Crossfire: Islamic banking avoids interest payments and thus prevents rich investors profiting from the poor

BADR EL DIN IBRAHIM and MALCOLM HARPER

In our regular debate between two experts, Crossfire invites Badr El Din Ibrahim and Malcolm Harper to argue the case 'Islamic banking avoids interest payments and thus prevents rich investors profiting from the poor'.

Dear Professor Harper,

Islamic banking prohibits interest payments on loans, but permits a return from *musharaka* or 'partnership'. This system generates higher profit to the poor entrepreneur who borrows capital, and also avoids massive profits for rich merchants via soaring interest rates. 'Partnership' is a limited period contractual agreement that combines the investment of skills, capital, and efforts of the entrepreneur with the financial resources of the banking partner, and divides any profit or loss in accordance with each of the partners' share in management, follow-up, or capital. As a result, the net rewards (and the returns on capital) of this partnership arrangement to the entrepreneur are greater than the net income (and the returns on capital) than if he or she were borrowing and paying the typical interest rate.

'Partnership' arrangements divide any profit or loss in accordance with each of the partners' share in management

A US$100 capital loan to a client from a conventional bank charging 36 per cent interest per year and generating a 50 per cent rate of return on capital ($50 dollar), ends up with total returns on capital of $14 per year, and the rate of return on capital is 14 per cent per year (a little more than 1 per cent per month). With a *musharaka* partnership agreement assuming the same capital investment shared by the bank and the client, and the same profit rate of return to the entrepreneur of 50 per cent, the picture is quite different. If the partner gets 20 per cent of net profit as a reward for his management and the bank gets 5 per cent, then the total non-capital shares out of the net profit of $50 is $12.50 ($10 partner's reward for managing the partnership project and $2.50 for the bank's following up). The remaining profit ($37.50) is distributed equally and the partner gets $18.75 ($37.50/2). The total partner's return therefore is

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$28.75, and the return on capital will be 28.75 per cent (2.4 per cent per month). This requires a higher investment by the entrepreneur, but if the profit margin is lower or non-existent, then the loss is shared by the bank and not carried by the entrepreneur.

In practical experience, my calculations of the partners' returns on capital of different small project sizes financed by a partnership-familiarized Sudanese Islamic bank (local bread making, flower nurseries, coffee shop, and small medical laboratory) are higher than what they can generate from an interest-bearing loan. The returns on capital for the bank and the client reach 100–1000 per cent per year and the bank's share of profit is usually less than that of a partner for an equal capital share. Moreover, the smaller the finance, the larger the rate of return and vice versa (see, for example, Ibrahim, 2004).

Partnership is fair and prevents the loss of the livelihood of the poor if the project fails

Partnership is fair and prevents exploitation, does not require clients' payment, or lead to a loss of the livelihood of the poor in the case of project failure beyond the client's control. Moreover, it also gives incentives, and allows Islamic banking to bear its social responsibility.

However, the current practice of Islamic banking worldwide is unfortunately heavily dependent on a sales-based formula, *murabaha* (purchase and re-sale of assets and raw materials to the client after adding a specific profit margin or mark-up) which is similar in practice, but not in principle to interest rate, and might not be a suitable formula to combat poverty and avoid profiting from the poor. Since the Islamic partnership is a modified short-term version of the conventional one, I believe that a non-Islamic system can adopt any conventional modified partnership formula to avoid excessive profiting from the poor without linking it to Islam.

Yours,
Badr-El-Din

Dear Professor Badr El Din,
Welcome to this issue of our journal. I must thank you for introducing me to Islamic microfinance, when we were working together in Sudan in 1995 or thereabouts. As I may have said then, and as I am happy to repeat now, I believe that *shariah*-compliant partnership finance is the most just and equitable form of financing that there is. My problem is that its sustainable application to microfinance is difficult on a large scale, if not impossible.

Partnership finance is the most equitable form of financing that there is

Ever since I first saw what it could do, at the 'Productive Families' branches of the Sudan Islamic Bank in Omdurman and Wad Medani, I have been searching in vain for further examples of its application. As you may recall, we organized an international conference in

Cairo in 1996 as part of that search. None of the participants was able to present a convincing example of successful large-scale *shariah*-compliant microfinance, the Productive Families branches are no longer operating, and I have not been able to identify anything since.

I am pleased that in your last paragraph you exclude *murabaha* 'purchase and resale' financing from the debate. Many institutions claim that this approach is *shariah*-compliant, but I agree with you that it is little more than a clever way of concealing interest charges.

I recently observed a microfinance institution in Somaliland which was using an unusually cumbersome and thus costly version of this method in order to satisfy the authorities. A representative of the institution accompanied the client to the supplier of whatever the client wanted to finance. The client then had to point out what she wanted to buy. The field representative then bought it from the supplier, and took it out into the street, accompanied by the client. The two parties then negotiated and agreed the terms and price at which the microfinance institution would re-sell it to the client. The client then paid off the loan as agreed.

Some institutions merely use terms such as 'administration fees' instead of 'interest'

Others merely use terms such as 'administration fees' or 'service charges' instead of 'interest' to conceal the fact that they are effectively charging for the use of their funds. These expedients may satisfy the religious authorities, but they do not in my opinion have any of the advantages which make *musharaka* partnerships so effective, from the point of view of both the banker and the client.

Partnership financing, or *musharaka*, such as you describe, is of course the ideal solution to the problem of the 'double whammy' which affects micro-entrepreneurs who borrow on fixed interest terms and whose businesses fail, as so many do. They lose their businesses, and they are left with an unpaid debt. In Sudan 15 years ago, *musharaka* also had the advantage of avoiding the loss caused by hyper-inflation; the bank was repaid with a share of the profits, which were made in today's money, rather than with the original capital sum plus interest calculated on it, in yesterday's money.

But, and it is sadly a very big 'but', the practical difficulties appear to be insurmountable. Many micro-business people do not know how much profit or loss their businesses have made, and if they do know, they are unlikely to have records of the results, or to be willing to tell their banker, particularly if he or she will use the information to calculate his share of the partnership. It is even more difficult and time-consuming, and thus expensive, to estimate the likely results in advance in order to be able to calculate the basis of the partnership agreement.

Partnership microfinance is effectively micro-venture capital. Most institutional venture capital investments are of several million dollars, in formal medium-scale businesses, whose profits or losses are subject to independent audit. The venture capitalists often take seats on their boards of directors, and the transaction costs may amount to a substantial percentage of the total sums invested. All this is clearly quite unpractical, and unaffordable, at the level of a microenterprise.

Partnership microfinance is effectively micro-venture capital

Yours
Malcolm

Dear Professor Harper,
Thank you for your response and the issues raised therein. With reference to your statement that, '…sustainable application [of *shariah*-compliant partnership finance] to microfinance is difficult on a large scale, if not impossible', I strongly believe that the application of *shariah*-compliant partnership has not gone far enough to detect and to solve the constraints. That explains why you 'have been searching in vain for further examples' outside Sudan. There are always problems with any new system. A refined system would probably require more time and extensive theoretical and practical efforts. I really appreciate that Islamic banking has done something on this line, based on conventional partnership. But unfortunately the share of 'partnership' in microfinance, as I mentioned before, is low compared with the share of sales-based formulae, mainly because it is easier and more profitable.

The cancellation of the Sudanese Islamic Bank's productive Family Branches was due to change in the top management. The new management was seeking high returns via normal branches working on sales-based formulae. Perhaps the limited Islamic microfinance experience world-wide delayed any genuine efforts for modification. The non-banking Islamic microfinance that was started several years ago was weak and not continuous. They were isolated and dependent on the mechanism of interest-free loans (experiment in Yayasan Tekun, Malaysia). This finance was amalgamated with *zakat* (alms) to cover defaults of repayment and the group guarantee was utilized just like in the Grameen experience. The *murabaha* formula (mark-up/deferred payment sales) was also used (microfinance experiment in Al-Hodeida, Yemen). The experiment in Al-Hos Mountain in Syria adopted *musharaka* (joint partnership) and *murabaha* formulae. The experience of Moasat Bait Al-Mal in Lebanon was financed according to the *qard hassan* (interest-free loan) and *musharaka* formulae. The Afghanistan experience adopted the *qard hassan* and *murabaha* formulae. There were also other narrow-based, non-banking experiments in Thailand, Azerbaijan, Brunei, Philippines, Kazakhstan, the West Bank, Bangladesh, Indonesia (Islamic cooperatives), and Egypt.

Islamic banking microfinance still covers a very limited number of experiments

On the other hand, Islamic banking microfinance is still covering a very limited number of experiments which includes the experiments of rural banks in Indonesia, the microfinance banks in Bangladesh, and the Islamic banks in Bangladesh via deferred sale formulae. In Iran, the Central Bank obliges the branches to render microfinance services to low-income earners through *qard hassan*. In Indonesia (microfinance sections in the Islamic banks, Islamic rural banks, and Islamic cooperatives) the microfinance uses *murabaha, musharaka, ijara*, (lease), *mudaraba* and *qard hassan*.

However, the Sudanese Islamic banking microfinance experience (which is mainly sales-based) is considered the most fortunate and the first of its kind worldwide. It started during the 1990s by applying the Financing Polices of the Central Bank of Sudan from 1994/95 which included 'Craftsmen, Professionals, and Small Producers, including the Productive Families' among the classes which should have priority in bank financing. The Bank is now using microfinance instead of these broadly described small producers.

The Islamic microfinance model needs to be of a short-term nature

The past experiences of Islamic microfinance can only be considered as isolated trials in the making of this type of finance. I still believe that there exist many opportunities for the application of this type of finance on a large scale. But, there are challenges as well that require support by the governmental regulatory framework. There is also need for the creation of a sustainable model for Islamic microfinance, or a number of conditions drawn from the coming microfinance institutions that will follow good practices. The practical difficulties you mentioned are genuine, but a modified version might overcome most of these problems. Moreover, I believe that, although partnership microfinance is effectively micro-venture capital, as you mentioned, it might not need to resemble the same features, such as independent audit or seats on the board of directors. The Islamic microfinance model needs to be of a short-term nature and suitable for the purpose at hand. Nevertheless, the transaction cost is an issue needing to be tackled in a new micro Islamic finance workable model.

Yours,
Badr-El-Din

Dear Professor Badr-el-Din,
Thank you for this erudite and detailed response; it confirms my respect for the breadth and depth of your knowledge of this field, which far exceeds my own.

But I wish I could share your apparent optimism. Perhaps I am too impatient, perhaps you are right to take a longer view than I do, but surely something more sustainable, on a much larger scale, would have emerged over the last 20 years if *shariah*-compliant micro-level partnership finance was a viable option?

Interest-based microfinance has grown mightily over the same period, and has evolved in many different forms. Why has micro-*musharaka* remained experimental? Why does it still require more time? I fear that micro-venture capital, which is what it effectively is, suffers from fundamental and ineluctable diseconomies, such as I mentioned in my earlier response, which mean that it can never really move to the scale which it theoretically deserves.

Micro-venture capital suffers from fundamental diseconomies

You are right to point out that the Sudan-Islamic Bank closed its 'Productive Families' branches because of the departure of its 'product champion' at the top of the organization. My own brief study of the two branches and my meetings with some of their clients, some 15 years ago, suggested that the branches were covering their own costs and that the clients were satisfied with the service. But there did not seem to be any margin for higher level overheads, and the profit, such as it was, seemed to be insufficient to cover the reward which depositors required to make funds available. I suppose that the Bank had more profitable ways of deploying its resources.

Akhuwat does not make any charge at all to its 30,000 or more clients

My admittedly very modest attempts to promote *musharaka* microfinance, in Sudan itself, in Yemen, in Pakistan, in Oman, and in Qatar, which were based on what I had learned in Omdurman and Wad Medani, do not appear to have succeeded. Even more recently, when I was searching for more examples of partnership microfinance for our book on faith-based microfinance, all I could find was a small NGO near Imphal in India (Harper et al., 2008). I shall continue my search, and I hope you do likewise, but I rather feel that the fundamental problems are insuperable.

There is one highly successful and wholly *shariah*-compliant microfinance institution, namely Akhuwat, based in Lahore in Pakistan. Akhuwat, however, does not make any charge at all to its 30,000 or more clients; they only have to repay the amounts they have borrowed. Many of them, however, make voluntary contributions to Akhuwat's running costs, and all of its funds come from voluntary donations. The institution has been growing steadily since 2001 when it was started, and can thus be claimed to be ‘sustainable’. It is not, however, based on risk-sharing partnerships; clients pay no more if they are successful than if they fail. It does not, therefore, fall centrally into our debate.

In a broader sense, of course, regular group-based microfinance already includes a substantial element of partnership. Group members may not be held formally liable to cover fellow-members’ defaults, but they often do so, frequently without the knowledge of the microfinance institution, to ensure that they themselves will continue to be able to borrow and also because of the community spirit which may in part have been engendered by the microfinance group.

The spirit and reality of partnership is therefore alive and well, regardless of whatever label is given to it, and I think we are agreed that what matters is what people do, not the labels under which they do it.

Yours
Malcolm Harper

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