rmw = (1 - \beta - \gamma) (RI_i - ELI) \dots \dots \dots (17)$$

Net returns on qard equals zero and the returns from small proportion of Zakah and other reserves are utilized for charity purpose and some portion of it is kept for the Takaful and Economic Reserves.

From equations (16) and (17) we get total expected zzznet income from investments (I) (utilized in micro finance activities) for the Microfinance Institute that is given as;

$$Rmfi = Rmd + Rmw$$

$$Rmfi = (1 - \mu) \beta (NI_i - ELI) + (1 - \beta - \gamma) (NI_i - ELI)$$

$$Rmfi = [(1 - \mu) \beta + (1 - \beta - \gamma)] (NI_i - ELI) \dots \dots (18)$$

Total net income of Microfinance Institute from assets (RA) is given as;

From equation (5) we have;

$$RA = Rmfi + Rf$$

$$RA = [(1 - \mu) \beta + (1 - \beta - \gamma)] (NI_i - ELI) + mnl \dots \dots \dots (19)$$

(since $Rf = L = mnl$)

UPCOMING OPPORTUNITIES

The above study supports that Islamic microfinance can be a success in the near future as there are a lot of opportunities for it that need to be exploited in a right way for the right purpose with a right management. These opportunities lie in all most all the developing countries (Muslim countries) and in India where

the conventional microfinance couldn't fulfil its main goal of poverty eradication. The various opportunities for the Islamic Microfinance in the Indian scenario can be dealt as,

- ✓ Emerging climate of entrepreneurship in India.
- ✓ India is moving towards the empowerment of micro entrepreneurs through its financial inclusion policy.
- ✓ Indian financial market moving towards equity culture in the current scenario.
- ✓ High unemployment, poverty and low levels of financial access to Muslims in India and other Muslim countries continue to create high demand for Islamic Microfinance.
- ✓ Islamic Microfinance can be a progressive step by addressing the deficiencies and challenges faced by the Conventional microfinance industry.
- ✓ Islamic microfinance is an innovative solution to cater to the populations that are outside the conventional financial access.
- ✓ A large population of unbanked includes a vast number of Muslims in India. So expanding the availability of affordable and sustainable "Shari'ah Complaint" services can prove to be a transformative for microfinance.

CONCLUSION

The paper gives an idea of revolutionary funds of Islamic Microfinance Institutions which may go on increasing both in volumes and in numbers with the passage of time. But at the same time as it has been discussed in this paper, this may require further monitoring by an independent monitoring agency (Shari'ah Advisory Boards) to evaluate its function especially the allocation of investment funds created through the Zakah amount accumulated from the microentrepreneurs. It also demands the development of financial reporting standards to build the infrastructure for transparency in the global Islamic microfinance sector. It is time for the industry to adopt innovative and sound practices and prove that the models work efficiently by giving an appropriate business idea from which the microentrepreneurs can gain more benefits and find a way out of poverty. The expected model is projected to have more focus on productive economic activities which would

in turn contribute to the Gross national Income. Since the model mainly focuses on providing the seed capital for starting a new enterprise that may encourage more job creation and an improvement in the standard of living. It can prove to be a fruitful initiative towards micro enterprise development and a positive accelerator towards economic growth. Islamic microfinance is a new concept still in infancy and demands a deeper market research to enhance the relevant market segmentation and customisation of products. It demands the development of training courses so that the microentrepreneurs are well trained about the upcoming opportunities.

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F. Jan Sofi

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