Studies show interest-free microfinance can benefit small businesses in Africa. (PHOTO CREDIT: ALBERT GONZÁLEZ FARRAN, UNAMID)

ISLAMIC BANKING

Making Islamic microfinance happen

In the second part of his article series, Professor **Badr El Din A. Ibrahim,** President of the Microfinance Unit at the Central Bank of Sudan, discusses ways to implement Shari'ah-compliant microfinance

How we can introduce interest-free microfinance (also known as Islamic, or Shari'ah-compliant, banking)? There are some options to introduce it in the existing conventional microfinance institutions (MFIs) that we can explore.

ESTABLISHING A SEPARATE BRANCH

Separate interest-free branches are one vital means to promote the interest-free finance and microfinance industry worldwide. This mechanism requires assigning certain branches to extend interest-free microfinance to targeted clients, based on certain selection criteria. The merit of this option is that Shari'ah-compliant financing can easily and fully be adopted via separate branch, as this allows separation of funds and responsibilities.

OPENING SEPARATE WINDOWS WITHIN THE EXISTING BRANCHES

Interest-free windows are playing an imperative role in promoting the interest-free banking parallel along with full-fledged interest-free banks in most part of the world. Islamic windows in non-Muslims countries are aiming at capturing the Islamic market. The establishment of Islamic windows means that the main business of these conventional banks is still based on interest but only a small part of their activities are run on interest-free principles. Some countries do not allow Islamic windows while some like Malaysia, South Africa, Oman, Pakistan and the UK have permitted Islamic banks to operate their windows and subsidiaries. Here, we are recommending separate windows for conventional MFIs, not banks, to extend interest-free finance. Challenges for the Islamic windows-based business model are Shari'ah compliance and the need for changing regulatory requirements to allow for this model.

In support of Islamic windows Sheikh Usmani, a leading scholar of Islamic jurisprudence, argued that if a conventional bank opens an Islamic window, this step cannot be criticised merely on the ground that the whole bank is not converted into Islamic bank. More specifically, in a 2002 article, he argued that:

> "In non-Muslim countries, in particular, we find numerous commercial institutions that offer Islamic and non-Islamic products simultaneously. For example, all the hotels and restaurants in non-Muslim countries sell liquor and soft drinks. Nobody can reasonably argue that so long as they deal in liquor, they should not sell soft drinks. On the same analogy, if a conventional bank offers real Islamic products through a separate window, it will not be justified to raise objection against it."

The choice of Islamic windows requires raising new capital exclusively for the window. If this is not possible for any reason, a portion of the initial capital of the bank is earmarked to be employed in the proposed window. The issue of the separation of the original source of the funds generated through a conventional bank's interest-based business and the conventional capital from the pure, interest-free windows is one major challenge of this option.

"THE CHOICE OF ISLAMIC WINDOWS REQUIRES RAISING NEW CAPITAL EXCLUSIVELY FOR THE WINDOW."

CONTRACTING SPECIALISED INTEREST-FREE INSTITUTIONS—WHOLESALE FINANCE

Microfinance wholesaling is everywhere in the world, but with different degrees of practices. The wholesale lending market worldwide includes wide and diverse bodies of private and public, profit and non-profit, local and international players. It also includes concessional and commercial forms. In addition, the wholesale lenders include governmental agencies, an umbrella or apex institution, NGOs, foundations, commercial banks, specialised funds or donors, and portfolios of different banks and stakeholders. MFIs that are funded through this market are different in accordance with their legal status (cooperatives, private companies, government-owned MFIs etc.), or whether they accept deposits or not.

There are numerous models in the international experience in wholesale lending markets. For example, the lending government institutions constitute a lower percentage and local banks are dominant in India, while international institutions are dominant in Peru and Tanzania, according to a 2011 study in the *Enterprise as Development and Microfinance* journal by Ana Marr and Paola Tubaro.

In environments like Peru and Tanzania, according to our knowledge, it is an ideal time to recommend a wholesaling from MFI or banks or investors and new players to interest-free MFI. The objective here is not wholesaling as such, but searching for an interest-free MFI or bank to provide lending funds on a retail basis, on behalf of the conventional MFI to specific target group.

This wholesaling option is an appropriate one in the case of foreign donor, as it is known that in countries of Sub Saharan Africa, microfinance debt and grants through wholesale/apex participation from international sources tends to increase as GDP per-capita decreases, and grants are more appropriate in the countries where the financial system is less developed. This option needs the encouragement of commercial bank lending to MFIs in the short run.

PARTNERING BETWEEN CONVENTIONAL AND INTEREST-FREE MFIS

The financial goal of any bank or company is profit maximisation, while the financial goal of an MFI is having a surplus to sustain, as the MFI is mainly a service institution, while banks are financial institution. This difference in role and goals paves the way for cooperation between the two types of institutions. Furthermore, banks ought to have an interest in MFIs because these MFIs credit lines enable banks to reach their priority sector obligations. Banks can have commercial relationships with many MFIs, microfinance networks and investors to develop products and services that promote greater financial inclusion. Recently, several MFIs have tapped new income streams by moving beyond financial activities and forming revenue generating partnerships with other organisations. In particular, micro-franchise partnerships have sprouted in several developing markets. These alliances have the unique trait of generating attractive returns for MFIs, their clients, and private companies.

Here we argue that activities of some larger and more established MFIs to support smaller and less developed organisations, especially in countries where microfinance is not so advanced. This option is an open one. It goes further than the wholesaling relationship to include any other partnership by which the conventional MFI will be able to use part of its funds in interest-free finance by another MFI.

ESTABLISHING A SEPARATE COMPANY

This option requires the MFI to establish another affiliate company to run the interest-free finance. Alternatively, another specialised microfinance initiative could be established as shareholder between the MFI and another bank or MFI. Whatever type of new institution, it must comply with the same rules and Shari'ah regulations. The idea of a new institution is not new. In Sudan, the regulatory framework to establish MFIs allows banks to establish their own MFI company as one vehicle to use part of the mandatory 12 per cent allocated for microfinance out of the total portfolio of each bank.

Interest-free finance is receiving attention all over the world, encouraged by the 2008-09 financial crisis. Interest-free microfinance also emphasises poverty alleviation and reducing income inequalities.

After investigating the status of interest-free microfinance in Africa, and given the size of the Muslim population, we concluded that there seems to be a large un-met demand for interest-free microfinance products in Africa. We, therefore, investigate the prospective of interest microfinance in Africa, without the need for a new Islamic microfinance policies and interest-free regulatory framework.