

Microfinance and Islamic Finance – A Perfect Match
By Dr. Linda Eagle

Islamic banking is one of the fastest growing sectors of the financial industry. But in order for Islamic Financial Institutions (IFIs) to remain competitive with conventional banks, IFIs must be able to deliver specialized products and services to meet customer needs. Microfinance—a division of finance ideologically compatible with Islamic finance, capable of Shariah-compliance, and possessing a sizeable potential market—is a perfect fit for inclusion in IFIs' new products and services.

Microfinance is comprised mainly of microcredit practices—the extension of very small loans, known as microloans, to those who do not have access to traditional financial services due to lack of collateral, employment and credit history.

Microfinance has a proven history as an economically viable credit program, as well as a proven history of serving customers in the Muslim world. In 1976, Muhammad Yunus, a Muslim Bangladeshi economist and economics professor, founded the Grameen Bank, the world's largest and most successful microfinance institution or MFI. Since its inception, Grameen has provided more than \$5 billion in microloans to several million borrowers in the Islamic nation of Bangladesh and boasts a repayment rate as high as 98%. Last year, the institution made a profit of \$20 million. Since its creation in 1987, Egypt's National Bank for Development's (NBD) microfinance program has been so successful that the Bank has implemented it in half of its branches. Unlike Grameen, which operates not for profit, Egypt's NBD has proven microfinance to be a profitable venture for private commercial banks in the Middle East.

Microfinance shares the same goals as Islamic finance. Islamic Banking began as an effort for Muslims to engage in financial services consistent with the principles of the Shariah, which promotes social and economic fairness. Likewise, the modern microfinance revolution began as an effort to combat poverty and social injustice in developing countries. Both the principles of Islamic finance and microfinance seek to prevent economic exploitation by prohibiting usury. In 2006, in recognition of the great humanitarian impact of microfinance, the Nobel Committee awarded Muhammad Yunus and the Grameen Bank the Nobel Peace Prize.

Microfinance is a flexible tool capable of being tailored to satisfy the needs and conditions of various environments, including the Islamic financial sector which forbids *riba*, or the payment and receipt of interest. The use of interest found in conventional microfinance products and services can easily be avoided by creating microfinance hybrids delivered on the basis of the Islamic contracts of *mudaraba*, *musharaka*, and *murabaha*. For example, in a *mudaraba*-based transaction, the IFI and the customer may enter into a partnership in which the IFI invests capital in the customer's microenterprise while the customer invests labor. The profits are shared according to a mutually agreed ratio while losses are borne by the IFI. In a *musharaka*-based transaction, both the customer and the IFI invest capital and share profits according to a mutually agreed ratio; losses are borne in proportion to capital contribution. In a *murabaha*-based transaction,

the IFI purchases a specific good which the customer will purchase from the IFI at a deferred mark-up that may be paid in installments.

Perhaps most alluring to IFIs is the large potential market for Islamic microfinance products and services. There are an estimated 1.3 billion Muslims worldwide, of which over 35% are living in poverty. In the North African and Middle Eastern region alone, there are approximately 4.5 million entrepreneurial poor who lack access to financial services. Of this number, only 112,000, or 2.4 %, of the potential demand are being served. There are only \$95 million of outstanding microloans—a fraction of the \$1.4 % demand. Egypt, the nation with the most borrowers, barely reaches 5 percent of its potential customer base. Three of the region's countries—Algeria, Iran, and Syria—lack any sort of microfinance program at all.

Islamic microfinance is the perfect opportunity for IFIs to promote the humanitarian principles of Islam, and to make a profit while doing so. Microfinance is a proven success. Shariah-compliant products are feasible. And a huge potential market is waiting to be seized.

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