Islam, Land & Property Research Series

PAPER 8: Islamic Credit and Microfinance

UN-HABITAT

2005
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Further Information:

This series contains eight brief position papers commissioned by UN-HABITAT. For a fuller treatment of the issues see Siraj Sait and Hilary Lim, Human Rights in Islam: Law, Property and Access to Land (London: Zed 2006) ISBN Numbers Paperback: 1 84277 811 0 Hardback: 1 84277 810 2. For longer versions and further information regarding the UN-HABITAT research and activities contact

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HS/794/05E
ISBN: 92-1-131794-0
92-1-131785-1 (Series)
Acknowledgements

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This research and publication was made possible through funding to the UN-HABITAT’s Global Campaign for Secure Tenure from the Governments of Belgium, Italy and Netherlands.
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INTRODUCTION TO THE ISLAM, LAND & PROPERTY RESEARCH SERIES

The global mandate and activities of UN-HABITAT (United Nations Human Settlements Programme) in promoting access to land and protecting security of tenure are derived from a range of international human rights and development standards. While land, property and housing rights are generally cross-cultural and asserted within every socio-economic and political system, it is recognised that practice regarding their regulation and protection may take different forms. The Land and Tenure Section, Shelter Branch of UN-HABITAT has carried out systematic research into distinctive land, housing and property issues and approaches in various regions of the world including Africa, Latin America and the Balkans. It uses a ‘best practices’ approach to develop affordable, pro-poor and flexible tenure types and land tools, particularly for women. These tools are incorporated into UN-HABITAT’s global campaigns and programmes as well as made available to governments, civil society and all stakeholders for their advocacy work and for implementation of relevant laws and policies.

During its work in a range of countries from Afghanistan to Indonesia, UN-HABITAT has been increasingly aware of the importance of Islamic land tenure conceptions and land rights. Over 20 percent of the world’s population is Muslim but there has been little research on the complex and distinctive forms of land tenure and land rights. Too often global reviews of land tenure are undertaken without taking Islamic laws relating to land sufficiently into account. The Land and Tenure Section of UN-HABITAT therefore commissioned two experts Mr. M. Siraj Sait and Dr. Hilary Lim from University of East London, United Kingdom to carry out a year long in depth study of the Islamic and other dimensions of land and property rights in the Muslim world.

The objective of this research was to produce a body of material, through eight position papers, accompanied by a database, with proposed strategies which could enhance the knowledge and augment the capacity of UN-HABITAT and its partners to work more effectively in Muslim contexts. However, these papers have been written for a general audience without any assumption of knowledge regarding Islam, law or property rights and are therefore offer basic information as well as an opportunity to revisit first principles.

The general findings of the research are that there are distinctive Islamic conceptions of land and property rights which are varied in practice throughout the Muslim world. Though Islamic law and human rights are often an important factor in the conceptualisation and application, they intersect with State, customary and international norms in various ways. In doing so, they potentially offer opportunities for the development of ‘authentic’ Islamic land tools which can support the campaign for the realization of fuller land rights for various sections of Muslim societies, including women. However, in order to facilitate that role, the various stakeholders must constructively review the normative and methodological Islamic frameworks and their relationship with other systems of formal and informal land tenure.

Paper I on *Islamic Land theories and Applications* contextualises and introduces Islamic property and land concepts as part of a sophisticated and alternate land framework.
running alongside international regimes. The Islamic property rights framework conceives of land as a sacred trust but promotes individual ownership with a re-distributive ethos. It argues that engagement with Islamic dimensions of land may potentially support land rights initiatives in Muslim societies and has implications for programmes relating to land administration, land registration, urban planning and environmental sustainability. Position Paper II on *Islamic Land Tenure and Reforms* explores how land tenure concepts, categorisations and arrangements within the Islamic world are multi-faceted, generally distinctive and certainly varied. This paper explores the socio-historical context and development of Islamic land tenure regimes leading to the ‘web of tenure’ in contemporary Muslim societies. An appreciation of the historical context of land tenure in Muslim societies and the range of land tenure forms contributes towards development of authentic and innovative strategies for enhancing access to land and land rights.

Position Paper III on *Islamic Law, Land and Methodologies* finds Islamic law (Shari’a) an important factor influencing land rights and tenure systems in Muslim societies. Islamic law can be seen as an evolving, responsive and assimilating sphere of competing ideologies and interests, though it is a site of struggle between conservatives and liberals. An appreciation of the distinctive features and sources of Islamic law, its methodologies and diversity in application and its dispute resolution mechanisms would contribute towards strategies aimed at enhancing security of tenure. Position Paper IV *Islamic Human Rights and Land* sets out to examine the relationship between international human rights and Islamic conceptions of human rights in theory and practice. It argues that, with respect to land rights, the difference between these two sets of rights appears minimal and a sensitive and careful recognition of Islamic religious and political sensitivities can help deliver international human rights more effectively in Muslim societies, without offending Islamic principles.

Position Paper V *Muslim Women’s Rights to Property* explores the nature and scope of women’s rights to property and land under Islamic law (Shari’a) through a socio-historical background to women’s property rights, an appraisal of modern legal reforms and the avenues for enhancing their security of tenure. It argues that despite assumptions to the contrary, there are potential empowering strategies for women through Islamic law which can enhance women’s access to land and enforcement of their other property rights. Position Paper VI *Islamic Inheritance Laws and Systems* considers how Muslim societies generally derived their inheritance rules from religious sources for the division of an individual’s property upon death, some of which are controversial. Yet, it argues that the application of these formal inheritance rules pertaining to designated shares must be understood in a broader socio-cultural and economic context and within wider inheritance systems of practice.

Position Paper VII *Islamic Endowments (Waqf) and Indigenous Philanthropy* outlines how the endowment (waqf, plural awqaf) is a key Islamic institution, which has incorporated within its legal sphere vast areas of land within the Muslim world, connected firmly with the religious precept of charity. Modern reforms in several Muslim countries have abolished, nationalised or highly regulated endowments but the endowment (waqf) remains influential and there are clear signs of its reinvigoration. The paper evaluates the role for the Islamic endowment (waqf) in strategies to improve security of tenure based on its legal foundations, history and socio-economic impacts. Position Paper VIII *Islamic Credit and Microfinance* considers the increasing demand from within Islamic communities that financial services be compliant with Islamic law.
This paper explores the Islamic context which stimulates such alternative credit systems, the key distinguishing features of the Islamic banking models, the development of Islamic microfinance models and the practical challenges to these innovations. It considers how Islamic finance, banking principles and credit, particularly housing microfinance, can contribute to security of tenure and in transforming the lives of the poor.

The findings of this study were discussed at a workshop on ‘Land tenure and Land law tools in the Middle East and North Africa’ in Cairo, Egypt on December 17 2005. This preparatory meeting for World Urban Forum (WUF III) 2006 was part of a meeting hosted by the Government of Egypt and organised by United Nations Economic and Social Commission for Western Asia (ESCWA), UN-HABITAT, and the League of Arab States. This research was also presented at the Expert Group Meeting (EGM) at Bangkok, Thailand on ‘Secure Land Tenure: New legal frameworks and tools in Asia and Pacific’ December 7-9 2005 organised by UN-HABITAT, United Nations Economic and Social Commission for Asia and Pacific (UNESCAP), International Federation of Surveyors (FIG) and World Bank.

Through this preliminary study, UN-HABITAT and its partners seek to discuss and develop appropriate strategies through identification and development of innovative and pro-poor land tools in their particular context.
Paper 8: Islamic Credit and Microfinance

[An] important function of Islamic finance that is seldom noted ... is the ability of Islamic finance to provide the vehicle for financial and economic empowerment ... to convert dead capital into income generating assets to financially and economically empower the poor ...

(Mirakhor 2002)

OVERVIEW

Acquisition of land and the access to, improvement and enjoyment of property are often predicated on the ability of individuals to secure easy and affordable credit and a range of financial and banking services. The significant and increasing demand from within Islamic communities that financial services be compliant with Islamic law (Shari’a) has led to diversification and innovation of banking activities from both Islamic and Western commercial banking institutions. This paper explores the Islamic context which stimulates such alternative credit systems, the key distinguishing features of the Islamic banking models, the development of Islamic microfinance models and the practical challenges to these innovations. As part of an overall project concerning Islamic law, security of tenure and poverty alleviation, this paper sets out to explore the extent to which Islamic finance, banking principles and credit, particularly housing microfinance, may contribute specifically to transforming the lives of the poor.

Scope of this Position Paper: This position paper contextualises the development of Islamic Financial Systems in Section 1. It examines some of the distinguishing features of Islamic finance, particularly the prohibition against riba (usury) in Section 2. Section 3 analyses the application of Islamic principles to microfinance while Section 4 discusses some Islamic financial objectives and products, and the need for regulation. Section 5 assesses the experiences of Muslim countries with microfinance, particularly Yemen and Bangladesh, and the opportunities for women. Section 6 offers five strategies for empowerment through Islamic Microfinance

* Authenticate Islamic finance products
* Regulate Islamic microfinance
* Diversify Islamic microfinance products
* Ensure Stability of Microfinance Financial Institutions (MFIs)
* Mainstream Islamic Microfinance
8.1 CONTEXTUALISING ISLAMIC FINANCE

Islamic financial systems are located within the larger context of Islamic religious, ethical and economic systems.

8.1.2 Modern revival of Islamic finance

Rapid growth in Islamic banking has led to most countries in the Muslim world, and many beyond, now having Islamic banks or financial institutions. In some countries, such as Iran and Sudan, Islamic banks are the only ones allowed to operate owing to their conformity with Islamic law (Shari'a). In other countries, such as Bahrain, Indonesia, Jordan, Egypt, Malaysia and Bangladesh, Islamic banking competes with conventional banking and finance. Islamic finance has seen annual growth rates of over 15% and the Islamic capital invested in global financial institutions is currently estimated at US$1.3 trillion. A key growth area is in the provision of Islamic mortgages, both within the Arab world and in Europe and North America.

8.1.3 Islamic economic foundations

The growth in Islamic finance is rooted in a desire for socio-political and economic systems based on Islamic principles. Economic activities are not considered to be a separate part of human behaviour within the Islamic framework and material pursuits occupy a sphere linked to spiritual values and religious beliefs. Commercial activities conducted in order to provide for the individual, family and loved ones are both permitted (halal) and in many circumstances commendable. There are sayings within the Muslim tradition in support of trade and which encourage, respect and praise it as a means for providing human sustenance, although not as an end in itself.

8.1.4 Ethical dimensions of Islamic economic systems

While the Qur'an celebrates good trading practices, it is also conscious of those who are unable to trade and praises charitable acts towards the poor and the destitute. The payment by Muslims of a levy or tax on certain kinds of wealth (zakat), to be distributed for charitable purposes, is one of the five pillars of Islam. It serves to purify both wealth and the person who makes the charitable payment.

Islamic law (Shari'a) lays down the boundaries of permissible economic behaviour and gains should not be achieved at the expense of spiritual or moral values.

8.1.5 Benefits of Islamic banking

Islamic banks have several interrelated benefits. They are able to mobilise funds and savings amongst those excluded from commercial banks because they are easier to access and conform to Islamic values. Islamic banks can provide a service for those who wish to assert their identity, are intimidated, or distrust large conventional banks, and/or prefer a system in which mutual co-operation between bank and customer is implicit. The close bank-customer relationship also offers responsible and profitable financial services.
8.1.6 Islamic economic principles - do they promote or stifle growth?

The role of religion in modern economics is controversial. Some commentators argue that Islamic principles are responsible for the backwardness of some Muslim countries, others that Islam promotes growth. There is no reason why Islamic beliefs should hold back development and there is space within the Islamic framework for 'inductive reasoning' in the development of Islamic economics.

8.2 DISTINGUISHING FEATURES OF ISLAMIC FINANCE

8.2.1 Principles of Islamic financial systems

Islamic financial systems have distinctive principles including: avoidance of interest; risk sharing; treating of money as potential capital; prohibition on speculation; sanctity of contracts; avoidance of prohibited activities such as gambling; the encouragement of entrepreneurs; and the promotion of economic/social development through charity.

8.2.2 Prohibition on speculation or risk (gharar)

The prohibition on risk or speculation requires risk sharing by a lender (a bank) with the borrower, the bank should be a partner in the borrower's risk. A relationship of creditor and debtor, as in the western model of commercial banking, in which interest is the price of credit and the pressure/risk is all on the borrower is not permitted.

8.2.3 Prohibition on usury (riba) and hoarding

The Qur'an prohibits usury (riba) in several different contexts and this prohibition arises out of an Islamic concept of money as nothing more than a means of exchange. Money has no value in itself and cannot be allowed to give rise to more money, it cannot accrue any return (i.e. interest). The prohibition against usury is a corollary of the prohibition against hoarding, or an excess accumulation of personal riches. Trade and financial gain are lawful, but excessive profiteering is immoral. Neither goods nor money should be hoarded.

8.2.4 Prohibition on usury (riba) and interest

The condemnation of usury as money lending for interest (riba) is well established within the Islamic framework. The dominant view, arising out of classical interpretations, is that the spirit of the prohibition on interest covers all forms of interest and 'interest-like' practices. There are a minority of Islamic thinkers who argue that there is a difference between usury, which is prohibited, and interest when it is for commercial lending, which is permitted.

8.2.5 Profits as distinct from usury (riba)

Labour and effort, including that of merchants and entrepreneurs, IS the creator of value and profits from trade are not unlawful. Profits are distinct from usury (riba). Profits do
include a return on financial investment, but the rate of return is neither fixed nor predetermined and carries with it a risk.

8.3 APPLICATION OF ISLAMIC BANKING TO MICROFINANCE

Microfinance in Muslim countries offers a choice of conventional, informal and Islamic financial products, but Islamic microfinance is better suited to some contexts.

8.3.1 Interface of Islamic Banking Principles and Microfinance

Islamic microfinance has emerged from the same principles of Islamic financing that have been applied to trading, business, investing and mortgages within Muslim communities.

8.3.2 Islam and microfinance

Islamic principles of equal opportunity, advocacy of entrepreneurship, risk sharing, disbursement of collateral free loans, and participation of the poor are supportive of microfinance principles. Islamic finance has an important role to play in widening provision of funds to enable the purchase of, or building of, homes, and in enabling their owners to use the property for further income generation.

8.3.3 Social and development roles of Islamic banks

Islamic banking has multiple objectives. It facilitates commerce, investment and legitimate socio-economic activity, but consciously works towards the alleviation of poverty and the more equitable distribution of economic opportunities. Islamic banks often offer interest-free benevolent loans to the needy, on which the bank has no expectation of making a profit. Competition is accompanied, therefore, by a deeper responsibility for social welfare through financing and some Islamic banks have used innovative schemes to meet the needs of the poorest Sections of society. There is potential for Islamic banks to play an important role in widening the provision of funds to enable the purchase of, or building of, homes or the use of property for income generation.

8.3.4 Informal Banking and Debt transfer (hawala)

There are several informal financing systems, some which are beneficial. A system of transfer of debt from one debtor's charge to another (hawala) operates in a number of Muslim countries. The lack of documentation circumvents official control and this debt transfer (hawala) system has been banned in most countries. The system is not, therefore, useful for extending housing, land and property rights.

8.3.5 Is Islamic microfinance truly Islamic?

In some social contexts MFI's make only cosmetic changes to their operations and products, such as changing the term 'interest' to 'service charge', in order to acquire Islamic credentials. In other cases, where beliefs regarding the prohibition of interest
(riba) are strongly held, MFI's may have to make greater and more fundamental adaptations to their systems and operations.

8.4 ISLAMIC FINANCIAL OBJECTIVES AND PRODUCTS

An Islamic financial system/institution will try to ensure that its business activities avoid prohibited activities and that its financial products permit the financing of individuals or commercial enterprises through the profit and loss sharing principle.

8.4.1 Financial products

Islamic banks have developed a variety of financial products but only a few are commonly used in practice. These transactions include: mark up/cost plus sale (murabaha); joint venture (musharaka); trust financing or limited partnership (mudaraba); and lease (ijara). Other products have developed to permit forms of cooperative Islamic insurance (takaful and micro-takaful), which also use the solidarity trust model (mudaraba).

8.4.2 Islamic Mortgages

Mainstream lending institutions across the Muslim world, in Europe and North America have developed Islamic law (Shari‘a) compliant financial products to enable the purchase of residential properties. The most commonly used instruments are the mark up/cost plus sale (murabaha) and mortgages involving the payment of rent, as opposed to interest (ijara). A further cooperative diminishing partnership model – which is particularly well established in Canada - may hold out greater possibilities for addressing the needs of Muslims in less privileged social sectors, not least because of its strong correlation to the microfinance institution.

8.4.3 Conventional Banking through the ‘back door’?

The Islamic credentials of Islamic banks and their financial products have been doubted in both newspapers and scholarly articles. It has been suggested that to the man on the street the Islamic bank may look very similar to its conventional counterpart. In particular the predominant murabaha contract, which is the financing of the purchasing of goods by banks and their subsequent sale to clients at mark-up prices, does appear to mirror conventional consumer credit.

8.4.4 Need for regulation

The relative infancy of Islamic financial institutions, in comparison to longer established conventional interest (riba) based banking, has led to some regulatory problems and some spectacular bankruptcies for Islamic investment institutions. There may be a lack of sufficient expertise amongst staff and/or a lack of training in some banks. No uniform regulatory and legal framework for an Islamic financial system has been developed, with Islamic banks having their own boards of guidance. The Asian Development Board, with the Islamic Financial Board set up in Kuala Lumpur, recently took the initiative to provide a regulatory structure. An appropriate regulatory framework for Islamic banks and microfinance institutions is critical for the robust financing of the housing, land and
property industry, especially as housing usually forms a major part of the national asset of any country.

8.5 ISLAMIC MICROFINANCE IN PRACTICE

8.5.1 Expansion of microfinance in the Arab world

Although microfinance is a relatively new phenomenon in some parts of the Muslim world, its outreach in the Arab world has grown considerably to more than 700,000 borrowers at the end of 2003.

8.5.2 Islamic microfinance in the Arab world

Microfinance services, including some compliant with Islamic law (Shari’a), in the Arab region tend to be limited to credit for enterprise, rather than the building or purchase of homes or home improvement. The most commonly used Islamic transaction is one in which the MFI purchases goods at the request of the 'borrower' and then sells the goods to the 'borrower' for a fee to cover administrative costs, with repayments in instalments (murabaha).

8.5.3 Experiences in Yemen

A large proportion of microfinance initiatives in Yemen is based on Islamic financial principles. There are administrative challenges to these initiatives and additional costs, but their strength is in reaching out to those otherwise excluded and in terms of acquiring broader local approval from their clients and the communities in which they live.

8.5.4 Experiences in Bangladesh

The Grameen Bank is largely a success story, particularly in terms of reaching out to Muslim women in Bangladesh. Membership of the bank leads to an expansion of assets for many women, including home improvements, the provision of services and the purchase of land for building houses or agriculture. Though it is not organised consciously on Islamic financial principles, the beneficiaries who are Muslim have not had qualms about the authenticity of its products.

8.5.5 Resistance to the Grameen Bank

The Grameen Bank has been subject to criticism and resistance, both at a local level from groups like moneylenders who stand to lose from cheap collateral free loans and at a national level from forces which denounce the Bank as a manifestation of an un-Islamic, foreign and secular culture.
8.5.6 Microfinance and Islamic values

There is great potential to apply Islamic financial principles and banking practices in a concerted manner to the provision of microfinance, particularly housing microfinance which remains less widespread than the provision of entrepreneurial credit. The complementary aspects of microfinance and Islamic banking principles hold out considerable possibilities for social and economic transformation. The strong correlation between Islamic principles and the values underpinning microfinance, particularly the emphasis upon partnership and mutual guarantee, may provide the basis for innovation even in the seemingly inauspicious circumstances of informal settlements.

8.5.7 Muslim women and microfinance

One of the potential benefits of microfinance is the empowerment of Muslim women. The ability of MFI's to deliver financial services to rural women is of particular relevance in gender segregated societies. The Arab region has seen a significant improvement in terms of outreach from MFI's to women borrowers who form as a group more than half of such institutions' clients. Working with Muslim women is a sensitive issue, sometimes raising accusations of meddling with social codes.

8.6 STRATEGIES FOR EMPOWERMENT THROUGH ISLAMIC MICROFINANCE

8.6.1 Authenticate Islamic finance products

Many customers of Islamic banks may have a history of banking in the conventional commercial banking sector. However, there is also evidence that an institution rooted in Islamic values and financial principles will draw in customers new to banking. These customers may have excluded themselves due to their religious beliefs, but the behaviour of the bank itself may also be a factor. The increasing demand for Islamic banking and financial products, the entry of a variety of financial institutions into the market and the sheer range of Islamic products, raises the question of whether these justify the label 'Islamic'.

That demand, rather than inherent Islamic expertise, triggered the explosion in Islamic finance is well documented. For example, a Western bank, Lloyds TSB, opened its Islamic banking services in the UK on the basis that there is a 'demand from over two-thirds of the 2 million Muslims in the UK who want Islamic banking' (BBC 2005). Global financial institutions that have established Islamic banking with Shari'a compatible services include Citibank, BNP Paribas, UBS and ABN Amro. Equally, there are an increasing number of national and local providers in the field. In many countries Islamic and conventional microfinance coexist and the difference is not always obvious.

Fadel (2004) notes that this proliferation has led to Islamic Law in the area of banking and finance being in a 'flux' with Islamic products needing to be 'sufficiently distinctive from conventional banking and finance to justify the label 'Islamic finance' (Fadel 2004). 'Islamic' banks are a co-operative venture between financial experts and Shari'a experts (or committees) who comment on the Islamic validity of the product. However, there is room for interpretive differences of opinion among jurists and different Shari'a committees may and do react differently to similar contractual provisions.
There are no easy answers, but sharing of best practice and harmonisation of general Islamic products, allowing for inherent diversity, would enhance the credibility of the Islamic finance industry. The demand for the development of Islamic microfinance products may not be as obvious or as strong as the demand for Islamic financial instruments in the commercial banking sector. However, it is also important in this regard that the vulnerable, particularly those on very low-incomes, are provided with the opportunities and fora to learn about Islamic products, particularly Islamic microfinance products, and ultimately to participate in their development. Microfinance schemes, particularly those funding the purchase of houses, their improvement or services, have an important role to play in extending and enhancing property and land rights, while alleviating poverty. In many Islamic countries, or in those countries with significant Muslim populations, Islamic microfinance which is both Islamic law (Shari‘a) compliant and shaped by local communities has the potential for enjoying consumer confidence and acceptance within those communities, which may not be so readily available to conventional schemes.

8.6.2 Regulate Islamic microfinance

The modern Islamic microfinance institutions are still a recent phenomenon and have not yet fully evolved. They have experienced also haphazard growth. While diverse models and practices are inherent in the choice and flexibility Islamic microfinance offers, these services need to be regulated in order to provide transparency, instil consumer confidence and prevent fraud on beneficiaries due to the unfamiliarity with the products. State regulation, though necessary, has been ad hoc and sometimes an obstacle to the evolution of effective microfinance mechanisms. Housing microfinance programmes in particular, although less developed than entrepreneurial credit, tend to involve larger loans and traditionally require guarantees and/or collateral. Effective regulation of housing microfinance schemes which are Islamic law (Shari‘a) compliant is, therefore, of particular importance.

A recent International Monetary Fund working paper (2004) points to the special risks surrounding Islamic banking. The first is that the profit and loss sharing modes of financing make the Islamic banks vulnerable to the risks that are normally borne by equity investors rather than holders of debt. The second relates to the special nature of investment deposits where capital value and rate of return are not guaranteed. Some suggest a modified CAMEL (capital adequacy, asset quality, management, earnings and liquidity) system of supervision for Islamic banking. There is a special risk for those banks involved in the profit-sharing forms of lending. In the case of microfinance, states should be encouraged to support the membership of Microfinance Financial Institution (MFIs) in the Islamic Financial Services Board (IFSB) and provide fora for sharing of best practice and success. An appropriate regulatory framework is required for a vigorous housing finance system, especially given the importance of housing as a key national asset in most countries.

8.6.3 Diversify Islamic microfinance products

Though Islamic microfinance schemes are relatively limited at present, their potential is significant. Islamic Microfinance products are suitable to enable housing microfinance that is within Islamic law and to enhance security of tenure, particularly for the poor. However, several studies of microfinance in the Muslim world show that there is an
emphasis on loans to the 'entrepreneurial poor', rather than the variety of financial services that the poor need. In addition to credit, microfinance needs to offer savings, insurance, and money transfer services.

A study by a Harvard research group points to groups within the general finance industry’s target population that are not currently being served by housing microfinance programs. In particular, the poorest of the urban poor, including squatters on remote or unutilized land and those living in rental arrangements in overcrowded inner-city slum tenements fall outside the net. The study argues that the development of appropriate financial instruments to meet the shelter needs of this latter population group is without doubt the greatest challenge facing the housing microfinance industry today. Appropriate financial instruments have been developed by the Islamic banking sector, which avoid usury (riba) and can enable individuals to purchase houses, just as they can provide funds to start up or expand businesses and loan money to those in particular need.

Similarly, there are types of Islamic insurance, based on cooperation, which can enable the poor to avoid the asset sales, including the sale of various rights of access to land, which are a common response to natural and personal disasters. There are dangers of high expectations and the limits of microfinance in the overall macroeconomic poverty alleviation strategies must be recognized. However, while priorities may differ according to contexts, microfinance programmes must expand the range of products for their target groups which are sustainable and viable in the long term. Islamic jurisprudence (fiqh), with its emphasis upon partnership and a concern for community welfare, together with the expansion in Islamic banking and microfinance, has the ability to respond creatively to the needs of the urban poor.

### 8.6.4 Ensure Stability of Microfinance Financial Institutions (MFIs)

Though banks and financial institutions offer capital, general management and expertise, it is the MFIs that deliver financial services to the poor, particularly the rural poor in remote areas. The success of any microfinance project is dependent on the building of permanent local financial institutions that can attract domestic deposits, recycle them into loans, and provide other financial services. The failures of microfinance in general have occurred when MFIs have not been regulated or supported by either their funding bodies or government.

The MFIs cannot exist in a hostile economic environment, just as they need to cultivate their credibility in a given socio-cultural and religious community. The role of the government is not to be a lender itself but to work through MFIs. Their most important responsibility is to support macroeconomic stability and the promotion of an enabling policy environment for the development of a vibrant financial sector. Similarly, donor funds should complement private capital, not compete with it and the success of MFIs lies in their ability to sustain themselves in the long run through their own capital.

The capacity building of MFIs depends on building strong and transparent management structures. Merely espousing Islamic principles does not absolve them from creating a culture of accountability. As several reports have indicated, microfinance works best when it measures —and discloses —its performance. Reporting not only helps stakeholders to judge costs and benefits, but it also improves performance. Microfinance
institutions (MFIs) need to produce accurate and comparable data on financial performance (for example on cost recovery) as well as social performance. An example of good practice comes from some smaller financial institutions. These are participative, not necessarily in terms of being owned and managed by the poor but in employing the poor, and have understood the experience, expectations and practices of the poor. Islamic MFIs which seek to enhance the position of the poor, including the realisation of their rights to secure shelter, must develop, like conventional microfinance institutions, a culture of financial and social accountability, which embraces innovative approaches to participation by their members.

8.6.5 Mainstream Islamic Microfinance

To improve the access of target groups to microfinance, it should shift from being considered as a marginal program and be integrated within the general banking and financial services industry. Microfinance will reach its full potential, both generally and with respect to extending housing and property rights, only if it is integrated into a country’s mainstream financial system. This is necessary to promote greater awareness of products, standardize regulation and transparency and strengthen outreach mechanisms. Rather than being ignored or bypassed on the basis of its perceived complexity or the sensitivity owing to its religious orientation, Islamic finance should be recognized for what it ultimately is – a financial product that needs to meet several standards. This is particularly important where microfinance is part of the informal economy or debt transfer (hawala) and based on trust and community practices.

Improving access to Islamic microfinance is not only an implicit social goal but also an imperative for the survival of most microfinance projects. In order to pay for itself it must reach out to very large numbers of poor people in order to be self-sustaining. Strategies to enhance the opportunities for the poor to participate in, and become educated about Islamic microfinance and products are an essential component of outreach. In the case of Islamic microfinance where interest is replaced by profit and loss methods and there may be uncertainty as to returns, reasonable service charges from a wider constituency are necessary to cover costs particularly where government subsidies and donor funds cannot be guaranteed in the long run.

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