

‘Asset-Backed’ Microfinance System: A Sharia (Islamic Law) Compliant Poverty Alleviation Technique for the Muslim Communities

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Abstract

The conventional microfinance programs performed well in many countries; however, its ultimate success in poverty alleviation is often criticized due to charging high interest and creating continuous repayment pressure on poor borrowers. Besides, a large section of Muslim communities reject this financing practice due to involvement of interest system. Alternatively, asset-backed microfinance (often termed as ‘Islamic Microfinance’) is a recently developed concept in poverty alleviation. The system, however, struggles to identify a feasible operational structure and to build up internal capital for the programs. This paper proposes a two-tier capital structure which designs a clear operational technique for asset-backed/Islamic Microfinance system; and would motivate borrowers to make voluntary contribution to the system and thus build up internal operational capital without involving any predetermined interest claim. Thus the proposed capital structure facilitates to overcome the limitations of operational structure deficiency and capital deficiency of current asset-backed/Islamic Microfinance practice.

Keywords: Asset-backed financing; Islamic microfinance; Poverty alleviation; Sustainable microfinance program; Sharia compliance finance

JEL Classifications: G21, P36

1. Introduction

Traditional financial institutions usually avoid disbursing small loans due to high processing and monitoring cost. Such avoidance keeps away the poor people from getting financial support to improve their living standard. This gap in financial market has induced the practice of relatively high-interest based microfinance system around the world. The underlying concept of microfinance is to accept low level of savings deposit and to disburse small loan to the poor people. However, making high profit from short-term loan worked as a major motivation behind the expansion of informal microfinance system for centuries, mostly in the form of pawnshops. As a result, poor people often lost the last asset they had to repay the high interest (Yunus, 1998). Thus their struggle of life never ended partly because they had no alternative source of funding. This leads to formalization of microfinance concept which was initiated in 1970s.

The conventional concept of formalized microfinance has been performing well in many countries for last three decades; however, a large portion of Muslim communities rejects this poverty alleviation technique due to the basic constitution of the microfinance program. The conventional microfinance programs are extensively interest-based programs. In Arabic, interest is known as *Riba*, which is strictly prohibited in Islamic law. Instead, Islam allows ‘asset-backed’ financing system, where the investor agrees to share the risk of investment as well as the profit. Due to this conceptual difference and the sharia-compliance issue, the Muslim communities in many countries are unwilling to accept the conventional microfinance programs. Thus many financially distressed Muslim families (particularly in countries where majority people are Muslims) are left out of the advantage of widely accepted micro-financing practices, and stay out of the hope of poverty alleviation.

In response to such drawback of conventional microfinance system, ‘asset-backed microfinance’ has recently emerged as a potential industry in the money market. The concept is popularly termed as *Islamic Microfinance* in the Islamic economics literature. In recent years, countries such as Malaysia, Indonesia and Yemen have introduced the asset-backed Microfinance system as a potential tool for poverty alleviation (Imboden, 2005). The underlying concept is that any financing should be made against an asset, and the payment schedule should be determined from valuation and income generation of the asset. Thus the ‘asset-backed’ concept avoids involvement of any predetermined interest claim. The concept is welcomed among Muslim communities, though the industry is at a very initial stage with immense scope to work for poverty eradication. Contemporary practices of Islamic microfinance are mostly based on the concepts introduced by Wilson (2007), Feroz and Goud (2009) and Rahman and Dean (2013). However, neither of these concepts is in complete form. This paper attempts to combine these three concepts to construct a complete model for asset-backed/Islamic microfinance system.

Major contribution of this paper is to develop a theoretical concept of a sustainable operational structure for Islamic microfinance system. The asset-backed approach of microfinance is still a new phenomenon and there are no usable operational structure and sustainable capital structure for the program. In this paper, we propose a two-tier capital structure for Islamic microfinance system which would overcome both limitations. In particular, voluntary repayment by borrowers plays an important role in sustainability of Islamic microfinance system. In the proposed capital structure, the first-tier capital should

come from some compulsory donation funds as guided by the Islamic law.¹ The second-tier capital should develop within the system through voluntary contributions of the users of first-tier capital. Ability to access the first-tier capital should be limited for the users, which will motivate them to voluntarily contribute to the system and thus building-up the second-tier capital. The second-tier capital should be relatively flexible and only accessible for the voluntary contributors. Such motivation driven voluntary contribution system of the two-tier capital structure is expected to reduce cost of capital and enhance sustainability of asset-backed/Islamic microfinance programs, and thus to successfully contribute in poverty alleviation.

The article is organized as follows. Section 2 revisits the operational procedure and performance of conventional microfinance practices to understand the fundamentals of the microfinance system. Section 3 explores the contemporary practice of asset-backed/Islamic microfinance concept and its working procedures, performances and challenges. Section 4 introduces a new concept of operation structure for asset-backed/Islamic microfinance system, which would enhance sustainability of poverty alleviation programs. The last section concludes the paper.

2. Conventional Practice of Microfinance Revisited: The Operational Procedure and Performance

Microfinance is a financial system with small sized loans which is disbursed to the poor people, who are barred from accessing any kind of formalized financial system due to lack of personal collateral (Roche & Rogaly, 1998). The conventional way of microfinance had been practiced over the past centuries in different forms of informal financing (like pawnshops, credit unions etc.). However, relatively structured form of micro-financing had been developed by Peace Nobel laureate Dr Muhammad Yunus in 1970s. The insight of the structured microfinance system is to provide credit facility to the poor people who do not have access to the commercial banking system (Yunus, 1998). According to Dr Yunus, some informal microcredit facilities which were available prior to 1970s sometimes charged 10 percent interest per day; whereas the required capital in some cases was even less than a dollar. Today's microfinance programs, instead, are observed to charge around 30 percent of annual rate (Roodman, 2011). Thus the cost of capital in conventional microfinance system is lower compare to the previous informal system, but much higher compare to the commercial

¹ such as *zakah* and *waqf* as suggested by Wilson (2007) and Rahman and Dean (2013)

banking system. Moreover, the level of success in poverty alleviation through microfinance programs is empirically inconclusive.

2.1. Foundation of Conventional Microfinance Concept

Microfinance is practiced in different ways in different times and across countries. Discrepancy mostly arises from operational technologies, where cost of managing groups is a major determinant (Bhatt, 1997). Microfinance technology also varies across contexts due to dynamism and changing configuration of the actors for institutional arrangement (Roche & Rogaly, 1998). Before 1990s, restrictive banking regulations, limited formal banking practice and ignoring the low end of the market for commercial loan was common worldwide. These restrictions encouraged people to develop informal finance sector for borrowing and lending. During this time, different non-government organizations (NGO) participated in informal financing sector through the microfinance programs (Aghion & Morduch, 2000). The primary goals of microfinance program for some countries (for example China, Albania and Russia) were to broaden the financial services and to facilitate income enhancement to small-scale entrepreneurs. Promoting private sector activity in reducing unemployment appeared as another goal. In Asia (Bangladesh is a good example), microfinance emerged as an effective tool for rural financial transaction (Khandker, 2000).

Microfinance activities in Latin America expanded during 1980s, which was driven by interest rate ceiling (for the banking system), barriers to market entry and related financial market inefficiency. The institutional financial system could not support micro-enterprises and self-employments, which in turn developed the donor dependent microfinance system to facilitate small entrepreneurs. During late 1980s and early 1990s, financial reforms took place in Latin America to eliminate interest rate ceiling and reduced entry barrier. During the reform, microfinance institutions became regulated financial intermediaries and gained leverage fund facility (Cuevas, 1996). The underlying concept of microfinance formalization was to license the institutions to leverage current capital and to enhance their financial service capacity. However, Cuevas (1996) doubts that such formalization reduces strength and sustainability of microfinance institutions and increases opportunistic behavior by the NGOs. Technically, information-based microfinance loans are already regulated by borrower's character and joint-liability arrangement. Hence formalization of this sector under traditional regulatory framework turns the sector less profitable.

As a result, microfinance actors became dependent on donors and government

agencies, which turned sustainability of microfinance programs questionable (Morduch, 2000). Initially, ample funds and grants are available to support different microfinance activities. Hence mobilization of saving does not occur at expected level to support lending activity. Besides, savings in microfinance programs are unprotected, which makes savings mobilization scheme even difficult (Khandker, 2000). Thus lack of saving mobilization suspends the prospect of self-sustainability of microfinance programs in long run. To overcome this limitation, general practice of conventional microfinance has been to create extensive pressure on poor borrowers for scheduled repayment of loans and making the programs sustainable. For better understanding of the issue, proceeding two subsections explore the operational procedure and the performance of conventional microfinance programs.

2.2. Operational Procedures of Conventional Microfinance Programs

Success of any microfinance program depends on the operational techniques of managing three key features which are direct monitoring, regular repayment schedules and use of non-refinancing threats (Aghion & Morduch, 2000). Typically, microfinance programs are managed either individually or through group-lending. However, creating joint liability through group lending technique is relatively popular way in managing unsecured microcredits. The technique was successfully introduced by Grameen Bank of Bangladesh and BankSol of Bolivia, and effectively practiced in China, East Europe and Russia. In particular, group lending technique works well in controlling transaction cost for small loans.

Group-lending technique follows working in group of 5, where 2 members getting loan at a time. The lending process continues with the group until their performance is satisfactory and none of the members default. Main driving force of this technique is creation of peer pressure, which is claimed to enhance success rate and to reduce screening and monitoring cost. However, the technique has some limitations. Park (1999) casts doubt that regular group meeting in fact incurs high cost for the borrowers. Thus joint liability system may transfer part of the screening and monitoring cost to the borrowers. Collusion among group members may also appear as a threat in group-lending (Besleya & Coate, 1995). In addition, the group-lending technique works as a barrier for a particular member with growing business (Aghion & Morduch, 2000).

Unlike group-lending, collateral is a requisite individual credit contract. The contracts generally involve tangible household assets as collateral (Ledgerwood, 1999).

However, valuation of collateral occurs based on the personal value instead of salvage value (Zeitinger, 1996; Churchill, 1999). The underlying perception is, poor borrowers usually do not have tangible asset with high salvage value, but they feel obligated to lose any asset which have high personal value to them.

Selection between individual lending and group lending process depends on size of the loan. Group lending is usually practiced for small sized loans disbursed to very poor people or to starter of business. This reduces the risk of default through creating peer pressure. However, group-lending reduces the scope for a particular potential member of the group to increase the size or frequency of his/her loan. Hence individual credit contracts are preferred for relatively larger loans (Aghion & Morduch, 2000).²

Association of Social Advancement (ASA) Bangladesh has introduced an alternative approach to group-lending. They practice public meetings of clients instead of managing small groups (Aghion & Morduch, 2000). This method has successfully reduced transaction cost, induced regular repayment, eased gathering information, provided education and training to clients, and attracted more female clients (for detail, see Rahman, 1999; Ito, 1998; Fuglesang & Chandler, 1994). Since women borrowers are more responsible and responsive than male borrowers to repay loans, women are major client base for rural microfinance programs (Khandker, Khalily, & Khan, 1995; Rahman, 1999; Yunus, 1998). Public meeting approach is proved more workable in rural areas where women are relatively conservative. Altogether, conventional microfinance programs mingle between individual-lending, group-lending and public meeting system as their preferred operation technique. A major objective of these managing techniques is creating repayment pressure on borrowers in an effective manner.

2.3. Performance of Conventional Microfinance Programs in Poverty Alleviation

Performance of microfinance programs is often controversial, in particular from financial sustainability and poverty alleviation aspect (Roche & Rogaly, 1998). Morduch (2000) criticizes the general perception that microfinance institutions with good banking principles are more successful in poverty alleviation. The criticism turns crucial for subsidized microfinance programs. Conventional argument claims that poor households require credit,

² For example, Opportunity International's 'Trust Bank' practices group-lending for loans below \$1000, while the average loan size for individual-based contract is around \$5000. In China, microfinance program follows group-lending method, and their average loan size varies from \$25 to \$360. In Russia, average loan size is around \$2500, and they mostly follow individual-based lending contract. (For detail, please see Aghion & Morduch, 2000)

no matter whether it is cheap or not. In that sense, programs should be capable of being self-dependent and sustainable in long run through self-generated fund. However, in practice, many programs supported by government and the key donors failed to become self-dependent and sustainable (Adams, Graham, & Pischke, 1984). Eventually, many microfinance programs are able to recover only 70% of their total cost, and thus struggle to be sustainable in the long run. This leads most conventional microfinance programs to charge high interest rate and to create individual or peer-pressure on borrowers. Such tendency raises question about real level of poverty alleviation by conventional microfinance programs.

Most microfinance institutions claim poverty alleviation as their long run success; however, literature often blames microfinance programs to lead poor people into a debt trap. Critics claim that borrowers often go to alternative informal lenders to repay the existing loans, thus falling into deeper trap of debt. Khandker (2000) shows that microfinance practices increase certain level of voluntary and involuntary saving in particular for women clients. However, Social and economic impact of microfinance programs is inconclusive in literature. Some authors are very optimistic (for example, Holcombe, 1995; Hossain, 1988; Khandker, 1998; Otero & Rhyne, 1994; Remenyi, 1991; Schuler, Hashemi, & Riley, 1997), some are very pessimistic (for example, Adams & Pischke, 1992); Buckley, 1997; Montgomery, 1996; Rogaly, 1996), and the rest remain in the middle (for example, Hulme & Mosley, 1996; Mosely & Hulme, 1998). Interestingly, Hulme (2000) criticizes about the effectiveness of impact analysis methodology and argues that different actors often influence the impact assessment to meet their need.

3. Development of Asset-backed/Islamic Microfinance Concept: The Background

In last three decades, conventional microfinance system has reached a matured tier in terms of operational techniques and consumer acceptability; however, obtaining a sustainable capital structure for effective poverty alleviation seems still underway. The attributes of high interest claim and repayment pressure on poor borrowers makes the objective of poverty alleviation difficult to achieve. In addition, two major sharia (Islamic law) aspects make conventional financial system controversial to Muslim communities (Karim, Tarazi, & Reille, 2008). First, money should not have intrinsic value; money value can only increase when backed by asset. Second, fund providers should be regarded as investors and not as creditors. Hence business risk should be borne by both lenders and borrowers. Apart from these two aspects, few more conditions are involved in Islamic financial system; such as financial

transactions be linked to real economic activity, investment not being involved in sharia prohibited activities, and contracts must be under mutual agreement with specified terms and conditions.

Considering these sharia (Islamic law) issues, a major portion of poor Muslim communities generally decline to accept conventional microfinance system. However, this perception is controversial because conventional microfinance system is observed to be highly successful in some Muslim majority countries (Karim et al., 2008).³ The underlined rational for such controversy may be the cultural factors that play important role in participation of microfinance programs in Muslim countries (Ashraf, Hassan, & Hippler, 2014). Secondly, while conventional microfinance has expanded in last two decades, sharia compliance microfinance system is yet at early tier and struggles to find an effective pathway to succeed (Sait & Lim, 2005). This leaves limited financing options available for the poor Muslim people. However, potential switchover towards Islamic microfinance has been observed in recent years, in particular in countries like Afghanistan, Indonesia, Syria and Yemen (Rahman & Dean, 2013).

Apart from the acceptance issue, selection of workable operation technique for sharia compliance microfinance system remains largely unresolved and controversial. Literature evidences 72% population of Muslim majority countries not to access any formal financial service due to Sharia-compliance issue (Honohon, 2007). This leads to emergence of the Islamic Finance and the Islamic Microfinance industries in global financial system. Islamic Finance is relatively simple; some sharia issues have been incorporated into the traditional banking system to modify the traditional banking system (Karim et al., 2008). In contrast, sharia-compliance microfinance system is relatively complex since the loans are given to poor people who do not have collateral. However, Imboden (2005) and Manzur *et al* (2013) claim that little difference exists between conventional microfinance and Islamic microfinance except the interest-based loan versus the asset-backed loan. Better understanding of this controversy requires in depth understanding of the current form of Islamic microfinance practices.

3.1. Current Forms of Asset-backed Microfinance Contracts

Current practice of Asset-backed/Islamic microfinance involves four basic types of contracts, which are generally initiated from the Islamic banking system. The four forms of contract are

³ Bangladesh for example

known as *Murabaha sale*, *Musharaka* and *Mudaraba*, *Ijarah* and *Takaful* (Karim et al., 2008). The *Murabaha sale* involves the financier to procure the asset as per client's requirement and resale to the client. The client purchases the asset with an added 'mark-up' (cost of service provided) and repays at equal installment. Thus the condition of 'asset-backed' is fulfilled in the contract, and relates financial transaction to real economic activity. The mark-up is fixed at the beginning of the contract.

Musharaka and Mudaraba contracts are profit and loss sharing agreements where both financier and client act as joint investor. *Musharaka* is mainly joint venture, while *Mudaraba* works as trustee financing where financier provides the fund and client provides expertise. In both *Musharaka* and *Mudaraba* contracts, the profit and loss sharing occurs at a predetermined ratio, thus avoiding involvement of intrinsic money value. Success of these contracts depends much on credential of clients in vigilant and transparent reporting. As such, partner selection plays important role in success of the contracts, and thus raises importance of screening process, monitoring process and building up rapport with the partners (Rahman & Dean, 2013).

Among other two forms, *Ijarah* is lease contract for financing small machines, where ownership of the asset and maintenance responsibility remains with the financier. Duration and payment of the lease is predetermined to avoid speculation. *Ijarah* often follow a sale contract where ownership is later transferred to the lessee. *Takaful* is a mutual insurance where all parties contribute to the fund, and the premiums are reinvested in other sharia-compliance contracts. The fund is used up if any member of the group is in trouble.

Hassan (2014) identifies social capital as an important element for successful Islamic microfinance programs. Social capital refers to networking between the agents acting in a system. Traditionally, Islamic social capital is guided by Islamic conventions and norms, which ultimately reduce the risks involved in Islamic microfinance system. Thus, group-lending technique is often considered as an effective way of managing Islamic social capital in the Islamic microfinance system. Thus, existing forms of asset-backed microfinance contracts are free from pre-determined interest rate but depends much on techniques of creating repayment pressure on borrowers. Besides, none of the contracts represent complete work-model for microfinance programs.

3.2. Asset-backed Microfinance Models in Practice: Some Challenges

The basic forms of contracts for managing asset-backed micro-funds are guided by readily

developed Islamic banking system; however, Islamic microfinance is yet to identify the sources of funds and to develop workable operational technique which would ensure self-dependency and sustainability of the programs. In that sense, the concept of asset-backed microfinance is at infant tier compare to conventional microfinance programs. In particular, Goud (2013) in a recent article identifies few factors that require clear guideline the Islamic microfinance structure. First, it is important to identify whether the ownership should go to the members or to any external group; second, should the contract be individual-based or group-lending based or village model based; and third, should the financial goal be profit generation or sustainability without external support. Several models of shariah compliant asset-backed microfinance are proposed or are already in practice, which attempt to partially solve these issues. The models include *wakalah* model (Wilson, 2007), *La Riba* model (Feroz & Goud, 2009) and *wakalah-waqf* (Rahman & Dean, 2013). These models are good initiatives for initializing the concept of asset-backed microfinance; however, neither is in complete form to ensure self-dependency and sustainability of the programs.

The *wakalah* model mostly concentrates on developing the capital structure for asset-backed/ Islamic microfinancing technique. The model suggests for four potential sources of funds; such as subsidy from NGOs and zakah fund, repayment of the fund by the participants, voluntary contribution or donation from participants, and finally, income generated by any financial asset involved in the fund.⁴ One potential problem with *wakalah* model is management remuneration, which must be transparent (according to Islamic law) to avoid exploitation of participants. Wilson (2007) suggests to separate management fee from the *wakalah* fund as a possible solution of this problem. The second problem is that repayment of some Islamic donations is prohibited by Islamic law (zakah for example). Hence, *wakalah* model suggests encouraging participants to make voluntary donations instead of creating repayment pressure on them. Overall, success of the *wakalah* model depends much on successful completion of the funded project. Hence strength of the project should be carefully assessed to estimate the credential of the loan. For getting management expertise in the assessment works, Islamic microfinance institutions are suggested to be governed by Islamic bank or Islamic window of conventional banks (Wilson, 2007).

The *La Riba* model mostly suggests the operational mechanism for asset-backed microfinance system. The idea commences with forming self-selected client groups joining

⁴ Zakah is a special fund arrangement directed by Islamic law, which is made compulsory for the rich Muslims to contribute a small portion of their annual savings for betterment of the distressed group of the society.

under Murabaha contracts. This contract is relatively effective than other contracts at the monitoring and screening tier. The clients who are regular in repayment of Murabaha contracts are suggested to be forwarded to Musharaka contract. Thus the model expects to reduce the risk of asymmetric information problem at the initial tier of relationship with clients. The La Riba model indicates Murabaha stage as a training period for clients for recordkeeping, which in turn increases the success rate when these clients are moved to Musharaka financing stage. In fact, Musharaka contract is preferred for the La Riba model due to its ability to diversify some of the cost and risk from the poor clients to the financing institutions. Considering the product effectiveness and cost-competitiveness, Feroz & Goud (2009) suggest the La Riba model would work for both 'asset-backed' and conventional microfinance system. The model develops the working procedure of Islamic microfinance programs; however, returns to the technique of creating repayment pressure on borrowers. Thus La Riba model limits scope of incorporating some Islamic donation funds to the microfinance system.

The *wakalah-waqf* model is a recent development of Islamic microfinance technique, which appears as a modified form of wakalah model. The wakalah-waqf model attempts to integrate *waqf* and *zakah* in the asset-backed/Islamic microfinance structure. In Islam, waqf and zakah are two useful and effective funds that have the potential to substitute donor's fund in the microfinance system.⁵ The model suggests that zakah fund can be directly integrated to the microfinance program for disbursement to the poor, or can be used up to create waqf fund. For indirect integration of zakah fund through waqf creation, waqf generated fund can be disbursed as donation. In either case (direct zakah disbursement or of indirect integration of zakah fund through waqf creation), repayment of the fund is not compulsory as per Islamic law (poor people have the right to receive the fund). Thus, being consistent to Wilson (2007), the *wakalah-waqf* model suggests for voluntary donation made by the clients. The insight is that repayment through voluntary contribution will privilege the clients for additional financing, and the donations collected from repayment will be recycled as new loans. Management fees are suggested to be collected separately under a predetermined time-frame. Similar to *wakalah* model, the *wakalah-waqf* model suggests encouraging borrowers to make voluntary repayment instead of creating pressure on them. However, either model fails to any operational technique to ensure such encouragement.

All three models are good initiatives for introducing 'asset-backed' microfinance

⁵ Zakah and Waqf has been explained in following section

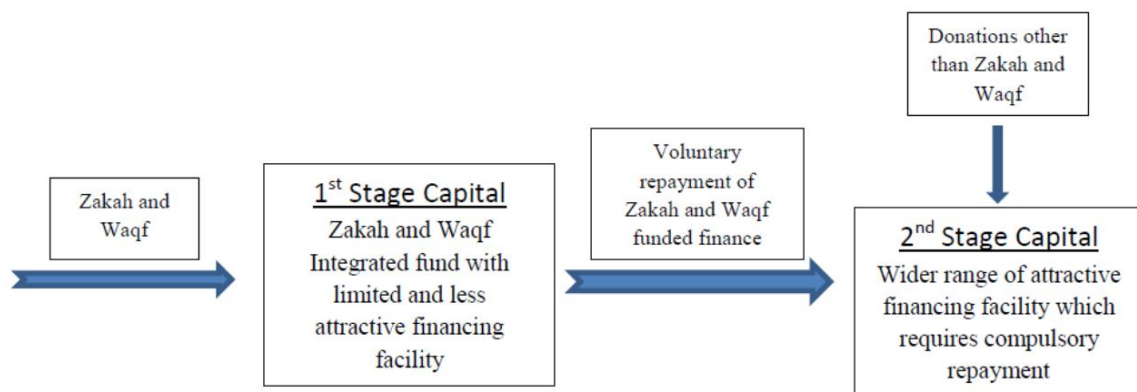
system. However, each model struggles to suggest any complete form of capital that can be generated within the system and can be rolled in for expansion of the programs. Restricting the management and transaction cost within acceptable level is also a challenge for current practice of asset-backed micro-financing. Existing literature identifies market penetration, sustainability, high transaction cost and effectiveness in poverty alleviation as other potential challenges in any asset-backed microfinance practice (Brandsma & Hart, 2002). In particular, lack of branch networking, less effective internal procedures and weak management are the key components for poor market penetration. Even many matured conventional microfinance programs being funded by donors and government agencies are subject to sustainability issue. Relatively, asset-backed/Islamic microfinance is at preliminary tier to accumulate savings and profits in reproducing loans. Hence lack of fund mobilization and high administration cost makes sustainability of Islamic microfinance under uncertain (Rahman & Dean, 2013).

4. The two-tier Capital Structure Model: A Proposed Concept of Sustainable Asset-backed/Islamic Microfinance System

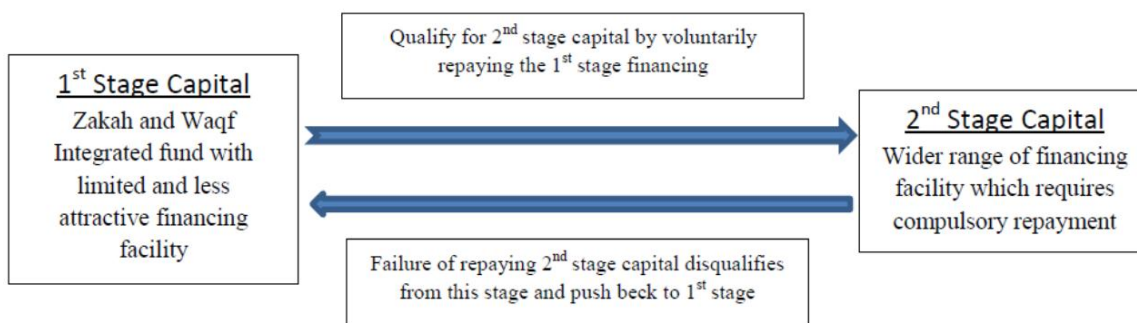
Asset-backed/Islamic microfinance is a recently developed area of Microfinance system. The concept inherits from the idea of asset-backed financing system guided by Islamic law (Karim et al., 2008). The system is currently at initial tier, and severely suffers from identifying a usable and sustainable capital structure. Existing literature often claims that Islamic microfinance programs should not differ much from the conventional ones except replacement of the interest-based lending system by the asset-backed lending system (Goud, 2013; Imboden, 2005; Manzur, Meisami, & Roayae, 2013). However, apart from the Shari'ah-compliance issue of microfinance, some other remarkable differences between conventional microfinance and Islamic microfinance are prominent. First, unlike conventional practice, Islamic economic system has inbuilt provision to finance the distressed group of the society through zakah, sadaqah, waqf and other voluntary charities. These special financial arrangements would serve as the major source of working capital for asset-backed microfinance programs (Wilson, 2007). Zakah is a special fund arrangement directed by Islamic law, which is made compulsory for the rich people to contribute a small portion of their annual savings for betterment of the distressed group of the society. Waqf is a kind of charity fund established under a trust, through which cash, land or real estate is used as deposited asset (which cannot be disposed of or the ownership cannot be changed). The asset

is often arranged for generating income to support the society. Second, conventional microfinance programs are often criticized for charging high interest rate. On the contrary, Islamic financing system is based on profit and loss concept, and does not oblige any intrinsic cost of money concept such as interest rate (Karim et al., 2008). Hence high interest problem does not comply with the Islamic microfinance system. Third, conventional microfinance privileges person (particularly women) as user of the microcredit. Instead, Islamic microfinance privileges the family as a whole. This enhances the integrity of borrowers for being involved in economic activity and increases their urge to repay the loan. The religious obligations also work in fostering loan repayment. Considering these factors, an appropriate guideline for Islamic microfinance system can enhance its success rate in poverty alleviation compare to the conventional ones.

Figure: Concept of Two-tier Capital Structure for Asset-backed/Islamic Microfinance System



Panel A - Operational perspective



Panel B – Borrowers' perspective

Existing Islamic microfinance system partially incorporates the above three attributes; however, struggles to discover a complete form of sustainable operational and capital structure for future expansion of the services. The *wakalah* model and the *wakalah-*

waqf model suggest for incorporating zakah, waqf and other donation funds as working capital for Islamic microfinance services. These funds, however, are non-refundable donations by Islamic law. Hence, sustainability of zakah and waqf integrated Islamic microfinance programs is highly dependent on voluntary repayment of the funds or collection of new donations. This limitation creates challenges for Islamic microfinance institutions to expand their existing programs. Some microfinance programs arrange training session for borrowers to encourage them in making voluntary repayment (thus replicating the conventional practice). These attempts often suffer from low turnout due high attendance cost from borrowers' end.

This paper proposes an alternative two-tier capital structure for Islamic microfinance programs which would automatically motivate borrowers to make voluntary contribution. The underlying idea is to encourage borrowers to participate in voluntary repayment by setting some borrowing restrictions. In this process, any voluntary donation funds including borrower's contribution should be separated from zakah and waqf integrated funds (as shown in Figure 1, Panel A). The zakah and waqf integrated fund will work as the first-tier capital for financing the less attractive and small sized murabahah contracts. The capital will be available for new borrowers and for those who are unable to make any voluntary repayment. However, each borrower should be barred from first-tier capital for few years before getting the next loan. This will motivate borrowers to make voluntary contribution to the program.

The second-tier capital will be the donation fund to finance mudarabah or musharakah contracts of larger loans.⁶ Borrowers, who are able to make substantial voluntary repayment of first-tier murabahah funds, should get access to the second-tier capital (as shown in Figure 1, Panel B). Loan size and frequency of loan disbursement should depend on the amount of voluntary contribution made by the borrowers. If the borrowers fail to repay the second-tier loans, they should be sent back to first-tier financing. This process will drive borrowers in building up internal working capital, and thus increase the long term effectiveness of Islamic microfinance programs. Thus, the borrowers will eventually pay back the principle amount of zakah and waqf integrated fund, which will be rolled over for creating further loan. This will enhance sustainability of Islamic microfinance programs.

The proposed two-tier capital structure technique combines the attributes of *wakalah* model, *wakalah-waqf* model and La Riba model in a structured way. This new model

⁶ This donation fund includes voluntary contribution from borrowers as well as external donations other than zakah and waqf contribution

introduces the asset-backed finance without involving any interest system. At the same time, the proposed technique motivates borrowers to comfortably repay loans instead of creating pressure on them. Thus the two-tier capital structure reduces risk of creating any debt trap for poor borrowers.⁷ Group-lending technique and public meeting technique could be followed in Islamic microfinance programs for monitoring and training purposes. In long run, the ability of members to access second-tier capital will work as an indicator for poverty alleviation.

In recent literature, Dr. Yunus has suggested a similar concept of internal capital build-up in his proposed Social Business system (for detail on social business capital, please see Yunus & Weber, 2010). The expectation of Social Business is that firms will donate a portion of CSR in a parallel production line. This special production line will be dedicated as a non-profit production line for producing goods which will be sold to the distressed group. The markup for these products will be low just to cover the operational cost. This is a noble concept for increasing social equity without affecting efficiency; however, Yunus's concept fails to provide any particular direction about sustainable growth of capital for such social business. In addition, the social business system cannot ensure employment creation for the poor people. Instead, our two-tier capital structure model would initiate locality based social business activities using the Zakah fund and involve the user of Zakah fund in those activities. Additionally, the process would motivate the users of the fund to expand their own working capital. In this process, Islamic microfinance system will work as a mechanism for disbursement of zakah funds as well as expansion of capital for the zakah fund users.

5. Conclusion

The article provides a broader guideline for operational structure and working capital build-up for Islamic microfinance system. The implementation phase, however, would be challenging. We suggest for implementation of first-tier capital in a smaller area particularly for monitoring purpose. Operational area could be gradually expanded in parallel to building-up of second-tier capital. Such gradual expansion technique should provide wider scope to handle initial challenges.

A successful implementation of two-tier capital structure would strengthen Islamic microfinance system. This will benefit the society in two ways. First, it will bring a large portion of Muslim community above the poverty line and out of illiteracy. Second, more

⁷ As shown by Khandker (2000) for conventional microfinance system

solvent and educated Muslim community of rural areas will be at less risk of being involved in anti-social activities. These benefits are indeed observed in non-Muslim countries where conventional microfinance is being widely and successfully operated. Eventually, a modified version of two-tier capital structure concept could be applicable for building additional capital for Dr. Yunus's Social Business system.

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