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Islamic Microfinance : a Vehicle for Promoting Financial Inclusion

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Islamic Microfinance: A Vehicle For Promoting Financial Inclusion

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Introduction

Microfinance is a general term describing credit, insurance, savings, and other essential financial services offered to low-income entrepreneurs and small businesses that lack access to the conventional finance system.¹ The microfinance movement aims to alleviate poverty, promote financial inclusion,² and advance global economic development by increasing income-generating opportunities for the working poor.³ Over 10,000 financial institutions worldwide offer microfinance services. The most reputable providers typically report their activities to the Microfinance Information Exchange, a non-profit organization that aims to support and increase industry transparency through oversight and data analytics.⁴

Microfinance loans are most often interest-based.⁵ While adding interest to a principal loan amount is generally a standard financial practice, many Muslim societies forbid it under *Shari'ah* law as an unjustified and unfair increase in total

¹ International Labour Office, *Small Change, Big Changes: Women and Microfinance*, http://www.ilo.org/wcmsp5/groups/public/@dgreports/@gender/documents/meetingdocument/wcms_091581.pdf

² Financial inclusion is “a state in which everyone who can use them has access to a range of quality financial services at affordable prices, with convenience, dignity, and consumer protections, delivered by a range of providers in a stable, competitive market to financially capable clients.” Center for Financial Inclusion, *About the Center: Who We Are*, <http://www.centerforfinancialinclusion.org/about>; See also Syed Nazim Ali, *Shari'a-Compliant Microfinance*. London: Routledge, 2012.

³*Id*; See also Oxus Group, *What is Microfinance*, <http://www.oxusnetwork.org/en/enour-activitiespublications-2-2/what-we-do>

⁴ Consultative Group to Assist the Poor, *MIX*, <http://www.cgap.org/about/people/mix>; See also Consultative Group to Assist the Poor, *CGAP: Helping to Build a Microfinance Industry*, <http://www.gdrc.org/icm/cgap-mfindustry.html>; See also MIX Market, *Microfinance Institutions*, <http://www.mixmarket.org/mfi>

⁵For example, microfinance watchdog organization Microfinance Transparency describes interest rate as “one of the main components to the price of a loan” and does not explore other types of loan repayment practices. Microfinance Transparency, *Flat vs Declining Balance Interest Rates*, <http://www.mftransparency.org/wp-content/uploads/2012/05/MFT-BRF-205-EN-Flat-versus-Declining-Balance-Interest-Rates-What-is-the-Difference-2011-09.pdf>. See, for example, Grameen Bank, *Interest Rate*, <http://www.grameen-info.org/grameen-bank-interest-rate/>; See also Rosenberg, *Richard, Microcredit Interest Rates*, Consultative Group to Assist the Poorest, <https://www.cgap.org/sites/default/files/CGAP-Occasional-Paper-Microcredit-Interest-Rates-Nov-2002.pdf>

repayment amount.⁶ Thus, a significant number of prospective Muslim clients do not pursue traditional microfinancing offers.⁷ Their alternative is to accept *Shari'ah*-compliant microfinance loans, but such offerings are not usually readily available. This paper presents a survey of the Islamic microfinance industry and describes barriers to its propagation. It also presents plans and processes that microfinance institutions and governments may implement to increase the availability of Islamic microfinancing structures to the individuals who need them.

Ensuring Loan Repayments in Microfinance Lending

Microfinance clients typically do not have verifiable credit histories.⁸ Conventional financial theory categorizes such borrowers as high risk because of the lack of proof that the borrower is responsible.⁹ To ensure the likelihood of loan repayment, the conventional microfinance industry utilizes a group liability mode of lending. The group-lending model's primary characteristic is the leveraging of social factors such as reputation and position as collateral in lieu of tangible collateral.¹⁰ For example, Grameen America lends to borrowers in five member batches, and each member is responsible for ensuring the group's timely repayments.¹¹ Should one batch member default on repayment, the rest of the group becomes adversely

⁶ Abdel-Rahman Yousri Ahmad, *Riba, Its Economic Rationale and Implications*, Institute of Islamic Banking and Insurance, http://www.islamic-banking.com/iarticles_8.aspx

⁷ Kajia Hurlburt, *What is Islamic Microfinance?*, Shuraako.org (December 2012), <http://shuraako.org/sites/default/files/documents/What%20is%20Islamic%20Microfinance.pdf>

⁸ *Id.*

⁹ Net Credit, *What are high-risk loans?*, <https://www.netcredit.com/glossary/high-risk-loan>

¹⁰ Anna T Schurmann and Heidi Bart Johnston, *The Group-lending Model and Social Closure: Microcredit, Exclusion, and Health in Bangladesh*, *Journal of Health, Population and Nutrition* (August 2009); 27(4): 518–527.

<http://www.ncbi.nlm.nih.gov/pmc/articles/PMC2928107/>

¹¹ Gayle Ferraro, *How Microfinance & Group Lending Works, To Catch a Dollar: Muhammad Yunus Banks on America*, <http://www.tocatchadollar.com/the-cause/what-is-microfinance/>

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affected because of the joint liability nature of the loans.¹² In addition, each batch meets weekly with a cohort consisting of three to six other local batches in order to build support and encourage responsibility.¹³ As a result, at least theoretically, each borrower experiences social pressure to make payments in order to preserve his/her community standing.

With Islamic microfinance ventures, the system of promoting repayment differs markedly. In lieu of social pressure, “the spirit of brotherhood, cooperation, and mutual help is applied” in cases of defaults or problems with repayment.¹⁴ Through this approach, under the idea of *kafalah* (translated as “responsibility, amenability or surety-ship”),¹⁵ a third party takes legal responsibility for a distressed individual’s debt repayment.¹⁶ Otherwise, a *Qard Hassan*, or “virtuous loan,” where the borrower repays only the exact loan amount without a profit for the lender is extended to the individual.¹⁷ *Qard Hassan* loans are based primarily on welfare and goodwill.¹⁸

In both conventional and Islamic microfinance lending, the local microfinance center is usually an individual’s only source for financial inclusion. As such, the individual will usually attempt repayment in order to avoid the effects of financial

¹² *Id.*

¹³ *Id.*

¹⁴ See Saad Al-Harran, Alfred Yong Foh Sen, and Sri Anne Haji Masri. *An Islamic Microfinance Enterprise: The Financial Vehicle That Will Change the Face of the Islamic World: the Power of Salam Financing*. Philadelphia, PA.: Xlibris Corp, 2008.

¹⁵ Alternative International Management Services, *Glossary: AIMS*, http://www.aims-gcc.com/?page_id=45

¹⁶ *Id.*

¹⁷ Institute of Islamic Banking and Insurance, *Glossary of Financial Terms*, http://www.islamic-banking.com/glossary_q.aspx

¹⁸

exclusion.¹⁹ Individual repayment rates are therefore often higher than predicted by conventional financial thought.²⁰

A Brief History of Conventional Microfinance

Various forms of grassroots microfinance ventures have long existed in different regions of the world. The current formal system of microfinance began in Bangladesh in 1976, when economics professor Muhammad Yunus extended a small non-collateralized loan to women in a small village.²¹ Contrary to conventional financial theories regarding loans made under such conditions, all the borrowers fulfilled their repayment obligations.²² The women also developed profitable long-term businesses that allowed them to lift themselves and their families from poverty.²³

Based on the success of his initial microfinancing experience, with the help of the Bangladeshi government, Professor Yunus launched the Grameen Bank in Dhaka in 1983.²⁴ Since its inception, Grameen Bank has made profits in all but three years: 1983, 1991, and 1992.²⁵ It has provided \$17.4 billion in microfinance

¹⁹ *Id.*

²⁰ *Id.*

²¹Grameen Bank, *Grameen Bank At a Glance*, <http://www.grameen-info.org/grameen-bank-at-a-glance/>; See also Renee Loth, *Women Entrepreneurs*, Boston Globe (July 2 2002), <http://search.proquest.com/docview/405464007?accountid=14657>

²² *Id.*

²³ *Id.*

²⁴UNESCO, *Education and Poverty Eradication: Grameen Bank*, <http://www.unesco.org/education/poverty/grameen.shtml>

²⁵ Grameen Bank, *FAQ*, <http://www.grameen-info.org/faq/>

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loans to more than 8.7 million borrowers.²⁶ Due to its early and continuing success, the Grameen Bank model has spawned many similar microfinance organizations.²⁷

Islamic Finance Law's *Qur'anic* Basis

Islamic finance law is based on *Shari'ah* law, or “a system of duties that are incumbent upon a Muslim by virtue of his religious belief.”²⁸ *Shari'ah* law originates from the *Qur'an*, Islam's holy book, and from the *Hadith*. The *Hadith* is a compilation of validated literal sayings of the Prophet Muhammed that are not present in the *Qur'an*.²⁹

Islamic jurisprudence, or *fiqh*, is defined as “the science of deducing and applying the principles and injunctions of *Shari'ah*, as well as the sum total of deductions by particular jurists.” The function of *fiqh* is to interpret and adapt *Shari'ah* law to be applicable to modern life “according to time and circumstance is necessitated by changes in society, and the influx of various cultures and material conditions” while ensuring that the rules continue to comply with *Qur'anic* writings. In 1985, the Islamic *Fiqh* Academy³⁰ made the following resolutions:

²⁶ Change the World 2015, Nike, Cisco, MasterCard, SABMiller, Vodafone, Google—and 45 other companies that are doing well by doing good, Fortune Magazine, <http://fortune.com/change-the-world/grameen-bank-12/>

²⁷Microfinanceinfo.com, *History of Microfinance*, <http://www.microfinanceinfo.com/history-of-microfinance/>

²⁸Encyclopaedia Britannica, *Shari'ah Islamic Law*, <http://www.britannica.com/topic/Shari'ah>

²⁹ According to an Islamic scholar interviewed by members of the University of Chicago Law School during an International Immersion Program trip to the United Arab Emirates, a good *Hadith* comes from multiple translations, and from multiple sources in which everyone in the sequence of passing down the story is beyond reproach; See also Alan Godlas, *Hadith and the Prophet Muhammad*, Islam and Islamic Studies Resources at the University of Georgia, <http://islam.uga.edu/Hadith.html>

³⁰ The Berkley Center For Religion, Peace & World Affairs At Georgetown University describes the Islamic *Fiqh* Academy as “an international body of Muslim experts on subjects of both religious and secular knowledge” that “seeks to advance knowledge in the realms of [Islamic] culture, science, and economics” and “promotes the interpretational reflection (ijtihad) of Islamic jurisprudence, or *fiqh*.” The Islamic *Fiqh* Academy is headquartered in Saudi Arabia. See Berkley Center For Religion, Peace & World Affairs At Georgetown University, *Islamic Fiqh Academy, Definition*, <http://berkeleycenter.georgetown.edu/organizations/islamic-fiqh-academy>

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1. Any excess or profit on a loan for a deferred payment when the borrower is unable to repay it after the fixed period and similarly any excess or profit on a loan at the time of contract are both forbidden as *riba* in the *Shari'ah*.
2. Alternative banks should be established according to the injunctions of Islam to provide economic facilities.
3. The Academy resolves to request all Islamic countries to establish banks on *Shari'ah* principles to fulfill all the requirements of a Muslim according to his beliefs so that he may not face any repugnance.³¹

These resolutions resulted in the expansion of Islamic finance and banking, as several countries moved to operate under these rules.³²

Islamic Microfinance

The nonviability of the conventional microfinance model in a significant portion of the Muslim world due to its interest-based profit structure³³ limits its success in promoting financial inclusion.³⁴ For example, Grameen Bank has been successful in Bangladesh, a country with an 89.7 percent Muslim population,³⁵ primarily because Bangladesh does not adhere to *Shari'ah* finance law.³⁶ Countries like Pakistan, on the other hand, are left with fewer microfinancing options.

Shari'ah law provides rules and guidelines for social, political, and economic undertakings in Muslim societies.³⁷ The degree to which an individual Muslim adheres to it depends on considerations such as his/her home state's laws, the

³¹ Institute of Islamic Banking and Insurance, *Shari'ah Rulings and Finance*, <http://www.islamic-banking.com/Shari'ah-rulings-finance.aspx>

³² *Id.*

³³ The "Frequently Asked Questions" section of the Grameen Bank website answers the question "How does GB fund its operations?" by stating that "Grameen Bank takes deposits from borrowers and non-borrowers which are sufficient to fund its operations." See Grameen Bank, *FAQ*, <http://www.grameen-info.org/faq/>

³⁴ For example, at the beginning of 2014, Grameen bank had total deposits of \$2.1 billion and a return on equity of approximately 11.4 percent. See MicroCapital.org, *Microcapital Brief: Bangladeshi Government Takes Interim Control of Grameen Bank*, (March 25, 2015), <http://www.microcapital.org/microcapital-brief-bangladeshi-government-takes-interim-control-of-grameen-bank/>

³⁵ Central Intelligence Agency, *The World Factbook*, <https://www.cia.gov/library/publications/the-world-factbook/geos/bg.html>

³⁶ See Grameen Bank, *FAQ*, <http://www.grameen-info.org/faq/>

³⁷ Institute of Islamic Banking and Insurance, *Shari'ah Rulings and Finance*, <http://www.islamic-banking.com/shariah-rulings-finance.aspx>

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history of the state's Islamic jurisprudence, and its cultural traditions.³⁸ For example, because of their stricter adherence to *Shari'ah* law, *Shari'ah*-compliant banking and finance assets are clustered predominantly among Malaysia, Iran, and the Gulf states, but represent only approximately 15 percent of banking assets in Bangladesh (and then, only due to rapid recent growth over the past ten years).³⁹ Bangladesh's financial system favors conventional finance products.⁴⁰

The legal systems of most majority-Muslim states are moderate mixed systems that include rules influenced by Islamic law, but which are primarily comprised of secular law.⁴¹ For instance, Bangladesh, classified by the United Nations as “moderate Muslim”, does not promote strict interpretation of Islamic rules.⁴² *Shari'ah* law does not form the basis of Bangladesh's legal system; most of its laws are based on British common law (a remnant of the colonial era).⁴³

³⁸ Various countries' treatment of their athletes during the 2012 Olympics provide an excellent example of the significant differences in interpretations of law and adherence to *Qur'anic* principles in the Muslim world. The Olympics took place during the month of Ramadan. The Moroccan soccer team chose to fast, trusting that God would grant them victory. Many Muslim Olympians chose to forgo fasting based on rulings that they depending on competing to make a livelihood. Some exemptions were based on the doctrine of necessity (discussed later in this paper), some based on fatwas (religious rulings) issued exempting competitors from the Ramadan fast. The United Arab Emirates used a *Qur'anic* exemption for travelers not remaining in more than one place for four days to relocate their athletes every few days so that they would be exempt. See Mark Durie, *The Ramadan Olympics and Islam's "Law of Necessity"*, Gatestone Institute International Policy Council (July 30, 2012), <http://www.gatestoneinstitute.org/3220/olympics-ramadan>

by

³⁹ Alfred Kammer, Mohamed Norat, Marco Piñón, Ananthakrishnan Prasad, Christopher Towe, Zeine Zeidane, and an IMF Staff Team, *Islamic Finance: Opportunities, Challenges, and Policy Options*, International Monetary Fund (March 2015), <https://www.imf.org/external/pubs/ft/sdn/2015/sdn1505.pdf>

⁴⁰*Id.*

⁴¹Jan Michiel Otto, *Shari'ah and National Law in Muslim Countries*, Van Vollenhoven Institute, Leiden University (August 2008), [https://openaccess.leidenuniv.nl/bitstream/handle/1887/20694/Shari'ah%20and%20national%20Law%20in%20Muslim%20countries.pdf?sequence=1](https://openaccess.leidenuniv.nl/bitstream/handle/1887/20694/Shari%27ah%20and%20national%20Law%20in%20Muslim%20countries.pdf?sequence=1)

⁴² Lailufar Yasmin, *Religion and After: Bangladeshi Identity Since 1971*, Open Security (April 19, 2013), <https://www.opendemocracy.net/opensecurity/lailufar-yasmin/religion-and-after-bangladeshi-identity-since-1971>

⁴³ Md. Ershadul Karim, *A Research Guide to the Legal System of the Peoples' Republic of Bangladesh*, Globalex, (April 2013), <http://www.nyulawglobal.org/globalex/Bangladesh1.html>

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Bangladesh's status as a moderate Muslim country is the main reason why though microfinance originated there, it does not usually comport with *Shari'ah* law. A second explanation is that the Islamic finance industry is relatively new, and both it and the microfinance industry were nascent in the mid-1970s. The first *Shari'ah* law-based bank was established in 1975 and Professor Yunus ran his initial microfinancing experiment in 1976.⁴⁴ Given this circumstance, early microfinance entities, even if they were interested in Islamic finance, would have had no strong institutions available to back the incorporation of Islamic banking principles into their operations.⁴⁵ The norm in 1976 was that most, if not all, banking and finance occurred under conventional terms. As such, that was the only template from which microfinance could form and grow.

A third alternative explanation stems from Bangladesh's moderate stance on Islam – Bangladeshi scholars have more lenient interpretations of the *Qur'an's* statements forbidding interest.⁴⁶ For example, Grameen Bank's founder, Professor Yunus, has never advocated for *Shari'ah*-compliant microfinancing. He contends that conventional microfinancing does not defy *Shari'ah* law because it does not involve collateral and the interest Grameen Bank and other microfinance institutions charge is not excessive.⁴⁷ (Many publications have presented research

⁴⁴ Ijara Community Development Corporation, *History of Islamic Finance*, <https://ijaracdc.com/history-of-islamic-finance/>

⁴⁵ *Id.*

⁴⁶ M. Umer Chapra, *The Nature of Riba in Islam*, *The Journal of Islamic Economics and Finance* (Bangladesh), Vol. 2, No. 1, January-June 2006, pp. 7-25, http://ierc.sbu.ac.ir/File/Article/THE%20NATURE%20OF%20RIBA%20IN%20ISLAM_94669.pdf

⁴⁷ MoneyScience, *Topics and Concepts in Islamic Finance and Banking*, <http://www.moneyscience.com/pg/pages/view/123691/topics-and-concepts-in-islamic-finance-and-banking>

that microfinance institutions do in fact regularly apply interest rates that could be deemed excessive.)

The *Riba* Prohibition

Riba, or the prohibition of receiving or paying interest on loans, is a principal tenet of Islamic finance law.⁴⁸ Though the term usually translates to English as “usury,” its literal translation is “increase, addition, or growth.”⁴⁹ *Riba* is defined as “monetary advantage without counter value, an advantage which is stipulated in favor of one of the parties in exchange of two monetary values.”⁵⁰ The *riba* prohibition is drawn from the following five verses of the *Qur’an*:

- (1) Those who eat *riba* will not stand (on the Day of Resurrection) except like the standing of a person beaten by Satan leading him to insanity. That is because they say: “Trading is only like *riba*,” whereas Allah has permitted trading and forbidden *riba*. (Al-Baqara, Chapter 2, Verse 275)
- (2) Allah will destroy *riba* and will give increase for Sadaqat (deeds of charity, alms, etc.) And Allah likes not the disbelievers, sinners. (Al-Baqara, Chapter 2, Verse 276)
- (3) O you who believe! Be afraid of Allah and give up what remains (due to you) from *riba* (from now onward), if you are (really) believers. (Al-Baqara, Chapter 2, Verse 278)
- (4) O you who believe! Eat not *riba* doubled and multiplied, but fear Allah that you may be successful. (Aal-e-Imran, Chapter 3, Verse 130)
- (5) And their taking of *riba* though they were forbidden from taking it and their devouring of mens’ substance wrongfully (bribery, etc.). And We have prepared for the disbelievers among them a painful torment. (An-Nisa, Chapter 4, Verse 161)⁵¹

⁴⁸ *Riba* is an Arabic word which means “interest, undue profits or excessive gain from a transaction.” See Alache Fisho-Oridedi, *The Prohibition Of Riba Under Islamic Law: What Are The Implications For International Contracts?*, The Centre for Energy, Petroleum and Mineral Law and Policy Gateway, <http://www.dundee.ac.uk/cepmlp/gateway/index.php?category=63&sort=author>

⁴⁹ Islamicfinance.com, *What is Riba?*, http://www.islamic-finance.com/item5_f.htm

⁵⁰ B.A.Law, Faris Lenzen, *Interest And Islamic Banking*, Mondaq Ltd, <http://www.mondaq.com/x/53350/capital+adequacy+BASEL/Interest+And+Islamic+Banking>

⁵¹ Global Islamic Finance Group, *Qur’anic Verses on Riba (Usury/Interest)*, <http://www.global-islamic-finance.com/2007/10/Qur’anic-verses-on-riba-usury-interest.html#ixzz3y78Ueg5n>

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None of the verses actually defines *riba*; rather Islamic legal and religious scholars derived its meaning from the *Hadith*.⁵² Consequently, individual Muslim countries and sects abide by varying interpretations. Some moderate Muslim countries allow reasonable interest rates, forbidding only compound interest and rates that rise to the level of usury.⁵³ Stricter Muslim countries and reformers within moderate Muslim countries prohibit all types of interest.⁵⁴ In the 1999 *Shari'ah* Appellate Bench of the Supreme Court of Pakistan case *Dr. M. Aslam Khaki v. Syed Muhammad Hashim*, for instance, the Court ruled that “any increase, big or small, over the principal under a contract of loan or debt is *riba* prohibited by the [*Qur'an*], regardless of whether the loan is for a consumptive or productive purpose.”⁵⁵ Thus, in the latter group’s view, payment of any type of interest, no matter how low the rate, is unjust and is usury.⁵⁶

Groups that strictly proscribe *riba* reason that money is merely a medium of exchange, and is not itself an asset capable of generating income or financial returns.⁵⁷ (Time value of money and cost of capital principles therefore do not arise in Islamic finance.⁵⁸) A key tenet of *Shari'ah* banking and finance is that

⁵² “The Qur’an does not explicitly define *riba* as one type of transaction or another.... The efforts of the Fuqaha’ or judicial scholars like Sh. Zuhayli and the examples of the *Hadith* allow us to determine a clear idea of what is *riba*.” Mohammad Omar Farooq, *Riba, Interest and Six Hadiths: Do We Have a Definition or a Conundrum?*, (December 27, 2009), Review of Islamic Economics, Vol. 13, No. 1, pp. 107-108, 2009, <http://ssrn.com/abstract=1528770>

⁵³ Oxford Islamic Studies Online, *Riba*, <http://www.oxfordislamicstudies.com/print/opr/t125/e2013>

⁵⁴ *Id.*

⁵⁵ World Bank, *The World Bank Legal Review: Law and Justice for Development, Volume 1, 2003*, Washington, DC: World Bank and Martinus Nijhoff, pp. 408, <https://openknowledge.worldbank.org/handle/10986/15167>

⁵⁶ *Id.*

⁵⁷ Institute of Islamic Banking and Insurance, *Islamic Banking: Prohibition of Interest*, http://www.islamic-banking.com/prohibition_of_interest.aspx

⁵⁸ Personal correspondence during the 2015 University of Chicago International Immersion Program Trip to the Gulf

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“transactions must be underpinned by real economic activities, and there must also be a sharing of risks in economic transactions.”⁵⁹ Contrastingly, conventional banking and finance systems ascribe money its own intrinsic worth.

Three *Fiqh* rules uphold the *riba* prohibition. The first rule is that any benefit obtained from a loan is *riba*.⁶⁰ This rule originates partly from the *Hadith* stricture that “the only reward for a loan is the thanksgiving and the repayment”⁶¹, and partly from *Qur’anic* text.⁶² A second rule arising from the first rule is that a capital lender must either share in the profit an asset purchased from the loan generates, or choose to receive a guarantee for full capital repayment.⁶³ These two choices are mutually exclusive.⁶⁴ The third rule is that unless a lender is willing to accept loss, it is not entitled to profit.⁶⁵ From these *Fiqh* rules comes the requirement that in lieu of interest-based transactions, Muslims should engage in financing methods under which risk and reward are equally allocated to both the borrower and the lender (for example, shareholder transactions or partnerships).⁶⁶

⁵⁹ Alfred Kammer, Mohamed Norat, Marco Piñón, Ananthakrishnan Prasad, Christopher Towe, Zeine Zeidane, and an IMF Staff Team, *Islamic Finance: Opportunities, Challenges, and Policy Options*, International Monetary Fund (March 2015), <https://www.imf.org/external/pubs/ft/sdn/2015/sdn1505.pdf>

⁶⁰ Sulaiman, Sa'idu, and Bashir S. Galadanci, *Islamic Banking and Finance: General Framework and Case Studies*, Kano: International Institute of Islamic Thought, Page 14.

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.*

The Shortage of Islamic Microfinance Products

Shari'ah-compliant microfinance currently accounts for only 1 percent of the total global microfinance industry.⁶⁷ In 2013, only 1.28 million of approximately 106 million microfinance borrowers used *Shari'ah*-compliant products.⁶⁸ Muslims account for 24 percent of the world's population, and roughly 50 percent of the world's poor reside in Islamic states.⁶⁹ An estimated 650 million Muslims live on less than \$2 a day.⁷⁰ These statistics indicate that there is a severe need for greater access to Islamic microfinance.

A 2008 CGAP study revealed that Bangladesh, Afghanistan, and Indonesia together generate 80 percent of Islamic microfinancing.⁷¹ (It is unlikely that these figures have significantly changed in recent years, as research papers written as recently as July 2015 cited them.) Even in these three countries, significantly fewer persons and entities have utilized Islamic microfinance loans compared to those receiving conventional microcredit.⁷² The study also revealed that Islamic microfinance accounted for only about .05 percent of total global microfinance

⁶⁷ Microfinance Africa, *Poverty in Muslim World is Rapidly Increasing: Zubair Mugha*, Microfinance Africa (March 12, 2014), <http://microfinanceafrica.net/news/poverty-in-muslim-world-is-rapidly-increasing-zubair-mughal/>

⁶⁸ Convergences, *Microfinance Barometer 2015*, http://www.convergences.org/assets/uploads/BMF-2015-ENG_web.pdf; See also Mayada El-Zoghbi and Michael Tarazi, *Trends in Sharia-Compliant Financial Inclusion* (March 2013), Consultative Group to Assist the Poor, <https://www.cgap.org/sites/default/files/Focus-Note-Trends-in-Sharia-Compliant-Financial-Inclusion-Mar-2013.PDF>

⁶⁹ Microfinance Africa, *Poverty in Muslim World is Rapidly Increasing: Zubair Mugha*, Microfinance Africa (March 12, 2014), <http://microfinanceafrica.net/news/poverty-in-muslim-world-is-rapidly-increasing-zubair-mughal/>

⁷⁰ The World Bank, *The Bank of Khartoum: Innovation in Islamic Microfinance* (August 5, 2014), <http://www.worldbank.org/en/news/feature/2014/08/05/the-bank-of-khartoum-innovation-in-islamic-microfinance>

⁷¹ See, for example, Ali Saleh Alshebami, D. M. Khandare, *Islamic Microfinance Industry in Yemen: Challenges and Opportunities*, MacroThink Institute (July 30, 2015), <http://www.macrothink.org/journal/index.php/ijsw/article/view/7937>

⁷² *Id.*

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outreach. Whereas Islamic microfinance lenders operating in Arab regions for 7 to 10 years served between approximately 2,000 to 7,000 active borrowers, similarly aged conventional microfinance institutions operating in the same areas served hundreds of thousands of active borrowers.⁷³

The glaring divide between the number of Muslims living in poverty and the reach of *Shari'ah*-compliant microfinance loans highlights that to promote global financial inclusion, it is necessary to ensure that microfinance institutions have access to and knowledge of lending methods that comport with Islamic finance law. A CGAP survey concluded that in the majority-Muslim countries Algeria, Syria, and Jordan, between 20 and 40 percent of potential microfinance clients have refused conventional microfinance loans due to their religious beliefs.⁷⁴ In a similar vein, a 2009 Pakistan-based study revealed that the “vast majority of [the] Muslim population refrains from availing conventional [microfinance] services due to the element of interest that is considered repugnant to *Shari'ah*.”⁷⁵ This research included Muslims residing in developed countries such as the United Kingdom, the United States, and Australia.⁷⁶

It is important to note that the low availability of Islamic microfinance loans may affect even non-Muslims in countries with strict *Shari'ah* law. Given that

⁷³ Nimrah Karim and Mohammed Khaled, *Taking Islamic Microfinance to Scale*, CGAP (February 23, 2011), <http://www.cgap.org/blog/taking-islamic-microfinance-scale>

⁷⁴ Nimrah Karim, Michael Tarazi, and Xavier Reille, *Islamic Microfinance: An Emerging Market Niche* <https://www.cgap.org/sites/default/files/CGAP-Focus-Note-Islamic-Microfinance-An-Emerging-Market-Niche-Aug-2008.pdf>

⁷⁵ Waheed Akhter, Nadeem Akhtar and Syed Khurram, *Islamic Micro-Finance and Poverty Alleviation: a Case of Pakistan*, COMSATS Institute of Information Technology, International Business Research Conference Proceedings (November 14, 2009), <http://www.kantakji.com/Fiqh/Files/Economics/401.pdf>.

⁷⁶ *Id.*

Shari'ah law underscores those countries' official legal systems, it is likely to be illegal for any individual, Muslim or not, to accept interest-based loans. Thus, the availability of *Shari'ah*-compliant microfinance loans may benefit a wider swath of individuals than statistics show. Furthermore, the availability of different repayment options and loan structures for non-Muslim individuals could increase the overall attractiveness of accepting microfinance loans. They might also find it easier to repay loans, given the relative flexibility of *Shari'ah*-compliant loan repayment plans.

Bahrain Family Bank

A major reason for the significant proliferation of the traditional microfinance initiative is the amenability of its lending structure to the involvement of small individual lenders from the public who are not themselves microfinancers. The business model of the microfinance organization Kiva illustrates the reach and success of the person-to-person microfinance operating structure. Kiva has made 1 million loans in more than 78 countries⁷⁷ totaling approximately \$808 million since its inception in 2005.⁷⁸ Approximately 1.4 million individual Kiva website users have contributed loan funds, and the average size of a loan is \$413.75.⁷⁹

Shari'ah-compliant microfinance loans are not suited for this type of lending. The required loan structures and legal principles involved are too complex for Kiva-style person-to-person funding to be feasible. The Consultative Group to Assist the

⁷⁷ Kiva.org, *Lender Testimonials*, <https://www.kiva.org/press/lenders>

⁷⁸ Kiva.org, *About Us: Latest Statistics*, <https://www.kiva.org/about/stats>

⁷⁹ *Id.*

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Poor rightly asserts that “[f]inancial tenets enshrined in [*Shari’ah*] challenge the microfinance sector’s ability to sustainably provide [*Shari’ah*]-compliant financial products at scale.”⁸⁰ As such, Islamic microfinancing ventures tend to be restricted to partnerships formed with large donors, banks and governments. These requirements significantly affect the level and extent of its outreach. However, there have been success stories in the field of Islamic microfinance, such as the Bahrain Family Bank.

Established in January 2010, the Bahrain Family Bank (the Family Bank) is the world’s first formal *Shari’ah*-compliant microfinance bank.⁸¹ Its mission is “to serve the low-income families in the Kingdom of Bahrain through the promotion of Microfinance to lead social development.”⁸² The Family Bank partnered with the Grameen Trust to launch its main product, the Grameen Program, which provides disadvantaged Bahrainis (only citizens are eligible for its services) with *Shari’ah*-compliant microfinance opportunities.⁸³

As is the case in conventional microfinance deals, the Family Bank does not require collateral from its clients.⁸⁴ Honor, trust, and mere practicality underscore the microfinancing relationship between the Family Bank and its clients: if honor and trust fail, clients eventually repay the loans from practical considerations

⁸⁰Mayada El-Zoghbi and Michael Tarazi, *Trends in Sharia-Compliant Financial Inclusion, Consultative Group to Assist the Poor* (March 26, 2013), <http://www.cgap.org/publications/trends-sharia-compliant-financial-inclusion>

⁸¹ Karen Hunt-Ahmed, *Contemporary Islamic Finance: Innovations, Applications, and Best Practices*. Hoboken, N.J.: John Wiley & Sons, 2013.

⁸² Family Bank, *Vision, Mission, Value*, http://www.familybankbh.com/fb_vision.asp

⁸³ Family Bank, *Our Products*, http://www.familybankbh.com/fb_products_grameen.asp; Personal correspondence during the 2015 University of Chicago International Immersion Program

⁸⁴ *Id.*

because they likely have no other alternative financing options.⁸⁵ The Family Bank assesses risk by completing a score sheet with prospective clients to evaluate whether the individual client's idea is marketable and/or feasible.⁸⁶ The score sheet includes the following factors:

1. The client's income,
2. Whether bank statements are available (though bank statements are not required for financing),
3. Whether there is a need for the proposed product or service
4. Whether the client has outstanding loans, and
5. The client's financial history.⁸⁷

Based on the total score, the Bank decides whether to extend a loan to the prospective client.⁸⁸

The Family Bank uses several well-established *Shari'ah*-compliant modes of financing. As is common with other Islamic microfinance institutions, it uses partnership, trade, or lease-based financing structures that result in ownership or provides usage rights for physical assets in an enterprise.⁸⁹ This paper discusses the *murabaha* financing method because it is the *Shari'ah*-compliant financing technique most commonly used in microfinance transactions.⁹⁰

⁸⁵ *Id.*

⁸⁶ Personal correspondence during the 2015 University of Chicago International Immersion Program Gulf Trip

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ Azhar Nadeem, *Islamic Business Contracts and Microfinance - A Case of Mudaraba*, Munich Personal RePEc Archive (October 27, 2010), https://mpa.ub.uni-muenchen.de/27194/1/MPRA_paper_27194.pdf

⁹⁰ Michael Looft, *Inspired Finance: The Role of Faith in Microfinance and International Economic Development*. <http://public.eblib.com/choice/publicfullrecord.aspx?p=1809232>

Murabaha

In a *murabaha* transaction, a lender and a client enter a contract under which the lender purchases property for sale to the client then sells it to the client for a pre-determined, agreed-upon, and reasonable mark-up price.⁹¹ (The seller-lender's profit and incentive to lend come from the mark-up.) The client thereafter repays the final price in fixed installments.⁹² This financing technique comports with Islamic finance law as both sides of the transaction benefit: the bank profits in selling the asset to the customer and the customer receives a zero down payment loan with flexible and affordable repayment terms.⁹³

Once the creditor-seller delivers the property to the buyer-borrower, the *murabaha* closely resembles the rent-to-own arrangement sometimes utilized in Western property transactions.⁹⁴ (Thus, the structure of a *murabaha* transaction is more akin to a buyer/seller transaction than a creditor/lender transaction.) Under *murabaha*, the seller-lender owns the property until the loan is fully paid. With each payment, the buyer-borrower gains an increased ownership percentage.⁹⁵ This structure is *Shari'ah*-compliant not only because of the absence of *riba*, but also

⁹¹ Michael Looft, *Inspired Finance: The Role of Faith in Microfinance and International Economic Development*. <http://public.eblib.com/choice/publicfullrecord.aspx?p=1809232>

⁹¹ Institute of Islamic Banking and Insurance, *Murabaha on Shari'ah Ruling*, http://www.islamic-banking.com/murabaha_sruling.aspx

⁹² *Id.*

⁹³ Islamic Bankers: Resource Centre, *Financing : Commodity Murabaha & Tawarruq*, <https://islamicbankers.me/islamic-banking-islamic-contracts/financing-commodity-murabaha-tawarruq/>

⁹⁴ Investopedia.com, *Definition of Murabaha*, <http://www.investopedia.com/terms/m/murabaha.asp#ixzz3yJRS8Lt4>

⁹⁵ *Id.*

because the bank and the creditor share the risks associated with the loss of the property.⁹⁶

Murabaha Tawarruq⁹⁷

The definition of each term of the *murabaha tawarruq* gives insight into how it is used. As previously explained, *murabaha* is a sales contract that includes mark-up or cost-plus financing.⁹⁸ “*Tawarruq*” is an Arabic word meaning “turns into silver.”⁹⁹ Thus, a *murabaha tawarruq* financing structure is one through which a bank sells a good to a client and the client converts it into cash.

The *murabaha tawarruq* is used in situations where a borrower requires cash or capital rather than property.¹⁰⁰ In a typical *murabaha tawarruq* transaction, the bank purchases an easily resalable product (for example, a diamond) based on the customer’s promise to purchase it from the bank for an above-market price.¹⁰¹ Upon receiving the product, the client either resells it on the open market or uses a bank-affiliated broker to resell it through an agency agreement. Either course of action results in the client receiving a cash influx.¹⁰² Thereafter, the client repays the bank for the purchased asset in installments.¹⁰³ This process fulfills the asset-backed financing requiring of Islamic finance law.¹⁰⁴

⁹⁶ Personal correspondence during the 2015 University of Chicago International Immersion Program Gulf Trip

⁹⁷ See Appendix.

⁹⁸ Institute of Islamic Banking and Insurance, *Murabaha on Shari’ah Ruling*, http://www.islamic-banking.com/murabaha_sruling.aspx

⁹⁹ Financial Times Lexicon, *Definition of Tawarruq*, <http://lexicon.ft.com/Term?term=tawarruq>

¹⁰⁰ Personal correspondence during the 2015 University of Chicago International Immersion Program Gulf Trip

¹⁰¹ Personal correspondence during the 2015 University of Chicago International Immersion Program Gulf Trip

¹⁰² Personal correspondence during the 2015 University of Chicago International Immersion Program Gulf Trip

¹⁰³ *Id.*

¹⁰⁴ Financial Times Lexicon, *Definition of Tawarruq*, <http://lexicon.ft.com/Term?term=tawarruq>

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Classical and contemporary Islamic law jurists have conflicting opinions as to whether *Tawarruq* is acceptable under *Shari'ah* law.¹⁰⁵ For example, the Central Bank of Malaysia *Shari'ah* Advisory Council views the practice as completely permissible, but some scholars view it as strictly prohibited.¹⁰⁶ Still other scholars argue that the *Tawarruq* structure is permitted only through invoking the doctrine of necessity (discussed later in this writing).¹⁰⁷

Islamic Microfinance Initiatives Depend on Government and NGO Support

Successful *Shari'ah*-compliant microfinance initiatives tend to depend greatly on support from domestic governments, international organizations, and non-governmental organizations. For instance, Sudan's Bank of Khartoum, a notable Islamic microfinance industry player, relies on the Sudanese government and the Islamic Development Bank¹⁰⁸ (one of its primary shareholders) for funding.¹⁰⁹ Additionally, to bolster Sudan's microfinance industry, the Central Bank of Sudan decreed that all commercial banks operating within Sudan must include microfinance offices as well as allocate 12 percent of their loans to microcredit issuances.¹¹⁰ Bahrain's Family Bank is similarly structured. Its shareholders

¹⁰⁵ Institute of Islamic Banking and Insurance, *Glossary of Financial Terms*, http://www.islamic-banking.com/glossary_t.aspx

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ The Islamic Development Bank is a Saudi Arabia-based international financial institution with 56 individual state members. It was established to foster the social and economic development and social progress of its member countries in accordance with Islamic Law. It also has a mandate to "establish and operate special funds for specific purposes including a fund for assistance to Muslim communities in non-member countries, in addition to setting up trust funds." See Islamic Development Bank, *About IDB*, <http://www.isdb.org/irj/portal/anonymouse?NavigationTarget=navurl://24de0d5f10da906da85e96ac356b7af0>

¹⁰⁹ Bank of Khartoum, *About BOK Micro Finance*, <http://bankofkhartoum.com/microfinance/>

¹¹⁰ The Worldfolio, *Arab Investments Boost Sudan's Banking Sector* (July 2015), <http://www.theworldfolio.com/news/arab-investmentsboost-sudans-banking-sector-/3785/>

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include the Bahrain Ministry of Social Development, the Royal Charity Organization, as well as several conventional banks.¹¹¹ The Family Bank receives more than 70 percent of its funding from shareholder donations.¹¹²

With such guaranteed backing, these Islamic microfinance banks are able to function on low profit margins and survive weak liquidity ratios in ways that independent microfinance lenders cannot. Because they are not self-sufficient institutions, their operating structures are not realistically expandable to independent Islamic microfinance organizations. They cannot be held as templates for expanding the Islamic microfinance market. Without their sponsors and subsidies, they would be less able to operate under *Shari'ah* law as they would lack funding. Given the level of outside support they receive, these banks' microfinance initiatives are more akin to public sector-backed social enterprises than microfinance lenders in the traditional sense.

Because the Islamic microfinance model in its current form is neither easily nor readily expandable worldwide, it is necessary to assess other areas of Islamic law that may widen access to *Shari'ah*-compliant microfinancing opportunities. In order to give individuals residing in predominantly Muslim countries more opportunities for financial inclusion, the governments of these states should consider making allowances based on the greater good. Several Islamic principles, discussed below, may prove helpful in such endeavors.

¹¹¹ Personal correspondence during the 2015 University of Chicago International Immersion Program Gulf Trip

¹¹² Personal correspondence during the 2015 University of Chicago International Immersion Program Gulf Trip

Toward Alternate Solutions: The Doctrine of Necessity

The doctrine of necessity allows for a suspension of Islamic law in situations of critical need.¹¹³ It originates from the following verse in the *Qur'an*:

He [God] has forbidden to you only carrion, and blood, and the flesh of swine, and that over which any name other than God's has been invoked; but if one is driven by necessity - neither coveting it nor exceeding his immediate need - no sin shall be upon him: for, behold, God is much-forgiving, a dispenser of grace.¹¹⁴

Invoking the doctrine is permitted only in compelling circumstances. To use it, an adherent must recognize the sanctity of the law to be breached and must use the granted exception as sparingly as possible.¹¹⁵ Strict *Shari'ah* scholars reinforce these rules with dicta from the Supreme Court of Pakistan case *Khaki v. Hashim*. There, the Court stated that “before deciding an issue on the basis of necessity one must make sure that the necessity is real and not exaggerated by imaginary apprehensions and that the necessity cannot be met with by any other means than committing an impermissible act.”¹¹⁶ In a circumstance that immediately affects only one individual (such as a decision to eat pork to escape certain death), the individual uses his own discretion in invoking the doctrine.¹¹⁷ In a situation pertinent to the public, *Shari'ah* scholars and experts in the field connected to the prospective ruling must agree on whether the doctrine's use is appropriate and warranted in order to issue a ruling.¹¹⁸

¹¹³ Mehran Tamadonfar, *Islamic Law and Governance in Contemporary Iran: Transcending Islam for Social, Economic, and Political Order*, Lanham, Maryland: Lexington Books, 2015.

¹¹⁴ *The Holy Qur'an*, 2:173

¹¹⁵ Ariff, Mohamed, Iqbal Munawar, and Shamsher Mohamad, *The Islamic Debt Market for Sukuk Securities: The Theory and Practice of Profit Sharing Investment*. Cheltenham, U.K: Edward Elgar (2012).

¹¹⁶ Qafila.org, *Riba (interest) and Doctrine of Necessity*, <http://www.qafila.org/riba-interest-and-doctrine-of-necessity/>

¹¹⁷ *Id.*

¹¹⁸ *Id.*

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In instances of severe financial need or distress, Muslims may invoke the doctrine of necessity to accept interest-based financing. For instance, a significant number of Muslims living in the western hemisphere have successfully invoked the doctrine of necessity to allow them to purchase houses through interest-based mortgages.¹¹⁹ In such cases, “a modest house or automobile obtained through financing for the security and welfare of the family might be deemed *makruh* (disfavored) rather than *haram* (prohibited).”¹²⁰ Islamic scholars have also applied the doctrine to permit Islamic banks to make deposits into interest bearing accounts in cases where no alternative investments were available at particular maturities.¹²¹ The most liberal scholars have taken a general approach to the doctrine. They argue that it should always be permitted for financial dealings because “the interest-based system has now become a universal necessity and no country can live without it.”¹²²

Religious sectoral and regional differences in beliefs may influence the amenability of state regimes to allowing Muslim acceptance of traditional microfinance structures by invoking the doctrine of necessity. In fact, a robust discussion regarding the viability the doctrine in allowing Muslims to use conventional bank and finance products exists among Islamic states as well as

¹¹⁹ L. Ali Khan and Hisham M. Ramadan, *Contemporary Ijtihad Limits and Controversies*. Edinburgh: Edinburgh University Press (2011), <http://universitypublishingonline.org/edinburgh/ebook.jsf?bid=CBO9780748646029>

¹²⁰ *Id* at 220.

¹²¹ Angelo M. Venardos, *Islamic Banking and Finance in South-East Asia: Its Development & Future*, Singapore: World Scientific (2012).

¹²² Qafila.org, *Riba (interest) and Doctrine of Necessity*, <http://www.qafila.org/riba-interest-and-doctrine-of-necessity/>

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Islamic banking, economic, and religious scholars.¹²³ For example, in *Khaki v. Hashim*, the Supreme Court of Pakistan ruled that the country's finance and banking sector could not invoke the doctrine of necessity in order to continue to use conventional interest-based banking and finance products and structures.¹²⁴ As previously mentioned, the Court emphasized that an issue qualifies for exemption from *Qur'anic* law under the doctrine of necessity only in the complete absence of feasible alternatives.¹²⁵ The crux of the ruling was that:

“the appellants’ apprehensions in this case [arise] from ignorance in recent developments in Islamic banking and [are] completely unfounded...[The Court] noted how in recent years Islamic banks and financial institutions have proliferated at rapid speed in many parts of the world, and how in certain countries interest-free banking has come to account for a sizeable proportion of the economy.... [The Court] declared that, at most, necessity can be pleaded as a grounds for allowing a reasonable time for the government to take steps to switchover to an interest-free, *Shari'ah*-based financial system.”¹²⁶

In light of this ruling, one may conclude that Muslims in Pakistan and similarly situated countries face a significant barrier to invoking the doctrine of necessity for microfinancing opportunities.

Toward Alternate Solutions: *Ijtihad*

Ijtihad is an Islamic legal term meaning “the independent or original interpretation of problems not precisely covered by the *Qur'an*, *Hadith*, [or] *ijma* (scholarly consensus).”¹²⁷ The requirements of *Ijtihad* are as follows:

¹²³L. Ali Khan and Hisham M. Ramadan, *Contemporary Ijtihad Limits and Controversies*. Edinburgh: Edinburgh University Press (2011),

<http://universitypublishingonline.org/edinburgh/ebook.jsf?bid=CBO9780748646029>

¹²⁴ World Bank, *The World Bank Legal Review: Law and Justice for Development, Volume 1*, 2003. Washington, DC: World Bank and Martinus Nijhoff, <https://openknowledge.worldbank.org/handle/10986/15167>

¹²⁵ *Id* at 408.

¹²⁶ *Id.*

¹²⁷ Encyclopædia Britannica, *Definition of Ijtihad*, <http://www.britannica.com/topic/ijtihad>

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Ijtihad requires a thorough knowledge of theology, revealed texts, and legal theory (usul al-*Fiqh*); a sophisticated capacity for legal reasoning; and a thorough knowledge of Arabic. It is considered a required religious duty for those qualified to perform it. It should be practiced by means of analogical or syllogistic reasoning (*qiyas*). Its results may not contradict the *Qur'an*, and it may not be used in cases where consensus (*ijma*) has been reached, according to many scholars.¹²⁸

Ijtihad allows a head of state to override a *Shari'ah* law deemed to generally detrimental to pass a new one that serves the public good.¹²⁹ The head of state may also abrogate a law that no longer benefits the public.¹³⁰

One limitation of attempting to employ *Ijtihad* is that Islamic scholars disagree about the extent of the force of *Ijtihad*-based laws.¹³¹ For example, Sunnis take the stance that because legal issues are subject to different interpretations, *Ijtihad* is fallible.¹³² Other Muslim factions debate whether *Ijtihad* is even still permissible, contending that the practice halted in the 15th century and Islamic laws are now static.¹³³ Reformer factions, on the other hand, promote “a revitalization of *Ijtihad* in the modern world.”¹³⁴ The validity of *Ijtihad* also varies by country. In recent times, for instance, Emirati rulers have used *Ijtihad* to change traditional inheritance laws.¹³⁵ In Saudi Arabia, contrastingly, *Ijtihad* is not

¹²⁸ Oxford Islamic Studies Online, *Ijtihad*,
http://www.oxfordislamicstudies.com/article/opr/t125/e990?_hi=0&_pos=3464

¹²⁹ Personal correspondence during the 2015 University of Chicago International Immersion Program Gulf Trip
¹³⁰ *Id.*

¹³¹ Shaista P. Ali-Karamali and Fiona Dunne, *The Ijtihad Controversy*, Arab Law Quarterly, Vol. 9, No. 3 (1994), pp. 238-257

¹³² Oxford Islamic Studies Online, *Ijtihad*,
http://www.oxfordislamicstudies.com/article/opr/t125/e990?_hi=0&_pos=3464

¹³³ Shaista P. Ali-Karamali and Fiona Dunne, *The Ijtihad Controversy*, Arab Law Quarterly, Vol. 9, No. 3 (1994), pp. 238-257

¹³⁴ Oxford Islamic Studies Online, *Ijtihad*,
http://www.oxfordislamicstudies.com/article/opr/t125/e990?_hi=0&_pos=3464

¹³⁵ Personal correspondence during the 2015 University of Chicago International Immersion Program Gulf Trip

wielded to change laws for the public interest.¹³⁶ Rather, judges use *ijtihad* primarily to make rulings on discrete cases.

Another impediment to the use of *Ijtihad* for authorizing traditional microfinance is that even scholars who accept *Ijtihad* disagree on whether it would be appropriate in this area.¹³⁷ This conflict stems from the fact that traditional microfinance is often associated with high interest rates.¹³⁸ Numerous commentaries in scholarly journals, watchdog entity publications, and newspapers describe and decry the interest rates accompanying the average traditional microfinance loan as excessive.¹³⁹ Bangladeshi commercial banks charge annual percentage rates of between 10 and 15 percent,¹⁴⁰ with the average rate as of January 2015 being 12.32 percent.¹⁴¹ Contrastingly, Grameen Bank loans usually have a 20 percent annual percentage rate.¹⁴² Even non-secular individuals and institutions view the divergence between commercial banks' and microfinancers' numbers as unfair.¹⁴³ It is therefore unlikely that such rates would stand up to the

¹³⁶ Karim H Karim and Mahmoud Eid, *Engaging the Other: Public Policy and Western-Muslim Intersections* (2014), Political Science Collection 2015, <http://www.palgraveconnect.com/pc/doi/10.1057/9781137403698>.

¹³⁷ *Id.* See also Farhat Shah, *10 Core Components of Islamic Microfinance Part II*, Microfinance Focus, <http://www.microfinancefocus.com/10-core-components-islamic-microfinance-part-ii>

¹³⁸ *Id.*

¹³⁹ Nikhil Chandra Shil, *Microfinance for Poverty Alleviation: A Commercialized View*, International Journal of Economics and Finance, Vol. 1, No. 2 (August 2009),

<http://www.ewubd.edu/~nikhil/Publications/Micro%20Finance.pdf>; See also Elizabeth Rhyne, *Why Are Microfinance Interest Rates So High?* The Huffington Post (May 25, 2011), http://www.huffingtonpost.com/elizabeth-rhyne/why-are-microfinance-inte_b_593359.html

¹⁴⁰ Jamal Islam and Haradhan Mohajan and Rajib Datta, *Aspects Of Microfinance System of Grameen Bank of Bangladesh*, International Journal of Economics and Research, https://mpra.ub.uni-muenchen.de/50691/1/MPRA_paper_50691.pdf

¹⁴¹ BDnews24, *Bangladesh Bank Instructs Banks to Cut Interest on Loans*, <http://bdnews24.com/business/2015/05/02/bangladesh-bank-instructs-banks-to-cut-interest-on-loans>

¹⁴² Grameen Bank, *Report on Grameen Banks' Interest Rate by Microfinance Transparency*, http://www.grameen.com/index.php?option=com_content&task=view&id=878&Itemid=199

¹⁴³ An August 2015 Wall Street Journal article asserts that "The [microfinance] industry needs to offer a reasonable profit to attract investment, but there is no industry definition of "reasonable profit." It isn't uncommon to find return on equity consistently in excess of 25%." Amy Yee, *Why Microfinance Loans Have Such High Rates*, The Wall Street Journal (August 11, 2015),

scrutiny of an Islamic review board. With these facts, it is easy to argue that traditional microfinance rates rise to the level of usury.

Islamic leaders could also decline to issue *Ijtihad* for microfinance loans by employing the “slippery slope” argument. If *Ijtihad* were to be granted in this area, mainstream banking and finance institutions might take it as an opening to design non-asset backed loans with relatively modest to high interest rates that ostensibly benefit the poor. Such financial instruments may end up being inadvertently covered by the *Ijtihad* decree, or may spawn requests for similar decrees to permit them.

To boost the idea of allowing an *Ijtihad* rule authorizing traditional microfinance, microfinance institutions should present positive client data and personal success stories to Muslim governments. They should illustrate through statistics that the average borrower comes out ahead, even with higher than average interest rates. In so doing, they would show that the lender-borrower relationship tends not to be one of exploitation. After all, borrowers typically lay down no collateral, usually do not experience financial loss, and commonly recognize profits.¹⁴⁴ The financing entities should also offer to institute interest forgiveness and refinancing programs akin to those that Islamic microfinance institutions provide for borrowers who experience significant personal hardship. In so doing,

<http://financingthefuture.wsj.com/article/SB10171014995452453472504581163731575525412>; See also questions asked by the general public regarding the high interest rates on microfinance loans at Quora.com, a crowd-centric information gathering website at <https://www.quora.com/Why-do-micro-finance-banks-offer-micro-loans-at-such-high-interest-rates-over-20-Does-the-Grameen-Bank-Nobel-Prize-do-the-same-and-why>
¹⁴⁴ Daniel Rozas, *Measuring Success in Microfinance*, European Microfinance Platform (April 2014), <http://www.e-mfp.eu/blog/measuring-success-microfinance>

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Islamic institutions might view them as having accepted more upfront risk, thereby bringing the transactions to resemble more closely an Islamic finance-approved loan.

Toward Alternate Solutions: Compassionate Microfinance and *Zakat*

In explaining his bank's involvement in Islamic microfinance, Fadi Salim Al Faqih, CEO of the Bank of Khartoum, asserted in a World Bank report that "Islamic banking is about how much you can contribute to the market, rather than being just an intermediary and taking a cut from the profit."¹⁴⁵ Islamic scholars tend to corroborate this viewpoint. The belief that a foundational principle of Islamic finance is that financial transactions should incorporate the principle that life is not only about money is widely accepted.¹⁴⁶ From this code comes the standard that lending should not occur solely to acquire profit, but also to show compassion.¹⁴⁷ This idea originates from the institution of *Infaq*, a foundational tenet of both the Islamic economic system and Islamic finance law.¹⁴⁸ *Infaq* (which literally means "spending") adds a "compassionate" component to the principle of *riba*; it counsels that spending in one's community should occur without an expectation of reward or recompense.¹⁴⁹ These principles underline the concept of compassionate microfinance.¹⁵⁰

¹⁴⁵ The World Bank, *The Bank of Khartoum: Innovation in Islamic Microfinance* (August 5, 2014), <http://www.worldbank.org/en/news/feature/2014/08/05/the-bank-of-khartoum-innovation-in-islamic-microfinance>

¹⁴⁶ Personal correspondence during the 2015 University of Chicago International Immersion Program Gulf Trip

¹⁴⁷ *Id.*

¹⁴⁸ Zakat Foundation of America, *Infaq & Its Benefits - The Nature Of Infaq*, <http://www.zakat.org/blog/infaq-its-benefits---the-nature-of-infaq/>

¹⁴⁹ *Id.*

¹⁵⁰ Personal correspondence during the 2015 University of Chicago International Immersion Program Gulf Trip

As previously mentioned, a major challenge in proliferating the availability of Islamic microfinancing is how to successfully provide wide-scale *Shari'ah*-compliant funding in the global interest-based lending regime. Some scholars propose that given the compassion foundation of pure Islamic finance, subsidies for microfinance should come from charitable giving.¹⁵¹ For further support, individuals, institutions, and governments should balance business activities between profit and not for profit.¹⁵² They further recommend that compassionate loans be interest-free, and that individuals should engage in microfinance using principles of venture philanthropy.¹⁵³ A limitation of compassionate microfinance is that it is unlikely that it will raise enough money or interest to become a widespread funding avenue.

To increase the amount of available funding, governments could combine compassionate microfinance initiatives with *Zakat*. *Zakat*, one of the Five Pillars of Islam, is the obligation of wealthy Muslims to annually contribute a specified percentage of their wealth to the poor.¹⁵⁴ (Contribution is not voluntary, and so it is more analogous to a tax than the voluntary compassionate giving described above.)¹⁵⁵ Given the number of Muslims living in poverty, however, *Zakat* cannot by itself significantly reduce poverty or further large-scale financial inclusion. Toward the goal of increasing *Zakat*'s impact, scholars have proposed redefining its

¹⁵¹ *Id.*

¹⁵² *Id.*

¹⁵³ *Id.*; Venture philanthropy “applies the tactics of venture capitalism to tackling social and environmental issues.” Tara Weiss and Hannah Clark, ‘*Venture Philanthropy*’ is the New Buzz in Business, *Forbes Magazine* (June 26, 2006), <http://www.nbcnews.com/id/13556127/#.VxzBXzArLIU>

¹⁵⁴ Garoot Suleiman Eissa, *Microcredit as a Strategy for Poverty Reduction: A Case Study of the Sudan*, *Journal of Modern Accounting and Auditing*, April 2013, Vol. 9, No. 4, 557-570, <http://www.davidpublishing.com/davidpublishing/upfile/5/13/2013/2013051365574565.pdf>

¹⁵⁵ *Encyclopedia Britannica, Zakat*, <http://www.britannica.com/topic/zakat-Islamic-tax>

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traditional deployment, where governments directly distribute cash to poor.¹⁵⁶ They suggest that governments should instead earmark *Zakat* payments for the *Shari'ah*-compliant microfinancing of income-generating ventures “rather than in the form of handouts to enhance consumption.”¹⁵⁷ A significant risk of this course of action, however, is that a new class of poor could arise from the ranks of former *Zakat* recipients who have no means of participating in the income-generating activities that would allow them to retain eligibility for *Zakat*.

Toward Alternate Solutions: Fostering Innovation

Since 2010, the Consultative Group to Assist the Poor in coordination with partners such as the Islamic Development Bank and Triple Jump has held an annual Islamic Microfinance Challenge. The Challenge aims to stimulate innovation in the Islamic microfinance industry as well as increase the reach of existing products.¹⁵⁸ Only “Islamic financial services providers with a track record of reaching clients and existing [*Shari'ah*]-compliant products that they hope to take to scale” are eligible for the Challenge.¹⁵⁹

Likely stemming from a push to reduce the Islamic microfinance industry’s heavy usage of the *murabaha* financing structure, the theme of the 2014 competition was “Beyond *Murabaha*.”¹⁶⁰ Wasil Foundation, the Pakistani-based

¹⁵⁶ *Id.*

¹⁵⁷ *Id.* at 565.

¹⁵⁸ The World Bank, *The Bank of Khartoum: Innovation in Islamic Microfinance* (August 5, 2014), <http://www.worldbank.org/en/news/feature/2014/08/05/the-bank-of-khartoum-innovation-in-islamic-microfinance>

¹⁵⁹ Al Baraka Banking Group, *Islamic Microfinance Challenge Seeks Innovative Approaches to Reaching Unbanked Muslims*, <https://www.albaraka.com/default.asp?action=article&ID=486>

¹⁶⁰ Kai Bucher, *Pakistan’s Wasil Foundation Wins Islamic Microfinance Challenge* (June 17, 2014), Consultative Group to Assist the Poor, <http://www.cgap.org/news/pakistan%E2%80%99s-wasil-foundation-wins-islamic-microfinance-challenge>

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winner of the competition, introduced an agricultural financing package based on *salam*¹⁶¹ and *ijara*¹⁶² products.¹⁶³ It won because of its “impact on the lives of its clients, the sustainability of the offering and its potential to scale up in Pakistan and in other predominantly Muslim countries.”¹⁶⁴ Ventures such as these are likely to precipitate an increase in the number of Muslims worldwide reached by microfinance initiatives.

Conclusion

Islamic microfinance is transformable into a widely available and valid alternative to conventional microfinance, but it faces several obstacles.

Governments, religious scholars, and conventional finance and banking institutions will have to be heavily involved in its propagation, as the field is not well suited for stand-alone private sector initiatives. All three types of entities in tandem can generate changes to ensure that Muslims are more represented in the worldwide push for financial inclusion opportunities.

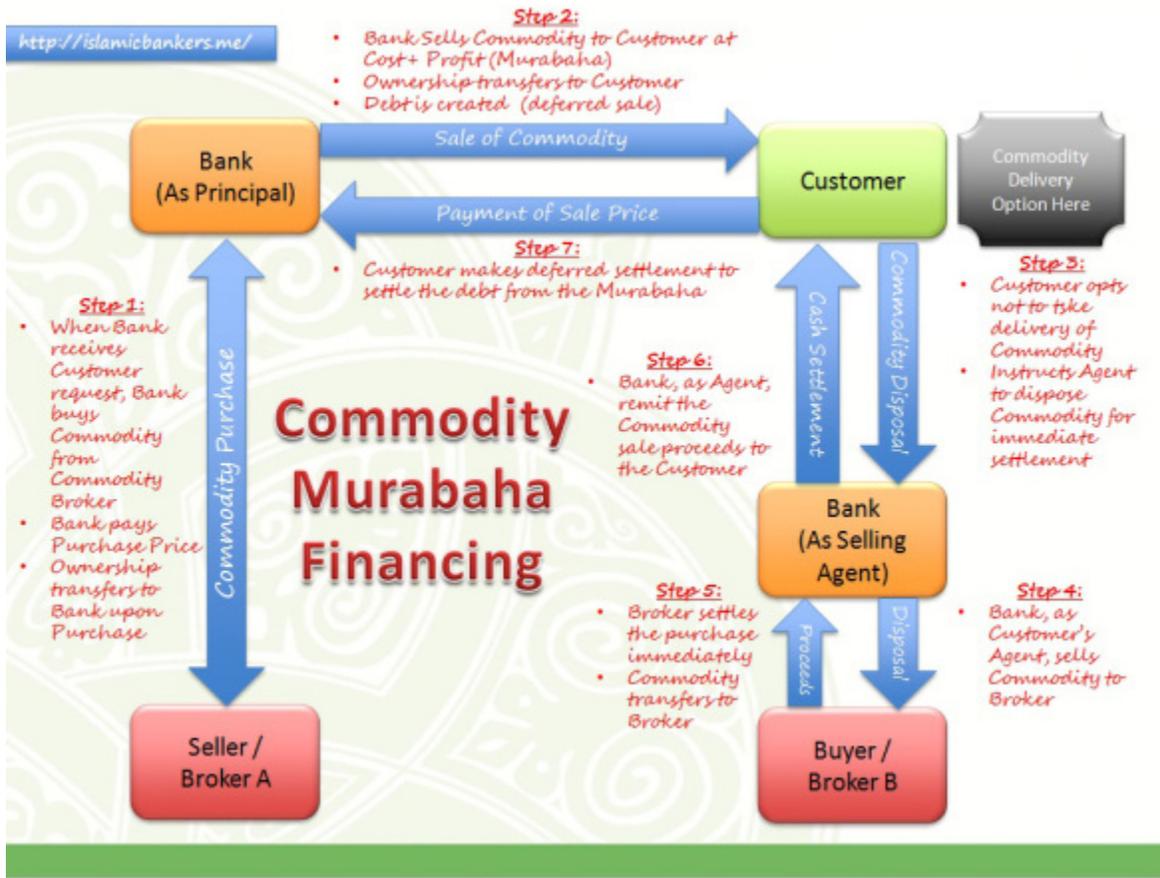
¹⁶¹ According to the website Financial Islam, “*salam* is a forward financing transaction, where the financial institution pays in advance for buying specified assets, which the seller will supply on a pre-agreed date.” Financial Islam, *Glossary*, <http://www.financialislam.com/salam.html>

¹⁶² Islamicfinance.com defines *ijara* as “an exchange transaction in which a known benefit arising from a specified asset is made available in return for a payment, but where ownership of the asset itself is not transferred.” Islamicfinance.com, *Resources*, http://www.islamic-finance.com/item_ijara_f.htm

¹⁶³ India Microfinance, *Wasil Foundation Wins Islamic Microfinance Challenge 2014*, (July 9, 2014) <http://indiamicrofinance.com/wasil-foundation-wins-islamic-microfinance-challenge-2014.html>

¹⁶⁴ Kai Bucher, *Pakistan’s Wasil Foundation Wins Islamic Microfinance Challenge* (June 17, 2014), Consultative Group to Assist the Poor, <http://www.cgap.org/news/pakistan%E2%80%99s-wasil-foundation-wins-islamic-microfinance-challenge>

Appendix



Source: Islamic Bankers: Resource Centre, *Discussions on Islamic Banking, Financing: Commodity Murabaha & Tawarruq*, <https://islamicbankers.me/islamic-banking-islamic-contracts/financing-commodity-murabaha-tawarruq/>