Islamic Microfinance: Sustainable Poverty Alleviation for the Muslim Poor

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I. INTRODUCTION

At the end of 2010, despite long-fought, multi-lateral wars on poverty and billions of dollars in aid to poverty-stricken countries, half of the world's population—over three billion people—was still living below the poverty line.[1] These people know a world where 22,000 children under age five die *every day* as a direct result of poverty;[2] a world where the poor are considered "unbankable" by conventional financial services structures that are built to serve only those who already have funds;[3] a world where the poorest 40 percent of the world's population account for a mere 5 percent of the world income, while the richest 20 percent of the population garner 75 percent of the world income.[4] Poverty is especially acute in Muslim societies, where hundreds of millions of people, in even the most economically and politically advanced Muslim countries, live well below the poverty line.[5] The Islamic faith strongly encourages regular charity to those in financial need,[6] but charity alone will not be enough to foster a sustainable solution to the broad poverty levels amongst its followers—charity is a stopgap, integral in maintaining life at its most basic point, but insufficient as an answer to needs beyond the basic. To impact the individuals living in poverty in the long-term, they need to be made into a productive, economically included population that can be self-sustaining. Fortunately, and perhaps fortuitously, the principles underlying such an approach have long-standing support in the Islamic faith. Take, for example, the following famous *hadith*:

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1 Anup Shah, *Poverty Facts and Stats*, GLOBALISSUES.ORG, http://www.globalissues.org/article/26/poverty-facts-and-stats (last updated Sept. 20, 2010) [hereinafter GLOBALISSUES.ORG].

2 *Id.*

3 *See* MUHAMMAD YUNUS, BANKER TO THE POOR 52–54 (1999).

4 Shah, *supra* note 1.

5 Radhika Madana Mohan, *Microfinance: Is There a Place for It in Islamic Finance*, ISLAMIC FIN. ASIA (Sept. 2010), http://www.islamicfinanceasia.com/article.asp?nm_id=18675.

6 *See generally* MOHAMMED OBAIDULLAH, INTRODUCTION TO ISLAMIC MICROFINANCE 25–40 (2008), *available at* ribh.files.wordpress.com/2007/08/islamic-microfinance-m-obaidullah.pdf.

> A man of the Ansar community came to the Prophet (peace be upon him) and begged from him.
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> He (the Prophet) asked: Have you nothing in your house? He (the man) replied: Yes, a piece of cloth, which we wear, or which we spread (on the ground), and a wooden bowl from which we drink water.
>
> He (the Prophet) said: Bring them to me. He (the man) then brought these articles to him and he (the Prophet) took them in his hands and asked to the assembly of people: Who will buy these? A man said: I shall buy them for one dirham. He (the Prophet) asked twice or thrice: Who will offer more than one dirham? Another man said: I shall buy them for two dirhams.
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> He (the Prophet) gave these to him and took the two dirhams and, giving them to the man of the Ansar, he said: Buy food with one of them and hand it to your family, and buy an axe and bring it to me.
>
> He then brought it to him. The Prophet (peace be upon him) fixed a handle on it with his own hands
>
> and said: Go, gather firewood and sell it, and do not let me see you for a fortnight.
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> The man went away and gathered firewood and sold it. When he had earned ten dirhams, he came to him and bought a garment with some of them and food with the others.
>
> The Prophet (peace be upon him) then said: This is better for you than that begging should come as a spot on your face on the Day of Judgment. Begging is right only for three people: one who is in grinding poverty, one who is seriously in debt, or one who is responsible for compensation and finds it difficult to pay.[7]

The principles endorsed in this *hadith*—support, empathy, and guidance for the poor, coupled with a requirement that a poor individual take affirmative steps to help himself—are the very principles which

[7] *Id.* at 14–15.

underlie microfinance, the most innovative and affective poverty-fighting tool to be implemented in the last half century. First conceived of by Nobel Prize winning economist Muhammad Yunus in Indonesia in the late 1970s,[8] microfinance is a process by which a poor individual is given a very small loan—Mr. Yunus began his bank by offering a mere $27 to a group of 42 individuals[9]—so that they may start a business, be it basket weaving, crop growing, garment sewing, or anything else that utilizes a skill the individual already possesses. This loan keeps the individual from having to borrow from a local loan shark who charges such exorbitant interest that any profit from the labor is forfeited to repay the loan.[10] When individuals are able to actually turn a profit from their enterprise, they are able to save money, invest in their own or their childrens' education, grow their business, improve their infrastructure, etc.—they are able to break the poverty cycle and pull themselves out of the mire they and their descendents would otherwise be eternally trapped within.

This Note explores microfinance as a poverty-alleviation tool specifically within the Muslim world. To begin, Part II will explain in much greater detail the beginnings and principles of microfinance as originally conceived by Muhammad Yunus, as well as the particularly pressing need for such initiatives in Islamic societies, and the unique benefits of the common practice of focusing on female borrowers. Part III will then give a general overview of the financial regulations dictated by Shari'a,which offer unique challenges and opportunities to those microfinance initiatives focused on the vast Islamic poor, as well as the Shari'a-compliant lending structures available to microfinance institutions serving Muslim populations. Finally, Part IV surveys the keys to successfully implementing and maintaining a microfinance initiative, which includes encouraging saving among borrowers, restricting microloans to only the "economically active," offering or requiring business education classes, and working diligently to understand and work within the given religious and societal structures of the relevant community. This Note argues that microfinance is an incredibly effective and sustainable tool in the fight against global poverty, and that its principles are not only capable of implementation in Islamic societies but are also fundamentally compatible with Islamic philosophy and ideology.

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[8] YUNUS, *supra* note 3, at viii–ix.

[9] Muhammad Yunus, Nobel Lecture at the Nobel Peace Prize Award Ceremony (Dec. 10, 2006), *available at* http://nobelprize.org/nobel_prizes/peace/laureates/2006/yunus-lecture-en.html.

[10] *See* YUNUS, *supra* note 3, at 45–48 (sharing the common story of a woman forced to borrow 22 cents per day for materials to build bamboo goods, and then sell the products back to the loan shark for 24 cents, leaving her with just 2 cents per day profit).

II. MICROFINANCE: HELPING THE POOR PULL THEMSELVES OUT OF POVERTY

A. *The Beginnings and Principles of Microfinance*

The first large-scale microfinance institution ("MFI") was Grameen Bank, founded in 1977 in Bangladesh by the economist Muhammad Yunus, who went on to win the Nobel Peace Prize in 2006 for his large-scale success.[11] During the height of a devastating famine in Bangladesh in the 1970s, Mr. Yunus was teaching economics in a local university, and became disillusioned with teaching beautiful economic theories while people starved to death around him—what good were the theories if the people in the village next to the university were dying in the streets?[12] And so he set out to discover the reality of poverty in Jobra, the village next to his institution.[13]

He discovered that many people were borrowing money from a middleman to buy supplies for their work—for example, bamboo stool making, with supplies costing just 22 cents—but the middleman required that the product be sold back to him at a price two cents above the loaned amount (below fair market value).[14] Leaving the villager with only a two-cent profit meant she could only subsist, and barely even that, and she could certainly never save money, or engage in such luxuries as education for her children, so the cycle of poverty could never be broken.[15] Mr. Yunus considered this a form of bonded slavery, and realized that the cycle could be broken if the villager was provided the very low capital to buy her own supplies—just 22 cents—so that she could sell her products on the free market for a greater profit.[16] Mr. Yunus approached the local bank to inquire about obtaining loans for the poor villagers, and he was essentially told that the population was unbankable: they were illiterate, so could not fill out the forms (this, at a time when 75 percent of those in Bangladesh could not read or write), and they did not have any collateral to offer as security for the loan.[17] For the former issue, Mr. Yunus offered his students' services as liaisons for filling out forms.[18] To the latter issue, Mr. Yunus astutely replied: "The poorest of the poor work twelve hours a day. They need to sell and earn income to eat. They have every reason to pay you back, just to take another loan and live another day! That is the best

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[11] *See* YUNUS, *supra* note 3, at 87–94; *The Nobel Peace Prize 2006*, THE NOBEL FOUND., http://www.nobelprize.org/nobel_prizes/peace/laureates/2006/ (last visited Feb. 25, 2012).

[12] YUNUS, *supra* note 3, at viii.

[13] *Id.*

[14] *Id.* at 47–48.

[15] *Id.* at 48.

[16] *Id.* at 49.

[17] *Id.* at 52–54.

[18] YUNUS, *supra* note 3, at 53.

security you can have—their life."[19] Still, the banker refused to entertain the idea, and replied that Mr. Yunus was an idealist.[20] But the economics professor walked away with a grand idea: find a substitute for collateral, and the poorest of the poor become a bankable population who can lift themselves out of poverty.

Group lending was the answer to the collateral problem. After much trial and error, Mr. Yunus and his colleagues realized that support groups were crucial to success, so they structured their lending program around group lending.[21] They continue to use this system today, along with most of the MFIs that have been founded since. Group lending requires that applicants be a part of a five-person group of like-minded people, living in similar economic and social conditions.[22] Groups are responsible for their own formation—the bank does not engage in that process, feeling that groups are stronger if formed under their own steam.[23] Group membership creates support and protection, and peer-pressure smoothes any individual's erratic behavior and keeps all members in line with the broader objectives of the program.[24] This structure also reduces the work of the bank by shifting vetting and supervision of borrowers from the bank to group members.[25] The group is delegated the responsibility of gathering information on prospective borrowers, assessing their creditworthiness, and critically analyzing their business plan, as all of their fates are interwoven.[26] Once the group is formed, which can take weeks or months as the first member must explain the process and convince a second member, and so forth, with members backing out or delaying for various reasons[27], the group must undergo seven days of training on bank policies, ending in an individual oral exam to demonstrate their understanding.[28] This testing process has the added benefit of weeding out those who are not committed to the program, unwilling or unable to give it their all.[29] Loans are extended first to two members of the group, for a six-week period.[30] If those loans are faithfully repaid, the same members may

[19] *Id.* at 54.
[20] *Id.*
[21] *Id. at* 62–63.
[22] *Id.*
[23] *Id.*
[24] YUNUS, *supra* note 3, at 62–63
[25] *Id.*
[26] Patrick Madden, Piercing the Veil: Using Microfinance Initiatives to Promote Female Entrepreneurship in Muslim Countries II(b)(ii) (2009) (unpublished comment), http://works.bepress.com/patrick_madden/1/.
[27] YUNUS, *supra* note 3, at 63.
[28] *Id.*
[29] *Id.* at 64.
[30] *Id.* at 63.

request another loan, and two more members may request initial loans.[31] Following successful completion of that loan period, the fifth member, who is usually the chairperson of the group, may request her loan.[32]

From the start, Grameen encourages borrowers to also build up savings to fall back on in hard times, or for use in additional income-generating opportunities.[33] Borrowers are required to deposit 5 percent of each loan into a group fund, from which any group member can take an interest-free loan with approval by the other group members, as long as the borrowed amount is not more than half of the fund's balance.[34] These funds may be used to "stave off seasonal malnutrition, pay for medical treatments, purchase school supplies," or to deal with the effects of a natural disaster or a death in the family.[35] As of 1998, the group funds for Grameen Bank had more than $100 million in total savings.[36]

On the point of repayment, Mr. Yunus offered another innovation from conventional loan processes. He realized that there was a weakness in conventional banks in that they usually demanded lump-sum payments on their loans.[37] He found that parting with a large sum at the end of a loan period was psychologically trying for borrowers, and so they would delay repayment as long as possible, growing the loan larger and larger.[38] In the end, many would decide not to repay the loan at all, the sum having grown too large for them to ever contemplate its forfeiture.[39] Mr. Yunus decided to do exactly the opposite: he instituted daily payments, making "the loan payments so small that [the] borrower[] would barely miss the money," and made the loan period exactly 365 days long for ease of accounting.[40] Eventually, for ease of collection, the payments were shifted to weekly installments over fifty weeks, but the premise of small repayments over a relatively short loan period remains.[41] Repayment rates are around 99 percent, the bank routinely makes a profit, and it has been financially self-reliant (no outside donations required) since 1995.[42]

Since Grameen Bank's founding, microfinance initiatives have spread to dozens of countries. The model has remained largely the same—small loans over short periods to the very poor, with some form of group lending standing in for traditional collateral. Microfinance has become a powerful

[31] *Id.*
[32] *Id.*
[33] YUNUS, *supra* note 3, at 65.
[34] *Id.*
[35] *Id.*
[36] *Id.*
[37] *Id.* at 61.
[38] *Id.*
[39] YUNUS, *supra* note 3, at 61.
[40] *Id.*
[41] *Id.* at 68.
[42] Yunus, *supra* note 9.

tool for reaching the poor—it raises living standards, creates jobs, and boosts demand for other goods and services, which contributes to overall economic growth.[43] Variations are made based on the culture of individual countries, including tailoring of lending structures to Shari'a requirements in Islamic countries, or among Islamic populations. Shari'a-compliant structures will be discussed in greater detail in Part III. Experience around the world shows that the poor are bankable, and that banking with the poor can be both profitable and sustainable.[44]

B. The Importance of Microfinance in Islamic Countries

Poverty is a global issue, but Muslim societies show some of the highest poverty rates in the world, and they are rising.[45] The largest Muslim-populated country, Indonesia, has 129 million poor individuals; in combination, Bangladesh, Egypt, Nigeria, and Pakistan have 399 million Muslims living on less than $2 per day; in Yemen, approximately one million people, or 46 percent of the population, live in poverty.[46] As discovered by Muhammad Yunus, these individuals are considered unbankable, and so financial services of any sort—savings, loans, insurance, etc.—are largely unavailable.[47] An estimated 72 percent of individuals living in Muslim-majority countries do not use formal banking.[48] With no banks in which to deposit whatever money they have, these people hide it, bury it, buy livestock that may die, or invest in jewelry that may be stolen or difficult to sell when the liquid value is needed.[49] For many, the only source of loans is a pawnshop, or a moneylender who may charge exorbitant interest and beat clients who do not pay on time.[50] Additionally, the governments of many developing Islamic countries are corrupt,[51] so aid and services from the government are non-existent, and foreign aid given to the government does not reach the people. For populations living in this situation, MFIs offer the only means to obtain secure, non-exploitative loans and to deposit savings without fear that the money will disappear.

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[43] Rahul Dhumale & Amela Sapcanin, *An Application of Islamic Banking Principles to Microfinance* 6 (U.N. Dev. Programme, Technical Note, 1999), *available at* http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2001/12/11/000094946_011102040 11331/Rendered/PDF/multi0page.pdf.

[44] *Id.*

[45] OBAIDULLAH, *supra* note 6, at 1.

[46] Mohan, *supra* note 5.

[47] YUNUS, *supra* note 3, at 52–53.

[48] Mohan, *supra* note 5.

[49] Tom Easton, *The Hidden Wealth of the Poor*, THE ECONOMIST, Nov. 3, 2005, *available at* http://www.economist.com/node/5079324?story_id=5-79324.

[50] *Id.*

[51] *Id.*

C. *Female-Centered Microfinance: Alleviating Poverty and Empowering Islamic Women*

When Muhammad Yunus founded Grameen Bank, he set a goal of giving half of the bank's loans to women.[52] He did this because he recognized a dearth in credit services for women in Bangladesh, which was even more extensive than the dearth of credit services for the poor generally.[53] After accomplishing this goal, he discovered a socio-economic reason for focusing on women: credit given to a woman brings about change faster than when credit is extended to a man.[54] For this reason, many, if not most, microfinance initiatives focus on female micro-entrepreneurs.

Women generally represent the poorest of the poor. In many developing countries, women are not only poor, but are socially and physically repressed as well. This problem is particularly acute in Muslim societies. A 2004 Organization for Economic Cooperation and Development ("OECD") study of discrimination against women by region showed the Middle East and North Africa ("MENA")—which comprises most of the Islamic world—to have the second-highest rate of gender discrimination in the world.[55] A 2005 OECD study of discrimination against women by religious affiliation showed Islam to have the highest levels of such discrimination.[56]

This is certainly not to say that all Muslim societies have the same level of discrimination against women.[57] Without delving too deeply into the societal and psychological history of gender roles under Islam, it should be noted that most of the discrimination against women is a function of centuries-old traditions and societal structures, and is not an ideal that is endorsed, or even condoned, by the balance of Muslims or Shari'a scholars.[58] However, it must be accepted that many Muslim cultures hold societal values that result in unequal treatment of women, and so any initiative that is able to both aid in developing a more equal role for women in a given society and conform to Islamic religious standards is an invaluable tool.

While it appears that women have the farthest to go in pulling themselves out of poverty, it also appears that their journeys have the

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[52] YUNUS, *supra* note 3, at 71.

[53] *Id.*

[54] *Id.* at 71–72.

[55] JOHANNES JÜTTING & CHRISTIAN MORRISSON, ORG. FOR ECON. COOPERATION AND DEV. CTR., CHANGING SOCIAL INSTITUTIONS TO IMPROVE THE STATUS OF WOMEN IN DEVELOPING COUNTRIES 9 (2005), *available at* www.oecd.org/dataoecd/24/32/35155725.pdf.

[56] *Id.* at 10.

[57] *Id.*

[58] For further information on this complex issue, see AHMAD ZAKI HAMMAD, 2 THE GRACIOUS QURAN 168 (2007).

greatest impact on society at-large. Muhammad Yunus observed:

> If the goals of economic development include improving the general standard of living, reducing poverty, creating dignified employment opportunities, and reducing inequality, then it is natural to work through women. Not only do women constitute the majority of the poor, the underemployed, and the economically and socially disadvantaged, but they more readily and successfully improve the welfare of both children and men. Studies comparing how male borrowers use their loans versus female borrowers, consistently show this to be the case.[59]

Studies have shown that, compared to men, "women are . . . more concerned and responsible towards their family, allocating to them savings and earnings . . . ."[60] By "[p]roviding aid to poor women, as opposed to the poor more generally," a "multiplier effect" is created, because "women spend more of their income on their families which leads to better housing, nutrition, healthcare, and children's education - especially for female children, [and so] the effects of aid given to women are essentially multiplied."[61] Mr. Yunus observed that "[a] man has an entirely different set of priorities. When a destitute father earns extra income, he focuses more attention on himself. Thus money entering a household through a woman brings more benefits to the family as a whole."[62] Without assessing the possible psychological, institutional, societal, or even evolutionary reasons behind this difference between men and women—a topic that can and has filled volumes—it is generally accepted that focusing microfinance on women provides greater benefits to her immediate circle and to society as a whole.

It also appears that women are a better bet financially for MFIs. They show higher rates of repayment,[63] are found to be more susceptible to the peer pressure that makes the eminently important group-lending model work,[64] and are more open to and inclined toward self-help,[65] which underlies the entire microfinance scheme. Mr. Yunus said that "poor women see further and are willing to work harder to lift themselves and

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[59] YUNUS, *supra* note 3, at 72–73.

[60] Valentina Costa et al., Women's Empowerment Through Islamic Microfinance in Egypt (Feb. 4, 2010) (unpublished thesis), *available at* http://www.microfinancegateway.org/p/site/m/template.rc/1.9.44770/.

[61] Madden, *supra* note 26, at Part I.

[62] YUNUS, *supra* note 3, at 72.

[63] Madden, *supra* note 26, at Part II(b)(iv).

[64] *Id.*

[65] YUNUS, *supra* note 3, at 72.

their families out of poverty. … and are more consistent in their performance than men."[66] A study on female micro-entrepreneurs in Egypt found women to be "more efficient, sustainable and cooperative" than men.[67] An additional financial incentive is the fact that female micro-entrepreneurs have exclusive access to female-only markets, which have been largely untapped by the male-dominated economies of most Muslim-majority countries. This is a rare instance in which traditions dictating separation of the sexes will benefit women: "women are granted sole access to women in gendered spaces creating the potential to make business [opportunities] that are unavailable to males. Essentially, microfinance creates the opportunity to create a female economy in the patriarchal Muslim society."[68]

There are, of course, difficulties incumbent in financially and socially empowering women, mostly stemming from patriarchal traditions in many Muslim societies. Upon starting Grameen bank, which served Muslim, Hindu, and Buddhist populations, Mohammad Yunnus recounts that the most formidable opposition was from husbands, who wanted the loans for themselves, and also from religious leaders who were very suspicious.[69] Additionally, Mr. Yunus recalls that at first it was difficult to recruit women borrowers because Muslims in his section of Bangladesh strictly interpreted and enforced the rules of *purdah*—a range of practices designed to guard women's modesty and purity which, in its most conservative interpretation, forbids women to leave their homes or to be seen by any men except their closest male relatives.[70] To get around this last issue, Mr. Yunus would stand in the street outside of a home and have a female colleague run back and forth between himself and the prospective borrower with questions and answers.[71] Moreover, there was reluctance from many women, who had either never handled money before and so wanted the loan given to their husbands, or who feared taking on debt because of negative experiences with moneylenders.[72] To answer these issues, Mr. Yunus would steadfastly answer their questions and explain the loan structure until their fears were assuaged.[73] Microfinance initiatives in every country with a patriarchal society have surely encountered very similar problems when starting or growing their projects,[74] but the benefits of overcoming those problems—the uplifting of entire societies, and a

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[66] *Id.*
[67] Costa, *supra* note 60, at 1.
[68] Madden, *supra* note 26, at Part IV.
[69] YUNUS, *supra* note 3, at 73.
[70] *Id.* at 74.
[71] *Id.* at 74–75.
[72] *Id.* at 76–77.
[73] *Id.*
[74] *See* Madden, *supra* note 26, at Part III.

more equal state for women—must be seen to outweigh the effort required.

III. MELDING MICROFINANCE WITH PRINCIPLES OF ISLAMIC FINANCE

A. *Introduction to the General Principles of Islamic Finance*

Islam uses its teachings on ethical, moral, social, and religious factors as a means of "promot[ing] equality and fairness for the good of society as a whole."[75] The principles of Shari'a "advocate entrepreneurship and risk sharing and believe that the poor should take part in such activities."[76]

With this focus on fairness and equality in mind, there are several Shari'a principles and prohibitions that dictate tenets of Islamic finance and distinguish it from conventional, or Western, financial structures. The most important of these, and the most challenging concept for traditional finance players, is the prohibition on *riba*, which is loosely translated to "interest." Additionally, there are strictures regarding *mayseer* (gain from speculation), *gharar* (uncertainty in terms) and *halal* (permitted purposes for activity).

1. Riba*: A Prohibition on Interest or Usury*

In regard to *riba*, the Qur'an[77] declares:

> Allah has permitted trade and forbidden *riba*. (2:275)
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> Allah will deprive *riba* of all blessing, but will give increase for deeds of charity: and Allah does not love the ungrateful and unjust. (2:276)
>
> O believers, fear Allah and forgo the interest that is owing, if you really believe. (2:278)
>
> If you do not, beware of war on the part of Allah and His Apostle. But if you repent, you shall keep your principal. Oppress none and no one will oppress you. (2:279)

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[75] Dhumale & Sapcanin, *supra* note 43, at 1.

[76] *Id.*

[77] The Qur'an is the most sacred text in the Muslim religion. Muslims believe that it contains the exact words of God (Allah), as communicated to the Prophet Muhammad through the archangel Gabriel. For a history and assessment of the Qur'an, see INGRID MATTSON, THE STORY OF THE QUR'AN: ITS HISTORY AND PLACE IN MUSLIM LIFE (2008), or MUHAMMAD M. AL-AZAMI, THE HISTORY OF THE QUR'ANIC TEXT: FROM REVELATION TO COMPILATION; A COMPARATIVE STUDY WITH THE OLD AND NEW TESTAMENTS (2003).

> O Muslims, Do not devour *riba*, doubling and redoubling it and fear (the punishment) of Allah that you may be successful. (3:310)
>
> What you provide with the prospect of an increase through the property of (other) people, will have no increase with Allah; yet what you give in alms and charity, seeking the countenance of Allah, (will increase): it is these who will get a recompense multiplied. (30:39)[78]

The prohibition on *riba* is intended to discourage any taking advantage of those in need that would possibly result if profit could be made from the dire circumstances of another. However, the precise meaning of *riba* has been hotly debated, both recently and throughout history, by Islamic jurists.[79] The debate centers around whether *all* interest is prohibited under Shari'a, or whether the prohibition is only on usury, or "excessive compound interest."[80] Those scholars who believe the latter—that only money lent at an exorbitant, exploitative interest rate is prohibited—think that charging interest is lawful in certain situations, such as "loans made by governments to induce savings, as a form of punishment for debtors, to finance trade, and to finance productive investments."[81] Other scholars believe that all forms of interest, regardless of purpose, are forbidden because "interest reinforces the tendency for wealth to accumulate in the hands of a few, thereby diminishing man's concern for his fellow man."[82] This debate is yet unsettled, and has clear and far-reaching implications for investment and more notably, profit in the Islamic finance sector. Erring on the side of caution, most actors in Islamic banking try to remove all forms of interest.[83]

Given this stringent restriction, those who wish to engage in Islamic finance turn to risk-sharing to make their profits. This is highly encouraged under Shari'a because "Islam deems profit, rather than interest, to be closer to its sense of morality and equity because earning profits inherently involves sharing risks and rewards. Profit-making addresses the Islamic ideals of social justice because both the entrepreneur and the lender bear the risk of the investment."[84] Risk-sharing helps ensure that the investor is not taking unfair advantage of a person in need through some arms-length

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[78] OBAIDULLAH, *supra* note 6, at 20.

[79] Theodore Karasik et. al., *Islamic Finance in a Global Context: Opportunities and Challenges*, 7 CHI. J. INT'L L. 379, 381 (2007).

[80] *Id.*

[81] Dhumale & Sapcanin, *supra* note 43, at 2.

[82] *Id.*

[83] *Id.*

[84] *Id.*

loan, but rather is sharing in an opportunity that, it is hoped, will be beneficial to all parties involved. This is the balance between morality, charity, and return on investment that Islamic finance hopes to strike. As will be discussed at length in Part III.B.2 most of the Shari'a-compliant microfinance structures use risk-sharing in lieu of charging interest to Muslim borrowers.

2. Mayseer*: Prohibition on Realizing a Gain from Speculation*

While it is recognized that some amount of speculation is incumbent in any commercial arrangement, Shari'a prohibits speculation beyond a certain limit, and with a certain intent. The line is a nebulous one, but focus falls on whether the intention behind the transaction is realizing gain from some productive effort, which is permissible, or realizing gain from pure speculation, which is not.[85] For example, if one makes an investment in a Shari'a-compliant business with a hope of realizing some gain from future dividends or other return, there is a degree of speculation regarding the future prospects for the company. Whether that speculation is permissible will rest on whether the investor intends to make a quick profit, such as speculating on the likely change in share price over a short period (as with day trading), or if, rather, the investor chose to invest based on careful evaluation of the company and likely future prospects.[86] The former intent is arguably impermissible speculation, while the latter intent is approved under Shari'a restrictions. As another example, gambling is explicitly prohibited under Shari'a, as the gambler hopes to make a profit from pure speculation.[87]

This restrictions impacts MFIs in that they must lend to borrowers of whom they have some studied, grounded expectation of future profitable returns, rather than acting like a day-trader or a gambler, hoping for a quick return from a transaction that creates nothing but more money in the process.

3. Gharar*: Prohibition on Excessive Uncertainty*

Gharar has multiple definitions, and is a broad concept. A catchall definition would be "uncertainty in terms of the agreement." This uncertainty may come from a variety of circumstances, including: "inadequacy of information shared between parties,"[88] "misspecification and inaccuracy of information shared between parties to a transaction

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[85] ALLEN & OVERY, LLP, INT'L DEV. LAW ORG., ISLAMIC MICROFINANCE REPORT 3–4 (2009), *available at* www.idlo.int/MF/Documents/Publications/7E.PDF [hereinafter "ISLAMIC MICROFINANCE REPORT"].

[86] *Id.* at 4.

[87] *Id.*

[88] OBAIDULLAH, *supra* note 6, at 21.

owing to fraud or deceit,"[89] or "undue complexity in transactions."[90] It also includes prohibition on "sale of things that do not yet exist . . . includ[ing] the fish a boat may catch on its next voyage, an unborn animal, or a crop that has not yet been planted."[91] This prohibition creates complexities for the use of a range of common financial products, such as derivatives, options, futures contracts, and any businesses engaged in speculative trading, arbitrage, or the like.[92] For MFIs, it simply imposes a requirement that the institution make every effort to spell out all of the terms of the lending contract, and ensure that their novice borrowers fully grasp the concepts and requirements. It helps that the micro-enterprises that MFIs are financing are generally simple and small—these are not huge corporate deals, so the contract terms can be understood by a novice with only minimal training, such as the week-long course required by Grameen Bank for new borrowers.

4. Halal*: All Activity Must be for Permitted Purposes*

When choosing which enterprises in which to invest, a Muslim must not engage in, or derive benefit from, any activity that is prohibited by Shari'a.[93] Such prohibited activities include "gambling and casino games, alcoholic beverages, pork consumption, pornography and prostitution, weapons/defense, and financial services dependent on [*riba*]."[94] For MFIs, this simply means that they must ensure that borrowers are not engaging in any such prohibited business activity, which is easily accomplished through generally required review of business plans prior to lending, as well as the group and societal peer pressure incumbent in the overall system.

5. The Evolving Nature of Islamic Law

Islamic law is not static in its regulations, but rather evolves as the circumstances it governs evolve. More accurately, *fiqq*—the dictate, or "law," that results from extensive study of religious texts and tradition by Islamic jurists—evolves as jurists continually study and refine their interpretation of God's dictates.[95] Islam recognizes that the world will change over time, and so some laws may become obsolete as the impetus to their adoption fades, and some laws may require tightening or

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[89] *Id.*
[90] *Id.*
[91] Karasik, *supra* note 79, at 382.
[92] *Id.* at 382.
[93] ISLAMIC MICROFINANCE REPORT, *supra* note 85, at 5.
[94] Karasik, *supra* note 79, at 382.
[95] BERNARD G. WEISS, THE SPIRIT OF ISLAMIC LAW 116 (1998).

broadening as a new impetus arises or as a standing impetus changes.[96] This capacity for practical and deliberate evolution is immeasurably important with regard to Islamic finance because the institutions and opportunities are young, and are in near-constant development.

One report aptly notes that the rapid expansion of Islamic finance in recent years has resulted in "incessant debates and deliberations among regulators, practitioners (in both conventional and Islamic finance), Shariah scholars, academicians, economists, lawyers, accountants and rating agencies"[97] and goes on to divide these contributors into three groups: idealists, realists, and reformists. The authors of the report assert that idealists are those who strictly follow the sources of Shari'a (*Qur'an, Sunnah, ijma,* and *qiyas*), and believe any interpretation should strictly follow the objectives laid out therein. The authors believe that idealists generally "do not have a strong grasp of economics or finance [and] are unfortunately unable to guide or suggest viable alternatives that meet the needs of society."[98] Realists, however, accept conventional structures on the ground that Islamic finance is in such a nascent stage that it must operate in a system similar to conventional finance if society is to reap its benefits.[99] As such, realists tolerate credit, debt, and leverage. Reformists—the group that the authors seem to most favor for the future of Islamic finance—believe that gradual changes, moving toward a more pure Islamic finance system, are the key to eventually establishing a viable Islamic finance market on par with conventional markets.[100] Reformists focus on equity rather than debt, and seek to establish new alternatives that comply with Shari'a principles. [101]

The Reformist view is closely in-line with the traditional willingness in Islam, as noted above, to adjust rules over time so that they are relevant, workable, and effective in accomplishing the desired goal. An apt analogy is the process through which the prohibition on *al kahmr* (alcohol) was developed and implemented in progressive stages. First, it was declared that alcohol had more bad than good in it. Then, it was declared that alcohol should not be consumed prior to approaching prayer. Finally, when anarchy was incited in Medina after the citizens consumed alcohol, it was entirely prohibited.[102] The prohibition was developed over three verses because, it is assumed, it would have been difficult for followers of Islam

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[96] *See generally* Umar F. Moghul, *Approximating Certainty in Ratiocination: How to Ascertain the* 'Illah *(Effective Cause) in the Islamic Legal System and How to Determine the* Ratio Decidendi *in the Anglo-American Common Law*, 4 J. ISLAMIC L. 125 (1999).

[97] ISLAMIC FIN. ASIA, EPISTEMOLOGY IN ISLAMIC FINANCE (2010), *available at* http://www.islamicfinanceasia.com/article.asp?nm_id=18680.

[98] *Id.*

[99] *Id.*

[100] *Id.*

[101] *Id.*

[102] *Id.*

to instantaneously abstain from consumption of alcohol, which had previously been customarily consumed.[103] By instituting the prohibition in stages, followers were able to progressively "learn, observe and realize [alcohol's] evils."[104]

In much the same way, purely Islamic finance is being established in stages. Understanding that fully Islamic companies are rare, Islamic jurists began permitting investment in companies that meet the following conditions:

- The company's core business must be permissible (*halal*).[105]

- The company's use of conventional debt must be limited (for example: real estate companies rely heavily on conventional, interest-based debt (*riba*), so are impermissible).

- The company must not derive a significant portion of income from interest (*riba*) (for example: a start-up company that is not yet earning extensive profit from sale of its product, but derives extensive profit from interest on its bank deposits, may be impermissible).

- The investor, or investment manager, must ascertain what portion of the company's income has been derived from impermissible sources and donate a corresponding portion of the investment to charity. This is called "purification," and it is a critical component of the role of an Islamic asset manager.[106]

These four guidelines have become common practice in screening opportunities in the Islamic investment industry, and are applied in some form by hundreds of equity funds and indices, including the Dow Jones Islamic Indexes.[107] However, "[c]ommentators have noted that Islamic scholars allowed investing in listed companies as a stepping-stone—a measure that was necessary for the industry to develop—but intended to encourage a migration toward more Islamic balance sheets in investment-worthy companies."[108] To that end, Taqi Usmani, one of the Islamic finance sector's most influential jurists, stresses that a "'Muslim

[103] EPISTEMOLOGY IN ISLAMIC FINANCE, *supra* note 97.
[104] *Id.*
[105] *See supra* Part III.A.4.
[106] AAMIR A. REHMAN, GULF CAPITAL & ISLAMIC FINANCE 192–93 (2010).
[107] *Id.* at 193.
[108] *Id.*

shareholder should raise his voice . . . in the annual general meeting of the company'" if the company uses conventional leverage or collects interest for income.[109] This assertion reflects the desire that Islamic investors not rest on Shari'a filters and "purification" of impermissible income, but should instead become activists, and seek to usher those companies in which the investor has influence toward more Islamic ethical standards.[110]

In some measure progress has been made, as shown by a shifting preference toward fully Shari'a-compliant investment and savings opportunities by a new generation of investors who have grown up during the rise of Islamic finance, and have greater expectations than older investors that they will be able to achieve world-class results without compromising ethical values.[111] In 2008, Ernst & Young conducted a study of preferences among Muslim investors for Shari'a-compliant investment products.[112] The study found that

> 20 percent of the market is willing to accept substantially lower returns in exchange for a product's being Shariah-compliant. A full 40 percent of the market, however, was found to prefer the Shariah-compliant products if they perform equally as well as conventional ones . . . . Another 30 percent of the market . . . [would] choose the asset with the highest return without preference for Shariah compliance. Only 10 percent was found to actually prefer conventional finance as a matter of principle.[113]

To this end, Shari'a-compliant microfinance is a valuable option for investors seeking to diversify their portfolio with an ethical, resilient, and profitable instrument. Currently of particular relevance is the finding that microfinance has been shown to be substantially resistant to recessionary forces.[114] This is due to a variety of characteristics particular to microfinance structures and circumstances. The current recession has affected economies across the globe in a domino-like procession because globalization of trade and finance has extensively integrated developed and developing economies—when the large economies fail, the smaller, developing economies slow considerably, or themselves enter recession.[115]

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[109] *Id.*

[110] *Id.*

[111] *Id.* at 195.

[112] REHMAN, *supra* note 106, at 196.

[113] *Id.*

[114] *See* Roberto Moro Visconti, *Global Recession and Microfinance in Developing Countries: Threats and Opportunities* (Università Cattolica del Sacro Cuore, 2009) (unpublished preliminary version), *available at* http://ssrn.com/abstract=1318581.

[115] *Id.* at 4.

Microfinance institutions, however, generally serve the poorest persons in the poorest countries—a market that is generally segmented from the global economy:[116]

> Empirical evidence suggests that MFIs—especially in already segmented developing countries—are to a significant extent detached from major markets and from macroeconomic conditions and this is why MFIs still remain stable in times of economic crisis . . . [and] have a lower market risk if compared to that of other financial institutions.[117]

MFIs are generally privately held companies, with both for-profit and non-profit investors who are less driven by market forces because they have long-term strategic interests.[118] Also, micro-entrepreneurs and other low-income borrowers have a strong repayment attitude, owing to an extent to the close relationship that the local MFIs have to the borrowing groups, making returns more reliable than is the case with many instruments.[119] Further, most MFIs serve primarily or exclusively female borrowers, who have above average repayment reliability, making those MFIs yet more sustainable in times of crisis.[120]

The strongest protection from recession, though, results from the focus of micro-entrepreneurs and MFIs on informal, local markets. Micro-entrepreneurs by and large use domestically produced goods and services, which insulates them from currency devaluation or exchange controls, makes them less connected to broader political or economic events, and, when currency volatility occurs, demand for their less expensive, locally produced goods and services increases.[121] These protective structures have proven themselves in past recessions in the 1990s (Mexico, Asia, Russia), where financial crises caused the collapse of corporate portfolios, but MFIs "barely blinked."[122] For scholars looking to move forward in the progression toward a diverse range of pure Islamic investment options, and for the new breed of Islamic investors seeking profitable, resilient, Shari'a-compliant opportunities, microfinance offers a compelling option.[123]

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[116] *Id.* at 7.
[117] *Id.*
[118] *Id.*
[119] *Id.*
[120] Visconti, *supra* note 114, at 8.
[121] *Id.*
[122] *Id.*
[123] Dhumale & Sapcanin, *supra* note 43, at 1.

B. *Shari'a–Compliant Microfinance Structures*

> [M]any elements of microfinance could be considered consistent with the broader goals of Islamic banking. Both systems advocate entrepreneurship and risk sharing and believe that the poor should take part in such activities. At a very basic level . . . Islamic banking and . . . microcredit programs may complement one another in both ideological and practical terms. This close relationship would not only provide obvious benefits for poor entrepreneurs who would otherwise be left out of credit markets, but investing in microenterprises would also give investors in Islamic banks an opportunity to diversify and earn solid returns.[124]

1. *Administrative Issues in All Microfinance Structures*

Before exploring the specific structures of Shari'a-compliant microfinance instruments, the common administrative structures should be reiterated and expanded upon. First, the MFI must have some substitute for collateral, which is used to secure conventional loans. The poor populations served by microfinance do not have assets to use as collateral—this is the primary reason that such populations are not served by conventional banking institutions[125]—and so MFIs may use one of several alternatives for incentivizing timely and full loan repayment. All of the models use social pressure and eligibility for future loans as the primary incentive for repayment:

a. Group Lending

Individuals form small groups—generally around five members—and apply together for a loan from the MFI.[126] The application includes basic business data, personal information, and a proposed loan size; and group members must sign a guarantee agreeing to vouch for one another and to pay any individual loan in case of default.[127] Funds are disbursed to individuals in the group, and all members share the risk of the others' repayment.[128] Pending full and reliable repayment by the group, the members are eligible for repeated finance for their enterprises in the future.[129] This is the most popular microfinance model, used by the original MFI, Grameen Bank in Bangladesh.

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[124] *Id.*
[125] OBAIDULLAH, *supra* note 6, at ii.
[126] *Id.* at 7.
[127] Dhumale & Sapcanin, *supra* note 43, at 11.
[128] OBAIDULLAH, *supra* note 6, at 7.
[129] *Id.*

b. Village Bank

This is somewhat group lending writ-large. The MFI will establish individual village banks, each with thirty to fifty members, and the parent-MFI will provide capital to the banks for financing individual members.[130] The individuals make weekly payments over several months, at the end of which time the village bank returns the principle, plus any profits, to the parent-MFI.[131] Exactly as in the group model, social pressure operates to ensure repayment by members.[132] A village bank that repays in full is eligible for subsequent loans from the MFI, and loan sizes are determined based on the accumulated savings of members.[133] This latter point encourages savings, and as the village bank accumulates sufficient internal capital it gradually becomes a self-sustaining institution.[134] This model has seen successful implementation in Syria, and is being introduced in Afghanistan by the Foundation for International Community Assistance ("FINCA").[135]

c. Self-Help Groups ("SHGs")

SHGs are comprised of ten to fifteen members who are relatively homogonous in income.[136] The members pool together their savings, and seek external funding from Non-Government Oranizations ("NGOs") or other charity groups (such as MFIs), and then use the pool for lending to members.[137] Again, social pressure is at work among the group members. This model, though, is only viable for micro-entrepreneurs who have attained a certain economic level, such that they have savings to pool. Thus, the model may work best for those who have been running their micro-enterprise for an appreciable amount of time, and are seeking to reduce their dependence on the MFIs that may have contributed to their start-up.

Moving beyond the collateral issue, MFIs must solve administrative issues incumbent in serving rural populations, which often have less experience in business than conventional business loan applicants. These issues include increased risk of default resulting from faulty business practices and a lack of reliable institutions for holding funds and transmitting loan payments. These issues are resolved by increased involvement, as compared to traditional banks, by the MFI. A loan officer may conduct random field visits to micro-entrepreneurs to ensure that the

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[130] *Id.*
[131] *Id.*
[132] *Id.*
[133] *Id.*
[134] OBAIDULLAH, *supra* note 6, at 7.
[135] *Id.*
[136] *Id.* at 8.
[137] *Id.*

enterprise exists, and is being run in an efficient and sustainable way.[138] Also, most loans are given in small amounts, with a repayment period of no more than a few months, and with weekly payments collected by an officer personally[139]—this means that if a micro-entrepreneur's business is performing poorly only a small amount of money is at risk of being lost (when the business performs well, and the loan is repaid, additional short-term loans are granted), and the loan officer serves as the transmitter of payments where there is no formal institution available for the task. This increased involvement results in higher administrative costs than is seen in conventional loan administration, but it is a necessary cost in implementing and sustaining a successful microfinance initiative.

2. *Shari'a-Compliant Microfinance Structures*

There are a number of Shari'a-compliant structures that have been developed for use in mainstream Islamic finance in general, which can also be used to provide Shari'a-compliant microfinance to the Islamic poor. The most widely used of these include both profit-sharing models (*musharaka, mudaraba*) and contracts of exchange (*murabaha, ijara*).[140] A number of Muslim countries are already using, and having success with, one or more of these structures.[141]

a. Profit-Sharing Models

(i) *Musharaka* (Partnership)

In *musharaka*, the micro-entrepreneur, the MFI, and possibly other investors, will inject equity into the micro-enterprise, and will then share all profits and losses according to the proportion of equity capital each party invested.[142] Each partner (investors and micro-entrepreneur) must receive information on business activity (such as accounting information), must authorize new partners for raising capital, and may receive a salary for participating.[143] Additionally, all partners have management rights in the enterprise, but they are not obligated to exercise them.[144] Classical *musharaka* makes the investor/MFI a permanent partner in the micro-enterprise.[145] This model has traditionally been used to finance medium-

[138] Dhumale & Sapcanin, *supra* note 43, at 11.

[139] OBAIDULLAH, *supra* note 6, at 6–7.

[140] *See* ISLAMIC MICROFINANCE REPORT, *supra* note 85, at 16–19. There are two more Shari'a-compliant structures under contracts of exchange—*istisna'a* and *salam*—but these are more specialized and utilized on a far smaller scale than the four widely-used models explored in this section. For further information on *istisna'a* and *salam*, see OBAIDULLAH, *supra* note 6, at 50–51.

[141] *See* ISLAMIC MICROFINANCE REPORT, *supra* note 85, at 16–19.

[142] Dhumale & Sapcanin, *supra* note 43, at 4.

[143] ISLAMIC MICROFINANCE REPORT, *supra* note 85, at 16.

[144] *Id.*

[145] OBAIDULLAH, *supra* note 6, at 52.

and long-term investments.

Musharaka is not a popular structure in microfinance because there are substantial operating costs resulting from the reporting and transparency requirements necessary for fair distribution of profits.[146]

(ii) *Mudaraba* (Trust Financing)

Mudaraba offers more protection for the micro-entrepreneur, and more risk for the MFI, than *musharaka*. Under *mudaraba*, the MFI invests all of the capital required by the micro-enterprise, while the micro-entrepreneur contributes labor and management, but no capital.[147] Profit is shared between the MFI and the micro-entrepreneur based on a predetermined ratio.[148] Financial losses are borne only by the MFI; the micro-entrepreneur risks only his or her time and effort.[149] However, the micro-entrepreneur may be held responsible for financial losses if they result from proven negligence or mismanagement.[150] To properly execute a *mudaraba* contract, a bank, or in this case the MFI, must fulfill certain legal obligations:

- Collateral may not be requested to reduce the lender's credit risk. However, collateral may be requested to reduce moral hazard.[151] [Note that collateral is unlikely to be requested from microfinance recipients, even to reduce moral hazard, because recipients generally do not have any collateral to offer. As discussed above, group lending and other protective structures are used as a replacement for collateral in reducing moral hazard.]

- Profit-sharing rates must be a predetermined percentage of profits—even though profits are unknown at the time of contracting—not a lump sum payment. In some cases the bank will receive part of the principle if a surplus exists at the end of the period.[152]

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146 ISLAMIC MICROFINANCE REPORT, *supra* note 85, at 16–17.
147 Dhumale & Sapcanin, *supra* note 43, at 8.
148 *Id.*
149 *Id.* at 3.
150 *Id.*
151 *Id.* at 3–4.
152 *Id.* at 4, 8.

- The micro-entrepreneur must have full control over the enterprise, though the MFI is permitted to supervise.[153]

The most interesting aspect of *mudaraba*, though, is the diminishing role of the investor. Each payment that the entrepreneur makes to the MFI is essentially used to "buy back" shares of the enterprise.[154] Because the MFI supplies all of the capital at the outset, they in effect own 100% of the "shares" of the business; but as each loan installment is made the entrepreneur buys back a corresponding percentage of the business, and the next payment to the bank is a lesser portion of profits, corresponding to the bank's diminished ownership in the enterprise.[155]

As an example, consider an entrepreneur who takes a 10,000 microcredit loan from the MFI, to be repaid in 20 weekly installments (for universality, currency units will be generic). The enterprise makes a weekly profit of 1,000, and the MFI is entitled to 10 percent of that weekly profit. Each share is worth 500 (10,000 loan amount divided by 20 weekly installments, representing 100 percent ownership in the MFI at the outset).

In the first week, the MFI owns 100 percent of the shares, and so receives 100 from the 1000 profit (10 percent of 1000), leaving 900 from the profit for the entrepreneur. The entrepreneur will use 500 of that 900 to buy back one share of the enterprise.

In the second week, the MFI owns 19/20ths of the enterprise, and the entrepreneur owns 1/20th. The MFI will now receive 10 percent of 950 (19/20ths of the 1000 profit), which is 95. The entrepreneur will get the rest: 905 (1000–95). Again, the entrepreneur will use 500 of his retained profit to buy another share of the enterprise. Going into the third week, the MFI owns 18/20ths of the enterprise, and the entrepreneur owns 2/20ths. This process continues throughout the 20-week repayment period, at which point the MFI no longer owns shares of the enterprise. A visualization of this repayment schedule is shown in Table 1.[156]

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153 Dhumale & Sapcanin, *supra* note 43, at 4.

154 *Id.* at 8.

155 *Id.*

156 See *id.* for a more extensive explanation of this example.

Week	Profit to be Shared	Program Income	Entrepreneur Income
1	20/20 x 1,000 = 1,000	1,000 x 10% = 100	1,000 x 90% + 0 = 900
2	19/20 x 1,000 = 950	950 x 10% = 95	950 x 90% + 50 = 905
3	18/20 x 1,000 = 900	900 x 10% = 90	900 x 90% + 100 = 910
4	17/20 x 1,000 = 850	850 x 10% = 85	850 x 90% + 150 = 915
5	16/20 x 1,000= 800	800 x 10% = 80	800 x 90% + 200 = 920
6	15/20 x 1,000= 750	750 x 10% = 75	750 x 90% + 250 = 925
7	14/20 x 1,000 = 700	700 x 10% = 70	700 x 90% + 300 = 930
8	13/20 x 1,000 = 650	650 x 10% = 65	650 x 90% + 350 = 935
9	12/20 x 1,000 = 600	600 x 10% = 60	600 x 90% + 400 = 940
10	11/20 x 1,000 = 550	550 x 10% = 55	550 x 90% + 450 = 945
11	10/20 x 1,000= 500	500 x 10% = 50	500 x 90% + 500 = 950
12	9/20 x 1,000 = 450	450 x 10% = 45	450 x 90% + 550 = 955
13	8/20 x 1,000 = 400	400 x 10% = 40	400 x 90% + 600 = 960
14	7/20 x 1,000 = 350	350 x 10% = 35	350 x 90% + 650 = 965
15	6/20 x 1,000 = 300	300 x 10% = 30	300 x 90% + 700 = 970
16	5/20 x 1,000= 250	250 x 10% = 25	250 x 90% + 750 = 975
17	4/20 x 1,000 = 200	200 x 10% = 20	200 x 90% + 800 = 980
18	3/20 x 1,000= 150	150 x 10% = 15	150 x 90% + 850 = 985
19	2/20 x 1,000 = 100	100 x 10% = 10	100 x 90% + 900 = 990
20	1/20 x 1,000 = 50	50 x 10% = 5	50 x 90% + 1,000 = 995
Total		**1,050**	**18,950**

Table 1: Program and Entrepreneur Profits Under The Mudaraba Example.

As compared to *musharaka*, this model has some vital strengths for serving the poor populations targeted by microfinance. First, it does not require any financial investment by the micro-entrepreneur, which, for obvious reasons, is key for these clients who are idea- and labor-rich but cash-poor. There is some concern that this arrangement will result in faulty ideas or mismanagement in the micro-enterprise, since the micro-entrepreneur has no personal financial liability in the enterprise. However, such a tendency is overcome by group pressure to perform well in the business setting, and the micro-entrepreneur's desire to perform well so that she may take out additional loans—as Mr. Yunus pointed out in his meeting with the doubtful banker, these people will endeavor to perform exceedingly well because their lives depend on it.[157] The second key strength is in the capacity to progressively take full ownership of the enterprise, which is an effective and natural way to accomplish one of the key goals of microfinance: to transition recipients from reliance on outside aid to full financial self-reliance.

However, *mudaraba* also has some significant drawbacks and difficulties in implementation. The first of these is the weekly fluctuation of profits, and the resulting inability to predict investment returns, making the above example, with its fixed weekly profit, somewhat misleading in its simplicity.[158] This fluctuation not only means volatility in profit returns for the MFI, but also greatly complicates an already confusing payment structure: the entrepreneur must repay a different amount each period, and the loan officer—who generally keeps track of 100–200 accounts—must collect a different amount each period from each entrepreneur.[159] This is yet further complicated by the circumstance that most micro-entrepreneurs do not keep accurate records, making profit calculation and distribution markedly more difficult and less accurate.[160] Given the generally high number of microloans granted by an MFI, even a small margin of error can have a considerable effect on returns for the MFI.[161]

These issues are to an extent remediable. Market data can cut down on profit unpredictability, and as the informal markets grow through micro-entrepreneurship, they may become more highly studied, more stable, and more predictable. As far as confusion over repayment schedules, while it is unlikely that the process will ever be simple and completely accurate, micro-entrepreneurs can and should receive education regarding the intricacies of the finance tool they are utilizing, as well as record keeping and accounting principles. This latter point will be discussed at more length below in Part IV.C. Alternatively, the MFI could set a default payment schedule, such that the payments are constant for each period. The default payment amount would have to be low enough that the MFI could be nearly sure that the micro-entrepreneur could easily meet it, and that it would not regularly cut too deeply into her profit. Such a rate will be easiest to set in markets that are well developed and well studied. Given that the payment rate in a default payment structure would possibly be lower than a rate set by a fixed percentage of profit, it may take longer for the micro-entrepreneur to pay off the loan, but the end result would essentially be the same, and administration would be significantly easier. Research has not revealed any MFIs that have attempted such a structure, so it is unclear how well this system would function.

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[157] *See* YUNUS, *supra* note 3, at 54.
[158] Dhumale & Sapcanin, *supra* note 43, at 9.
[159] *Id.* at 10.
[160] *Id.*
[161] *See id.*

b. Contracts of Exchange

(i) *Murabaha* (Cost-Plus Mark-Up)

Under *murabaha*, the MFI will purchase necessary goods from a third-party seller, and then sell the goods to the micro-entrepreneur at a fair mark-up to recover administrative costs.[162] The micro-entrepreneur will repay the amount (cost + mark-up) in equal installments to the MFI.[163] It is required that both parties to the transaction know the base price of the goods and the markup.[164] Similarly, the prohibition on *gharer* (uncertainty in contract terms) means that frequency and amount of installments must be pre-determined and clearly understood by both parties, so there is little confusion facing the loan officer or the micro-entrepreneur (unlike with *mudaraba*).[165] Additionally, profits do not affect the amount to be paid, so accurate records are not required, and there is a decreased opportunity for abuse through inaccurate or false record keeping.[166] This structure is the most popular of the Shari'a-compliant microfinance structures broadly in use, and is used by MFIs in Afghanistan, Bangladesh, Indonesia, Sudan, Syria, and Yemen.[167]

However, Shari'a scholars increasingly do not approve of *murabaha*, feeling that the process is disguised lending where the MFI has no actual interest in acquiring the underlying commodity, making the process too close to prohibited *riba*.[168] As discussed above, Shari'a-compliance requires that the MFI share a sufficient amount of risk in the transaction to legitimize its returns.[169] Scholars hold that the MFI must have either physical or constructive ownership of the commodity before it can sell the commodity to the micro-entrepreneur—this inheres in the MFI a risk of destruction of the asset, and any liabilities incumbent in ownership.[170] The way this process plays out in reality is routine, frequent, and lightning fast. Often, the MFI acquires the commodity and transfers it to the micro-entrepreneur so swiftly that it appears the MFI has not had any possession, or the accompanying risk, in the commodity.[171] This issue, though, is largely cosmetic—the problem arises less in the structure of the financial instrument and more in the implementation. If MFIs are careful in their use

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[162] *Id.*

[163] *Id.* at 10–11

[164] OBAIDULLAH, *supra* note 6, at 47. Where the base-price and mark-up are not disclosed by the lender, the transaction is called *musawama*. *Id.*

[165] *Id.*

[166] *Id.*

[167] ISLAMIC MICROFINANCE REPORT, *supra* note 85, at 17–18.

[168] *Id.* at 18.

[169] OBAIDULLAH, *supra* note 6, at 47.

[170] *Id.*

[171] *Id.* at 49.

of *murabaha*, i.e. clear and consistent record-keeping showing sufficient ownership—which, by some accounts, can be only "fleeting" and still satisfy the risk-sharing requirement[172]—this issue will not be so detrimental as to remove *murabaha* from the list of viable Islamic microfinance instruments.

(ii) *Ijara* (Sale and Leaseback)

Under *ijrara*, the MFI owns the necessary asset and leases it to the micro-entrepreneur for a predetermined time period, and for predetermined rental payments.[173] The rental payments are structured such that the cost of the asset, plus a fair financial return and, sometimes, the cost of insurance premiums, is recovered by the MFI by the end of the lease term.[174] Unlike most conventional lease contracts, the risks of ownership remain with the MFI for the entire duration of the lease period, which resolves the risk issue associated with *murabaha*. The micro-entrepreneur will only be responsible for covering destruction of asset value if the loss is caused by his or her negligence.[175] At the end of the lease period, the MFI may reclaim possession of the asset, sell it to the micro-entrepreneur for a nominal price, or simply donate it to the micro-entrepreneur.[176]

This option is particularly useful for micro-enterprises that are in need of non-diminishing assets, such as tools, machinery, or vehicles. Additionally, it is administratively simple in its equal payment schedule, it provides a highly predictable return to an investor, and there is little argument over Shari'a-compliance. Clearly it is not a structure that can serve all types of micro-enterprises. *Ijara* would not be a good option for businesses that require primarily diminishing assets, such as raw building materials, for their output. But as a targeted micro-finance scheme, it is a valuable one.

IV. KEYS TO MAXIMIZING EFFICACY

Microfinance initiatives are in many ways strikingly simple, especially given the far-reaching, multi-layered capacity they have for improvement of the lives of very poor individuals. However, there are some pitfalls in administration that can decrease the efficacy of an initiative, and, following years of trial-and-error, many solutions, too. Any microfinance initiative, Islamic or otherwise, would do well to observe the following suggestions.

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[172] *Id.* at 47.
[173] *Id.* at 49.
[174] *Id.* at 49–50.
[175] OBAIDULLAH, *supra* note 6, at 50.
[176] *Id.* at 49.

A. *Encourage or Require Microfinance Recipients to Engage in Formalized Saving.*

When trying to solve the problem of poverty, it is easy to focus on the need to generate income for poor individuals—they lack money, so we must find a way to give them money or the means to make it. However, it is extremely detrimental to stop our thinking there; we must go further, and consider what they will do with the money they generate. To say that the poor lack reliable financial services is not only to say that they lack access to loans, but that they also lack safe and convenient places for deposits and withdrawals, which may be as key to financial success as loan access.[177] Without access to such services, the money made in a micro-enterprise may be stolen or lost, leaving the micro-entrepreneur back at square one.

Poor individuals need secure, convenient deposit services that allow for small balances, small transactions, and offer easy access to the funds.[178] They also may require more personalized service, such as door-to-door collection, in rural settings where a bank branch does not exist.[179] Additionally, Muslim populations will need Shari'a-compliant mechanisms to substitute conventional savings mechanisms that generally rely on the bank using the deposits for investments and returning interest to the depositor.[180] Thus, the savings contracts must be free from *riba* and *gharar*, and the activity for which the bank uses the deposited funds must comply with *halal* requirements.[181]

One such deposit mechanism is *wadia*. Here, deposits are held in trust, as *amana*, and used by the MFI at its own risk.[182] The depositor does not share in any form of risk or return—the MFI is the sole beneficiary of returns on their investment choice, and will bear all losses.[183] Thus the depositor receives no interest (*riba*) or other return that could violate *gharar* or *mayseer*. *Wadia* contracts also do not allow any return of excess over the principle deposit, even as a unilateral gift by the MFI to the depositor—the fear is that, if the MFI routinely gives "gifts" of returns to account holders, or other advantages to attract deposits, it would amount to *riba* through a back door.[184] An important additional aspect of *wadia* accounts is that they do not have any conditions regarding deposits and withdrawals,[185] which is important for micro-entrepreneurs who may have

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[177] *Id.* at 4.
[178] *Id.* at 44.
[179] *Id.*
[180] *Id.*
[181] OBAIDULLAH, *supra* note 6, at 44. *See* discussion *infra* Part III.A.1 for information on *riba, gharar, and halaal.*
[182] OBAIDULLAH, *supra* note 6, at 44.
[183] *Id.*
[184] *Id.*
[185] *Id.*

business and deposit needs that vary in less predictable ways than a conventional, larger business depositor.

In a slight variation on a *wadia* account, the bank could treat the depositor's funds as *qard hasan*, or a benevolent loan to the bank by the depositor.[186] Here again, the depositor cannot receive interest or any other return on the deposit, and the MFI is free to use the funds for investments, at its own risk. The depositor is permitted to make withdrawals at his discretion, given that the strictures of *qard hasan* allow the lender (here, depositor) to recall the loan at any time.[187]

A final Shari'a-compliant micro-savings model is a variation of *mudaraba*,[188] in which the MFI takes the deposit and requires the depositor to authorize it to invest the funds (appoint the MFI as *mudarib*).[189] Profits on the investment are then shared by the depositor and the MFI based on a previously-agreed ratio, and any losses on the investment are absorbed by the depositor[190]—thus the depositor is engaging in a sufficient level of risk-sharing in the investment. Depositors have the right to withdraw funds at any time, and so profits are calculated based on the minimum balance maintained for the relevant time period, and a certain "minimum balance is required to be maintained in order to qualify for a share in profits."[191] This form of savings involves a considerable downside risk for the depositor, and so it is rarely offered by MFIs.[192]

Whether to require or simply to strongly encourage savings by micro-entrepreneurs is at the discretion of each MFI. It is relatively simple to administer some requirement that, say, 5 percent of profits be deposited in some savings mechanism when the micro-entrepreneur is making her regular installment payment, under whichever mechanism is at work, to the MFI. The importance of savings cannot be overstated. Savings provide not only a protection against everyday theft or loss, but also give the micro-entrepreneur some cover when the unexpected strikes—be it a natural disaster, a death in the family, or any other of the various emergent situations that can crop up on the rich and the poor alike, but can financially devastate the poor if they are unprepared.

B. To Maximize Benefits, Restrict Microfinance Loans: Extend Loans Only to the Economically Active

To maximize their positive effects, microfinance initiatives should not extend loans to the "poorest of the poor." This can seem counter-intuitive

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186 *Id.*
187 *Id.*
188 *See* discussion *infra* Part III for *mudaraba*.
189 OBAIDULLAH, *supra* note 6, at 44.
190 *Id.* at 45.
191 *Id.*
192 *Id.*

when considering a poverty-alleviation institution, but it in fact does more harm than good to loan to the chronically destitute. This class includes individuals and families whose basic needs—food, clothing, and housing—are not being met.[193] These people will not be able to use a loan to begin a micro-enterprise because they will instead need any money they receive to first meet those basic needs. Without a micro-enterprise, they are not generating income with the loan, and are then unable to make their repayments, digging themselves further into debt and becoming poorer.[194]

This is not to say that these people should be abandoned by aid organizations and initiatives. Rather, they should simply be served by different mechanisms (i.e. charity mechanisms that do not require repayment). The Islamic faith strongly encourages and supports charitable giving. It is said that the Prophet Muhammad asserted "[p]overty is almost like disbelief in God," and Islamic jurists unanimously hold that it is a collective obligation (*fard kifayah*) of a Muslim society to care for the basic needs of the poor.[195]

The broad term for charity in Islam is *sadaqa*; and when charity giving is compulsorily mandated on a Muslim it is called *zakah*.[196] *Zakah* is the third of the five pillars of Islam,[197] and its payment is the obligation of every eligible Muslim, to benefit eligible recipients, as determined by certain criteria laid out in the Qur'an.[198] Another means of charity is *waqf*, which is an inalienable endowment of certain physical assets, which will be preserved to give continuous benefits "to a specified group of beneficiaries or [a] community."[199] Finally, there is *qard hasan*, which is an entirely interest-free loan.[200]

1. Zakah

"*Zakah* literally means 'to purify, to develop, and, to cause to grow.'"[201] *Zakah* "prescribes a share of one's wealth to be distributed among categories of those entitled to receive it." Eligibility for receipt of *zakat* is determined by the *Qur'an*:

> The offerings (*zakah)* given for the sake of Allah are (meant) only for *fuqara* (poor) and the *masakeen* (needy), and *ameleen-a-alaiha* (those who are in charge

[193] Costa, *supra* note 60, at 9.
[194] *Id.*
[195] OBAIDULLAH, *supra* note 6, at 13.
[196] *Id.*
[197] *Id.* at 14. The other five pillars of Islam are faith, daily prayer, self-purification through fasting, and pilgrimage to Makkah; WEISS, *supra* note 95, at 146.
[198] OBAIDULLAH, *supra* note 6, at 26.
[199] *Id.* at 31.
[200] *Id.* at 37.
[201] *Id.* at 26.

> thereof), and *muallafat-ul-quloob* (those whose hearts are to be won over), and for *fir-riqaab* (the freeing of human beings from bondage), and for *al-gharimun* (those who are overburdened with debts), and *fi-sabeelillah* (for every struggle) in Allah's cause, and *ibn as-sabil* (for the wayfarer): (this is) an ordinance from Allah- and Allah is all knowing, wise. (9:60)[202]

Breaking this verse down further, the categories of eligible recipients of *zakat* are these:

- *Fuqara* (poor) and *masakeen* (needy) include individuals whose basic necessities are not met because they have no means of livelihood, or their income is inadequate. This will include orphans, the sick and disabled, and the homeless.[203]

- *Ameleen-a-alaiha* (those who are in charge thereof) includes personnel employed for the purpose of maintaining the integrity and independence of collection and disbursement of *zakah* funds, so their salaries may be paid out of *zakah* funds.[204]

- *Muallafat-ul-quloob* (those whose hearts are to be won over) implies non-Muslims who are close to accepting Islam as their religion.[205]

- *Fir-riqaab zakah* allows payment of ransom or compensation for freeing slaves and prisoners of war.[206]

- *Al-gharimun* (those who are overburdened with debts) refers to those trapped in debt, as long as the debt is not the result of frivolous and conspicuous consumption, and delinquency in repayment is not willful and deliberate. Additionally, scholars insist that the debt be between Muslims.[207]

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202 *Id.*
203 *Id.*
204 OBAIDULLAH, *supra* note 6, at 26.
205 *Id.* at 27.
206 *Id.*
207 *Id.*

- *Fi-sabeelillah* (for every struggle) is broad, and includes expenditure for the propagation and defense of Islam, as well as charitable projects in the field of education, medical care, and social welfare.[208]As a caveat to this category, it is required that funds must clearly flow to specified categories of beneficiaries only. Thus, the funds must be clearly distinguished from any treasury pool of taxes and other state revenues, and cannot be used by the state to finance projects that are generally beneficial to all Muslims, or to meet administrative expenditures.[209]

- Finally, *ibn as-sabil* (the wayfarer) includes any person who is far from home and who, because of circumstances beyond his or her control, does not have sufficient means of maintaining livelihood. [210] This may include, for example, a political exile or refugee.

Zakah is only required to be paid by those considered eligible, which can broadly be stated as any sane, adult, Muslim individual who possesses wealth beyond a prescribed minimum.[211] For wealth to become subject to *zakah*, it must have been in the ownership of the individual for one Hijri calendar year (*haul*), and it must exceed a minimum threshold (*nisab*).[212] The wealth at issue in this calculation only includes savings, agricultural output, and wealth that is "characterized as stocks (e.g. gold, silver, and the inventory of trade and livestock)."[213] The calculation does not include (1) income which is used for consumption, (2) "items of wealth, which are used for personal and family purposes," or (3) "wealth that is in the nature of means of production, such as, tools and equipments, machinery etc."[214] The rates at which the included wealth will be levied vary with the forms of wealth, though most forms carry a rate of 2.5 percent.[215]

In an ideal world, *zakah* would be used to care for the extremely poor, such that their basic life needs could be met. Once that is achieved, it is hoped that those individuals will then be able to use *zakah* funds to receive education or targeted training, such that they become more economically able. Then, it is hoped that the individuals will obtain such a state that they

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[208] *Id.*
[209] *Id.* at 26.
[210] OBAIDULLAH, *supra* note 6, at 27
[211] *Id.* at 28. It is unsettled among scholars whether organizations are also required to pay *zakah*.
[212] *Id.*
[213] *Id.*
[214] *Id.*
[215] *Id.*

are viable recipients of microfinance, such that they can begin a micro-enterprise and develop the means to fully support themselves. Finally, the individual should one day reach such a position that he or she is able to fulfill an obligation to give *zakah* to a person who is in need, as they once were themselves.[216]

2. Waqf

Waqf (plural: *awqaf*) is an inalienable endowment of certain physical assets, which will be preserved to give continuous benefits to a specified group of beneficiaries or a community.[217] *Waqf* typically applies to non-perishable properties, such as land or buildings, mostly devoted for religious or charitable purposes.[218] Some scholars allow books, agricultural machinery, and livestock to be *waqf* because the asset itself is not depleted by its use.[219] Stocks and cash may also be *waqf* if the original endowment is kept intact, with the generated returns used for the prescribed benefits.[220] Doing a *waqf* is entirely voluntary, and beneficiaries need not be only Muslims.[221] The rules governing *waqf* are elaborate and well-documented, and generally aim to protect the donations, assert conditions for development and expansion, ensure income from the *waqf* is spent as intended by the donor, and that the trustee-managers execute their responsibilities diligently and with integrity.[222] As far as helping to meet the needs of the extremely poor who are not good candidates for microfinance, *awqaf* may be used to set up homeless shelters or soup kitchens, education facilities, or any other myriad institutions outfitted to uplift the most destitute in society.

3. Qard Hasan

Qard hasan literally means "beautiful loan."[223] It is granted without any expectation of return on the principal, and is a highly prized act of giving in Islam.[224] On the point of *qard hasan*, the *Qur'an* says:

- Who is it that will lend Allah a *qard hasan* which He will multiply for [the lender] many times and for him shall be a generous recompense. (11:57)[225]

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[216] OBAIDULLAH, *supra* note 6, at 29.
[217] *Id.* at 31.
[218] *Id.*
[219] *Id.* at 31–32.
[220] *Id.* at 32.
[221] *Id.*
[222] OBAIDULLAH, *supra* note 6, at 32–33.
[223] *Id.* at 37.
[224] *Id.*
[225] *Id.*

- Verily, those who give *sadaqa* [charity], men and women, and lend to Allah a *qard hasan*, it shall be increased manifold (to their credit), and theirs shall be an honorable good reward. (57:18)[226]

- If you lend Allah a *qard hasan*, He will multiply it for you. Allah is the most appreciating, the most forbearing. (17:64)[227]

A *qard hasan* to a person in need is considered to be a loan to Allah Himself, and it is believed that Allah will reward the lender to a degree many times greater than the loan itself, without specification of whether such awards will be in this life or in the hereafter.[228] Any expectation or demand of profitable return on a *qard hasan* is forbidden as *riba*; however, the Prophet encouraged borrowers to be generous in repayment by, if possible, returning more than was originally borrowed in the form of a gift (*heba*).[229] The loan may or may not have a specified date for repayment.[230] If the date is unspecified, the lender has the right to recall the loan at any time.[231] If the borrower is forced to default, the lender is encouraged to give a time extension or waive a portion of the loan.[232] No penalty is allowed for unintentional default; however, a penalty may be imposed as a deterrent in the case of willful default, and the amount collected as penalty must be donated to charity.[233]

Some scholars believe that *qard hasan* is a valuable tool for MFIs that wish to provide funds that are flexible, i.e. can be used for both consumption needs (personal or family needs unrelated to business) and production needs (business related needs).[234] Unlike other microfinance models, *qard hasan* puts cash in the hands of the recipient, and leaves her to allocate the funds as necessary to fulfill her needs.[235] Some current scholars on microfinance favor this broad approach to poverty alleviation because it provides more flexibility to a borrower that may have unfulfilled consumption needs, but also would like to fulfill production needs.[236] However, as a means of microfinance this model is unsustainable. It is quite possible that the recipient of the funds will fall on hard times and be

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[226] *Id.*
[227] *Id.*
[228] OBAIDULLAH, *supra* note 6, at 37.
[229] *Id.*
[230] *Id.* at 38.
[231] *Id.*
[232] *Id.* at 37.
[233] *Id.*
[234] OBAIDULLAH, *supra* note 6, at 38.
[235] *Id.*
[236] *Id.*

forced to use all of the funds to meet basic needs, rather than being able to engage in any income generation. The borrower will then be unable to pay back the loan. *Qard hasan*, as a charitable tool, was made for such a possibility. But *qard hasan* as a viable model for MFIs is more difficult because, while MFIs primarily focus on poverty alleviation, most of them also need to make some profit, both to attract investors and to sustain their operations. While Islamic scholars have decided that MFIs extending *qard hasan* are permitted to collect some excess over the principle loaned to cover administrative costs,[237] there is still the issue that if the borrower cannot repay the principle, she certainly cannot pay any excess for administrative costs either. This being the case, it is best for *qard hasan* to specifically target those who require funding to cover basic needs; other, more sustainable models should be used to capitalize micro-enterprises.

There are some who have criticized the increasing use of microfinance to help Islamic populations because they feel that it contributes to a growing disregard for charity such as *zakat*, *waqf*, and *qard hasan*.[238] There is a feeling that, in the past, such charity successfully catered to the needs of the poor, but modern Muslims "have adopted the capitalist approach of interest-and-debt based banking . . . [and] [m]any have resorted to self-help; thus the rise in demand for credit in which microfinance has found a ready-made following."[239] However, it is clear that charity and microfinance can, and more importantly *should*, be used in conjunction with one another to meet the nuanced needs of the different classes of the poor. Using a multi-lateral approach is the most efficient and most effective means of putting a very large dent into the very large problem that is poverty in the Islamic world.

C. Require All Recipients to Complete A Business Training Course

Most of the world accepts that education is one of the most important keys to success in any enterprise. As such, education must be provided by MFIs providing microfinance loans to the poor populations in developing countries—many of which have little or no formal education available to much of the population. Providing formalized business-related education could exponentially increase success rates in microfinance initiatives.

An extensive study on whether business training could have a substantial impact on microfinance clients and institutions was conducted by Dean Karlan, an economics professor at Yale University, and Martin

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[237] *Id.*

[238] Mohan, *supra* note 5.

[239] *Id.* (quoting Syed Hoque, a consultant at SHAPE Financial Corporation).

Valdivia, a senior researcher for GRADE, a non-profit research center.[240] They asked if one could teach basic entrepreneurship skills, or if, rather, such skills were fixed personal characteristics.[241] To find out, they conducted a study of FINCA in Peru, in which they randomly assigned pre-existing lending groups to either a control group, which did not receive training, or a training group, which received weekly training sessions.[242] The training consisted of two modules. The first was an introduction to what a business is, how it works, and the marketplace.[243] This included lessons aimed at teaching trainees to identify their customers, competitors, the position of their business in the marketplace, and strategies for promotion and commercial planning.[244] A second module delved into how to separate business and home finances by establishing the difference between income, costs, and profit, and taught trainees how to calculate production costs and product pricing.[245] The researchers administered a baseline survey before the start of training, and another between one and two years later.[246]

Overall, their findings support provision of a required business-training program for microfinance recipients.[247] Research showed a 3 percent higher repayment rate from the training groups as compared to the control groups.[248] Members of the training group were 4–5 percent less likely to dropout of the microfinance program.[249] Those in the training groups who did dropout often cited the length of the meetings as a factor in dropping out of the program,[250] so it would be interesting to explore whether shorter, or less frequent, training sessions would carry the same benefits without contributing to dropout rates. The study conjectures that increased retention rates for the training groups could be linked to an improvement in the clients' business outcomes, leading to higher incomes and higher repayment capability.[251] It was found that the "improvement in repayment rates and client retention are strongest for clients with larger businesses (as measured by sales) and for those who expressed the *least* interest in business training in the baseline survey."[252] As far as business skills and

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240 Dean Karlan & Martin Valdivia, *Teaching Entrepreneurship: Impact of Business Training on Microfinance Clients and Institutions* (Ctr. for Global Dev., Working Paper No. 107, 2009) *available at* http://www.cgdev.org/content/publications/detail/12331/.

241 *Id.*

242 *Id.* at 2.

243 *Id.* at 5–6.

244 *Id.* at 6.

245 *Id.*

246 Karlan & Valdivia, *supra* note 240, at 2.

247 *Id.* at 3.

248 *Id.* at 14.

249 *Id.*

250 *Id.* at 14–15.

251 *Id.* at 15.

252 Karlan & Valdivia, *supra* note 240, at 15.(emphasis in original).

practices go, the "[t]raining participants demonstrated greater business knowledge, . . . [which] translated into better business practices . . . ."[253] The training participants were 4 percent more likely to reinvest profits in their business, 3 percent more likely to maintain sales records, 7 percent more likely to maintain withdrawal records, and 5 percent more likely to report having made innovations to their businesses over the prior year.[254] It also appears that training helped clients identify and implement strategies to reduce fluctuations in their sales, such as diversifying the goods and services they offered or identifying clients with different seasonality in their purchases.[255] On a non-business front, the research also showed an increase in the number of hours that female children of the training participants dedicated to school work, and the researchers conjecture that perhaps this indicated an increase in the mothers' preference for education for their daughters.[256]

Overall, the study concluded that:

> Training led to better business practices and increased revenues and profits. Clients report engaging in some of the exact activities being taught in the program: separating money between business and household, reinvesting profits in the business, maintaining records of sales and expenses, and thinking proactively about new markets and opportunities for profits. The implementation of these strategies seemed to have helped clients increased business income, mainly by smoothing fluctuations between good and bad periods.[257]

Clearly, this is a limited study in that it explored only the clients of one MFI in one country, while all of the cultures that benefit from microfinance initiatives will have different cultural norms and structures, which may cause the results to vary from those of this study. However, it is difficult to imagine how a required education program for new micro-entrepreneurs could be *detrimental* to their success (apart from the marginal increase in dropout rates, which might be solved by shorter sessions). Certainly an MFI that is engaging with a given population could, to a large extent, tailor the education program to the culture in which it operates, which, again, can only improve the results of the participants. This study found that the cost to MFIs of administration of an education program was 6–9 percent of the total costs, which was covered mostly or

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[253] *Id.*at 16.
[254] *Id.*
[255] *Id.* at 17.
[256] *Id.* at 18.
[257] *Id.* at 19.

entirely by the increased repayment rates seen by the training groups.[258] Assuming that the results of this one study could be duplicated by other MFIs, the impact on poverty alleviation across the globe would be quite substantial.

D. *Intrinsically Understanding, and Working Within, Relevant Cultural Norms is Absolutely Necessary for Success*

Female empowerment is viewed by many as a valid and important policy goal; but, it can also engender fear, anger, and accusations of cultural imperialism.[259] Gender structures are deeply ingrained in the cultural practices, institutions, laws, traditions, and codes of conduct of all groups, and, unfortunately, are often the main source of persisting discrimination against women in developing countries.[260] For an MFI to be successful in both alleviating poverty and encouraging gender equality, the organization must make every effort to understand the sources and depth of discrimination.[261] Valid indicators that capture the various aspects of gender inequality must be searched for and explored, including "gender disparities related to access to education, health care, political representation, and earnings or income…[as well as] the institutional frameworks that govern the behaviour [sic] of people and hence the treatment of women."[262]

The regional indices of discrimination against women are among the highest in the MENA region, as compared to other world regions.[263] Further, levels of discrimination against women are by far the highest among Muslims, as compared to other world religions.[264] This being the case, Muslim populations can be expected to offer some of the most vehement opposition to initiatives that challenge their long-standing cultural norms. Despite the fact that gender equality is "good for growth, economic development and poverty reduction,"[265] gender discrimination persists for a number of reasons.

"*First*, the 'legitimacy' of reform is often contested."[266] Cultural norms are, by nature, long-standing and deeply ingrained, even in those who experience discrimination under the standing system. It is easy to see why

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[258] *Id.* at 20.

[259] Johannes Jütting & Christian Morrisson, *Culture, Gender and Growth*, ORG. FOR ECON. COOP. AND DEV., POLICY INSIGHTS NO. 15, 1 (2005), *available at* www.oecd.org/dataoecd/55/50/35636812.pdf.

[260] *Id.*

[261] *Id.*

[262] *Id.*

[263] *Id.* at 2, Figure 1.

[264] *Id.*, Figure 2.

[265] Jütting & Morrisson, *supra* note 259, at 2.

[266] *Id.*

many would resist challenges to the system they have grown up in and were always taught was correct.

"*Second*, flawed interpretations of religious laws and the depth of tradition often stand in the way of further progress… The Islamic countries have received particular attention with respect to the relationship between the Islamic law (Sharia) and the situation of women… In fact, interpretations of certain *surates* of the Koran have often been tailored to fit pre-existing traditions or to suit power relations between men and women."[267] But, whether these interpretations are valid or not, they are wholly believed and strictly upheld by many Muslims who believe they are the dictates from Allah. Such deeply held beliefs offer a formidable wall against any movement aiming to alter what an individual believes Allah has decreed.

Third, reform favoring women is difficult because men perceive the changes to be against their interests.[268] In societies where women have an inferior status, men enjoy material advantages that they fear losing upon reform.[269] Given that women generally spend income on benefits for the entire family, particularly children, and men often buy consumption goods instead, economically empowering women will shift the distribution of benefits in the household away from men.[270] When one group has long been receiving the lion's share of benefits, it is difficult to convince them to voluntarily give up those benefits. In reality, everyone in the family, and in the culture at large, will economically benefit from increased gender equality.[271] But, when dealing with cultural norms it is often not the reality that matters; it is perception that rules the day.

Finally, in many countries with long standing gender discrimination there is an issue with enforcing new or existing laws that are designed to foster gender equality.[272] Good intentions are nearly worthless when they cannot be put into action on the ground.[273] Although Shari'a scholars agree that a man is not entitled to any income that his wife generates (which would include her income from a micro-enterprise), that dictate does not matter if the government or judiciary refuses to intervene on the woman's behalf when her husband takes the money. MFIs can only do so much; the overall success of cultural reforms depends largely on the "willingness of governments to challenge traditions and privileges in existence for centuries."[274]

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[267] *Id.*
[268] *Id.*
[269] *Id.*
[270] *Id.* at 3.
[271] Jütting & Morrisson, *supra* note 259, at 2.
[272] *Id.* at 3.
[273] *Id.*
[274] *Id.*

These issues are not small, and will not be easily surmounted. However, an MFI or any other aid organization will have an important leg up just from identifying, recognizing, and understanding these issues before they begin their work. Deep cultural study should be undertaken before an initiative begins its work on the ground. Strategies should be adapted, as far as possible, to maximize efficacy. In Islamic countries, that means not only understanding Shari'a law, but also understanding how the particular population being approached understands and interprets Shari'a law, because it can vary relatively broadly among different Muslim communities. Also, MFIs working with Muslim populations should understand the reasons behind the Shari'a restrictions on finance, and be sure not to cut corners in implementing the Shari'a-compliant structures that have been outlined herein.

Beyond the religious aspects, strategies will need to be different when working with rural versus urban populations, as well as based on the level of education of borrowers. On the gender issue, often programs for gender equality focus entirely on women, but if intervention includes addressing and including men from the outset, positive results will be more far-reaching and resilient. If possible, staff should be recruited with particular knowledge of the relevant culture, particularly of the relations between men and women.[275]

Cultural change is daunting in the breadth of deep, nuanced information that one must understand before even beginning to make a difference. However, success depends on the level to which an organization is willing to put aside their assumptions and judgments, and focus on finding every available path to improvement for the position of women, and the state of the society as a whole. It is perhaps most important that an organization recognize that change will not happen overnight, or even over years; patience is key, as well as conviction that change will eventually be accomplished.

V. CONCLUSION

The foregoing analysis proves the extent to which the Islamic faith and microfinance principles are naturally, intrinsically congruent and harmonious. This is an invaluable partnership that has the capacity to make huge bounds in sustainably alleviating the poverty that grips so many Muslims. Microfinance initiatives have a range of Shari'a-compliant options for implementing a program, and if each institution endeavors to integrate the keys to success outlined in Part IV there are virtually no bounds to the success microfinance can accomplish. This is not to say that implementation of a program is easy, particularly given the political,

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[275] *Id.*

cultural, and social stumbling blocks that are in place in many Muslim countries. However, the incredible benefits that can be seen on every level of society must be worth the struggle those benefits entail.