

## **AFFORDABILITY OF ISLAMIC MICROFINANCE**

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### **Abstract**

The affordability of the microfinance, Islamic and conventional, is questionable. The review of empirical studies thus far shows that the majority of them are expensive and only some of them are cheap and successful. Only those, which have less cost, can afford to make microfinance cheap and hence not only affordable but also have the prospect of assisting the poor, effectively releasing them from their cycle of poverty. To make an Islamic microfinance programme cheaper, alternatives are found in the literature, and the manner in which the costs of Islamic microfinance schemes through offer of sustained grants and subsidy for the cost of capital and operational costs is proposed. Zakat and sadaqah funds are proposed for grants and subsidy while awqaf funds are proposed for loans and investment in microenterprises.

**Keywords:** *Islamic microfinance, zakat, waqf, cost, affordability*

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### **1.0 Introduction**

We refer to microfinance as a financing service designed to assist the poor. Poor would refer to the group with a household living on less than five American dollars.<sup>1</sup> Small financial loans are often given to the poor for meeting their needs and necessities, post disaster remedy, personal emergencies and investment opportunities<sup>2</sup> (Rutherford, 2000). The borrower could own land and building or could be unbankable, and thus the loan could be with or without collateral, or group guarantee, or through savings before the grant of loan.

Microfinance products and services were praised for helping the poor “maintain and improve their human and social capital throughout their lives” (Matin, Hulme, & Rutherford, 1999). These products have been in the market since the 70s of the 20<sup>th</sup> century. Nevertheless, not much has been changed since then, as poverty is still high and the GDP of Muslim countries (World Bank, 2012) is disappointing except that in petro-economies of the gulf. The gaps between the top and bottom twenties of a nation, or those living on below five American Dollars are even more alarming.

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<sup>1</sup> We do not consider the \$1.90 a day (2011) of the World Bank to be the necessary criteria for getting loans by the poor from the microfinance organizations.

<sup>2</sup> Such as weddings, funerals, childbirth, education, homebuilding, widowhood, old age; sickness, injury, unemployment, theft, harassment or death; fires, floods, cyclones and man-made events like war or bulldozing of dwellings; expanding a business, buying land or equipment, improving housing, securing a job (which often requires paying a large bribe), etc.

The conventional micro-financing entities are criticized (Morduch & Haley, 2002; Amin et al, 2003; Roodman & Morduch, 2009; Young, 2010) for making high profits at the expense of the poor (Mishra, 2006; Vakulabharanam, 2005) and the merit of Islamic microfinance is debatable (Mitias, 2009). It is viewed costlier in the Middle East due to the cost of capital and transactions, and cheaper in Bangladesh for the lack of it (UNDEP, 2012). Hence, mix demand for Islamic microfinance in Islamic countries is reported: in the Middle East, for example, more than 60 per cent in the West Bank and Gaza, an estimated 40% in Yemen, 24.9–32% in Jordan, and 20.7% in Algeria preferred Islamic products (Karim et al, 2008). In spite of critique, Muslims would prefer Islamic microfinance, if it were relatively cheaper for reasons of risk sharing, profit sharing, fixed repayment rate, transparency, social welfare and justice (Mahaini, 2012). The main concern is the high cost of microfinance, which is justified among others based on operational costs.

Few Muslim scholars considered the integration of waqf, zakat and other charitable donations into Islamic microfinance to make it cheaper. Nevertheless, these studies do not explore which of the costs could be paid from the Islamic charitable funds and whether such it is a sustainable solution. This paper therefore aims to identify the types of costs that could be paid out of consumptive and repayable grants and credits. Attempt is also made to identify which type of charitable funds and their subclasses could be used for subsidy of costs, in terms of consumptive and repayable grants or loans. To do so, this paper in its first section reviews the literature explaining the current scenario about the costly microfinance (conventional and Islamic), its causes and the burden on borrowers. In the second section, the paper reviews the current opinions as well as expands the same ideas further in order to achieve the aim of this study. The authors also suggest policy proposals and further research.

## **1.1 The Cost OF Islamic Micro Financial Institutions**

This section explains the costs of capital and operations, sustainability of fund and the affordability of the microfinance offered by Islamic Micro Financing Institutions (IsMFI) and conventional Micro Financing Institutions (MFI).

### **1.2 *Lender's costs in conventional MFIs***

MFIs have two types of costs: cost of capital and cost of expenses. The cost of capital consists of the interest paid to investors. Usually they pay 4.5% to 6% on savings (Acha, 2012; Schumpeter, 2013). The operational costs are the financial transactions costs incurred by MFI in the field (supervision and monitoring) and in the headquarters. These are often called service charges and “include the administrative costs of making payments, keeping open offices, cost of loan monitoring, etc.”. Gonzalez (2007) opines that profits in the capital cost is less than 8% while operating expenses amount to 63%, and financial expenses are 21%.

### **1.2 *Borrower's Costs under conventional MFIs***

Global empirical studies show a variant range of interests and charges. The lower costs of conventional microfinance is at the rate of 8% and higher costs at 100%. In India the cost of funds is up to 60% by moneylenders, and up to 36% by NGOs (S.C.Vetrivel & S. Chandra Kumarmangalam, 2010). In Nigeria and Mexico microfinance banks charge interest at the rate of 30% to 100% on loans (Acha, 2012; Schumpeter, 2013). Up to 1996, the lending rate of interest by Grameen Bank was between 11%-17% despite heavy subsidies from donors (Morduch, 1999). It has been reported that, since 1996 Grameen Bank has increased its interest rate by 21% to avoid dependence on external subsidies. The government of Bangladesh has imposed a 12.5% flat interest rate (Iftekhar Hossain, 2006) and in 2010 the Grameen Bank disclosed its interest rate

between 8% to 20%, and sometimes interest free loan to the ultra poor (Counts, 2010). The effective rate may be 30% as claimed by Schreiner (1999).<sup>3</sup>

Ehrbeck, Leijon, & Gaul (2011) confirmed the interest rates at the range below 0%-15% and above 60%. They also found that the majority of MFIs expect 30% return, regardless whether they are provided by for-profit or not-for-profit organizations. Charging 36% interest rate by an MFI is considered reasonable (Erase Poverty, (n.d.)). It is explained below. Contributing factors to the high costs of microfinance are: (1) borrowing costs and (2) operating costs. Both are passed to borrowers. The borrowing costs mean (i) the interest that an MFI pays to external fund providers and depositors of the given MFI and (ii) the interest charged by an MFI. The MFI charges interest when it lends available funds (equity and other funds). Thus if the institution uses external funds, the cost of the loan would be double (i.e. the borrowing cost, and the interest charged by MFI).

There are other costs, such as shaming, additional borrowing and payment of interest for two loans and losses of income, that need to be considered. For instance, physical collateral is replaced with group guarantee (Ahmad, 2007); the employees of an MFI may use harsh collection methods. Additionally, group pressure over their members may cause humiliation and eventually may force the members to quit. To pay for the previous loan new credit may be obtained from other source. Thereafter, the cost of the credit, then, may increase. Over all one can see the existence of very high interest rate. Even the reasonable rate of Erase Poverty (n.d.) seems expensive considering comparing it to normal banking rates. Indeed, it is very high after considering the humble income of the borrowers. Therefore, one can conclude that there could be cases where microfinance is a mere liability and entrapment of the poor in their perpetual misery.

#### **1.4 Islamic Microfinance**

Is Islamic Microfinance expensive too? The answer to this question could be relative: relative to the rate of competitors and the income of the borrower. First the cost, and affordability followed by the dilemma of sustainability.

##### **1.4.1 The cost of borrowing**

Two views are expressed about the cost of borrowing from IsMFIs. On one hand, studies in the Middle East have found the cost of Islamic microcredit to be higher than the conventional institutions. On the other hand, in other countries the cost of credit looks lower.

For instance, Amanah Ikhtiar Malaysia (modeled on Grameen Bank but offers qard hasan and charges ujri) charges 4%-10% (Omar, Rindam, & Nor, 2012). Malaysian banks, which also offer microfinance, charge between 1.5%-17% (Norma & Azizah, 2009). Both of these are comparable to the rates offered for loans to bankable persons. Even better, the Akhwat of Pakistan charges 5%<sup>4</sup> (Allen & Overy, 2009) due to their extremely efficient services (Allen & Overy, 2009;

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<sup>3</sup> Schreiner (1999) claimed the Annual reports of Grameen Bank are not transparent with intent to make the bank look different from moneylenders, and avoid questions from donors that the borrowers may be burdened. He thought the bank needs no subsidies as it earned 30% annually based on its effective interest rates it charges. This and the savings are not declared income for the fear of being taxed.

<sup>4</sup> It is the understanding of the writers that recently Akhwat is offering zero interest loans for the same reasons. Costs are covered by the donations of its graduate borrowers.

Kazim & Haider, 2012). Abdul Rahman, A. (2007) proposed Murabahah and musharakah based microfinance. It is said that the cost of finance in Bangladesh is between 10%-12.2% (UNDP, 2012), if one assumes it is the effective rate.

The most common rate of the cost of microfinance by Amanah Ikhtiar is at 11%, slightly higher than what Allen & Overy (2009) has asserted i.e. 4%-10%. In our sample of limited respondents, we only found one borrower to have been charged at the rate of 8.3%, and some seemed to be charged as high as 18.3%, but such results would not be conclusive as the sample was small from two locations. We also examined this in the context of long-term and short-term loans, and in comparison with that of normal banks. It seemed expensive, compared to 5% offered by normal banks. We tested the cost of capital for a home loan for a period of five years at prevailing interest rates (between 4.8%-5.9 % BLR offered by normal banks) with that of Amanah Ikhtiar Malaysia, which was estimated at 11%-12%.<sup>5</sup> We found that by the end of the fifth year, the borrower has to repay to the bank RM50,000 plus RM6,339 which means the conventional bank charges were at the rate of 12.6%. This indicated that the actual rate of Amanah Ikhtiar was slightly cheaper, provided the term of loan is not less than one year. Loans disbursed for shorter terms may be expensive and hence may cause defaults. The reason is that Amanah Ikhtiar charges fixed service charge at 11% of the amount lent. Considering the variant rates based on the amount borrowed, and the term paid (Hup Chan, 2010), the findings of Mukhtar (2012) may explain why some borrowers defaulted; as it would be consonant to the view that project failure is related to the level of interest rates (Obaidullah, 2008a).

In the case of IsMFI, service charges and the ratio of profit and loss sharing might be considered the cost of capital. The rate of profit sharing between IsMFI and lender may be low or high. In either case, the higher the cost incurred by an MFI the more expensive it would be for the borrower.

It is clear from the above discussion that Islamic Micro Finance is relatively cheaper than conventional micro credit as the highest rate of profit is reported at 18%. This is lower than 20%/21% of Grameen Bank or 36% of rate accepted by Erase Poverty (n.d). Nevertheless, in Malaysia, it seems both conventional and Islamic MFIs offer cheaper rates when compared with rates charged by firms located outside Malaysia. Some government-subsidised loans were even cheaper than Amanah Ikhtiar, which runs based on qard hasan, ujr, and takaful products.

Theoretically, IsMFIs should be cheaper. They may have received cheap credit and sometimes cost free. They demand borrowers to open saving deposit accounts with IsMFIs, and demand borrowers to be insured, and therefore risks are minimized. Furthermore, IsMFIs charge fixed service charges (ujr), if the transaction involves qard hasan. They also expect profit in other cases. Some transactions are based on profit and loss sharing. Ideally therefore the cost of capital to the borrower should be subsidized and be lower.

It is significant to note that the cost of an Islamic microfinance should not be evaluated based on the rate offered by a conventional commercial bank alone. Neither the justification of the cost of capital and operation should be sufficient for promotion of IsMFIs products. They must be evaluated based on the affordability of the borrowers and helping them escape from economic misery. The following discussion is based on affordability and economic development.

## **2.0 Discussion**

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<sup>5</sup> We examined a loan given by Amanah Ikhtiar for RM10,000, but releasing to the borrower only RM9,802. They withheld 0.019% of the total sum for takaful and hibah (called halal). The borrower has to pay RM11,000, plus a weekly savings of RM15. Considering the RM10,000 loan, and RM1,000 as the ujr (as they call it) the cost of the ujr and others reached up to 11%.

Microfinance prices are higher than banking (El Tabaa, n.d.). There is concern about the expensiveness of microcredit (Islamic and conventional) and borrowers' inability to repay (Gonzalez-Vega, 1998; Hardy et al, 2002; Ahmad 2007; Obaidullah, 2008a). We therefore thought that the merit of an Islamic micro finance should be judged based on the ability of the borrower to repay the loan with ease and improvement in his prosperity. The latter is discussed first.

## **2.1 Affordability and borrower's prosperity**

We did not find clear answers from some previous studies in regard to affordability of the loans offered by Islamic Micro Financing Institutions. Ahmad (2002) mentions the economic impact of loans in terms of paying with money, increase in volume of goods/services, diversification into new goods/services, increase in assets, improved premises but he is silent on the burden of repayment and others. Studies in Malaysia (Fazidah, (2011); Norma, and Jarita (2009) Kasim, 2002, Salma 2006; and Omar, Rindam, and Nor, 2012; Mokhtar, 2012; Haneef, Pramanikb, Mohammed, Dahiru, & Amin 2013), Bangladesh (Khandker, Samad and Khan, 1998), Ghana and South Africa (Afrane, 2002) indicate the increase of income and expenditure at a range of 50%-215% after the loans were given. However they do not prove whether such increase was after the deduction of loan payment or otherwise. These and other studies show relatively substantial number of defaulters and dropped out from the programme, as well as borrowers being unable to be *zakatable*. These make Islamic MFIs suspect of being unaffordable.

Where a loan is unaffordable, loan default or over indebtedness may occur. This is in line with the findings of Haneef, et al (2013) that certain Malaysian borrowers opted for additional loans, and that a substantial number of them considered themselves indebted. This study is relatively clear by showing that more than one third of the borrowers, if sole breadwinners, would remain below poverty line (earning less than RM900), a substantial majority did not know whether the programme was beneficial to them or if it is Islamic. Besides, Norma and Azizah (2009) surveying 1,803 program participants in Malaysia found that 42.7% felt they were either indifferent or worse. Their study does not shed light on the ability of the participants to pay their loans, or on the reasons why the 42% of the population were unable to escape from poverty.

Unless rebutted empirically, one may presume that the lack of change in the economic wellbeing of the borrowers may be an indicator of unaffordability of the microloans offered by IsMFIs as the surplus would add to their savings or disposable income which can be used for purchasing more goods or services.

## **2.2 Affordability and Defaults**

Whether or not a loan is affordable, and easily repayable, one has to consider the total monthly income of the borrower. For purpose of affordability, one has to look at the said income and the amount paid for repayment of loan and other charges related to the said loan. Where the deduction for gross periodical repayment (loan repayment, savings, and others) makes the borrower unable to pay for the costs of necessities, and liabilities to third party, then it would be unaffordable and expensive according to the criteria for affordability of housing loans. We use this notwithstanding the fact that such a criteria is high considering that the borrower has to pay for housing and other expenses too, which may push his/her monthly deductions to 60%.

Considering, in Malaysia, the average monthly income of these groups, between RM500-RM1,500 (Haneef, Pramanikb, Mohammed, Dahiru, & Amin 2013), and the loans for a week (Davis, n.d), for a year (Mokhtar, 2012), and 3 years (Omar, 2012), small loans given on a very short-term basis would be less affordable. One would doubt the claim of 50%-215% of increase in income could solve the question of unaffordability. Haneef, et al (2013) confirm that a substantial segment of their pilot study was facing difficulty to repay their loans and remained poor.

Default over repayment is estimated at 39% in the Caribbean (Lashley, 2004), 40% in Bangladesh (i.e. Grameen Bank) despite the fact that the given bank declares it at 2% of the current total rate of loans disbursed (Morduch, 1999) and Ethiopia 5%. In Malaysia the rate of defaults is between 2%-20% even though the rate of periodical instalments is not as high as in other countries.

Several interconnected factors can cause loan defaults. Shu-Teng et al. (2015) have categorized them based on characteristics of borrowers, business, loans, and lenders. They include the following: Small loans (Brehanu & Fufa, 2008; Shu-Teng et al, 2015), and longer period of loans (Roslan & Abd Karim, 2009), shorter period of loans, higher sum of weekly instalments i.e. more than RM200 for low income earners and agricultural loans (Mokhtar et al, 2012) are the reasons for non-repayment. Other reasons are non-timely disbursement of loan, and low number of supervisory visits (Okorie, 1986). Ahmad, (2007), Chaudhary & Ishaq, (2003) identified defaults due to loan for non-productive purpose, and higher interest (Ahmad, 2007). Small business: lower business revenue, less productivity and income (Brehanu & Fufa, 2008; Okorie, 1986), education level (Shu-Teng et al, 2015), youth and less experience (Mokhtar Et al, 2012). Some of these factors are linkable to unaffordability of the loan.

Higher cost of borrowing is a challenge (Reta, 2011). The repayment of the loans, the cost of the loans at 4%-100%, and savings and other costs may amount to higher weekly payments, which may cause loan defaults because of lower income, especially when the term of loan is between a week to a year. Consequent to default, penalty may be imposed and increased interest may be charged. For these, more money may be borrowed and this eventually may result in over-indebtedness.

Time magazine has reported indebtedness of borrowers. No more 99% repay; it is increasing (Knowledge@Wharton, 2012). The magazine has reported over-indebtedness and over borrowing from several MFIs, default on repayment, due to “exorbitant interest rates” or expensive credit by not-for-profit and for-profit MFIs and banks’ “increasing competition”. Borrowers have also committed suicide. The borrowers from Grameen Bank borrow from others to service their debt to the bank, which was later considered to be “sucking blood from the poor in the name of poverty alleviation”. In India, the repayment system of 50 weekly equal instalments is considered not practical because the poor do not have stable jobs or if the communities are agrarian. Pressure for high repayment drives members to moneylenders (Vetrivel & Kumarmangalam, 2010). Jain, and Mansuri (2003) put it in this way: “Since the borrower knows that repayment must begin almost immediately after loan disbursement, and typically much before project returns are realized, she must be able to access funds to finance the instalment”. The negative effect of this is reported too; a string of borrowers have committed suicides over alleged “exploitation”, and “harsh collection tactics”.

Over-debtedness is the worst of all results one can expect from an MFI. This ties the borrower to the lender, which is a trap that cripples borrowers. If so, it will not only be considered a contemporary form of slavery but it may also bring down the given MFI, as it would not be able to lend funds and hence become unsustainable. Both of these two consequences have to be avoided by an IsMFI. Therefore for the sake of avoiding the above consequences, the authors suggest supplementary measures that need to be added to the current structure of microcredit and micro financing.

### **3.0 Sustainability**

Some writers are concerned with sustainability of MFIS. However, this should not be achieved at the expense of borrowers by charging higher interest or profit rates. Higher cost of

lending to the poor may be viewed not only as burdening the borrower but also is a risk to the sustainability of the MFI or IsMFI itself. Therefore, efficiency in both aspects is desirable.

There could be no cost if MFI has its own capital, but it will necessarily have operational expenses. To Gonzalez (2007), MFI characteristics and country characteristics play important roles in the efficiency of an MFI. The size of loan, the number of borrowers (MFI size), the maturity of MFI, and the number of borrowers per employee are the drivers of efficiency. The larger the number of sum borrowed, the broader the borrowers' base is and the greater the number of borrowers per employee, the higher is the age of maturity of the MFI, and the less expensive are the loans. On a country level, good physical infrastructure (roads, electricity, the rate of electricity outage etc.), and higher density of target population, good financial infrastructure (institutional), price and better availability of inputs, efficiently doing business, and good macroeconomic environment helps the MFI reduce its costs of operations.

#### **4.0 Conclusion**

The merit of an Islamic micro finance should be judged based on the ability of the borrower to repay the loan with ease and improve the dispensable income of the borrower. This may be achieved if the IsMFI could (a) rely on interest free loans, (b) have dedicated charitable funds for microfinance, (c) provide loan for enterprise, and sustenance, (d) grant small loans for a term exceeding one year, and (e) lower service charges. The result of this would be avoiding cost of capital, reducing the number of defaulters due to higher repayment amount, access money for sustenance, saving or having surplus income, and therefore improves their standard of living through new prosperity achieved by way of the affordable loan.

The costs of MFIs are said to be higher than commercial banks. Higher cost of lending to the poor in traditional MFIs is justified on organizational sustainability and freedom from subsidies. However, higher cost of borrowing by the poor should be viewed not only as a burden on the borrower but also a risk to the sustainability of the MFI or IsMFI itself. This vicious circle can be avoided by incorporating the Islamic philosophy of economic system. Attention has to be paid to the difference between the two systems. While in a neoliberal economic system a subsidy-free sustainability may seem to be the built-in components of the system, in Islam, the built-in component of its economic system is subsidies through zakat, waqf, and other donations. Incorporating all the three in an IsMFIs should be viewed the means for sustainability of the organization.

Additional efficiency tool however could not be disregarded. Several efficiency measures can be taken to reduce the costs of operation, and therefore keep the organization sustained. This also include reducing the number of human resource in headquarters and regional centers, cutting down on excessive traveling, holding training in big groups and monitoring loans from the center while undertaking collection through online banking. Banking practices can be learned and adopted to improve cost efficiency. Islamic microfinance may thrive if it starts operation under waqf where normal banking activities could subsidize the cost of operation. This will benefit the public and charitable organizations by making available charity funds to the deserving poor. To ascertain the above, further research in the effectiveness of the above ideas can be conducted especially on the role of charitable funds such as zakat and waqf and the operation of microfinance by a waqf bank.

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