Banking for the poor: the role of Islamic banking in microfinance initiatives

Asyraf Wajdi Dusuki

Department of Economics, Kulliyyah of Economics and Management Sciences, International Islamic University Malaysia, Kuala Lumpur, Malaysia

Abstract

Purpose – The main purpose of this paper is to review the microfinance scheme and discuss how Islamic banks can participate in such an endeavour without actually compromising the issue of institutional viability and sustainability.

Design/methodology/approach – The paper is based on an extensive review of microfinance with the objective of building a case for Islamic banking to participate in a microfinance initiative.

Findings – As reviewed in this paper, microfinance requires innovative approaches beyond the traditional financial intermediary role. Among others, building human capacity through social intermediation and designing group-based lending programmes are proven to be among the effective tools to reduce transaction costs and lower exposure to numerous financial risks in relation to providing credit to the rural poor. This paper also suggests the use of a special purpose vehicle (SPV) as one of the possible alternatives for Islamic banks channelling funds to the poor.

Research limitations/implications – Islamic banks may benefit from the spectrum of Shariah-compliant sources of funds and offer a wide array of financing instruments catering for different needs and demands of their clients. Furthermore, the use of a bankruptcy-remote entity like SPV can protect Islamic banks from any adverse effect of microfinance activities.

Originality/value – The analysis here is valuable in drawing the attention of Islamic banking practitioners to the fact that they can actually practise microfinance without undermining their institutional viability, competitiveness and sustainability. This is evident from the proposed model to incorporate SPV into their microfinance initiatives.

Keywords Banking, Poverty, Disadvantaged groups, Financial services, Islam

Paper type Research paper

1. Introduction

Attacking persistent poverty and overcoming low levels of social and economic development of Muslims worldwide are the greatest challenges in facing the global development community as the world has already moved into the new millennium. Despite progress during the last three decades, witnessing a revolution in providing finance for alleviating poverty across the globe, the battle is far from won. Consequently, the issue of financial inclusion has emerged as a policy concern primarily to ensure provision of credit to small and medium enterprises that are normally denied access to credit mainstream financial institution and market. The emerging microfinance revolution with appropriate designed financial products and services enable the poor to expand and diversify their economic activities, increase their incomes and improve their social well-being (Bennett and Cuevas, 1996; Ledgerwood, 1999).

The concern over poverty reduction via microfinance initiative is also of relevance to Islamic banks. As business entity established within the ambit of Shariah (Islamic law), Islamic banks are expected to be guided by an Islamic economic objectives, among others, to ensure that wealth is fairly circulated among as many hands as possible without causing any harm to those who acquired it lawfully (Ibn Ashur, 2006).
Indeed, Islamic banking industry is one of the fastest growing industries, having posted double-digit annual growth rates for almost 30 years (Iqbal and Molyneux, 2005). What started as a small rural banking experiment in the remote villages of Egypt in the early 1970s, has now reached a level where many mega-international banks worldwide offering Islamic banking products. While the estimates about the exact magnitude of the Islamic banking market vary, one can safely assume that it presently exceeds US$150 billion and is poised for further growth (Iqbal and Molyneux, 2005).

With such an impressive growth of Islamic banking over the last 30 years, this paper argues that it is time for the industry to be reoriented to emphasize on issues relating to social and economic ends of financial transactions, rather than overemphasizing on making profits and meeting the bottom line alone. Islamic banks should endeavour to be the epicentre in the financial business galaxy of promoting financial inclusive by engaging with community banking and microfinance programme.

This paper reviews the evolution of microfinance industry with the objectives to build a case for Islamic banking to participate without jeopardising their viability and sustainability in the market. The remaining of this paper is organised as follows. Next section delineates some theoretical issues on the existing numerous barriers to finance the poor; section 3 discusses the potential of microfinance in enforcing social intermediation role and group-based lending mechanism to overcome such barriers. Section 4 discusses the relevance of microfinance initiatives to Islamic banking. Section 5 then highlights the potential of special purpose vehicle (SPV) as an alternative approach for Islamic banks to practice microfinance without compromising with the issue of viability and sustainability. Fittingly, the conclusion is in the final section.

2. Barriers in banking for the poor
It is well established in finance theory that credit markets characterized with high asymmetric information, notably, the existence of moral hazard and adverse selection problems, leads to severe distortion and sometimes complete collapse of the formal credit market (Akerlof, 1970; Daripa, 2000). Financial contracts will not be written under this condition. Hence, goods and services will be under-produced and under-consumed. The contracts between borrower and lender will only be honoured if the element of trust exists in such transactions. The basis of trust depends on two critical elements: first is the applicant’s reputation as a person of honour (Diamond, 1991); and second is the availability of enough capital or collateral against which claims can be made in case of default (Holmstrom and Tirole, 1993).

The essence of conventional profit-maximization banks as financial intermediaries providing financial services to people hinge upon these two elements. As formal lenders, risk-averse banks would only be willing to lend if these two elements serving as a basis of trust exist in their reciprocal relationship with clients (as borrowers). For instance, the bank is able to assess the reputation of borrowers based on bank’s intimate knowledge embedded in the clients personal accounts as well as other documented history of past borrower behaviour. At the same time, the clients have material value such as properties or any valuable assets serving as collateral to pledge against risk.

However these two elements poised important impediments to the poor especially in the rural areas to access into credit market. The poor are usually perceived by the “profit-orientated” banks as high-risk borrowers due to inherent difficulties in
assessing their creditworthiness at the same time their inability to provide collateral to pledge against any potential risk.

These traditional formal lenders faced with borrowers whom they do not personally know, who do not keep written accounts or “business plans” and who want to borrow small and uneconomic sums (Jacklen, 1988); thus exposing them to very high risks due to the inherent screening problems faced by the lenders at the same time make the project appraisal become too expensive (Rhyne and Otero, 1992).

Most formal intermediaries like commercial banks also regard low-income households as “too poor” to save, thus further accentuates the risk of supplying credits to them (Adams and Vogel, 1986; Sinclair, 1998). Furthermore, no insurer is willing to insure against possibility of non-repayment due to natural and commonest hazards afflicting small producers in developing countries; for example, drought, livestock disease and breakdown of equipment (Hulme and Mosley, 1996). The risk exposure in supplying credits to the poor clients is further exacerbated due to the inherent difficulty for the commercial financial institution to diversify their portfolio. For example, most of the rural clients who derive their incomes from agriculture need to borrow in the pre-harvest season, making it difficult for banks to diversify their portfolio (Zeller and Sharma, 1998).

Both financial institutions and poor clients face high transaction costs due to asymmetric information problems, which naturally appear in the financial transactions. These costs related to searching, monitoring and enforcement costs, which are directly related to the information problems inherent in the rural financial markets. The uncertainty regarding the ability of borrowers to meet future loan obligations, inability to monitor the use of funds and demand for small sum of loans by the rural households further reinforces the higher units of transaction costs, which is characterized by fixed costs[1] (Braverman and Guasch, 1986; Zeller and Meyer, 2002).

Likewise, physical and socio-economic barriers may also contribute to the market failure. These include poor infrastructure, remote, difficult terrain and stagnant, illiteracy, poor healthcare, malnutrition, caste or ethnicity and gender (Bennett et al., 1996). These barriers are more apparent in developing countries whereby over 90 per cent of households living in the rural areas are without access to institutional sources of finance (Robinson, 2001). Thus, matching access to or supply of financial services with demand has been a consistent challenge for financial institutions attempting to serve clientele groups outside the frontier of formal finance (Pischke, 1991).

Figure 1 depicts the common factors faced and perceived by both the supply side (formal financial intermediation) and the demand side (the poor) resulting in the financial market failure for the poor.

3. Evolution of microfinance
The failure of commercial banking to provide financial services to the poor coupled with disadvantages of using informal markets are major rationales for intervention in the market for financial services at the micro level. Consequently, microfinance emerged as an economic development approach intended to address the financial needs of the deprived groups in the society. The term microfinance refers to “the provision of financial services to low-income clients, including self-employed, low-income entrepreneurs in both urban and rural areas” (Ledgerwood, 1999).

The emergence of this new paradigm was encouraged by the successful story of microfinance innovations serving the poor throughout 1970s and 1980s. The most
quoted examples are Grameen Bank Bangladesh, the unit desa system of Bank Rakyat Indonesia, ACCION International in United States and Latin America and PRODEM, BancoSol’s predecessor in Bolivia. The microfinance adopts market-oriented and enterprise development approach. It emphasises institutional and programme innovations to reduce costs and risks and has greater potential to expand the financial frontier to the poor in sustainable manner (Littlefield et al., 2003).

The following section highlights some salient features of microfinance mechanism.

3.1 Integrating social intermediation
Providing financial services to marginalised society often requires more than traditional style of financial intermediation. Financing the poor entails some measures of up-front investment to nurture human capacity (e.g. knowledge, skills, confidence and information) and build local institutions as a bridge to reduce gaps created by poverty, illiteracy, gender and remoteness (Ledgerwood, 1999). This process of building capacity among the marginalised society is known in microfinance literature as social intermediation.

Thus, social intermediation is defined as “a process in which investments are made in the development of both human resources and institutional capital, with the aim of increasing self-reliance of marginalised groups, preparing them to engage in formal financial intermediation” (Bennett et al., 1996; Pitt and Khandker, 1996). Social intermediation is different from other common types of social welfare services because it offers mechanism enabling beneficiaries to become clients who should then ready to enter into a contract involving reciprocal obligations. This aspect of social intermediation should eventually prepare individuals to enter into solid business relationships with formal financial institutions. The process normally involves training members in basic accounting and financial management as well as business
strategy to ensure viability and sustainability of financial services offered. Figure 2 illustrates the process of social intermediation in microfinance initiatives aiming at preparing groups to enter into solid business relationship (a contract involving reciprocal obligations) with formal financial institutions.

By playing the role of social intermediation, banks are not only building self-reliant groups of poor people in rural areas with related skills that could foster long-term business relationships, but also exploiting cost advantage of informal monitoring and enforcement systems in the long-run, which is inevitably important for a more efficient and effective role of financial intermediation.

### 3.2 Group-based financial services

Many successful microfinance initiatives worldwide adopt group-based lending approach capitalising on peer monitoring and guarantee mechanism. Group-based approach normally involves the formation of groups of people who have a common objective to access financial services. One important feature of group-based lending is the use of peer pressure as a substitute to collateral. It has been proven empirically as one of the most effective ways of designing an incentive-monitoring system in the presence of costly information[2].

Another important feature of group-based lending mechanism is its potential to reduce transaction costs in credit delivery and disbursements (searching, monitoring and enforcement) of the lender by shifting onto the groups. Within such systems, the functions of information acquisition and monitoring and enforcement of financial contracts are largely transferred from a bank to group borrowers and savers [3]. It may also harness “social collateral” constituting a powerful incentive device to yield higher repayment rates than individual lending (Besley and Coate, 1995). The self-selected group members share a common interest in gaining access to credit and savings services, and possess enough low-cost information to adequately screen each other and apply sanctions to those who do not comply with the rule[4].

---

**Figure 2.** The process of social intermediation

---

**SOCIAL INTERMEDIATION**

I Using Groups to Expand Access to Existing:
- Social Services (health, adult literacy, family planning etc.)
- Production Support Services (agricultural extension)

II Building Self-Reliant Groups through:
- Training in Group Dynamics and Participatory Management.
- Training Group Members in Accounting and Basic Financial Management Skills.
- Developing a user-friendly MIS

**FINANCIAL INTERMEDIATION**

III Sustainable Delivery of:
- Credit
- Savings
- Insurance

**Sources:** (Bennett et al., 1996)
Hence it lowers transaction costs, reduces financial risk and facilitates a greater range of market transactions in outputs, credit, land and labour, which can in turn lead to better incomes. For example strong social link among borrowers may increase their ability to participate in credit transactions characterized by uncertainty about compliance[5]. In particular, social capital could lead to a better flow of information between lenders and borrowers and hence less adverse selection and moral hazard in the credit market. Social capital also potentially expands the range of enforcement mechanisms for default on obligations in environments in which recourse to the legal system is costly or impossible. Again, trust (social capital) plays a paramount role in the formation of group lending success, particularly in the absence of collateral (Besley and Coate, 1995; Bhatt and Tang, 1998; Collier, 1998; Krishna et al., 1997; Narayan and Pritchett, 1999; Otero and Rhyne, 1994; Stiglitz, 1990; Zeller and Sharma, 1998).

3.3 Savings mobilization
Savings are also regarded crucial in building self-sufficient microfinance institutions. Saving mobilization can strengthen microfinance institutions and reduce their dependence on government subsidies and donors for loanable funds (Gurgad et al., 1994; Pischke et al., 1986; Rhyne and Otero, 1992, 1994). Well-crafted saving services can encourage a move from non-financial savings into financial savings, with advantages for entrepreneurs of safety and liquidity and for society of providing funds for investment by others (Vogel, 1984). For example, Grameen Bank, Amanah Ikhtiar Malaysia and several programmes of ACCION International have used some form of compulsory savings, where borrowers are required to save a portion of the amount they borrow.

The amount required for compulsory savings is sometimes determined based on a percentage of the loan granted or sometimes as a nominal amount. For example, in the case of Amanah Ikhtiar Malaysia, participants who signed as a member but yet to borrow are required to save RM1 per week as a compulsory saving and an amount between RM3 and RM15 for borrowers depending on the loan size. A distinctive characteristic of compulsory savings is that the funds cannot be withdrawn by members while they have a loan outstanding. In this way, savings act as a form of collateral and serve as an additional guarantee mechanism to ensure repayment of loans. On the other hand, BRI Unit Desa System in Indonesia offers a voluntary savings instruments such as passbook savings, with free access to deposits, which better meets depositors’ liquidity requirements.

3.4 Over-dependence on subsidies
There is also a growing debate on the need for microfinance institutions to be independence from subsidy or self-sufficient. Several shortcomings have been identified in the microfinance literature with regards to over-dependence on subsidies. Among the arguments include: subsidies can cause a lack of financial discipline on the part of both lender and borrower. While the lenders may have less concern about repayment rates, borrowers on the hand perceived loan as grants which may reduce their sense of obligation to repay their debts (Bennett et al., 1996). Low and subsidized interest rates also have been empirically proven to result in regressive income distribution, credit rationing and non-sustainable institution (Gurgad et al., 1994). Furthermore, the infusions of subsidies may induce entry and lead to perverse effects to borrowers’ welfare in the face of stiff competition among the unregulated moneylenders (Hoff and Stiglitz, 1998)[6].
Therefore there is mounting concern that financial services can be sold to the poor without recurrent subsidies under conditions that allow the financial intermediary to become self-sustainable. One of the alternatives is to respond directly to the World Bank’s long-standing concern about economic rationality of credit project interest rates (Pischke, 1996). Appropriate interest rate charged is one that will allow social banking institution to cover its operating costs without further reliance on subsidies and donor funds. One of the important components in calculating appropriate interest rates besides the costs (including inflation rate) to be covered is profit, as measured by the capitalization rate. However, this component of charging interest on microfinance product is not feasible for Islamic banks to emulate since it violates the fundamental principle of Shariah, which we are going to discuss in the following section.

4. Islamic banking approach to microfinance
Concern over credit provision and finance accessibility for the poor via microfinance is also relevant to Islamic banks that should place greater social welfare responsibilities and religious commitments to achieve the Islamic economic objectives, including social justice, equitable distribution of income and wealth and promoting economic development. Many writers such as El-Gamal (2006), Al-Harran (1990, 1996, 1999), Akhtar (1996, 1998), Dhumale and Sapcanin (1998), Ahmed (2001), and others, believe in the great potential of Islamic banking to be involved in microfinance programmes to cater for the needs of the poor who usually fall outside the formal banking sector.

In fact the earliest Islamic banking experiments in India and Egypt were small rural co-operatives inspired by European mutuals. The institution such as Mit Ghamr in Egypt had focused on economic development, poverty alleviation and fostering a culture of thrift among poor Muslims. However, with the passage of time, the orientation of Islamic banking and finance has somehow dominated by profit-maximisation doctrine, vying for countless billions of Arab petrodollars. As a result, most of the financial engineered instruments are designed favorably catering the needs of the well-off clients while the poor left unbankable due to the inherent impediments as discussed earlier.

Perhaps this phenomenon does not reflect the raison-d’etre of Islamic banking, which is supposed to be a Shariah-based institution. As the name suggests, Islamic banking is first and foremost about religious identity and duty. There are fundamental differences between Islamic banks and their conventional counterparts, not only in the ways they practice their business, as argued by the advocates of Islamic banking, but above all in the values which guide the Islamic banks’ whole operation and outlook (Ahmad, 2000; Ahmad, 1984; Chapra, 1987, 2000; Khan and Mirakhor, 1987; Rosly and Bakar, 2003; Siddiqi, 1983, 1985; Siddiqui, 2001). The values as prevailed within the ambit of Shariah are expressed not only in the minutiae of their transactions, but in the breadth of their role in society as a manifestation of religious belief and a commitment to addressing the issue of income inequality, poverty eradication and social justice.

On the whole, Islamic banking is concerned with much more than just refraining from charging interest. It is a system that aims at making a positive contribution to the fulfilment of the socioeconomic objectives of Islamic society inscribed in Maqasid al-Shariah (the objectives of Shariah). As business entity established within the ambit of Shariah, Islamic banks are expected to be guided by an Islamic economic objectives, among others, to ensure that wealth is fairly circulated among as many hands as possible without causing any harm to those who acquired it lawfully (Ibn, 2006). Hence the issue of financing the poor via microfinance initiative is not alien to Islamic
banking. Instead it is a natural outlook that should transpire in the operation of any Islamic institution, especially those claiming to be based on the principles of Shariah.

While Islamic banks may emulate the existing model of microfinance practice, the activities however must be carried out in ways, which do not conflict with the principles of Shariah. In other words, Islamic microfinance initiatives should be free from any involvement of activities prohibited by Islam and from elements like usury (riba), gambling (maisir), harmful substance (darar) and excessive ambiguity (gharar). Having mentioned this, Islamic banks can always learn from various approaches used by microfinance institutions to ensure effectiveness in providing finance to the marginalized society.

In addition to the innovative approaches used by many microfinance institutions, Islamic banking can apply diverse financial instruments together with other available mechanisms such as zakah, charity and waqf, which can be integrated into microfinance programmes to promote entrepreneurship amongst the poor and subsequently alleviate poverty (Akhtar, 1996, 1998; Al-Harran, 1995, 1996, 1999; Al-Harran, 1990; Al-ZamZami and Grace, 2000; Dhumale and Sapcanin, 1998; Hassan and Alamgir, 2002).

The following sections delineate the various instruments in Islamic finance for mobilization of funds and financing the poor.

4.1 Mobilization of funds
As noted earlier, conventional microfinance relies heavily on simple interest-based deposits, government subsidies, donations and loans. On the other hand Islamic microfinance can benefit from a wide array of instruments for funds mobilization. Islamic microfinance instruments may be broadly divided into: (1) internal resources and (2) external resources. The former relates to financial resources that can be mobilized internally to ensure self-sustainability and self-sufficiency, while the latter reflects the common practice of microfinance institutions worldwide which rely on external parties to provide financial resources like government grants, subsidies and donations. A brief description on the instruments for funds mobilization is discussed below.

4.1.1 Internal resources. The internal resources can be further divided into two main categories, namely deposits and equity. The following describes the salient characteristics of Islamic deposits and equity that can be mobilised for microfinance purposes:

(1) **Deposits**: Islamic microfinance can mobilise various forms of deposits such as wadiah (safekeeping), qard al-hassan (benevolence loan) and mudarabah (profit sharing). Under wadiah mechanism, the deposits are held as amanah (trust) and utilised by the bank at its own risk. The depositors are not entitled to any return since the profit or loss resulting from the investment of these funds is entirely belonged to the bank. However, bank can offer unilateral and discretionary gifts which sometimes commensurate to the rate of return given by conventional counterpart on its interest-bearing deposits. Another model is using qard al-hassan mechanism, whereby the funds deposited in the bank is treated as a loan by the depositor. Here, bank shall have to guarantee the principal amount but is not allowed to offer any return to depositors. **Mudarabah** deposits on the other hand are based on profit sharing between the bank acting as the entrepreneur (mudarib) and depositors as the capital owner.
Banking for the poor

57

(rabb-ul maal). The amount deposited is not supposed to be guaranteed and depositors are entitled to any return derived from the invested funds.

(2) **Equity**: Islamic microfinance initiative may also mobilise funds through participatory models such as *musharakah* and *mudarabah*. There is a great potential to attract depositors amongst the rich who intend to do charity via Islamic participatory approach of risk and profit-sharing. In *musharakah* model of fund-raising, public can buy shares and become owners of the whole microfinance programme initiated by Islamic banks or choose specific financing project of their choice. Any profits realised from the project are distributed annually to the shareholders. While losses incurred shall be shared proportionate to the amount of capital contributed by each participant. In this regard, Islamic banks guarantee the participation of every segment of society. In particular, the adoption of Islamic participatory approach in fund mobilization and financing promotes justice, brotherhood, social equality and financial inclusion as opposed to the emerging financial exclusion which is becoming a common phenomenon in most developed countries.

4.1.2 **External resources.** As mentioned earlier, conventional microfinance institutions charge high interest rate to allow them to cover their operating costs without further reliance on subsidies and donor funds. Islamic banks on the other hand are not allowed to charge interest and thus require alternative mechanisms for funds mobilization to preserve institutional financial sustainability. Islam offers mechanisms for redistribution of income and wealth and enhancement of social inclusion, so that every Muslim is guaranteed a fair standard of living (Metwally, 1997). These mechanisms include *zakah*, donations, gift and *waqf* are inherent in Islamic charitable contracts (*tabarru*). *Zakah* is a compulsory religious levy which can be mobilised from Muslims and disbursed to the designated recipients as prescribed by *Shariah* (Al-Omar and Abdel-Haq, 1996). It can be used to resolve the issue of financing the poorest of the poor or hardcore poor who normally require certain amount of funds for their basic consumption purposes. In other words, *zakah* can be utilised for consumption needs of the poor while other types of funds shall be used for financing productive activities.

*Waqf* is a form of perpetual charity that entails the use of assets such as cash, land, real estates for charitable purposes. One of the unique characteristics of *waqf* instruments is its perpetuity that does not allow *waqf* asset to be disposed of and its ownership cannot be transferred. Thus *waqf* creates and preserves long-term assets that generates income flows or indirectly help the process of production and creation of wealth.

4.2 **Demand-oriented financing**

Impact studies on microfinance initiatives have shown that the effectiveness of microfinance in alleviating poverty depending on how sensitive the microfinance institution to client demand. The need to focus on demand-oriented financial services induces them to greater institutional and programmes innovation especially in products differentiation, operation efficiency and more outreach improvement. For instance, the scope of lending services offered to the poor must address not only production- and income-generating activities but also consumption needs such as health, education and social obligation. Consequently better financing products will generate greater economic benefits for poor clients and eventually larger impact to the society, particularly the poor (Seibel and Parhusip, 1998; Zeller and Meyer, 2002).
Accordingly, Islamic banks can offer a wide-array of Shariah-compliant financing instruments addressing various needs and demands of the client especially among the poor entrepreneur. These instruments can be broadly divided into: (1) participatory profit-loss-sharing modes like mudarabah and musharakah; (2) exchange (muawadat) modes like murabahah (cost plus sale), bay’ bithaman ‘ajil (deferred payment sale), bay’ al-Salam (forward sale) and bay’ al-Istisna’ (commission to manufacture sale), Ijarah (leasing); (3) voluntary charitable contract (tabarru’), such as, pawning contract (ar-Rahn) and benevolence loan (qard al-hassan) and (4) hybrid-modes like diminishing partnership (musharakah mutanaqisah), hire purchase (ijarah thumma al-bay’) etc. A brief description of each financing instrument and its relevant application is provided in the following Table I.

5. Financing through SPV

A major concern for banks to be involved in microfinance is how to manage their risk inherent in financing activities involving the poor and small entrepreneurs. The issue of risk is paramount especially in banking business that requires efficient and effective mechanisms and instruments in managing asset and liability on banks’ balance sheet to ensure their viability and sustainability.

One of the possible alternatives for banks to get involved in microfinance is through a SPV or popularly known as SPV. An SPV is a legal entity created by a firm (known as the sponsor or originator) to undertake some specific purpose or restricted activity spelt out by the sponsoring firm (Gorton and Souleles, 2005). The SPV may be a subsidiary of the sponsoring firm or it may be an independent SPV, which is not consolidated with the sponsoring firm for tax, accounting or legal purposes. The latter has an added feature of being a bankruptcy-remote entity.

The legal form for an SPV may be a limited partnership, a limited liability company, a trust, or a corporation (Gorton and Souleles, 2005). In case of Malaysia, SPV normally takes the legal form of a trust and governed by Trustee Act. SPV is a trust set up to fulfill specific purposes. In this regards, it can perform specific microfinance activities to benefit certain beneficiaries. The trustee will be appointed by the sponsoring bank to oversee the operations and activities outlined in the trust deed. More importantly, the designated funds channelled by the bank as a form of trust should be used only for the prescribed objectives.

An essential feature of an SPV, which makes it promising as a vehicle to offer microfinance is its bankruptcy-remote in nature. This implies that should the sponsoring firm or Islamic bank enter a bankruptcy procedure, the firm’s creditors cannot seize the assets of the SPV. To ensure the SPV as bankruptcy-remote as possible, its activities can be restricted. For instance, it can be restricted from issuing debt beyond a stated limit (Gorton and Souleles, 2005; Standard and Poor, 2002). The shares are customarily being held by a charitable trust established for that purpose. The trust will be the sole shareholder in the SPV. There must also be no provision in the constitutional documents of the SPV giving the sponsoring bank a right to control the affairs of the SPV. Standard and Poor (2002) provides the following list of characteristics for a bankruptcy-remote SPV:

- restrictions on objects, powers and purposes;
- limitations on ability to incur indebtedness;
Table I. Shariah-compliant financing instruments for microfinance

<table>
<thead>
<tr>
<th>Category</th>
<th>Instrument</th>
<th>Description</th>
<th>Application</th>
</tr>
</thead>
<tbody>
<tr>
<td>Participatory-based</td>
<td><em>Mbusharakah</em></td>
<td>A partnership contract between two parties who both contribute capital towards the financing of a project. Both parties share profits on a pre-agreed ratio, but losses are shared on the basis of equity participation. Either parties or just one of them may carry out management of the project. This is a very flexible partnership arrangement where the sharing of the profits and management can be negotiated and pre-agreed by all parties.</td>
<td>This financing mode is suitable for working capital financing, fixed asset purchased, project financing, etc.</td>
</tr>
<tr>
<td></td>
<td><em>Mudarabah</em></td>
<td>An agreement made between two parties: one which provides 100 per cent of the capital for the project and another party known as a <em>mudarrib</em>, who manages the project using his entrepreneurial skills. Profits are distributed according to a predetermined ratio. Any losses accruing are borne by the provider of capital. The provider of capital has no control over the management of the project.</td>
<td>This financing mode is suitable for working capital financing, fixed asset purchased, project financing, etc.</td>
</tr>
<tr>
<td>Exchange-based</td>
<td><em>Murabahah</em> (muawadat)</td>
<td>A contract sale between the bank and its client for the sale of goods at a price, which includes a profit margin agree by both parties. As a financing technique, it involves the purchase of goods by the bank as requested by the client. The goods are sold to the client with a mark-up. Repayment, usually in instalments is specified in the contract.</td>
<td>This financing mode is suitable for working capital financing, fixed asset purchased project financing, etc.</td>
</tr>
<tr>
<td></td>
<td><em>Bay’ Bithaman ‘Ajil</em></td>
<td>This contract refers to the sale of goods on a deferred payment basis. Equipment or goods requested by the clients are bought by the bank, which subsequently sells the goods to the client at an agreed price which includes the bank’s mark-up (profit). The client may be allowed to settle the payment by instalments within a pre-agreed period, or in a lump sum. Similar to a murabahah contract, but with payment on a deferred basis.</td>
<td>This financing mode is suitable for working capital financing, fixed asset purchased project financing, etc.</td>
</tr>
<tr>
<td></td>
<td><em>Bay’ al-Salam</em></td>
<td>A contract of sale of goods where the price is paid in advance and the goods are delivered in the future.</td>
<td>This financing mode is suitable for agricultural financing, which requires capital at certain critical stage (e.g. during plantation stage).</td>
</tr>
<tr>
<td></td>
<td><em>Bay’ al-Istisna’</em></td>
<td>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.</td>
<td>This financing mode is suitable for financing assets which require capital at different stages of construction and tailor-made manufacturing.</td>
</tr>
</tbody>
</table>

(Continued)
<table>
<thead>
<tr>
<th>Category</th>
<th>Instrument</th>
<th>Description</th>
<th>Application</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ijarah</td>
<td></td>
<td>A contract under which a bank purchases and leases out equipment required by its clients for a rental fee. The duration of the lease and rental fees are agreed in advance. Ownership of the equipment remains in the hands of the bank.</td>
<td>This instrument is suitable for financing fixed assets such as machinery, motor vehicles, etc.</td>
</tr>
<tr>
<td>Voluntary charitable contract (tabarru')</td>
<td>Ar-Rahn</td>
<td>A pawning contract which involves holding a valuable non-fungible good as insurance against a debt, where the non-fungible may be used to extract the value of the debt or part thereof. In some jurisdiction, a minimum custodian fee may be charged to the borrower for safekeeping of pawned property.</td>
<td>This financing mode is suitable for all purposes including working capital, personal consumption, fixed assets purchase, etc. This mode of financing requires customer to have valuable asset eligible for pawning such as gold or silver.</td>
</tr>
<tr>
<td>Qard al-Hassan</td>
<td></td>
<td>An interest-free loan given mainly for welfare purposes. The borrower is only requires to pay back the amount borrowed. In some cases, a minimum administrative fee may also be charged to the borrower. However this service charge must be the actual administrative cost incurred in managing the loan and not a fixed percentage on the amount of loan.</td>
<td>This financing mode is suitable for all purposes including working capital, personal consumption, fixed assets purchase, etc.</td>
</tr>
<tr>
<td>Hybrid</td>
<td>Musharakah Mutanaqisah</td>
<td>This instrument involves three different contracts, namely musharakah, sale and ijarah. Islamic banks jointly purchase and own an asset with client aiming at transferring the ownership to the client. The bank’s share will gradually be redeemed by client by executing sales contract. The bank is also allowed to lease its portion of the asset to client for rental income.</td>
<td>This financing instrument is suitable for fixed asset financing.</td>
</tr>
<tr>
<td>Ijarah</td>
<td>Thumma al-bay'</td>
<td>This instrument involves two separate contracts namely leasing and sales contracts executed separately and in sequence. The bank normally purchases the asset and leases it to client. At the end of leasing period, the ownership is transferred to the client by executing sales contract, which normally at a nominal price.</td>
<td>This financing instrument is suitable for fixed asset financing such as motor vehicles.</td>
</tr>
</tbody>
</table>
restrictions or prohibitions on merger, consolidation, dissolution, liquidation, winding up, asset sales, transfers of equity interests, and amendments to the organisational documents relating to “separateness”;

incorporation of separateness covenants restricting dealings with parents and affiliates;

“Non-petition” language (i.e. a covenant not to file the SPV into involuntary bankruptcy);

security interests over assets; and

an independent director (or functional equivalent) whose consent is required for the filing of a voluntary bankruptcy petition.

Based on the above discussion of SPV, this paper suggests that Islamic banks may establish an SPV by allocating certain amount of funds for microfinance purposes. The Articles of Association of the SPV will limit its business activities to a particular activity of the deal, such as the microfinance. The SPV must be fully bankruptcy-remote so that the Islamic bank is fully protected from the failure of the SPV and hence maintaining its viability and sustainability in banking business. This means, for instance, that it cannot be a subsidiary of the Islamic bank. The transfer of funds must be on a “full sale” basis for accountancy and regulatory purposes. There must not be any possibility of the SPV being consolidated with the selling bank. The benefits to the bank will be lost if the accounts of the SPV are consolidated with those of the selling bank.

The basic procedures of microfinance through SPV are straightforward and summarised in Figure 3. The key elements are as follows.

1. The Islamic bank mobilises various sources of funds with specific microfinance objectives.
2. The Islamic bank creates a bankruptcy-remote SPV.
3. The bank allocates certain amount of funds and pass it to the SPV.
4. The funds are channelled to various clients depending on needs and demands. For example, zakah funds may only be allocated to poor clients for consumption purposes and capacity building initiatives, while other type of funds can be used to finance their productive economic activities.

6. Conclusion

This paper highlights the relevance of microfinance as a globally accepted practice to Islamic banks. The Islamic banking system has an in-built dimension that promotes financing activities to the poor, as it resides within a financial trajectory underpinned by the forces of Shariah injunctions. These Shariah injunctions interweave Islamic financial transactions with genuine concern for poverty eradication, social justice and equal distribution of wealth at the same time as prohibiting involvement in illegal activities, which are detrimental to social and environmental well-being.

Perhaps, after more than 30 years of impressive growth, it is time for the industry to be reoriented to emphasize on issues relating to social and economic ends of financial transactions, rather than overemphasizing on making profits and meeting the bottom line alone. There are fundamental differences between Islamic banking and conventional banking, not only in the ways they practise their business, but above all,
the values which guide Islamic banking whole operation and outlook. The values as prevailed within the ambit of Shariah are expressed not only in the minutiae of its transactions, but also in the breadth of its role in society. This demands the internalisation of Shariah principles on Islamic financial transactions, in its form, spirit and substance. By doing so, it epitomises the objectives of Shariah in promoting economic and social justice.

As reviewed in this paper, microfinance requires innovative approaches beyond the traditional financial intermediary role. Among others, building human capacity through social intermediation and designing group-based lending programmes are proven to be among the effective tools to reduce transaction costs and lower exposure to numerous financial risks in relation to providing credit to the rural poor. Group-based approach also fosters a better flow of information between lenders and borrowers and hence less adverse selection and moral hazard in the credit market.

The success of various approaches used in microfinance programme worldwide should be emulated by Islamic banks. Additionally, Islamic banks may benefit from spectrum of sources of funds and offer a wide array of financing instruments catering different needs and demands of their clients. This paper also suggests the use of SPV as one of the possible alternatives for channelling funds to the poor. With its unique bankruptcy-remote feature, Islamic banks are fully protected from any failure of SPV that involves microfinance activities. In the final analysis, Islamic banks can practise microfinance without compromising with institutional viability, competitiveness and sustainability.
Notes
1. Transaction costs have a large fixed-cost component, so unit costs for smaller savings deposits or smaller loans are high compared with those for larger transactions. The conventional banks are structured to handle much larger individual transactions or loans than those required by the poor. Lending to the poor who normally demand small amount of loans is regarded expensive because of high overhead costs (Jacklen, 1988; Zeller and Meyer, 2002).

2. Grameen Bank (Bangladesh), which started operation in 1976 has now a daily loan volume of $1.5 million and has 98 per cent repayment rate, appears to be a model of success in applying this mechanism. One of the distinctive characteristics to the Grameen Bank is that loans are made to self-formed groups of approximately five farmers, who are mutually responsible for repaying the loans. Additional amounts of loans will be further granted if all members of the group have settled all the outstanding amounts. In such arrangement, Stiglitz (1990) argued that the Grameen Bank devised an incentive structure called “peer monitoring” whereby the others within the village do the monitoring on their behalf by exploiting the local knowledge of the members of the group. However, Besley and Coate (1995) and Hulme and Mosley (1996) assert that even though the group-lending may prove to have a positive effect on enhancing the incentive of loan repayment, it may have perverse effect when the whole group defaults, even when some members would have repaid individually.

3. Many of the transaction costs arise from the need to acquire information about the counter-parties involved in transaction. Obtaining such information for small loans can be costly if the bank agent is asked to do this. Traditional financial intermediation techniques, such as judging the loan application based on written information, are either not feasible due to the illiteracy or too costly to administer. However information about the creditworthiness of a loan applicant is readily available within the local community through neighbours and peers, which can be obtained at least cost if networks or institutions are based at community level.

4. In their model, Besley and Coate (1995) postulate a social penalty function that describes the punishments available within a group rather than the bank. This social penalty implies that members in the community who do not comply with the norms, trust and values of the communities can be ridiculed or ousted from the family. This may constitute a powerful incentive device, since the costs of upsetting other members in the community may be high.

5. In Tanzania, social capital at the community level impacted poverty by making government services more effective, facilitating the spread of information on agriculture, enabling groups to pool their resources and manage property as a cooperative, and giving people access to credit who have been traditionally locked out of formal financial institutions. For details data analysis and empirical studies refer (Narayan and Pritchett, 1999).

6. In their paper, Hoff and Stiglitz (1998) demonstrate two ways that a subsidy may increase equilibrium prices in a monopolistically competitive market. There may be induced entry and a resulting loss of scale in economies, or induced entry with negative externalities in enforcement across suppliers. The paper explores these issues in a context where enforcement problems are particularly acute and expenditures on enforcement are often large especially in rural credit markets in developing countries. According to them, in a monopolistically competitive market where there is free entry into moneylending, a subsidy has been found to induce new entry, and eventually the new entry reduces the market of each moneylender. This forces him to operate at a higher marginal cost of transacting loans. Thus it increases the marginal cost of lending. On the other hand, they also present alternative argument that the subsidies may cause the marginal cost of moneylenders to rise. In this model, an increase in entry adversely affects borrowers’ incentives to repay, which increases the enforcement effort that each moneylender must expand per borrower to ensure repayment. New entry thereby raises each moneylender’s cost of taking on an additional customer. See Hoff and Stiglitz (1998).
References


Ledgerwood, J. (1999), Microfinance Handbook: An Institutional and Financial Perspective (Sustainable Banking with the Poor), The World Bank, Washington, DC.


**Corresponding author**
Asyraf Wajdi Dusuki can be contacted at: asyraf.w@iiu.edu.my

To purchase reprints of this article please e-mail: reprints@emeraldinsight.com
Or visit our web site for further details: www.emeraldinsight.com/reprints