



ISLAMIC (MICRO)FINANCE: CULTURE, CONTEXT, PROMISE, CHALLENGES

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Cover photograph: an Islamic microfinance field officer makes a weekly repayment visit to clients. (Chittagong Division, Bangladesh, 2010)

Author: Bridget Kustin (bkustin2@jhu.edu)

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1 EXECUTIVE SUMMARY

The worth of worldwide Islamic financial assets leapt from half a million dollars in the 1970s to over one trillion USD by 2009. With an annual growth rate of around 14 percent, assets have doubled over the past five years, and now exceed two trillion USD.¹ Ernst & Young estimates that global Islamic assets will top 3.4 trillion USD by 2018.² While Islamic banking and finance has long been dominated by the liquidity-rich, advanced economies in the Persian Gulf, the fastest-growing markets are now more evenly spread across the world. Qatar, Indonesia, Malaysia, Saudi Arabia, Turkey and the United Arab Emirates are estimated to currently hold 80% of IBF assets, with a five-year compound annual growth rate (CAGR) of 18% from 2009 to 2013, and an expected CAGR of 19% from 2014 to 2019.³

Within this field, the slow-but-steady growth of Islamic microfinance has recently become more dynamic, fueled by increased attention from governments, central banks, donors, and commercial Islamic banking and finance institutions (IBFIs), with some estimates projecting a global Islamic microfinance five-year CAGR of 19.7% from 2013 to 2018.⁴ This report explores how *the promise of Islamic microfinance lies in its unique benefits in terms of user experiences, poverty alleviation-related outcomes and product innovation, and access to poor clients who need liquidity but may be reluctant to engage with non-Islamic finance.*

Islamic microfinance is poised to increase the overall market share of Islamic banking and finance by folding untapped populations into formal financial activity. As IBFIs in established economies push up against the borders of *Shari'a* (Islamic law) compliance in the race to establish viable *sukuk* (bonds), *takaful* (insurance), and a *Shari'a* compliant stock exchange, *expanding the reach and profile of Islamic microfinance through partnerships and funding strategies can help meet the liquidity and market access needs of the poor—and help the global IBF industry better embody motivations for Islamic economic activity in the Qur'an and Sunnah* (the practices, teachings, and path of the Prophet Mohammed). Islamic microfinance holds, for example, tremendous potential to tap into and productively channel scattered Islamic donor streams (namely *zakat*, *sadaqat*, and *waqf*) toward strategic, impact-oriented goals.

Several recent reports focus on the unique considerations of development and the global Muslim population. According to these reports, the inherent social justice potential of Islam is a rich and underutilized resource for poverty alleviation.⁵ While this is not untrue, Islamic microfinance—like all methods promoting financial inclusion—is no silver bullet. *This report fills a gap in existing reviews and quantitative research on Islamic microfinance that focus on indicators and metrics without examining the place of cultural contextualization. An anthropological perspective investigates how financial tools come to life in the hands of clients.*⁶ Qualitative, longitudinal

¹ Ang 2013, Express Tribune 2015

² Bloomberg 2014

³ Ernst & Young 2014: 7, 10

⁴ TechNavio 2014

⁵ Amr 2008

⁶ Primarily qualitative ethnographic research conducted in Bangladesh (Dhaka and Cox's Bazar District) and Pakistan (Islamabad and Rawalpindi) from 2010 to 2014 consisted of: (1) Nearly 18 months of full-time, Bangla-medium participant observation in Bangladesh among Islamic microfinance clients of the Islami Bank Bangladesh Limited, shadowing clients in their daily lives. Engagement was mostly with women; men generally worked away on fishing

anthropological fieldwork enables complexity and nuance in institutional practice and user experience to arise through a methodology of “participant-observation,” repeat minimally-structured interviews, and relationship-building. This addresses methodological challenges in microfinance research: banks, acting as gatekeepers, can (un)intentionally circumscribe access for researchers. The need for the poor to ensure continued access to banks affects their responses to market research and customer surveys. Male field researchers may face difficulty in eliciting information about intimate familial or financial challenges from female microfinance clientele.

This report also offers historical and theological contextualization for present-day debates and developments, overviews of commonly used Islamic (micro)finance products, and descriptions of key countries and institutions in the global Islamic (micro)finance industries. Examinations of the Islamic (micro)finance landscapes in Bangladesh, Indonesia, and Pakistan along with case studies of Islamic microfinance programs in Bangladesh and Pakistan illustrate the variation in relevant legal, political, economic, and geographic considerations. *Ethnographic attention is given to the unique challenges faced by female clients and female-headed households, implications of client relationships with IMFI field officers, and the absence of tools for clients to address personal accounting and calculation challenges.*

Finally, there is a lack of relationships between Islamic microfinance and digital tools that could easily promote product and platform innovation and aid service provision. *The report offers starting points for digital interventions to meet the needs of the poor while addressing longstanding cost and value chain inefficiencies in Islamic (micro)finance.* The Islamic Development Bank is arguably the best-positioned institution to currently act as a research and development hub for Islamic microfinance, shaping and testing new products and services, optimal legal environments, and basic computing requirements. The scope for the collaboration is high and the capacity for innovation in this still-nascent industry, where supply has not met demand, should encourage impatient optimism of industry observers, providers, and clients alike.



Main Road, field research site, Chittagong Division, Bangladesh, 2012

boats, as migrant workers abroad, or had abandoned their wives or died. (2) 2.5 months in Pakistan as a consultant to Islamic Relief Worldwide, during which I evaluated their Islamic microfinance program, conducting interviews and administering a survey for clients, staff, and other stakeholders. In both settings, I studied how Islamic microfinance was taken up and embedded into clients' everyday lives by tracking financial flows in and out of households, financial management and accounting strategies, debt relationships, and value and monetary calculations.

2 ISLAMIC BANKING AND FINANCE: A GLOBAL OVERVIEW

2.1 Brief history, 1970s – present

Before the 1970s, the vast majority of global oil was traded in long-term agreements with multinational corporations. When these monopolies and the contractually agreed-upon prices broke apart in the mid-1970s, the immense cash liquidity of the Persian Gulf “petrodollars” produced by the new oil market enabled small, local experiments in Islamic finance to develop into multinational institutions. Treatises on Islamic economics from the 1930s and 1960s⁷ provided intellectual foundations for a modern system. By 1975, the multilateral Islamic Development Bank in Saudi Arabia and the first major commercial bank, Dubai Islamic Bank were established.

In 1977, Sudan established its first Islamic Bank with the help of Saudi funders, eventually transitioning its entire finance and banking infrastructure into Shari’a compliance in 1989. In 1983, a Saudi diplomat to Bangladesh helped establish the Islami Bank Bangladesh Limited (IBBL), the first Islamic bank in South and Southeast Asia outside Pakistan. Iran rendered its economy fully Shari’a compliant in 1983 as well.⁸ By 1985, Pakistan’s entire banking and finance sector, including commercial and specialized banks, was mostly interest-free.⁹ The dominant lending and financing modes were *murabaha* (a “mark-up” contract in which the projected interest is added to the initial cost or original purchase price of a good) and *musharaka* (a mark-up contract with provisions for profit and loss sharing and responsibility for initial capital). The cosmetic change in the placement of interest to the beginning of the transaction as a mark-up was not accidental; these contracts were meant to ease consumer transition into interest-free banking.¹⁰

In 1992, the prominent Islamic economic theorist M. Umer Chapra released *Islam and the Economic Challenge*, arguing for IBF as the best economic hope after the collapse of the Soviet Union. Global IBF received a similar wave of positive attention after the 2008 financial crisis, as Islamic mortgages and financial institutions were shielded from its worst effects. In 2015, the IMF released a report using data from Pakistan to suggest the greater general stability of IBFIs during financial panics.¹¹

Today, numerous conventional banking and financial institutions offer parallel Islamic services through dedicated “windows” or divisions, including JPMorgan Chase, Standard Chartered (Saadiq), Citibank (Citi Islamic Investment Bank), and BNP Paribas (Najmah) – particularly in countries with large Muslim populations. Windows and other forays into IBF are subject to criticism for insufficient Shari’a compliance. In 2011, Goldman Sachs failed in its initial bid to sell

⁷ Particularly by Sayyid Abul Ala Mawdudi (in Urdu) and Muhammed Baqir Al-Sadr (in Arabic).

⁸ The roots of that movement were in early anti-Shah Marxist formations. Iran’s economy remains fully Shari’a compliant. However, Iran is normally excluded from IBF reports (including this one) because of the idiosyncratic trajectory of its political upheaval-driven evolution, and to the isolation of its economy under economic sanctions.

⁹ Al-Omar and Abdel-Haq 1996: 99

¹⁰ Lewis and Algaoud 2001: 91. By 1991, Pakistan’s Federal Shariat Court declared these mark-up activities non-Shari’a compliant as they too-closely modeled secular banking, disguising *riba*/interest as mark-up prices failing to embody the “spirit” of Islam. This upheaval is common to the IBF industry, as scholars revise and issue new rulings.

¹¹ Farooq and Zaheer 2015

sukuk (bonds) when Shari'a compliance could not be guaranteed. In September 2014, Goldman successfully sold 500 million USD of sukuk, receiving three times as many bids, after restructuring for greater compliance.¹² 2014 also heralded sovereign sukuk offerings from the UK, Hong Kong, Luxembourg, and South Africa. Ekmeleddin Ihsanoglu, Secretary General of the Organization of Islamic Countries, does not view Islamic finance as an “alternative,” to secular banking, but as a “complimentary service, a way of doing service.”¹³

Connecting Islamic finance and Islamic microfinance would be innovative, but not unprecedented: Islam has long concerned itself with social justice through economic affairs and transactions. However, major IBFs possess these social justice obligations alongside obligations to successfully compete with conventional institutions with interest income, aggressive risk-taking, and unrestricted investment in all types of industries. IBF observers have long identified a split between two types of IBFs: those focusing on technical Shari'a compliance (the letter of the law, so to speak) in their contract forms, and those devoted to the social justice mission of Islam (the spirit of the law).¹⁴ In other words, a hierarchy of Islamic authenticity exists within IBF. Corporate culture also varies: some of the largest IBFs in the Gulf Cooperation Council (GCC) prefer applicants with conventional business and economics degrees over Islamic finance certifications, and are heavily staffed at top levels by non-Muslim expatriates with conventional banking and finance backgrounds. As governments and institutions experiment with different degrees of adherence to the letter or spirit of the law, this does not necessarily reflect on inherent religiosity. IBF activities are contextual, relating to peer institutions and national or regional trends, politics, and laws.

2.2 Theological foundations

The modern Islamic finance industry is only the latest incarnation of Islam's long engagement with economics. The Qur'an links economic accounting with the spiritual accounting conducted upon death, before God, and these verses are often included in IBFs' annual reports, websites, and other documents.¹⁵ The “remembrance of death”¹⁶ this yields during one's earthly life keeps the



Qatar Islamic Bank's Shari'a compliant ATM (Doha, Qatar, 2010)

¹² Sharif and Solovieva 2014

¹³ Brant 2009

¹⁴ El-Gamal 2006, Khan 1986, Lewis and Algaoud 2001, Vogel and Hayes 1998

¹⁵ This includes, among other verses: “Woe unto those who give short measure: those who, when they are to receive their due from [other] people, demand that it be given in full—but when they have to measure or weigh whatever they owe to others, give less than what is due! Do they not know that they are bound to be raised from the dead [and called to account] on an awesome Day—the Day when all men shall stand before the Sustainer...” (83:1-4); “Behold, God has bought of the believers their lives and their possessions, promising them paradise in return” (9:111); “Hence, let them fight in God's cause - all who are willing to barter the life of this world for the life to come...” (4:74); and “And be conscious of the Day on which you shall be brought back unto God, whereupon every human being shall be repaid in full for what he has earned, and none shall be wronged.” (2:281)

¹⁶ Al Ghazali 1995

promise of an eternal hereafter ever-present. Through this remembrance, and a view of existence as a continuum from the here to the hereafter, “self-interest and social interest are integrated,”¹⁷ making social justice a “shared endeavor...between God and humankind.”¹⁸ Engaging in Islamic finance can thus be understood as an ethical duty, emphasizing human accountability and “a fulfillment of this-worldly endeavors in the world to come.”¹⁹

The history of early Islam is also an economic history: The Qur’an, Sunnah, *hadith* (collected sayings and acts of the Prophet Mohammed), and *fiqh* (juridical interpretations of Shari’a) offer guidance for trade and business, and produced a rich Islamic contract law tradition. The protracted timeframe of long distance merchant trade for in medieval Islam gave rise to the *mudaraba* and *musharaka* contract—two common Islamic financing contracts today.²⁰ Guidance also exists regarding socially just distributions of wealth. In Islam, believers are recognized to struggle against tendencies toward self-benefit. Self-interest is foundational to the principle of scarcity in conventional economics, where limited supply interacts with demand. As individuals are presumed to maximize self-interest, they ostensibly engage in ethical behavior only when it is in their self-interest to do so.²¹

Islamic economics, by contrast, posits a sufficient amount of God-given resources for all human needs. The strain on the supply or the “perceived scarcity” of goods results from the “lack of effort and insatiable needs on the part of man,” due in part to *haram* indulgences or activities counter to Islamic social justice.²² Wealth is not inherently immoral; the Qur’an allows for the acquisition of wealth and acknowledges that wealth disparities will always exist.²³ Redistribution of wealth in the following forms helps mitigate the most egregious economic inequalities:

- **Sadaqat:** voluntary charity given without expectation of reciprocity or recognition.
- **Waqf** (plural, *awaqf*): immovable property established by an individual owner to be used in perpetuity for charitable or religious purposes, often mosques, orphanages, or religious schools.
- **Zakat:** mandatory alms-giving and one of the “five pillars” of Islam;²⁴ the Qur’an specifies an annual tax on all income after expenses to be given to certain categories of recipients. Believers can use online calculators to determine personal zakat contributions. State involvement in the collection and distribution of zakat varies widely. In deference to Malaysia’s religiously pluralistic population, citizens can pay income tax as either a secular tax or as zakat. Saudi Arabia mandates zakat contributions. In Bangladesh, zakat is private and voluntary, although subject to social pressure. One Bangladeshi NGO, the Center for Zakat Management, encourages corporate zakat and aims to channel it toward strategic development goals.²⁵

¹⁷ Tashkiri 2004, see also Chapra 1979

¹⁸ DeLorenzo and McMillen 2007: 137

¹⁹ Smith and Haddad 2002: 106

²⁰ Kuran 2010

²¹ Within this framework, “ethical behavior is a commodity that needs to be economized.” (Sandel 2012: 26)

²² Jackson-Moore 2009: 3

²³ Kuran 2010, Lewis and Algaoud 2001, DeLorenzo and McMillan 2007, Meenai and Ansari 2001, Saeed 1996

²⁴ These refer to the mandatory obligations of all Muslims, health and circumstances permitting: daily prayer; completing the *Hajj*, or pilgrimage to Mecca; observance of the holy month of Ramadan; reciting the *Shahada*, or declaration of faith.

²⁵ For more on the current state of these charitable and wealth redistribution methods, including several country-wise breakdowns, see IRTI/Thomson Reuters 2014.

2.3 Guiding principles and common controversies: more than just ‘interest-free’

IBFIs differ in terms of mission and products and services offered, due to different political, religious, economic, and regulatory contexts in which they operate. All incorporate certain principles (with modes of interpretation and implementation occurring across a spectrum) to promote social justice in Islam.²⁶ These principles include the prohibition of *riba*, avoidance of excessive uncertainty and gambling, the importance of mutually-agreed upon contracts, and the encouragement of risk sharing, mutual assistance, and asset-or equity backed rather than debt-backed transactions. UK-based Islamic Relief Worldwide (IRW) has operated small but effective Islamic microfinance programs in Bosnia & Herzegovina, Kosovo, Pakistan, and Malawi, among other countries, for over a decade. For IRW,

“The core belief in Islamic finance is that *money is not an earning asset in and of itself*. Importantly, risk must be present in the commercial or productive venture, and transactions should be directly or indirectly linked to tangible economic activity and not financial speculation and excessive uncertainty. Furthermore, the product bought or sold must be clear to both parties and only socially productive activities that are not exploitative and socially or morally harmful should be funded. Selling what one does not own is impermissible, and financial risk must lie solely with the lenders of capital and not with the manager or agents who work with the capital.”²⁷

RIBA, SOCIAL JUSTICE, AND THE QUR’AN:

“Profits obtained through interest-bearing loans involving an exploitation of the economically weak by the strong and resourceful: an exploitation characterized by the fact that the lender, while retaining full ownership of the capital loaned and having no legal concern with the purpose for which it is to be used or with the manner of its use, remains contractually assured of gain irrespective of any losses which the borrower may suffer in consequence of this transaction.”

“...the question as to what kinds of financial transactions fall within the category of *riba* is, in the last resort, a moral one, closely connected with the socio-economic motivation underlying the mutual relationship of borrower and lender...”

Mohammed Asad, *Message of the Qur’an* (30:39 fn)

Riba and risk sharing: The definitive Qur’anic prohibition of *riba* in economic transactions constitutes a foundational tenet of Islamic finance.²⁸ However, there is no single interpretation of *riba*; the Arabic root appearing in the Qur’an does not translate exactly to interest or usury, but has meanings spanning “increasing,” “unjustified profit,” “illicit gain,” “usury,” and “unlawful gain.”²⁹ Qur’anic verses 2:275-281 forbidding *riba* were the last revelations received by the Prophet before his death, limiting the ability of companions to ask for additional explication.

The definitional confusion is largely due to the existence of two contrasting hadith. The first one limits *riba* to *riba al-jahiliyya*, an increase through “doubling and redoubling” analogous to interest

²⁶ Al-Sadr 1990 and 1994, Taskhiri 2004, Hamoudi 2008

²⁷ Original italics. Khan and Phillips 2010: 3-4

²⁸ These include: Those that live on *riba* shall rise up before God like men whom Satan has demented by his touch; for they claim that tradition is no different from *riba*. But God has permitted trading and made *riba* unlawful (2:275); God has laid His curse on *riba* and blessed almsgiving with increase. God bears no love for the impious and the sinful. (2:276)

²⁹ Khan 1987, Saeed 1996

rates on loans.³⁰ Here, *riba* is unjust because it requires the receiver to compensate the lender beyond the cost of an initial investment even if the receiver sustains complete losses. Interest-bearing banks contribute to structural inequity by acting in self-interest to minimize default risk, in order to maximize profit. Allocating credit to ensure the security of the investment, and not according to a project's social promise runs counter to social justice, centered upon a repudiation of self-interest in favor of a more equitable distribution of God-given resources.

This also explains the preference for risk-sharing investment vehicles. Risk-sharing allow the institution and the client to forge profit-loss sharing partnerships that replace excessive self-interest—the hallmark of conventional capitalist financial activity—with collaborative concern for mutual growth.

A second hadith sets out two other forms of *riba* that allow for credit sales as long as non-equal, non-identical goods are transacted. Goods can be exchanged for money with a delay in time (the transaction can not be immediate). However, money cannot be exchanged for money—a category of *riba* invoked against securitization, currency trading, or other debt-backed transactions.³¹

Jurists have struggled with interpretation over centuries as economic conditions evolve, and modern financial products and services continue to require the input of Islamic scholars to mediate disagreements, clarify ambiguity, and offers pathways to proceed.³² Since their inception, IBFIs have been subject to frequent and sudden ruptures as theologians and Shari'a courts ruled upon, revised, and crafted ever-more Shari'a compliant products and services. These deliberations do not treat *riba* and interest as interchangeable concepts—although financial institutions and vocabularies often do so. In Qur'anic verses printed on IBBL's Annual Reports, *riba* is translated as usury.³³ In Urdu, Islamic microfinance is referred to as *sood se paak qarz*, literally, interest-free loan. However, maintaining a linguistic separation between interest and *riba* is a useful practice in understanding what makes certain structures Shari'a compliant or not. Interest is included within *riba*, but *riba* is not reducible to interest alone.

Asset & equity-backed transactions: 'Money cannot beget money' in Islamic economics; transactions must involve a material asset. Otherwise, the "free-floating, amoral power" of money represents a threat to social justice.³⁴ A tangible increase or decrease in assets generates materiality for transactions, thus forcing an endpoint to transactions. Asset or equity-backed transactions rather than cash or debt-backed transactions are necessary to avoid *riba*. Trading money as a commodity—the work of derivatives, for example—allows money to increase through time. Islam

³⁰ Hamoudi 2006: 22

³¹ Vogel and Hayes 1998: 74

³² Khan 1987, Maurer 2005, Wigglesworth 2009.

³³ These verses include:

- Those who gorge themselves on usury behave but as he might behave whom Satan has confounded with his touch; for they say, "Buying and selling is but a kind of usury" - the while God has made buying and selling lawful and usury unlawful. Hence, whoever becomes aware of his Sustainer's admonition, and thereupon desists [from usury], may keep his past gains, and it will be for God to judge him; but as for those who return to it - they are destined for the fire, therein to abide! (2:275)
- You who have attained to faith! Do not gorge yourselves on usury, doubling and re-doubling it - but remain conscious of God, so that you might attain to a happy state; and beware of the fire which awaits those who deny the truth! (3:130-131)

³⁴ Tripp (2006: 5) describes a fear in Islamic economics "that money, detached from the objects which give it value, has a free-floating, amoral power, representing a serious threat to the social order and the ethical community." Islamic economics attempts to "control monetary exchange" by requiring transactions to be tied to material assets.

does recognize the time value of money, but only within contracts that take into account the potential degradation of certain assets over time, e.g. within particular credit sales.³⁵

Haram entities: IBFIs must limit themselves to engagement with *halal*, or permissible activities or goods and avoid *haram*, or forbidden entities such as alcohol, pork, pornography, conventional finance, or gambling. For some, this list also includes weapons manufacturers and entertainment industries. One South Asian Islamic bank recently rejected an investment request for fertilizer for use in tobacco farming, deeming support for tobacco as non-halal.

Maisir and gharar: *Maisir* refers to gambling, specifically games of chance or divination,³⁶ and *gharar* refers to financial transactions embedded in uncertainty.³⁷ Maisir and gharar are avoided in Islamic finance to eliminate the potential for a party to lose or double an initial investment simply due to market fluctuations or other circumstances, as this would constitute a form of *riba* (here, ‘money begetting money’).³⁸ But classical Islam could not have anticipated modern esoteric finance, and participation in futures markets or speculative investments remains subject to scholarly disagreement. In 2009, for example, the chair of AAOIFI’s Shari’a Board declared the vast majority of all sukuk non-Shari’a compliant, creating industry-wide shockwaves.³⁹

It remains unclear how much uncertainty can be borne before legitimate speculation, where inherent risks can be mitigated through information, devolves into mere chance—a gamble on a future outcome.⁴⁰ Practically speaking, risk or speculation cannot be categorically unlawful. Some jurists have specified that since no contract is completely free from uncertainty, ‘minor’ gharar is permitted.⁴¹ Consensus generally exists that ‘major’ gharar, or a fully gharar-based sale (known as *bay’ al-gharar*), is prohibited.

However, contracts with major gharar can be deemed permissible if a certain threshold of necessity is met: if “excessive” costs would result from avoiding gharar, a transaction may be permitted.⁴² *Makharij*, or legal exceptions can be mobilized to prevent detrimental or haram activity that might occur without an intervention. These types of “adaptive mechanisms” are attuned to ‘urf (prevailing standards or customs), *maslaha* (public interest), and *darura* (necessity).⁴³ As a result, determinations of excessive uncertainty remain contested. *Fatawa* (rulings) and guidelines from Shari’a advisory boards, Shari’a courts, and regulatory institutions regularly contradict. Exceptions abound, such as the *salam* contract for purchase of non-material abstract entities, and the *istihsan* contract for purchase of goods before they are manufactured.⁴⁴

‘Interest by another name’: The most persistent critique of IBF by industry insiders and observers alike is whether offerings are ‘truly,’ quantifiably Islamic or thinly Islamic adaptations of conventional, capitalist offerings. In Bangladesh, both the Grameen Bank and IBBL are defined by

³⁵ El Gamal 2006: 50

³⁶ Rosenthal 1975

³⁷ Classic examples from *ahadith* include: “the sale of the fruit of a tree; the sale of flowers before they appear on the plant; the sale of fish caught in one throw of the net; the sale of an unborn camel; the sale of a bird in the air”

³⁸ Iqbal and Molyneux 2005, Jackson-Moore 2009

³⁹ Foster 2009

⁴⁰ Al-Zarqa, in El Gamal 2001: 5

⁴¹ Al-Baji Al-Andalusi, in El Gamal 2006: 59, Hamoudi 2006: 25

⁴² Opinions from three classical jurists in El Gamal 2006: 59

⁴³ Warde 2001

⁴⁴ El Gamal 2001

poverty alleviation commitments. Yet IBBL's 10% service fee is Shari'a compliant, whereas Grameen Bank's higher interest rate is not. Some of the strongest critiques come from within Muslim communities, faulting IBFIs for duping pious but poor, minimally educated Muslims. For these critics, IBF constructs an alternate means of arriving at the same ends as conventional banks, and represents strategic branding to capture a 1.6 billion market of Muslims worldwide.

IBFIs must, of course, successfully compete with conventional institutions for clients, market share, innovation, and positive ratings. IBF service fees and profit-sharing ratios are often pegged to interest rates or other interest-bearing metrics; LIBOR was long a benchmark for IBFIs. In 2011, an "Islamic Interbank Benchmark Rate" was established, but has not been widely adopted. In its standards regarding *takaful* (insurance), one of IBF's international regulatory bodies, the Islamic Financial Services Board, readily acknowledges that it takes "as a starting point" international best practices and regulatory codes. Its goal is to "adapt and reinforce" these standards into modes appropriate for IBF to enable IBF to "stand on a level playing field" with conventional competitors.

Q&A AFTER A CENTRAL BANK LECTURE ON "PRINCIPLES OF ISLAMIC FINANCE": TYPICAL IBF CRITIQUES AND REJOINDERS

(Bangladesh fieldwork, 2010)

ATTENDEE, ON PROFIT-LOSS SHARING: Why should I take the loss for a customer's risk?

LECTURER: It is Shari'a. You must either follow or reject [it]. You are not asking about the other rules of Islam. Why are you not ready to assume the risk? Even in conventional banks, the shareholders can lose.

ATTENDEE, ON SERVICE CHARGES ADDED TO A COMMODITY'S PURCHASE PRICE IN MURABAHA FINANCING: We're just calling [interest] by different names.

LECTURER: No—there is a difference between a halal chicken and a haram chicken. Both are chicken, they look and taste the same, but Muslims can only eat one.* You do not ask why. If you are Muslim, you follow the rules for Muslims.

ATTENDEE: The difference is basically spiritual.

LECTURER: The difference is functional.

*The global halal meat industry reached 1.1 trillion USD in 2013, with Indonesia and Turkey as the first and second largest markets, respectively. (Arab News 2014)

IBF Shari'a compliance officers typically conduct spot audits to assess operational Sharia compliance. According to one former Islamic bank chairman in Bangladesh, this is necessary because "local staff do not fulfill all interest-free operations [...] Lapses happen." For this institution, profits that came in contact with non-Shari'a compliant (e.g. interest-generating) processes are called "doubtful income." This money is diverted to the bank's philanthropic foundation, and not disbursed to investors as Shari'a-compliant income.

Conventional institutions making forays into IBF through Islamic windows, indexes, sukuk, and benchmarks are contentious—but enjoy expanding growth rates.⁴⁵ Shari'a compliance is neither

⁴⁵ Hamoudi 2008, Davies 2012, Arab News 2012

‘true’ nor ‘false’ nor absolute. *Ijtihad* (independent reasoning in light of the Qur’an, Sunnah, and hadith) creates intelligibility between a complex modern financial landscape and Islam.

Shari’a boards: One understudied aspect of IBF is the role is IBFI’s own Shari’a boards, charged with ensuring Shari’a compliance of operations. An exceedingly small pool of scholars is adequately trained in both Shari’a and finance/economics; these individuals are recruited to multiple IBFI boards. There are no disclosure requirements, safeguards against conflicts of interest, common compensation standards, or transparency in vetting and selection. Shari’a advisors or board members can be full-time employees, external volunteers, or serving on a contractual basis. This leads to scenarios where, as one reporter put it, a required fatwa simply goes to the highest bidder.⁴⁶ Decision-making on the boards is similarly non-transparent, leading to industry-wide disagreement about products and services, creating consumer confusion and hampering institutional efficiency and nimbleness. In other cases, Shari’a advisors are theologians or Islamic jurisprudential experts who lack training in capital markets or consumer finance and regulation. This can lead to Shari’a compliant policies that do not promote institutional growth or stability.

FEATURES OF ISLAMIC FINANCE

PROMOTES:

- Social justice, repudiation of self-interest in favor of more equitable resource distribution
- Basing transactions on assets/equity, rather than debt
- Acquiring assets instead of stockpiling money
- Sharing risk, including between the institution and client

PROHIBITIONS OR STRONG INCLINATIONS AGAINST:

- The collection or payment of *riba* (typically interest or usury, but any form of unfounded ‘increase’)
- Engagement with *haram* (forbidden) entities
- Excessive *gharar* (uncertainty), but risk or speculation is not universally unlawful
- *Maisir* (gambling), as probabilities can unfairly disadvantage one party

KEY CHALLENGES:

- Lack of standardized regulatory, accounting, auditing, external ratings, and Shari’a compliance procedures
- Lack of standardized oversight or monitoring of Shari’a board members; conflicts of interests remain unchecked
- Lack of standardized or accredited IBF certification or education programs
- Over-reliance on new Islamic financial contracts and forms to compete with conventional finance, and diversion from social justice goals
- New forms of risk are being created (e.g. new moral hazards regarding intention)
- Most commonly used products tend to have short or medium-duration maturities

⁴⁶ Foster 2009

2.4 Key institutions and governments

BAHRAIN

Accounting and Auditing Organization for Islamic Financial Institutions (see Section 2.5): Established in 1991, AAOIFI is comprised of over 200 member institutions from 40 countries, and is widely considered the Islamic financial standard-bearer. However, uptake of their standards is voluntary, and local scholars, IBFI's in-house Shari'a boards, or government regulations can supersede their recommendations. AAOIFI is unofficially more attuned to the needs of Middle East and North African (MENA) and South Asian IBFIs, as opposed to those in Southeast Asia (particularly Malaysia and Indonesia)—AAOIFI's standards reflect, to an extent, schools of Islamic jurisprudence more common in MENA and South Asia. Sukuk and takaful have commanded the most vigorous attention from AAOIFI in recent years, leaving best practices for Islamic microfinance institutions local and non-standard. AAOIFI offers its own certifications in accountancy and financial management, but these jostle for legitimacy with competing certifications.

Al Baraka Banking Group: Founded in 2002, the Group is one of the world's largest Islamic banking networks offering a range of corporate, retail, and investment facilities via subsidiaries in 12 countries across the Middle East, Africa, and South Asia. Among other milestones, the Group founded the first Islamic bank in Turkey in 1984, offered the first sukuk in Pakistan in October 2014, and plans a 26 million USD South African sukuk offering in 2015. Its Turkish subsidiary, Albaraka Türk, is the largest Islamic bank in Turkey and one of the largest providers of musharaka worldwide. The Group also plans to establish an Islamic bank in Morocco in 2015. In 2014, the World Bank announced a partnership with the Group to undertake a research project examining risk management for profit-loss sharing contracts, particularly musharaka and mudaraba. The Group actively promotes branchless banking and mobile platforms among its subsidiaries.

Islamic International Rating Agency: Opened in 2005, IIRA remains the only banking and capital markets rating agency with a dedicated focus on IBFIs.⁴⁷ Their ratings are less critical for institutions than high marks of conventional agencies such as Standard & Poor's and Moody's.

BANGLADESH

Islami Bank Bangladesh Limited: See Section 3.4, and Case Study, Section 3.5

KUWAIT

Kuwait Finance House: Established in 1977, KFH ranks as the second largest IBFI in the world, with assets over 45 billion USD. It runs numerous subsidiaries across Kuwait, Malaysia, Saudi Arabia, and has an upcoming project in Ecuador.

LEBANON

Union of Arab Banks: Founded in 1974, this is the largest consortium representing the interests of Arab banks, with over 330 members.

⁴⁷ Saleem 2013: 6-10

MALAYSIA: (see Section 3.4) Kuala Lumpur is easily Asia’s Islamic finance capital, due to prolific scholars, product development, and a high concentration of Islamic financial educational institutions and certification programs. While Gulf Cooperation Council (GCC) countries, particularly Saudi Arabia, have the most assets invested in IBF, Malaysian IBFIs are experiencing the most dynamic growth. Malaysia also easily dominates the global sukuk market, raising 14 billion USD in 2014.⁴⁸ In 2013, the Islamic Financial Services Act enabled Malaysia’s central bank create a more favorable regulatory environment for Islamic banks, improving cohesion in the country’s Islamic and conventional banking and finance sectors—changes that benefitted Maybank Islami, in particular.

Islamic Financial Services Board (see Section 2.5): an international regulatory authority based in Kuala Lumpur, the IFSB’s 200-plus membership includes the International Monetary Fund, World Bank, Bank for International Settlements, Islamic Development Bank, Asian Development Bank and the Islamic Corporation for the Development of Private Sector, along with over 150 other global financial institutions. IFSB regulatory and risk management guidelines are largely informed by secular banking guidelines,⁴⁹ with arguably more attention to the particularities of Islamic finance in Asian markets (particularly Malaysia and Indonesia), rather than the unofficial MENA and South Asian focus of the AAOIFI. However, both the IFSB and the AAOIFI have overlapping agendas, and it is common for institutions to seek membership at both.

KINGDOM OF SAUDI ARABIA: KSA, described in one report as an “undisputed leader” of development and humanitarian aid to the MENA region and global Muslim populations more broadly, spent \$90 billion, or 3.7% of its GDP on aid from 1975 to 2005.⁵⁰ More recently, KSA has outspent Western countries in response to recent crises, including 2007 floods in Bangladesh, the 2010 Haitian earthquake, and the 2010 floods in Pakistan. It also provides foundational assistance to multilateral organizations targeting Islamic populations: in 2013, via the national Saudi Fund for Development, KSA provided 30% of the total capital of the OPEC Fund for International Development, 24.5% of the Arab Bank for Economic Development in Africa, 24% of the Arab Fund for Social and Economic Development, 24% of Islamic Development Bank (IsDB), and 10% of the Islamic Solidarity Fund for Development (a branch of the IsDB).⁵¹

KSA’s formidable development assistance is formulated and distributed without a central authority or policy governing the process. The patchwork of NGOs, government-affiliates, public campaigns, private donors, and government bilateral agreements (the preferred mechanism for official assistance⁵²) operate with minimal-to-nonexistent transparency.

Al-Rajhi Bank: Al-Rajhi is the world’s largest Islamic bank controlling over US\$49.2 billion in assets, with the Al-Rajhi family as the wealthiest non-royals in Saudi Arabia. Al-Rajhi was established in 1978 as the Al-Rajhi Trading and Exchange Corporation, renamed Al Rajhi Banking and Investment Corporation in 1987, and rebranded as Al-Rajhi Bank in 2006. In 2012, a US Congressional report linked Al-Rajhi Bank to terrorist financing activity, although implications

⁴⁸ Bloomberg 2014

⁴⁹ Haron and Hock 2007

⁵⁰ Al-Yahya and Fustier 2011: 40

⁵¹ Saudi Fund for Development 2013: 82

⁵² Ibid, 9

from this have arguably been more pronounced in other banks with investments or board members from Al-Rajhi.⁵³



Islamic Development Bank, Jeddah, Saudi Arabia

Islamic Development Bank (see Section 3.4): Founded in 1973, IsDB is the world's largest multilateral, primarily Arab-funded financial institution. IsDB negotiates national, religious, and cultural differences as it provides Shari'a compliant investment funds and develops Islamic financial products to meet the diverse needs of its 56 member countries (many of which have large or majority non-Muslim populations) across Asia, Africa, Europe, and the Middle East. IsDB also provides extensive assistance to Muslim communities in over 70 non-member countries, managed through its Special Assistance Operations. IsDB maintains a low public profile, and up until recently has been deeply centralized. But in recent years, its four regional offices have received greater autonomy for project implementation, and five more "Gateway Offices" are opening.

Member countries contribute through waqf donations of cash or property, rather than annual donations or dues. Major shareholders can be major borrowers, e.g. Turkey, Iran, and Pakistan. IsDB also has significant investments in wealthy GCC countries. IsDB has traditionally invested in large-scale infrastructure projects. Only in the past few years has IsDB tentatively expanded social development work; resources for this remain small and largely grant-based.⁵⁴

SUDAN

Bank of Khartoum: BOK is the largest and longest-running bank in Sudan, although its Islamic financial history is recent: BOK was privatized in 2002 with Dubai Islamic Bank owning a controlling share. In 2008, BOK merged with a year-old Islamic bank established by IsDB, Sharjah Islamic Bank and Abu Dhabi Islamic Bank. Since then, BOK has earned numerous awards as a leading African Islamic bank.

UNITED ARAB EMIRATES

Dubai Islamic Bank: DIB, launched in 1975, is the flagship institution of the modern IBF industry. It continues to be an industry leader, and in 2014 was the third largest Islamic bank, with assets of about 33.7 billion USD.⁵⁵ Dubai has particularly robust competition among IBFIs, and part of

⁵³ In an August 2012 press release, IBBL vociferously disagreed with a U.S. Congressional assessment of them as a bank linked to terrorist financing activity, due to their engagement with Al-Rajhi (at that time, institutions and individuals associated with Al-Rajhi held a 27.51% share of IBBL). This association is also a cause of frequent criticism from Bangladesh's current secular government, as evidence of Saudi-based foreign interference in Bangladeshi affairs.

⁵⁴ Many thanks to the numerous individuals at the Islamic Development Bank who generously gave their time for interviews in Jeddah in March 2015.

⁵⁵ Kassem 2015

DIB's strategy in recent years is greater focus on retail banking operations. In 2014, this strategy included acquisition of Barclays retail banking operations in Dubai in a bid to gain market share among expatriate non-Muslims⁵⁶ — a reversal of the usual trend of conventional institutions opening up Islamic windows.

2.5 Regulatory and legal challenges

Risk management: Risk assumes a unique ethical tenor in Islamic finance, where clients and institutions are presumed bound by shared values. However, IBFIs face new, emergent risks. In profit-loss sharing contracts (e.g. *mudaraba* and *musharaka*), the lack of repercussions for defaulting borrowers can incentivize risky behavior, but scholars remain inconclusive about enforcement mechanisms. Requiring borrowers to provide collateral is not necessarily Shari'a compliant, as the future value of the collateral may shift. Profit-loss sharing also creates a moral hazard for entrepreneurs to report lower profits and exaggerate losses—particularly in countries with endemic corruption and weak monitoring and enforcement mechanisms. Real estate and construction are notorious for easily falsified, non-transparent accounting, to the extent that some Islamic banks in some countries avoid these sectors.⁵⁷

Accordingly, clients possessing adequately “Islamic” intent and strategies for institutional assessment of intent can become a preoccupation. Absent formal mechanisms for correcting information asymmetries related to client intent, some banks provide the most lucrative financing to clients they personally trust as an *ad hoc* risk management strategy. Of course, this unfairly disadvantages less-known individuals, corporations, or organizations. Ultimately, profit-loss sharing arrangements, particularly *musharaka*, are underused. The problem of crafting contracts that “reduce the inducement to cheat through a reward/punishment mechanism”⁵⁸ highlights a tension within Islamic finance—it aspires toward social justice, while planning for the contingencies of greed.⁵⁹

Regulation, taxation, and accounting (see also Section 2.4): Conventional regulations and ratings agencies alongside Shari'a compliance doubly bind IBFIs. Countries home to IBFIs and IMFIs might have minimal (e.g. Bangladesh) or robust (e.g. Pakistan) regulations or accounting standards tailored to Islamic institutions. An international regulatory infrastructure providing standardized procedures and oversight mechanisms was absent in the Persian Gulf oil-funded IBF boom decade of the 1980s. The Islamic Financial Services Board (IFSB, established in 2003 in Kuala Lumpur), and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI, established in 1991 in Bahrain), were created to fill this void. Membership and adherence to their standards remains optional. These disparate, emerging regulatory structures do not have specific provisions for microfinance, making IMFIs structures and practices highly variable.

⁵⁶ The Banker 2014

⁵⁷ El-Hawary et al 2004 (World Bank), Iqbal and Molyneux 2005: 145

⁵⁸ Iqbal and Molyneux 2005: 145

⁵⁹ Risk management can lead to a trade-off with Shari'a-compliance: in the early years of mandatory Islamic banking in Pakistan from 1985 to 1991, banks offered *musharaka*, but with declining or static profits. Pushed by State Bank of Pakistan (SBP) standards, banks gradually adopted a more risk-averse reliance on mark-up *murabaha* contracts to increase consumer uptake and bolster capital reserves.⁵⁹ However, these contracts were later deemed non-Shari'a compliant by Pakistan's Federal Shariat Court, veering too close to conventional interest-bearing loans.

Sukuk, takaful, and ijara have commanded most of the attention of IFSB and AAOIFI in recent years, as these represent the most theologically contentious and dynamic growth areas (by November 2014, sukuk issuances totaled 110.9 billion USD). Also in November 2014, AAOIFI announced plans to revise standards concerning murabaha, the most common product in Islamic microfinance.⁶⁰ Murabaha has been the subject of multiple conferences and competitions calling for innovation amidst provider concern in stagnation and minimal client benefit.⁶¹

A range of taxation issues specific to the structure of Islamic financial contracts and products can facilitate or impede the rise of a national IBF sector. Islamic mortgages, cross-border payments, the treatment of non-interest mark-up fees, and the applicability of value-added tax or goods and services tax to the assets anchoring transactions all require tax structures and provisions that differ from the conventional equivalents. Without a tax regime specifically suited to IBF, IBFs can face some degree of double taxation and/or indirect tax.⁶²

Innovation in Shari'a compliant accounting software and management information systems has also historically lagged behind industry demand, although this has been changing in recent years. There is no institutional or geographic hub for IT innovation in IBF; efforts remain scattered.

IBF accountancy, auditing, and risk management professionals also lack a set of common certifications or credentials, and there is no accreditation body for the array of non-profit and for-profit educational institutions and programs. This crowded field includes degrees and certifications administered by Durham University (UK), the Qatar Foundation, King Abdulaziz University (Saudi Arabia), AAOIFI, International Centre for Education in Islamic Finance (Malaysia), Al Huda CIBE (Pakistan), and the online program Ethica. Women are rare in the global IBF industry. This issue has not yet received sustained attention from prominent institutions or industry leaders.

3 ISLAMIC MICROFINANCE

3.1 Introduction

A disproportionately high rate of global poverty is concentrated in Muslim communities; over half a billion individuals live on under 2 USD per day in Indonesia, India, Pakistan, Bangladesh, Egypt, and Nigeria alone,⁶³ many of whom struggle to access sufficient liquidity, manage savings, and transfer and receive money. Islamic microfinance is often described as a valuable and novel tool for development and poverty alleviation. In the past five years, Islamic microfinance has been the subject of several international conferences, studies, and workshops sponsored by IsDB, AAOIFI, and Harvard Islamic Finance Project, among others.

⁶⁰ Vizcaino 2014

⁶¹ In 2014, the theme for CGAP's third Islamic Microfinance Challenge was "Beyond Murabaha."

⁶² Amin et al 2013, PwC 2012

⁶³ Obaidullah and Khan 2008

Market surveys by financial institutions and other reports on Islamic microfinance consistently argue that poor Muslims in particular “[show] significant rates of rejection of traditional microloans,”⁶⁴ and that Shari’a-compliant financing can promote the financial inclusion of populations who are self-excluding from conventional financing options.⁶⁵ Perhaps the most frequently cited statistics regarding demand-side market potential for Islamic microfinance come from a 2008 CGAP paper suggesting that up to 40% of potential microfinance clients reject non-Shari’a compliant loans.⁶⁶

These statistics and subsequent surveys would benefit from the inclusion of critical survey metadata including: terms of non-Islamic loans that were rejected, other local microfinance options, and what financing market was targeted (e.g. new entrepreneurs, preexisting business owners seeking expansion, or those needing “social” financing for health, education, marriage, sanitation, etc.).

Randomized control trials or surveys publishing such information are not yet available, and it does a disservice to the poor to not acknowledge they can be strategic in their financial choices. For example, local staff for IRW’s Islamic microfinance program in Bosnia noted, “Some borrowers may have been inclined to exaggerate the importance of religion,” and applied for financing “for financial rather than religious reasons.”⁶⁷

A broad demand-side argument also risks grouping together countries with different gender practices and political and cultural environments. For example, Pakistan has a successful and well-regulated microfinance industry—but it is concentrated in the Punjab and Sindh provinces for political, security, and feasibility reasons. In the vast, underserved Balochistan and Khyber Pakhtunkhwa provinces, microfinance providers have either scaled back or ended operations. Providers and their reputations also matter: contentious national government involvement in tribal areas or against separatist groups has led to suspicion of government-related activities. Histories of unsuccessful foreign development aid and military activity have led to distrust of large multinational and/or Western organizations. By contrast, Islamic NGOs such as Islamic Relief, Muslim Aid, IsDB, Red Crescent, and small, village banks find greater receptivity, and might be more suitable Islamic microfinance partners than a large bank, NGO, or government fund.



Islamic microfinance field officer collecting weekly repayments (Chittagong Division, Bangladesh, 2014)

⁶⁴ El-Gamal, El-Komi, Karlan, and Osman 2012: 2

⁶⁵ TechNavio 2014; Kroessin 2012: 44-46; El-Gamal et al 2012; Khan and Phillips 2010

⁶⁶ Karim, Tarazai, Reille (CGAP) 2008. Survey questions and methodologies were not available for analysis for this report, and preferences may have shifted in certain markets in past 7-8 years since they were conducted.

⁶⁷ Khan and Phillips 2010: 7.

In my fieldwork in Bangladesh and Pakistan, I consistently observed poor clients using Islamic microfinance alongside other non-Islamic, interest-bearing resources. In one conservative, primarily Muslim Bangladeshi slum, many Islamic microfinance clients kept gold jewelry in bond at jewelry shops with high interest rates. The advantage was flexibility: women could drop their off gold at any time in a private transaction, make payments when they had spare cash, and repeat the process an unlimited number of times without a waiting period, home evaluation visits, or public/group repayment. Receiving the money in cash was another advantage; Islamic microfinancing is typically disbursed toward the purchase of assets and not available for discretionary spending. The jewelry, typically received by women upon marriage, became a renewable liquidity source. Studies indicate that perhaps the most critical service for the poor is safekeeping money to enable accumulation of a usefully large sum.⁶⁸ Placing the gold jewelry at a shop was safer than keeping it at home (theft is a concern) and cheaper than a local bank locker.

The women freely acknowledged interest as the downside of their transactions, both because of the extra cost and because they knew it was forbidden in Islam. However, *the harm of engaging with interest was neutralized by financial need and the advantages of the bond when compared to options for safekeeping, quick access to liquidity, and a flexible repayment schedule.*

Research outcomes on Islamic microfinance demand will also be affected by the fact that financial needs, preferences, and behaviors can shift according to seasons or calendars. In rural areas sustained by agriculture, animal husbandry, or aquaculture, financial management strategies (e.g. an exclusive preference for Islamic microfinance) can differ during the high versus the low/fallow seasons. Marriages are often concentrated during wedding seasons. *Ramadan*, a month of fasting and prayer on the Islamic calendar, and its culminating *Eid-ul-Fitr* holiday typically mark a period of large household expenditure due to social obligations of gift giving and shared meals.

While further research is needed to establish more detailed metrics for demand in different countries, the overall strength of the demand side is not in question—and it will grow as Islamic financing options become more visible and available. However, the viability, scalability, and success of an Islamic microfinance operation cannot be assured simply by the fact of consumer demand—a valuable lesson from numerous critiques of conventional microfinance. The goal is not just for Islamic microfinance to exist, but to thrive. *Whether clients reject non-Islamic providers will likely be linked to the terms of the funding, the provider's local reputation, and the funding needs and the socioeconomic status of the client—not just client religiosity.*

3.2 Structural comparisons with conventional microfinance

Terminologies and nomenclature: IBFIs and IMFIs typically use “financing” instead of “loan” in order to be fully Shari’a compliant. “Loan” denotes the presence of interest, but Islamic offerings are sales or partnerships. However, different institutions approach this issue with varying sensitivity, depending on corporate culture and local languages. In Bangla, *riin* and *kudroriin* (loan and microloan, respectively) are used by conventional and Islamic (micro)finance institutions. In Urdu, *qarza* (loan) is similarly used.

⁶⁸ Banerjee and Duflo 2011: 193

Research suggests that the growth of Islamic consumer banking may be hindered by confusion engendered by the Arabic nomenclature used by IBFIs.⁶⁹ However, abandoning Arabic terms to spur growth is contentious. As one former managing director of a Bangladeshi Islamic bank explained, the Arabic will be assimilated over time into religious and financial vocabularies: “Translation won’t capture the full nuances. In time everyone will know what the terms mean. This will bring unity to the whole *umma* [Islamic community].” Some industry observers, such as Ernst & Young, support re-branding Islamic banking and finance as “participation banking” for more inclusive market appeal.⁷⁰ During interviews at IsDB, officials dismissed a one-size-fits all approach and explained that local markets and preferences should determine whether Islamic microfinance projects are marketed as “Islamic finance” or “participatory finance.”

ISLAMIC RELIEF WORLDWIDE ON THE PITFALLS OF INCLUDING ISLAMIC MICROFINANCE ALONGSIDE OTHER CHARITABLE ACTIVITIES: (A.A. Khan 2008: 24)

- *“There is always a danger that borrowers will see loans as something that does not need to be repaid, especially if the same organisation is also implementing other projects that involve donations.”*
- *“Successfully combining a microfinance programme with other essentially humanitarian work within the same country programme is a difficult task and something that perhaps should not always be attempted.”*

Client education, misunderstandings, and market distortions: Just as the global IBF industry struggles with a lack of scholars equally educated in theology and finance who can craft more uniform regulatory and accounting standards, so are microfinance clients often similarly unfamiliar with what makes Islamic microfinance Islamic, especially beyond the absence of *riba*.

My ethnographic interviews with Islamic microfinance clients in Rawalpindi, Pakistan reflected frequent misunderstandings about the Islamic-ness of their program. Some clients mistook the service fee for interest, others objected to the need to receive materials instead of cash, and others were confused about why some products carried a service fee (*murabaha*), while others did not (*qard hassan*). In rural or tightly-knit communities where word-of-mouth is a valuable source of information for prospective clients, IMFIs offering an array of products can paradoxically harm their reputations for fairness or introduce market distortions. Some clients were upset because their expectations had become skewed; they expected to receive *qard hassan* for all financing needs, even though it was earmarked for certain charitable purposes only (education, latrine construction, etc.). Client education is critical to manage expectations and ensure clients’ Shari’a compliant usage of their financing.

Impacts of institutionalized compassion: For IMFIs, Shari’a compliance is the paramount duty; the “Islam” of the enterprise resides in faithful attention to Shari’a. By contrast, poor clients have a more complex relationship to the Islam of Islamic microfinance. During fieldwork in Bangladesh and Pakistan, the vast majority of the clients knew that *riba*/interest (*shudh* in Bangla, *sood* in Urdu) was haram, and did not want to take it. But access to liquidity was more important, and clients managed complex debt portfolios and availed multiple liquidity sources, some of

⁶⁹ Khan, Noman, Hassan, and Shahid 2007

⁷⁰ Ernst & Young 2014: 6

which had formal schedules, payout terms, and restrictions.⁷¹ Clients often held multiple microfinance accounts, a fact they often concealed from providers.

For clients, the economic benefits of their local Islamic microfinance program (low fees, suitable payment structures, quick access to funds) were more important than the Sunnah principle of riba-free financing because the economic benefits were, in and of themselves, seen as expressions of Islamic compassion toward the poor (see chart below). Respect and compassion shown to clients during their encounter with IMF staff was, for the clients, Islam manifest.

Respect and compassion for poor clients becomes particularly critical regarding late payments. *Microfinance is unsustainable without acceptance of periodically late payments—particularly for weekly rather than monthly repayment schemes. Official acceptance of late payments would set a negative precedent, but providers tacitly accept them in order to secure their typically high repayment statistics.*

Conventional MFIs have been scrutinized for subjecting clients to harassment, house-breaking, asset seizures, or entrapment in expanding debt cycles when clients feel pressured to take on new debts to pay down outstanding loans. *The ethical orientation of IMFs, by contrast, tends to motivate a more compassionate approach to late repayments, working with clients to informally readjust payment schedules.* Accordingly, the microfinance ‘Portfolio at risk’ 30-day benchmark indicator is less reliable than a 60-day or 90-day indicator, to accommodate institutions with formal or informal leeway for late payments.

WHAT IS IMPORTANT TO YOU IN A MFI? WHY DID YOU CHOOSE ISLAMIC MICROFINANCE OVER OTHER NON-ISLAMIC PROGRAMS? (From 50 in-depth interviewee responses, Pakistan fieldwork, 2013)

- **More affordable / better structure (n=30)**
 - The lack of extra installments / other organizations charge interest, or want you to place jewelry or property papers with them. (n=17)
 - Low formalities / loans are given faster than at other organizations / loans are larger than at other organizations (n=10)
 - Good monthly installment size and repayment period (n=2)
 - They gave double the loan amount of others (n=1)
- **Respect / compassion (n=8)**
 - IR doesn't bother clients / Professional, good conduct / Their attitude allows you to maintain your self-esteem
- **My relative was a beneficiary and gave a good recommendation (n=5)**
- **The name is Islamic / I follow the Sunnah (n=4)**

This also explains the appeal of IMFs to non-Muslims: IMFs in Pakistan count Christians as clients, and Hindus and Buddhists in Bangladesh. *For members of religious minorities with whom I spoke, IMFs' emphasis on compassion, respect, and dignity toward the poor was more*

⁷¹ *Portfolios of the Poor* (Collins et al 2009) helped establish the field of “poor economics” by explaining how financial inflows and outflows are continuously subject to diversion, bundling, or forestalling, all in service to managing varied needs with predictable liquidity shortfalls.

compelling and visible than Islam. But most importantly, service fees were lower than interest rates charged by non-Islamic institutions.

However, compassion for late payments transferred pressure to guarantee full repayment onto field officers. Combined with chronic overwork and low salaries, this poses risks to officer retention and to the value of the client-officer interaction. In both Bangladesh and Pakistan, the amount of time and the quality of the interaction between officers and clients was directly linked to the client's overall Islamic microfinance experience. Particularly in rural areas, female clients often cannot read, have irregular television access due to power outages, and might not leave their households or immediate communities unaccompanied. The “high-touch” labor of field officer home visits can potentially turn officers into a valuable source of information and advice.

The ethical orientation of IMFIs also raises unique considerations in cases of client death or permanent disability. Islamic Relief Pakistan and IBBL in Bangladesh both absorb outstanding loans. For FirstMicroFinance Bank of Pakistan, life insurance is mandatory and packaged into client loans, with costs added into the processing fee. In case of death or permanent disability, an insurance company pays off an outstanding loan and the family receives 10,000 PKR to cope with the loss of an earning family member.

The need for fungible funds: The poor meet expenses by reliance on a multiplicity of sources, which imperils the Shari’a compliance of funds obtained from Islamic microfinance. The role of contracts and asset-based transactions in Islamic finance means that money is not fungible. The common Islamic microfinance products of bai-muajjal and murabaha require that money given toward the purchase of an asset be used exclusively for that asset. In this sense, Islamic microfinance places more constraints on the daily economic decision-making of the poor, who will often “[show] creativity in devising arrangements to fit their circumstances, taking a standard product....but bending it to make it work for other ends.”⁷²

Development of an all-purpose investment fund not tied to the purchase of an asset is a central challenge for Islamic microfinance. One promising new model was recently tested against a traditional Grameen Bank-style collective in Egypt. In this model, researchers helped communities set up a typical ROSCA (rotating savings and credit association), in which each member provides a fixed sum to the group on a predetermined schedule, e.g. each month. Each member then receives the full month’s amount once per cycle. For a small fee, a local bank provided insurance against member default, which encouraged otherwise cautious members to join. This riba-free means of accessing a usefully large sum of money had better uptake than the Grameen control option.⁷³

Institutional status, scalability, and self-sufficiency: While its low fees can make Islamic microfinance more desirable than conventional microfinance, it is rarely profitable. Providers struggle to develop sustainable funding mechanisms. Should programs be financially self-sufficient through fees and the scalable provision of funds? Or should programs offer more generous, impact-driven loans via long-term subsidization by external donors or in-house coffers? If the latter, subsidization sources should be Shari’a compliant, making charitable donors and Islamic banking and finance institutions ideal partners.

⁷² Collins et al 2010

⁷³ El-Gamal et al. 2012

Despite recent enthusiasm surrounding Islamic microfinance, providers are not awash in funds; NGOs have reported some difficulty in persuading donors. Limited resources tend to focus on improving officer-to-client ratios, client selection, and monitoring and evaluation. ***One way for IMFI to expand into public funding while avoiding non-Islamic capital markets debt financing and commercial loans is by accessing national zakat or waqf funds*** – forms of charitable giving in Islam (see Section 2.2). For example, billions of PKR are received via donation boxes at waqf properties in Pakistan annually, in excess of what is needed for property upkeep.⁷⁴ Innovative partnerships with religious organizations can also be pursued: Akhuwat, the market leader for Islamic microfinance in Pakistan, keeps its administrative costs low by basing its lending operations out of local mosques. Partnerships, whereby corporate zakat of IBFIs flows to IMFI, are another option that can be facilitated by multilateral bodies such as IsDB.



A field officer counts weekly microfinance repayments, often given in denominations of 5, 10, and 20 BDT notes (5 BDT equal about 6 USD cents). (Chittagong Division, Bangladesh, 2014)

3.3 Key countries and institutions

BANGLADESH

Islami Bank Bangladesh Limited: See Case Study, Section 3.5

INDONESIA (See Section 5.2)

Baitul Maal Wat Tamwil (BMT, literally “Social and Business House”): BMT is the largest, oldest, and most prominent IMFI in Indonesia, with the same local cooperative model common to Indonesia’s conventional consumer finance banks. Despite having 2.2 million members, total BMT holdings are small, with 550 branches and cumulative balance sheet assets of 800 million USD.⁷⁵ Streams of charitable funds (e.g. waqf, zakat, and sadaqat) are channeled into a stream for “social” (non-productive) financing purposes. Members’ savings provide the liquidity needed for productive financing for micro and SME clients.

MALAYSIA (See Section 2.4)

Amanan Ikhtiar Malaysia: This Islamic microfinance institution was established in 1987, and is currently Malaysia’s largest microfinance provider. The national prevalence of microfinance is low; a little over 300,000 households have received financing from AIM, which focuses on Shari’a compliant entrepreneurial loans and insurance.

⁷⁴ Kazim and Hyder 2012

⁷⁵ PBMT 2015

PAKISTAN

Akhuwat: Akhuwat is the IMF market leader in Pakistan, but financing approval typically takes about a month due to their popularity—a significant drawback, as clients often need money urgently. Its 343 branches are concentrated in Punjab province, with a small presence in the more difficult-to-access Khyber Pakhtunkhwa and Balochistan provinces. Akhuwat is entirely funded through charitable donations, making operational sustainability a non-issue. Costs are further kept down by meeting with clients in local mosques. It only offers qard hassan with different amounts, repayment schedules, and eligibility tailored to meet a range of beneficiary needs.⁷⁶

1. *Family Enterprise* loans comprise 91% of Akhuwat’s loan portfolio, and are used to establish or expand new or existing businesses. Loan sizes range from 10,000 to 30,000 PKR, with initial loans available for up to 15,000.
2. *Liberation* loans are for repayment of moneylender loans. Up to 50,000 PKR is available; a committee reviews requests for larger loans.
3. *Education* loans are available for up to 25,000 PKR.
4. *Health* loans for necessary health care; from 10,000 to 20,000 PKR.
5. *Emergency* loans processed within 2-3 days for crises in business, health care, motor vehicle/machinery repair, veterinary expenses, admissions fees, etc. These loans range from 5,000 to 10,000 PKR, are repayable over one year, and may be used alongside other loans.
6. *Housing* loans are available from 30,000 to 70, 000 PKR, to be repaid within two years.
7. *Marriage* loans are available up to 20,000 PKR.

Additionally, Akhuwat’s Mutual Support Fund gives clients the option to pay 1% of their financing as insurance (loans below 4,000 are exempt). In case of client death or permanent disability, the remaining repayments are waived, and the family receives an additional 5,000 PKR.

Al Huda Center for Islamic Banking Excellence (Al Huda CIBE): This Lahore-based firm has established itself as a vocal advocate for Islamic microfinance, particularly in Pakistan. As a Shari’a compliance consultancy and trainer, Al Huda offers workshops across South Asian and MENA. In 2014, Al Huda CIBE announced it would open an office in Uganda to help develop Africa’s small Islamic microfinance industry.

Wasil Foundation: The winner of CGAP’s 2014 Islamic Microfinance Challenge for proposing an “Agricultural Financing Package” for smallholder farmers. This package features salam (also referred to as bai-salam, salam is an investment vehicle allowing for advance payment of goods), and ijara (leasing) products.

SAUDI ARABIA

Islamic Development Bank (See also Section 2.4): For nearly the past 20 years, IsDB continues to be at the forefront of the international development of Islamic microfinance through development of national Islamic microfinance funds, regulatory engagement, product creation, and investment in programs. An early proponent of the world’s first large-scale Islamic microfinance project, the IBBL’s Rural Development Scheme, IsDB understood IBBL as a model for other countries,⁷⁷ and helped arrange IBBL Islamic microfinance trainings to Nigerian and Sri Lankan delegations.

⁷⁶ Akhuwat 2014

⁷⁷ Obaidullah 2008

Today's IsDB's Islamic Financial Services Department seeks to develop enabling environments for the Islamic microfinance sector through technical assistance to regulators, capital markets authorities, and governments. The Access to Finance Team, housed within the Agriculture Department, funds an array of Islamic microfinance projects across the globe, with particular attention to solutions for reducing the high cost of microfinance and promoting financial sustainability for programs over-reliant on grants and/or with high financing costs. Another priority is developing programs with multiple applications (e.g. health and microinsurance) beyond straightforward microcredit. The Islamic Research and Training Institution maintains a robust research and evaluation agenda, often in collaboration with the World Bank, CGAP, universities, and other institutions.

YEMEN

Al Amal Microfinance Bank: Founded in 2008, Al-Amal was one of the first Islamic microfinance institutions in MENA. Al Amal won CGAP's Islamic Microfinance Challenge 2010 for proposing an ijara (leasing) product, funded through the bank's own Shari'a compliant investments.

3.4 Islamic (micro)financial products and services

Products and contracts most commonly used in Islamic (micro)finance include:

Bai Salam / Salam: This investment vehicle allows for the advance payment of goods. This is particularly useful for agricultural inputs, to ensure that a shortage of cash will not derail production later on. Bai salam is differentiated between bai muajjal and murabaha because the assets being purchased do not yet exist.

Bai Muajjal: A credit sale utilizing a contract to establish deferred payment terms between a buyer and a seller. The contract sets both a fixed price and singular payment date or installment payment dates. Fees are not disclosed separately, but are rolled into the price quoted to customers. Even if there is a purchase of a good at some point in time, if the good is not bought and delivered to the client per the original terms of the contract, then the transaction will not be Shari'a-compliant. Monitoring & evaluation is required to ensure Shari'a compliance, but is often prohibitively expensive.

Ijarah: A leasing contract whereby a financier buys a productive asset on behalf of a client, and then leases it out to the client in exchange for regular repayments. The financier maintains liability for the asset throughout.

Istisna: A payment contract for a made-to-order asset with all materials/inputs provided by the manufacturer. A delivery date does not have to be set in advance, nor does full payment necessarily need to precede manufacture. This tends to be a longer-term contract suitable for infrastructure projects, power development, or other types of construction, whereby installment payments can be tied to construction progress.

Mudaraba: An equity investment between a financier (*mudarib*) and an entrepreneur who share profits according to a predetermined ratio. Losses are borne by the financier who supplied the capital; the entrepreneur bears the loss of his or her time and labor.

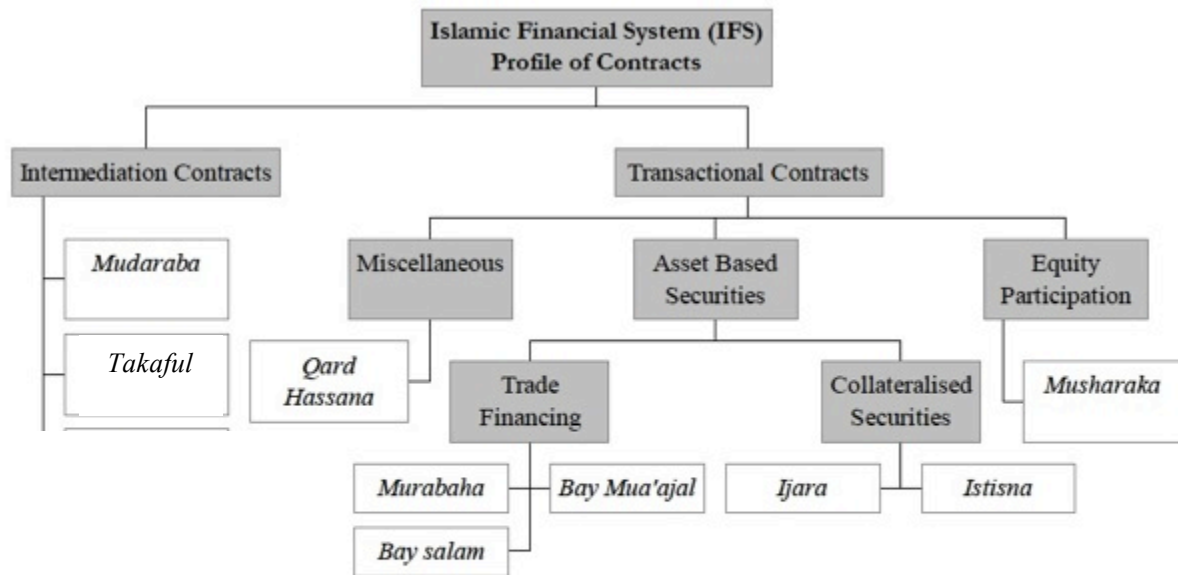
Murabaha: A “mark-up” or “cost-plus” sales contract in which the bank’s fee/profit is added to the purchase price of a good and the client pays in installments toward the single, non-disaggregated price. An industry-wide overreliance on murabaha is widely acknowledged,⁷⁸ fueling criticism of the IBF industry as only nominally Islamic, as the mark-up fee is seen as analogous to interest. For taxation purposes however, the distinct between fees versus interest can become critical (see Section 2.5). The bank’s offer of murabaha and the client’s acceptance of it must be two distinct contracts signed by both parties, rather than one general agreement, with the offer contract being signed before the good is purchased. This document must also include a detailed description of the good, and all dated invoices must be supplied.

Murabaha with an “agency agreement”: This refers to situations where the client or a third party is deputized to make a purchase on behalf of the institution, due to limitations in the institution’s capacity or specific knowledge of good/market. Transport costs and liabilities are borne by the institution. Only after the institution is presented with an invoice or other proof of purchase does ownership of the purchased item officially transfer to the client.

Among IMFI, overworked and understaffed NGOs with limited budgets might not seek out multiple price quotes for assets they intend to purchase, and so regularly purchase assets above their market cost. This can distort local markets and cause IMFI to spend unduly high prices, the costs of which will then be borne by clients. Microfinance murabaha also poses logistical challenges, especially in rural and/or insecure areas. Staff buying agents regularly travelling with large sums of cash in order to make client purchases are exposed to security risks. Debit cards, mobile money transfer, and shop billings are often rejected by vendors because they cannot process them or because these formal, documented methods add tax to transactions. Both of these challenges would benefit from digital interventions.

Musharaka: An equity investment similar to mudaraba except for differences in the sharing of profits and losses and responsibility for the initial capital. Musharaka is difficult to implement at the microfinance and even SME level because the transparent and standardized client accounting practices necessary to monitor profits and losses are often rare or unevenly developed skill sets. For regular consumer and commercial financing, the risk of corruption, deliberate overstating of losses and/or underreporting of profits dissuades widespread use of musharaka. The information asymmetries and amount of monitoring and evaluation needed is too labor intensive for many institutions. As a result, despite the risk-sharing ethos of musharaka embodying central ideas of Islamic economics, this contract remains underdeveloped and underused.

⁷⁸ Kroessin 2012



Adapted from: El-Hawary, Grais, and Iqbal. 2004

Qard hassan (quarz-e-hassna, quard, quard e hasana): An interest free loan, often disbursed for welfare or charitable purposes, mentioned specifically in the Qur'an (57:11). Suitable use of qard hassan depends on the institution: some restrict it to education and health care; Akhuwat in Pakistan provides qard hassan for a range of needs, including marriages, emergencies, house building/purchase, and to pay down existing loans. The IBBL in Bangladesh restricts it to collective rather than individual benefit: group microfinance collectives can use qard hassan to build a community latrine or tube-well for groundwater access. Institutions are divided on providing financing for weddings (often a major family expense), particularly for orphans, due to different views on appropriate wedding expenditures. Scholars are divided as to whether qard hassan may include fees related strictly to the cost of its disbursement (excluding overhead costs), or whether it must remain fee-free.

Takaful: Takaful encompasses several forms of Islamic insurance, referring broadly to a group of participants who agree to support one another jointly for losses arising from specified risks, motivated by the principle of *ta'awun*, or mutual assistance.⁷⁹ A "takaful operator" (the company or institution) organizes this group. A participant contributes a sum of money (akin to a premium) into a common fund as insurance against specified loss or damage. Takaful underwriting is thus undertaken on a mutual basis. Money in the common pool held in reserve is invested (according to Shari'a); profits and losses are distributed between participants and the takaful operator according to the type of takaful model.⁸⁰

⁷⁹ "Help one another in goodness and piety, and do not help one another in sin and aggression" (Al Qur'an 5:2)

⁸⁰ Islamic Financial Services Board 2009

3.5 Case study: Islami Bank Bangladesh Limited

IBBL is a groundbreaking institution both for its status as the first and largest formal Islamic microfinance provider, and because it has successfully integrated a poverty-alleviation platform into regular commercial banking operations, becoming the biggest private sector bank in Bangladesh in the process. IBBL has turned small individual transactions into profit by leveraging scale, particularly through the millions of Bangladeshis working overseas who remitted 3.69 billion USD back to Bangladesh in 2013 through IBBL. After government-run banks, IBBL is the third largest processor of remittances, with 26.7% market share.⁸¹

In 2013-2014, there were an estimated 38 million Islamic banking customers in the world (excluding Islamic microfinance).⁸² In 2013, over 8.5 million of those customers belonged to IBBL.⁸³



An Islamic microfinance collective gathers for its weekly repayment meeting (Chittagong Division, Bangladesh, 2010)

The Islamic Development Bank and other GCC-based institutions own 66% of IBBL. According to IBBL staff, foreign investors and board members play a minimal role in bank operations and strategy, insisting that the bank is, first and foremost, a Bangladeshi institution. However, these foreign associations can be contentious for the current, secular government (See Section 5.1)

IBBL links “welfare oriented” banking with regular commercial operations in its mission statement, positioning the IBBL as an exceptional institution within global Islamic finance:

“To establish Islamic Banking through the introduction of a welfare oriented banking system and also ensure equity and justice in all economic activities, achieve balanced growth and equitable development through diversified investment operations particularly in the priority sectors and less developed areas of the country. To encourage the socio-economic development and financial services to the low-income community particularly in the rural areas.”

Of the IBBL’s 286 branches, two-thirds are located outside the main urban centers,⁸⁴ making IBBL available to rural and small town customers. IBBL enjoys a popular reputation as the bank with the least paperwork, the simplest procedures especially for those who cannot read or write, and a respectful environment most hospitable to poor clients. This latter point is not inconsequential;

⁸¹ Islami Bank Bangladesh Limited 2014: 17-20

⁸² Ernst & Young 2014: 8

⁸³ Islami Bank Bangladesh Limited 2014: 39

⁸⁴ Ibid: 12

disrespect, harassment, or discomfort experienced by the poor in other banks can deter ongoing engagement with formal finance.

A cornerstone of IBBL's mission is the Rural Development Scheme (RDS), an Islamic microfinance program established in 1995. The program has consistently operated at a loss for IBBL. In 2014, officials noted during our interviews that RDS provides IBBL with 4% of its income but consumes 21% of its human resources. RDS is separate from IBBL's philanthropic Islami Bank Foundation and CSR programs, and does not receive funds from IBBL's annual zakat contribution. Local branch officers and high-ranking officials alike pride themselves on the program's endurance and expansion over the past 20 years despite its unprofitability. It indicates, I was repeatedly told, the depth of the IBBL's commitment to Islam and social justice over profits alone.

A complementary Urban Poor Development Scheme (UPDS) was launched in 2012, offering the same Islamic financing and savings facilities as RDS to urban clientele. In 2013, out of IBBL's 286 branches, 209 operate RDS and UPDS programs, dispensing services to 816,274 members in 17,104 villages – a 20% growth in membership from 2012.⁸⁵ Even then, current operations are insufficient to meet customer demand. IBBL collects a 10% flat annual rate of return, although this can be reduced by 2.5% for long-term members who consistently pay on time—a more attractive rate than the 11% flat interest rate on income-generating loans charged by the Grameen Bank.

Both programs require members to open *mudaraba* savings accounts, and most commonly offer small business investment through *bai-muajjal*, hire purchase under *shirkatul melk* (a form of *ijara*), and less frequently through *musharaka* and *bai-salam*. *Qard hassan* is offered on an *ad hoc* basis for constructing latrines or tube wells for underground water access.

Each microfinance collective is comprised of 10-40 clients subdivided into two to eight groups of five members each, a model borrowed from the Grameen Bank, whereby group members bear liability for each other's weekly repayments. Unlike Grameen, however, IBBL bases its group liability model on a "Group Approach" in accordance with Qur'anic guidance. As program materials explain, "Allah loves those 'who conduct their affairs by mutual consultation' (Al-Qur'an 42:38)."⁸⁶ Field officers assign the groups, which can be a source of tension due to a lack of privacy or placement with someone disliked or distrusted.⁸⁷ Collectives must be located within 10 kilometers of an IBBL branch to keep the branch reachable for clients and minimize field officers' travel times to the collectives.

Unlike Grameen, RDS does not provide access to microfinance for the poorest Bangladeshis. A steady stream of income or land ownership up to 0.5 acres is a baseline requirement for membership. The decision to limit RDS clientele to a more financially solvent poor demographic supports a key goal of the program: client transition into a robust Small Medium Enterprise (SME) investment program.

⁸⁵ Ibid: 49-50

⁸⁶ Islami Bank Bangladesh Limited 2006: 8-9

⁸⁷ The only discord I observed in the context of non-Muslims using Islamic microfinance was linked to the group model: a Buddhist family in a Muslim village did not renew their financing because although they had a positive experience with IBBL, they experienced shaming from other group members in ways that referenced their minority religious status.

3.6 Case study: Islamic Relief Pakistan

Islamic Relief Worldwide is an international NGO headquartered in Birmingham, UK, with Islamic microfinance programs across the globe tailored to local needs. Islamic Relief Pakistan's (IRP) Islamic microfinance program has existed for about 10 years, funded by a succession of grants. The program, then titled "Small Scale Business Development (SSBD)," named its financing products "productive purpose" and "social purpose" in lieu of murabaha and qard hassan. Productive purpose financing supports entrepreneurial or income generation activities, and social purposes financing supports a commodity needed to improve quality of health, such as an indoor toilet or a room addition or home refurbishment. Like most MFIs, when I conducted an evaluation of SSBD in 2013, IRP had not yet found a split between their murabaha (larger, graduated fee related to the size of the financing) and qard hassan (small, fixed service fee only) offerings to enable the program to be self-sufficient.⁸⁸

Even though Akhuwat is by far the largest Islamic microfinance provider in Pakistan – especially in Rawalpindi where most SSBD clients were based – SSBD possesses several advantages. First, IRP generally approves clients in two weeks or less, making it a desirable option for those needing financing immediately due to sudden income opportunities, repair needs, or emergencies.

Second, IRP offers significantly larger financing than Akhuwat, and with shorter routes to receiving the higher financing amounts. Third, the professional environment of IRP's field offices makes it an appealing option for a more financially solvent poor demographic best positioned to benefit from the "productive purpose" financing for income generation. During our interviews, clients emphasized a preference for privacy when discussing personal financial affairs. Like IBBL in Bangladesh, IRP does not employ coercive repayment tactics (threats, harassment, embarrassment, selling off assets, house-breaking) that can be common in conventional microfinance. Compassion toward late payments maintains an ultimately high repayment rate and positive relationships between field staff and clients.



Islamic microfinance clients meet with their field officer at a field office. (Rawalpindi, Pakistan, 2013)

Unlike the Grameen Bank and IBBL collective model, IRP's financing is distributed to individuals, who required a guarantor. Pakistan Poverty Alleviation Fund, an apex funding body, also prefers individual loans instead of group lending, as individual loans tend to be larger and thus more likely to be used for true investment in productive activities. The smaller amounts common to group loans are often diverted from business purposes to fill liquidity gaps, e.g. daily needs and crises. Group members are also less likely to guarantee larger loans.

⁸⁸ The program has since been revised; social purpose financing has been eliminated and all both murabaha and qard hassan are now used for productive purposes.

Field officers visit both parties at home as part of IRP's approval process, where one crucial aspect for selection involves assessment of home ownership for either the client or the guarantor. While this was not a requirement, *a critical difference between urban versus rural microfinance markets is the comparative lack of tight-knit social ties in urban areas. Individuals and families, particularly those more recently arrived from rural areas, can be more transient due to shifting rental terms or income opportunities. For urban clients, home or property ownership is emphasized because it reduces repayment flight risks.*

IRP's program struggled with Rawalpindi's deeply specific challenges to poverty alleviation and sustainable small-scale enterprise. The Punjab province has a 13.1% Hepatitis C infection rate—a rate reflected in my random interviewee sampling as well. This and other chronic illnesses drained household funds and often preventing those afflicted from working.⁸⁹ Electricity costs fluctuate wildly; metering systems are nontransparent and unreliable. During the research period, taxi drivers could not afford to work more than three or four days per week: compressed natural gas (CNG) was inexpensive and provided good mileage, but was only available 3 days a week, per regulations. Petrol was available the other 4 days, but was too expensive for most drivers to use more than one day a week.⁹⁰ Inflation is extreme, (excepting those rare individuals earning government salaries keeping pace with inflation). With flour (a necessity for the flatbread meal staple) and electricity particularly inflation-prone.⁹¹ Moreover, only 6% of interviewees reported stable, fixed incomes; 20% reported having one stable income in the house while all other income sources were variable, and 74% of interviewees' income fluctuated each month, often significantly. This was due largely to seasonal work, the unpredictability of customers or orders, lost wages due to illness, and other factors.⁹²

4 WOMEN, HOUSEHOLDS, AND ETHNOGRAPHIC LESSONS

Conventional microfinance is overwhelmingly disbursed to women and decades of scholarship have named microfinance a signature women's empowerment initiative.⁹³ Some IMFI's avoid this discourse, or have replaced it with "family empowerment." For example, IBBL's Islamic microfinance program, the Rural Development Scheme (RDS), has long committed itself to the economic uplift of families, as opposed to women. Officials described this perspective as more in accordance with Islam, less disruptive to conservative rural mores, and more conducive to IBBL serving as a partner in poverty alleviation rather than an interloper with an unwelcome agenda.

⁸⁹ Daily Times (Pakistan) 2013.

⁹⁰ As further evidence of the extreme volatility of the price of basic supplies, for several months from 2014-15 CNG was altogether unavailable in Punjab province filling stations, rendering many taxi drivers temporarily out of work.

⁹¹ As one client explained, "This September 2013 my electricity cost 2,000 [PKR], but in summer [2013] it reached 10,000." According to another client, "The average in 2012 for electricity was 800-1,000, but this year [2013], it's 2,500." Another noted, "Over three years, the price of flour has gone from 150 to 900 for 20kg."

⁹² See also Collins et al 2009: 18. Understanding how the poor manage their money and increase their net worth comes from tracking borrowing and lending cash flows, rather than analyzing assets, liabilities, or income at a given moment in time.

⁹³ Armendáriz 2008, 2010, Burra 2005, Khandker 1998, Rahman 1999. Numerous studies have confirmed that women regularly give their loans to male relatives, and often become clients because the gendered division of household labor predisposes them to manage repayment schedules.

Perhaps the most vigorous defense of family empowerment comes from IsDB's Islamic Research and Training Institute, which recently explained:

"Islam promotes the concept of 'family empowerment' by exhorting men and women to play their respective roles in seeking economic and social well-being of all members of the family. Indeed, the 'women only' approach to conventional microenterprise development and poverty alleviation is alien to Islamic principles and values. Further, there is the possibility that women may be doubly exploited instead of being empowered where they are made to take the loan related liability while the male member in the family manages to 'pocket' the cash. Therefore, there is merit in the argument that Islamic MFIs should aim to empower families and not women alone."⁹⁴

However, the "family" unit is not fixed. In South Asia, the poor typically live as joint families where the number of dependents can be highly mobile. The division of expenses in a shared household can change frequently, particularly during lean times or periods of high expense, such as holidays or illness.⁹⁵ The contingency and complexity surrounding "family" highlights the utility of ethnographic research, including methods of long-duration local immersion and participant-observation, to understand the complexity and nuance that can evade even qualitative elements of randomized control trials. *During fieldwork conducted over 2010-2014, I observed the issues below in the daily lives of female microfinance clients in rural and small-town Muslim communities in Bangladesh and Pakistan. These issues indicate that unique circumstances for female-headed households and female clients should encourage MFIs' greater strategic engagement with women, rather than a deferral to the "family."*

Challenges for female-headed households

- The absence or delinquency of men poses a particular challenge to notions of "family" as an intact, bounded, and mutually supportive unit. In the Bangladeshi slum where I was based, female clients whose husbands had deserted them or taken other wives were unable to protect and maintain control of their money from these husbands, who would sporadically visit and demand money.⁹⁶ This is partly due to shame and secrecy surrounding spousal abandonment. Women would tell visitors that their husbands worked in different towns or abroad, when their husbands may have left them or taken other wives. This also meant that new IMFI field officers could not necessarily immediately tell which households were female-headed.
- Some households are functionally female-headed even if a husband is present, due to a lack of spousal support, illness, alcoholism, and/or unemployment. Research interviews are usually conducted in the presence of neighbors or family, but deeply sensitive information was typically only shared when I spoke with a woman by herself, and after establishing trust. Accordingly, some sensitive information was only shared with female IMFI field officers (in the case of the Pakistani IMFI that employed women). However, women are rarely field officers, especially in rural areas.

⁹⁴ IRTI/Thompson Reuters 2014: 21

⁹⁵ In the small sample (n=50) of a long-form, qualitative survey I conducted among randomly-selected microfinance clients in Pakistan, 18% of interviewees reported that the number of household dependents shifts frequently. 36% said that the division of household expenses between relatives shifts every month/sometimes.

⁹⁶ Kustin 2014



A typical day at a small town Islamic bank branch, which the bank's microfinance recipients are required to periodically visit. Air conditioning throughout makes the office a welcoming environment in the hot, humid summers. The presence of Buddhist clients (here, the woman in the blue shirt) is common. (Chittagong Division, Bangladesh, 2014)

- Government or NGO schemes might exist to benefit widows, but requisite death certificates are not always available. Two widows in the same Bangladeshi slum were ineligible for assistance when their husbands drowned at sea in fishing boat accidents. Without the bodies, the women could not obtain death certificates without costly bribes.
- Several households were female-headed because husbands had migrated overseas for work. In these households, irregular amounts of money were irregularly remitted back,⁹⁷ and the unpredictable lean periods could last for months. When money was received, it was through *hawala* or *hundi* networks—informal, unregulated, but sophisticated money transfer systems common in South Asia and MENA. For these women, the advantage of *hawala* over mobile money was trust and ease: they were typically visited in their homes by someone bearing money, and the arrangement was initiated by their husbands.

Relationships with IMFI field officers

- Often, female clients do not liaise with the field officer directly, but will give their repayments to another woman or to an older child to deliver to the officer on their behalf. This is a strategic move that allows for a more neutral third party negotiation if the payment is late or incomplete (See Transcript 1 below).
- The presence of a visiting field officer (as opposed to use of mobile money transfers) allows for negotiations over late or incomplete payments that are specific to client's past record, the total amount that the loan officer is temporarily forgiving from other clients, and the new proposed repayment timeframe. The client-field officer interaction can be central to client experience. Feelings of shame versus support played a direct role in the decision of some women to pursue repeat financing through that provider.
- *Purdah* or modesty observance and mobility can vary widely, even within a community. For women who might rarely leave home, cannot read, have irregular or limited access to

⁹⁷ The irregularity of the remittances was due to a variety of factors, e.g. seasonal or other downturns, an exploitative employer withholding wages, an expired visa rendering the worker subject to contingent and *ad hoc* employment.

television, and are otherwise limited in accessing educated external opinions from sources they trust, field officers can be a source of advice (contingent on the temperament and spare time of the field officer). Vulnerability to counterfeit bills is an issue in the Bangladeshi slum; one field officer trained women to spot them. Women regularly sought out field officer opinions on a range of topics, such as children's schooling, business opportunities, future investments, and even an insolent son spending time with undesirable friends (See Transcript 2 below).

Accounting and calculation challenges, and the absence of tools to address them

- Women are not necessarily the sole managers of their household accounts and IMFI repayment obligations. In Bangladesh, Islamic microfinance clients are organized into collectives with weekly group repayment meetings. The collective's leader keeps track of everyone's debts through memory, and negotiates late payments with the field officer. As a result, managing very small amounts of weekly repayment and/or contribution into mandatory savings accounts—from about 60 cents USD to 4 USD—takes a great deal of work for both the leader and the field officer. During these meetings, counting and basic math often posed significant difficulties for clients, so there was value in performing these processes verbally, as a group. A preference was consistently expressed for round numbers. I never observed clients using calculators available on their basic mobile phones. If educated children were home, they were asked to help. But during the daytime repayment meetings, these children were typically at school or working (See Transcript 1).

TRANSCRIPT 1: The microfinance collective has assembled to make weekly repayments to the field officer. Client Jebunessa has missed several installments and the field officer is now insisting she pay off the outstanding amount; he cannot wait any longer. Ameena, the collective's leader, intervenes when Jebunessa starts to cry.

Ameena to Jebunessa: Please listen, you should manage. You are suffering, and Sir [Field Officer] is also suffering.

Field Officer: Give 3,050 taka.

Ameena: 3,000.

Field Officer to Ameena: Why 50 taka less?

Ameena: It will be good for Jebunessa if it a round figure, like 3,000.

Field Officer: No, 3,050.

Ameena: It will be good for her if it's 50 taka less, because it's a round figure. You can start actually collecting the money if it's a round figure [laughs], then later you'll manage to get the 50 taka from her.

Ameena to Jebunessa: Sister, on the 9th, if you are not able to pay, give at least 1,500 taka.

Jebunessa: Ok, I will.

Ameena: Sir, you understand? On the 9th, she will give 1,500 taka. And on 16th she will give another 1,500 taka.

[...]

Field Officer calls out while leaving: Hey, Jebunessa! By the 15th! You'll give 3,050 taka!

Ameena, interrupting: On the 9th, there will be one installment.

Field Officer: Ok, on the 9th, at least you will give half, and the remaining you give on the 15th. All good, right? Please remember.

Ameena, to Jebunessa: You will give it happily.

- The inability to do math or keep written financial records can lead to a lack of knowledge about one's true financial position (see Transcript 2 below), or exploitation in microfinance-funded business ventures. One woman invested the approximately 390 USD she received into a family friend's fishery business, located three hours away by bus. The friend never gave her information about business profits and losses, or sent her money of his own accord. She never asked questions about the business accounts because she said she wouldn't understand anyway. She managed the repayments through deferrals and renegotiations with the loan officer, and when she needed money to pay down a bill that had become too high, she would call and ask the friend to dispatch some money, which he often did after delays. She never received any profits despite bearing significant liability.

TRANSCRIPT 2: The microfinance collective has finished its weekly business and clients disperse. Client Muni did not attend school past 5th grade and cannot read. She asks her field officer to examine her passbook to tell her exactly when she entered the Islamic microfinance program and how long until she can collect the sum from her 10-year mudaraba savings account. The program has required her to contribute to the account every month. She does not know when she can collect it or how much she will receive, making it difficult for her to manage her longer-term debts.

Muni: Oh Sir, please look at my passbook. What about my savings account? How many years do I have now?

Field Officer: It's all on the computer [at the branch], you can see it on the computer...

Muni: Oh Sir, please... [She opens the passbook and shows it to him.]

Field Officer: It is important to see it on the computer.

Muni: But who will ever actually see it on the computer?

Field Officer [relenting, takes the passbook]: It was a long time ago [that you started].

Muni: Check how many years have passed.

Field Officer: You started in 2005. It has been 8 years, 8 months.

Muni: 8 years, 8 months.

Field Officer: If this month is omitted.

Muni: If this month is omitted. So how many months are needed to fulfill 10 years?

Field Officer: 16 months are remaining to fulfill 10 years.

Muni: For the remaining 16 months I will have to continue on in hardship.

Field Officer: 16 months will go quickly.

Muni: So if it is every month, 300 taka [3.75 USD], then after 10 years, how much will I get [from the savings account?]

Field Officer: [does not answer, hands back the passbook, defers to the computer]

- These challenges are not unique to women: among the 50 Pakistani Islamic microfinance clients I interviewed, a lack of finance or accounting knowledge made definitions of "income" inconsistent. 40% calculated income and expenses by the day. Most taxi drivers gave a figure that excluded daily petrol/compressed natural gas costs. Most shopkeepers could not provide a daily or monthly income, as they replenished stock continuously as cash came in. Some shopkeepers took family groceries out of their stocks, making business and household expenses difficult to separate.

The limits of charity

- Receipt of sadaqat or zakat—often given following holidays—was rare, serendipitous, and minimal, contingent on a comparably wealthier person in the community (e.g. a child’s teacher, a relative) providing gifts of clothing, food, or money. However, the holidays were equally likely to be a financial burden. The month of Ramadan and concluding holiday of Eid-ul-Fitr are particularly costly. Transport costs to visit relatives, new clothes and shoes for children, and the purchase of special foods for guests are common expectations. For several families, this was a time of food insecurity, with meals consisting of white rice seasoned with dried chilies. Meanwhile, restaurant or tea stalls workers might be out of work if their workplace closes for Ramadan, and other businesses run reduced hours.

IMFI strategies for female-headed households

- Employment opportunities for women can be slim, especially for women observing purdah or modesty who might not leave their home or immediate community without a male relative. Skills training and facilitation of market linkages are complementary IMFI strategies that can enable home-based income generation (e.g. tailoring/stitching, product assembly, craft work).
- Giving clients the option of mobile money repayment (currently a rare practice) would accommodate women for whom to travel to offices is a hardship.
- Developing products and services specifically for abandoned and widowed women. This could include qard hassan, which carries only a minimal fee, or pairing microfinance with school scholarships for orphaned⁹⁸ children to provide an inter-generational approach to poverty alleviation.
- Public critique or even commentary on the lack of women working in global IBFIs and IMFIs is practically nonexistent. However, the presence of female employees in IMFIs—particularly those in client-facing rather than support roles—can enable outreach to female clients potentially hesitant to interact with unknown men by themselves. The Islamic Relief microfinance program I studied in Pakistan saw an uptick in timely repayments and positive client experiences by adding female field officers.

5 REGULATORY, POLITICAL, AND ECONOMIC CHALLENGES

5.1 Bangladesh

In Bangladesh, a nation of nearly 160 million with the world’s fourth-largest Muslim population, about 70% of inhabitants live in rural or semi-rural areas.⁹⁹ The economy suffers from a less-than-ideal annual growth rate, and foreign direct investment continues to be hampered by political

⁹⁸ In Bangladesh and Pakistan, children whose mothers are widowed or abandoned are often referred to as orphans.

⁹⁹ CIA World Factbook 2014

instability, unsafe and even deadly working conditions (particularly in the case of the readymade garments industry), and abysmal road conditions from factories to ports. Financial corruption is endemic, and Bangladesh is frequently ranked near the bottom of international corruption indexes.

Despite these limitations, or perhaps due to the innovation and creativity they engender, Bangladesh has repeatedly emerged as a financial pioneer: bKash is a top mobile money platform, BRAC's model of frugal, scalable innovation has led it to become the largest NGO in the world, and the Grameen Bank and founder Mohammed Yunus received the 2006 Nobel Peace Prize for establishing microfinance for the poor. The Grameen Bank continues to carve out a niche in a

densely populated microfinance market by offering services for the poorest ("ultra-poor") Bangladeshis, with interest rates charged on a sliding scale according to the type of loan and the recipient's background.



Remittance partners advertised at an Islami Bank Bangladesh Limited branch (Chittagong Division, 2014)

Islamic (micro)finance: Bangladesh is also the global leader of Islamic microfinance, anchored by its oldest and largest Islamic bank, the Islami Bank Bangladesh Limited (IBBL, see Section 3.5). The surge of Islamic banking in the country is striking: From 1996 to 2002, IBBL's annual investment growth rate ranked highest in the world among IBFIs, at 19.55%.¹⁰⁰ Several underperforming conventional banks have undergone conversions into Islamic banks. Today, out of Bangladesh's 57 total banks, 8 are wholly Islamic and 15 conventional banks operate Islamic branches or windows.¹⁰¹ Almost 14 billion USD flows into Bangladesh via remittances, and of the over 15 banks licensed to receive foreign inflows, IBBL captures 26.7%, behind two government banks.

Regulatory environment: Despite the strength of the Islamic banking and finance sector, for the first 27 years of Islamic banks' existence,

Bangladesh Bank (the central bank) did not explicitly incorporate them into its regulatory fold. Only in November 2009 did Bangladesh Bank finally publish a document outlining principles for Islamic deposits and investments and establishing guidelines for Islamic banks' liquidity ratios, rates of return, and annual financial statements.¹⁰² Regulations or guidelines for Islamic microfinance are similarly scattered, although a voluntary collection of providers established in 2014 aims to establish coherence and national goals for the sector. IMFIs are subject to different regulatory authorities depending on their structure: dedicated MFIs are under the purview of the Microfinance Regulatory Authority. Commercial banks are regulated by Bangladesh Bank. NGOs are subject to the notoriously non-transparent and arbitrary NGO Affairs Bureau, which recently

¹⁰⁰ Iqbal and Molyneux 2005

¹⁰¹ Bangladesh Bank 2014

¹⁰² Bangladesh Bank 2009

came under scrutiny for a draft law that would impose onerous oversight on NGOS receiving foreign funding.¹⁰³

Islam and political contestations: IBBL's success in increasing Islamic banking among the poor is deeply politicizing.¹⁰⁴ Its efforts are occurring against the backdrop of sharp—and at times violent—contestations regarding Islam versus secularism in political parties, the public sphere, and the Constitution. An ongoing War Crimes Tribunal has imprisoned or executed leaders of the main Islamic political party, Jamaat-i-Islami for their support of Pakistan during Bangladesh's 1971 Liberation War. As IBBL continues to capture a proportion of the bottom-of-the-pyramid market, it frequently comes under scrutiny by the current, secular Awami League government for perceived ties to Jamaat-i-Islami.¹⁰⁵

As a result, IBBL is the only bank in Bangladesh required to allow a Bangladesh Bank monitor to observe its Board of Directors meetings. IBBL's philanthropic and poverty-oriented activities attract particular government scrutiny, as the government tends to approach development work as political work. This helps explain why IBBL is singled out for criticism amidst its rival Islamic institutions in Bangladesh, such as Shahjalal Islami Bank, EXIM, and Al Arafah Islami Bank: differences exist in corporate cultures and executive profiles. IBBL is commonly known as the most 'Islamic' in spirit, with current and former directors and Board members known to be private supporters of Jamaat-i-Islami. In 2011, Bangladesh Bank ordered IBBL to stop directing its corporate zakat and "doubtful income" (profits that came in contact with non-Shari'a compliant processes) to its Islami Bank Foundation. These monies are now directed to IBBL's CSR programs.

Development landscape: Since Bangladesh joined IsDB in 1974, IsDB has invested 19 billion USD, mostly in large-scale infrastructure projects. Today, Bangladesh constitutes one of IsDB's largest portfolios. While IsDB helped establish IBBL in 1983 and remains an investor, overall investment in financial sector projects remains slim. The power sector has dominated IsDB's engagement in recent years and will continue to do so. Health is another emerging priority sector. A new Dhaka-based Gateway Office is set to open in 2015.

This tremendous, transparent support occurs alongside flows of documented and undocumented funds from other Saudi Arabian charities and religious entities. These funds support development projects, mosques, and private *madrassas* (schools) that are free from government oversight—a point of contestation as these schools have produced several conservative Islamic movements in recent years, and are periodically implicated in small-scale extremist organizing activities. Critics also point toward a growing acceptance in Bangladesh of more conservative forms of Islam aligned with Wahhabism.¹⁰⁶

5.2 Indonesia

With over 253 million residents, 87% of whom are Muslim, Indonesia possesses the largest Muslim population in the world. With about 6,000 inhabited islands and high variability in resource allocation, poverty persists despite impressive upward growth trends since the 1997

¹⁰³ Human Rights Watch 2014

¹⁰⁴ *Daily Star* 22 Jul 2011

¹⁰⁵ *Daily Star* 24 Jul 2011

¹⁰⁶ The dominant form of Islam in Saudi Arabia adhering to strict readings of the Qur'an and shunning many practices culturally acceptable in Bangladesh and South Asia more broadly.

Asian financial crisis. Indonesia's geography also sets the development of its conventional and Islamic microfinance industry apart: the islands are largely serviced by over 5,000 local cooperative banks, in which clients are also shareholders. One downside to this decentralized model of banking is a lack of information-sharing between institutions regarding best practices, challenges, client demographics, and needed reforms to related judicial and legal frameworks.

Regulatory environment: Over the past 13 years, the Islamic finance industry has flourished, due to consistent, deliberate governmental attention to their long-term development. Anchored by the Blueprint of Islamic Banking Development, issued by Bank Indonesia (the central bank) in 2002 and the government's Islamic Banking Act of 2008, Indonesia has a formal dual banking system. Specifics are outlined in the Indonesian Banking Architecture (Arsitektur Perbankan Indonesia, or API), launched in 2004. *Bank Indonesia describes the importance of Islamic finance in terms of the macroeconomic benefits of the industry's asset-based activities, particularly "mid-long term price stability," rather than as something inherently valuable for its Muslim-majority population.* Islamic finance will link the "financial sector and real sector and create harmonization between the two sectors," and "will also reduce speculative transactions," thereby supporting "the stability of overall financial system."¹⁰⁷

Islamic microfinance: Despite the prominence of Islamic finance, Islamic microfinance remains comparatively underdeveloped. The largest, oldest, and most prominent IMFI is Baitul Maal Wat Tamwil (BMT, literally "Social and Business House,"), an NGO with the same local cooperative model as conventional consumer finance banks. Despite having 2.2 million members, total BMT holdings are small, with 550 branches and cumulative balance sheet assets of 800 million USD.¹⁰⁸ Streams of charitable funds (e.g. waqf, zakat, and sadaqat) are channeled into a stream for "social" (non-productive) financing purposes. Meanwhile, members' savings provide the liquidity needed for productive financing for micro and SME clients. The offerings are diverse; products often available only in regular Islamic consumer banks in other countries are here often available on a micro-level. In theory, this model allows BMT to serve a range of both male and female clients, from the poorest to the more financially stable.



Perhimpunan BMT Indonesia (PBMT, or BMT Center) serves as a the central organizing body linking the disparate BMT cooperatives to donors, the government, researchers, and companies offering market linkages for small-scale producers. In May 2014, PBMT established PBMT Social Ventures in Singapore, "as a fund raising entity to attracting venture philanthropic funds to support BMT Indonesia's social investment programmes."¹⁰⁹

However, the social-plus-productive model has drawn criticism, including from IsDB's Islamic Research and Training Academy. In a 2014 report, the authors explain that BMT's model combining philanthropy with for-profit finance:

¹⁰⁷ Bank Indonesia 2013

¹⁰⁸ PBMT 2015

¹⁰⁹ Ibid

“...may involve serious problems due to conflicting organizational culture and conflicting policy and regulatory framework...most of [the BMTs] have over time, preferred to do away with their philanthropic aspirations (as charity houses) and concentrated on for-profit financing (as financing houses). The twin-track nature of the model seems to have been abandoned for all practical purpose.”¹¹⁰

However, the sector is poised to expand: IsDB is currently preparing a new four-year “Member Country Partner Strategy” for Indonesia to guide its engagement there, and financial inclusion is slated to play a role. IsDB has assisted Indonesia’s government and central bank with developing a strategic plan for its Islamic microfinance sector, and a national Islamic microfinance fund is reportedly under development. A new Jakarta-based “Gateway Office” is also set to open in the coming years, deepening opportunities for collaboration and project management.

5.3 Pakistan

Pakistan is often cited as having low microfinance penetration, but this data must be disaggregated by province and district: while wide swaths of the country remain underserved, parts of the Punjab (e.g. Islamabad, Rawalpindi, and Lahore) and Sindh provinces (e.g. Karachi) have microfinance saturation.¹¹¹ Within underserved areas, food insecurity and recent, catastrophic earthquakes and floods have been prioritized by development organizations. Geography and political instability also restrict providers’ ability to serve certain regions. In expansive Balochistan, a long-running separatist movement and the high operational costs of serving a dispersed population deters providers. Violent insurgencies in Khyber Pakhtunkhwa have prompted MFIs to reduce or close operations, despite vast potential in the agriculture and livestock industries and resurgent enterprise, particularly in Swat Valley.

Regulatory environment: Pakistan has 3 types of MFIs: microfinance banks (MFB), Rural Support Programmes (RSP) that operate exclusively in rural areas, and NGOs (often just referred to as MFIs) that offer microfinance alongside other services. Pakistan has one of the world’s most favorable regulatory environments for microfinance,¹¹² but this only applies to the 35% of providers that are MFBs and under the purview of the State Bank of Pakistan (SBP). MFIs and RSPs, meanwhile, account for about 65% of the market.¹¹³ Most Pakistani MFIs are financially unsustainable, with debt funding far outstripping equity¹¹⁴ and operational costs dominating budgets.¹¹⁵ To manage high operational costs, NGOs must rely on donor funding, and typically fund expansion by shifting to apex funding (e.g. PPAF), which offers subsidized lines of credit.¹¹⁶

¹¹⁰ IRTI/Thompson Reuters 2014: 21

¹¹¹ Saturation in Punjab province contributed to a crisis on non-repayments and defaults in 2008-09 (Burki 2009). See PPAF’s “District Prioritization Map” <http://www.pfaf.org.pk/doc/DISTRICT%20PRIORITIZATION%20MAP%20October%2001,2012.pdf> for depiction of high priority regions (PPAF 2012).

¹¹² Economist Intelligence Unit 2012. Pakistan’s microfinance business environment ranked 3rd best globally, behind Peru and Bolivia.

¹¹³ Shah 2011: 4-5

¹¹⁴ Pakistan Microfinance Network 2013: 36

¹¹⁵ Haq and Khalid 2011: 1; A.A. Khan 2008: 49

¹¹⁶ By contrast, the cost of borrowing is the biggest expense for non-micro banking in Pakistan.

The success of Pakistan's microfinance sector is due in part to restrictive rules for MFBs imposed by the SBP, including requirements for account reporting and publishing, internal and external audits, governance structures, and high capital reserves. Capital reserve requirements pose a particular challenge for NGO IMF programs or small community banks (a set-up supported by PPAF) looking to transition into a formal IMF. Meeting capital requirements and capital adequacy can easily require 5-10 years.

The financial inclusion sector in Pakistan is also dynamic: MFIs can avail SBP's Microfinance Credit Information Bureau, launched in 2012, with data continuously being added. Microfinance client national ID card numbers can be entered in a database, enabling future MF providers to assess credit history and ensure that they are not contributing to cyclical indebtedness, whereby new microfinancing is used to pay down outstanding loans.¹¹⁷ Microfinance institutions continue to see an uptick in clients using savings facilities.¹¹⁸ EasyPaisha, a partnership of Telenor Pakistan and Tameer Micro Finance Bank, is a successful mobile money platform, although like most mobile money platform, one-off over-the-counter transactions outstrip durable consumer 'wallet' accounts.



Islamic microfinance-funded home-based income generation. (Rawalpindi, Pakistan, 2013)

Despite a favorable regulatory environment, microfinance and SME financing are harmed by inflation, limited electricity, and reduced economic activity limiting entrepreneurial activities and new business growth disadvantage urban microfinance. From 2000-2006, Pakistan experienced high economic growth, and MFIs ballooned in Punjab province. However, this growth masked longstanding imbalances. By 2006, growth rates and productivity had decreased and inflation was rising: "real GDP growth rate plummeted from 9% in 2005 to 5.8% in 2008, and average annual inflation rose from 7.9% in 2005 to 20.5% in 2008."¹¹⁹ From 2010 to 2013, the average inflation rate was 11%, although it dropped to an average of 7.2% in 2014, and fell to an 11-year low in December 2014.¹²⁰

Islamic microfinance: Among IMFIs in Pakistan, Akhuwat has become the market leader through its charity-driven model; financial sustainability is not needed. Recipients are expected to become donors, even if they only donate 5 or 10 PKR per month. The simplicity of only offering one product—qard hassan—keeps Akhuwat's message clear and accessible to the general public. Akhuwat partnered with Muslim Aid in 2007, helping Muslim Aid to develop an in-house IMF program that was initially limited to qard hassan, but has since branched into murabaha. The

¹¹⁷ The MF-CIB is a joint project of the SBP, PPAF, and PMN, with funding from the UK Department for International Development

¹¹⁸ Hameed and Basharat: 2013

¹¹⁹ This also contributed to the 2008-09 microfinance repayment/default crisis in Punjab (Burki 2009: 9).

¹²⁰ Trading Economics 2015

Punjab government has thrown its support behind Akhuwat with a multi-year, multi billion PKR partnership,¹²¹ that is still in the planning stages and will likely add additional international funding partners.

Despite the success of Akhuwat and the positive reputations of the small but high-impact Islamic microfinance campaigns of Islamic Relief Pakistan and Muslim Aid, Islamic microfinance remains a niche industry in Pakistan's strong, diversified microfinance sector.¹²² Mainstream microfinance institutions and apex funds like PPAF are not prioritizing adoption of IMF products or services. PPAF only supports programs that are sustainable, further contributing to a national tilt toward sustainable microfinance, with Akhuwat's charity-based model standing apart as a notable exception. For any organization interested in operating an Islamic microfinance program as more than a 4-5 year, standalone project, financial sustainability must be at the center of planning.

Funding challenges for IMFIs: A critical challenge for Islamic microfinance in Pakistan is a lack of Shari'a-compliant funding through partnerships with governments, commercial banks, and apex funds. An NGO-MFI might transition into a full-fledged MFB, enabling it to access commercial bank loans, capital markets debt financing, and then equity financing. However, access to public savings is not an option for IMFIs: these typically interest-bearing funds are not Shari'a compliant. PPAF supports about 40% of the microfinance in Pakistan, including from three IMFIs. However, PPAF's funding is not Shari'a compliant, and the liability side of the IMFIs it supports is interest-bearing.

Charitable donations tend to be the safest option for Shari'a compliance, but public health, disaster relief, and education tend to take priority among donors. With few exceptions, corporate banks have been largely unwilling to subsidize or otherwise involve themselves with IMFIs, preferring development projects with clearer deliverables. For some industry insiders, the fact that MFBs are increasingly run by commercial bankers instead of development professionals has reoriented microfinance toward financial sustainability at the expense of traditional impact and development goals, deemphasizing outreach to women and other vulnerable groups in the process.

This conundrum becomes critical in the case of the Pakistan government's own, new, *qard hassan* fund of 5 billion PKR. Guided by recommendations from an advisory committee, it devised a market segmentation-based disbursement mechanism targeting the chronic poor (particularly youth and women), to address the shortfall in assistance to this demographic.¹²³ Microfinance industry insiders readily agree that Islamic microfinance would have more appeal in the more conservative, underserved Balochistan and Khyber Pakhtunkhwa provinces than conventional microfinance. This makes the Shari'a non-compliance of the fund relevant: it is being marketed as "*quarz-e-hassna*" even though it is *not* Islamic, nor is the government claiming it to be. The funds are raised through debt; it is an interest-bearing liability for Pakistan's government and citizens. In Arabic, *qard hassan/quarz-e-hassna* means 'benevolent loan,' which is what the funds will technically provide. Using a term aligned with Islamic finance suggests Shari'a compliance, without actual compliance.

¹²¹ Abduhu 2012

¹²² Other sources of interest-free lending are family, friends, and ROSCAs, known as "committees." Conventional and Islamic MF clients typically combine financing with monies from these other sources.

¹²³ While another government cash transfer scheme targets the ultra poor, resources for the chronic poor are slim, particularly in areas with low MFI penetration.

In light of these challenges, the Shari'a compliant funds of IsDB would be a welcome addition to Pakistan's microfinance sector. IsDB has high social capital in Pakistan, with 1.6 billion USD in current investments, and about 9 billion USD in investments since Pakistan joined IsDB, divided roughly between trade finance and development finance.

6 CONCLUSION: ISLAMIC (MICRO)FINANCE, FINANCIAL INCLUSION, AND DIGITAL STRATEGIES

Large IBFIs and advisory firms frequently indicate that poor, underserved markets can fuel the growth of the overall IBF industry – a different orientation than that of development or charitable organizations for whom positive outcomes for the poor are the primary goal. Perhaps the timeliest challenge for development organizations is thus forging partnerships or otherwise guiding corporate strategies in this arena. *In the rush to 'claim' the unbanked and capitalize on latent marginal gains from a bottom-of-the-pyramid client base, a gulf could easily emerge between the interests of the poor and the wealthy in ways inimical to the spirit of Islamic economics.*

Development organizations, such as the Bill and Melinda Gates Foundation and the Islamic Development Bank, are well positioned to bridge these potential divides and chart a strategy inclusive of Islamic financial corporations, microfinance providers, and most importantly, clients.

Other challenges remain. For example, home ownership and freedom from rent or capricious landlords can be a major determinant of financial confidence and the ability to withstand negative external shocks. A housing loan would not have to be a mortgage per se, but rather large murabaha financing where the procurement officer acquires a land deed and/or purchases home-building supplies. Alternately, qard hassan could be increased for housing/land acquisition. The presence of ROSCAs even by the ultra-poor suggests that contracts with longer maturities of 1-3 years in exchange for large payouts are feasible. Sustainable, cost-effective monitoring and evaluation would need to be developed to ensure funds go toward land and/or building materials.

A 2008 IRW report notes difficulties in preparing Islamic microfinance house loans due to the need to secure "fixed payments over long periods of time, a stable and verifiable source of income, a credit history, and full legal title to the property." The author instead proposes offering several "relatively small repeat loans over periods of between 1-4 years,"¹²⁴ which clients can use to make home repairs or build up a home. However, interviewees in Pakistan who wanted home loans were not using their existing loans this way. Multiple small loans risk diversion toward more immediate needs. The goal of a mortgage should be to allow renting clients to transition into home ownership. This would likely be a highly individualistic endeavor, with client background and needs determining payment terms and mortgage duration.

Another challenge is the lack of relationships between Islamic microfinance and digital tools that could easily promote product and platform innovation and aid service provision. Only in 2014-2015 is IBBL, the world's oldest, largest, and most established Islamic microfinance provider, migrating to a fully computerized management information system. Digitization of client records

¹²⁴ A.A. Khan 2008: 40

can ease administrative burdens for NGO providers, enabling lower-cost operations and thus broader reach. Beyond this, other *interventions to meet the needs of the poor while addressing longstanding cost and value chain inefficiencies in Islamic (micro)finance include:*

- Creating legal frameworks and technological platforms to digitally and transparently channel (e.g. via a smartphone app) corporate and individual zakat, sadaqat, and waqf into liquidity pools for qard hassan, providing a dependable source of Shari’a compliant funds. Religious requirements for a direct link between zakat and its recipient can be accommodated through client pre-screening and selection processes (e.g. of abandoned or widowed women and/or their children), subsidization of administrative costs through other means, etc.
- Encouraging mobile money “wallets” for vendors used in murabaha, bai muajjal and bai salam procurement. This would reduce safety risks associated with transporting cash, reduce institutional costs and procedures related to cash handling, and encourage the growth of a digital ecosystem among vendors in local markets.
- Developing/expanding platforms with up-to-date mobile-based market information for banks and clients sourcing assets for murabaha, bai muajjal and bai salam. This would reduce procurement costs for both banks and clients, and would avoid skewing local market prices. Farmers have used similar technology to sell crops at fair prices and reduce the role of exploitative middlemen.
- Developing methods for digital paper trails related to accounting, procurement, etc. to reduce the information asymmetries and propensity for corruption that make musharaka and mudaraba underused profit-loss sharing contracts.
- Encouraging Islamic microfinance providers to allow mobile money repayment as an option per the needs of each program and client demographic. This could reduce expensive client travel to offices, accommodate female clients preferring not to travel outside the home, and reduce costs associated with weekly field officer visits.
- Cash transfers are increasingly popular for development organizations, but cash transfers without mutual contractual agreement and underlying assets are not Shari’a compliant. One option is a card preloaded with cash for use by specific vendors for a limited set of products—a system being pioneered in UN refugee camps in Turkey and Bangladesh. Simple adjustments can render strategies Shari’a compliant, even if the strategies are not inherently “Islamic.” Another example of this would be support for the Shari’a compliant bank-insured ROSCA model.

Islamic microfinance remains a scattered industry, with a mix of small-scale experiments and more established institutions. National or regional databases or other systematic methods of collecting and processing information related to best practices and lessons learned are minimal. The Islamic Development Bank is arguably the best-positioned institution to currently act as a research and development hub for Islamic microfinance, including new products and services, optimal legal environments, and basic computing requirements. The scope for the collaboration is high and the capacity for innovation in this still-nascent industry, where supply has not met demand, should encourage impatient optimism of industry observers, providers, and clients alike.

7 APPENDIX

7.1 Abbreviations

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
BDT	Bangladeshi taka
BMT	Baitul Maal Wat Tamwil (Indonesian Islamic microfinance institution)
GCC	Gulf Cooperation Council
IBF	Islamic banking and finance
IBFI	Islamic banking and finance institution
IBBL	Islami Bank Bangladesh Limited
IFSB	Islamic Financial Services Board
IMFI	Islamic microfinance institution
IRP	Islamic Relief Pakistan
IsDB	Islamic Development Bank
KSA	Kingdom of Saudi Arabia
MENA	Middle East and North Africa
MFI	Microfinance institution
NGO	Non-governmental organization
OIC	Organization of Islamic Cooperation
PKR	Pakistani rupee
PPAF	Pakistan Poverty Alleviation Fund
PMN	Pakistan Microfinance Network
RDS	Rural Development Scheme (rural Islamic microfinance program of IBBL)
ROSCA	Rotating savings and credit association
SBP	State Bank of Pakistan
SSBD	Small Scale Business Development (past title of IRP's Islamic microfinance program)
SME	Small/medium enterprise
UAE	United Arab Emirates
UPDS	Urban Poor Development Scheme (urban Islamic microfinance program of IBBL)
USD	United States dollar

7.2 Glossary

Bai-muajjal	Credit sale utilizing a contract to establish deferred payment terms between a buyer and a seller
Bai-salam	Advance purchase investment contract
Fatwa (fatawa, plural)	Scholarly rulings or judgments
Fiqh	Juridical interpretations of Shari'a
Hadith	Collected sayings and acts of the Prophet Mohammed
Halal	Permitted in Islam
Haram	Forbidden in Islam
Hawala/hundi	Unregulated trust-based forms of money transfer
Ijtihad	Independent reasoning conducted in light of the Qur'an, Sunnah, and

	hadith
Ijara	Lease
Istisna	Payment contract for the manufacture/construction of an asset
Gharar	Excessive uncertainty
Maisir	Gambling
Mudaraba	Trustee financing, a financing partnership
Murabaha	Mark-up/cost-plus financing contract
Mushakarah	Profit-loss sharing contract
Purdah	Curtain, veiling, seclusion, modesty
Qard hassan	A loan for which only the principle must be repaid
Riba	Unwarranted increase of money, often interchangeable with usury or interest
Sadaqat	Voluntary charity
Shari'a	Islamic law
Sukuk	Islamic bonds
Sunnah	Practices, teachings, and path of the Prophet Mohammed
Takaful	Insurance
Umma	Islamic community
Waqf	Immovable property placed in an irrevocable trust
Zakat	Mandatory annual giving for both individuals and corporations, post-expenses

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