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# Exploring the Potential for Profit-Loss Sharing Models in Islamic Micorfinance

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# Exploring the Potential for Profit-Loss Sharing Models in Islamic Microfinance

**Keywords**

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# Exploring the Potential for Profit-Loss Sharing Models in Islamic Microfinance

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## **Executive Summary:**

The microfinance industry carries promises of poverty alleviation, however in recent years the industry shifted from an emphasis on entrepreneurial loans to consumer loans. Furthermore, numerous crises around the world, fueled by careless lending practices, prove that financial inclusion alone is insufficient to achieve poverty alleviation. While access to financial capital has benefits, it does not guarantee that poor individuals will engage in income-generating activities, and can sometimes cause more harm than good. The industry has not reached its potential for poverty alleviation.

The microfinance industry is paying increasing attention to observant Muslims who reject conventional loans on the religious grounds that interest is prohibited in Islam. The growth of Islamic microfinance is an attempt to provide financial capital to poor Muslims around the world. Islamic microfinance currently attempts to take the conventional microfinance model, disregarding its present shortcomings, and create a Sharia-compliant product. This is done through the use of the trade-based Murabaha contract, which has little appeal to ordinary Muslims and is widely considered to involve “disguised interest.”

This limited approach to Islamic microfinance inhibits the industry’s ability to leverage Islam’s emphasis on economic justice and discover innovative means that can achieve poverty alleviation. Paradoxically, however, the prohibition of interest in Islam provides the microfinance industry with an opportunity to experiment with the financial product offered to the poor to better meet the industry’s goal of poverty alleviation, mainly through a new emphasis on profit-generating activities. Profit-loss sharing contracts provide an alternative to conventional microfinance and a more acceptable financial product for conservative Muslims.

This paper proposes an alternative lending contract that modifies the traditional profit-loss sharing loan to a form more compatible with the challenges inherent to microfinance; the Musharakah Mutawaqqi`a contract proposed is just one form that this innovation can take. Ultimately the microfinance industry must identify Islamic microfinance as an opportunity to advance the goal of poverty alleviation through innovative means, and not simply succumb to the temptation to supply conventional microfinance products in an Islamic form.

## I. Introduction

In recent years there has been controversy over the effectiveness of microfinance loans and their social impact on borrowers. People who were once staunch supporters are now taking a second look at the practices of the industry and placing it under greater scrutiny. Controversies in countries around the world suggest that the mere supply of financial capital to the developing world is an insufficient method to end poverty. With the dispersing of loans comes great responsibility to the microfinance institution (MFI); if honest and careful measures are not taken, then the presence of microfinance in a region can cause more harm than good to the local population.

It is a fact that microfinance has helped many individuals in all corners of the world; supporters are quick to recall hundreds of anecdotal stories of women whose lives were turned around by a few hundred dollars. Borrowers who strategically invest money in profit-generating businesses are incredibly satisfied by the microfinance industry and appreciative of the access to capital. However, not all clients express gratitude, such as those in the Indian province of Andhra Pradesh, where over eighty individuals took their lives after defaulting on micro-credit loans. The average debt of families was \$660, while the average annual income was only \$1,060 — requiring that more than 60% of a family's fragile salary be dedicated to repaying loans.<sup>1</sup> Irresponsible lending practices, in addition to coercive recovery practices, trapped thousands of individuals into a vicious cycle of debt, and some believed that suicide was their only way out. Such drastic variations in a borrower's experience show the important role of MFI policies and practices. While some MFIs positively impact the lives of their clients, others are charged

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<sup>1</sup> Soutik Biswas, "India's Micro-finance Suicide Epidemic," *BBC News*, December 16, 2010.

with unethical lending practices. Access to financial capital alone is insufficient for poverty alleviation; poverty alleviation depends on the lending practices of the MFI and it is time for the industry to reassess the model it relies upon.

The ultimate goal of microfinance is to end poverty in the world. In order for the industry to be successful, poor individuals must take part in the economic system and develop sources of income. Although numerous initiatives attempt to measure the social impact of a loan on the life of a borrower, little attention is given to a loan's financial impact. Borrowers are expected and obligated to repay loans irrespective of the success of the business, which gives MFIs little incentive to prioritize business development, a key element of economic development. This paper argues that in order to justify the role of MFIs, there must be a positive financial impact on the income stream of the borrower. Specifically, profit-loss sharing (PLS) models have the potential to better align the incentives of MFIs with economic growth. The presence of PLS models in Islamic finance and the popular appeal that such structures have for Muslims afford the Islamic microfinance industry the unique opportunity to advance of these loans, which promote income-generating activities, and better alleviate poverty.

This paper begins with a brief overview of the current microfinance industry, followed by a description of both the benefits and challenges of implementing a profit-loss sharing model at the microlevel. It then provides an overview of Islamic microfinance and the role of economic justice in Islam. Finally, a new lending tool called *Musharakah Mutawaqq`a* is proposed, which is a hybrid of two Islamic financial tools and more applicable to the inherent challenges of the microfinance industry. The successful implementation of a PLS model in microfinance can more accurately align operations of

the microfinance industry with the goal of poverty alleviation through an emphasis on income-generating activities, as opposed to mere financial inclusion.

## II. The Microfinance Industry Today

“I strongly believe that we can create a poverty-free world, if we want to...in that kind of world, [the] only place you can see poverty is in the museum.”

These are the charismatic words of Muhammad Yunus, pioneer of the Grameen Bank and “father of microfinance.” The Grameen Bank, founded in 1983, offered poor communities an alternative to the rich moneylenders and traders that charged usurious interest rates. By achieving 98% repayment rates from the very poor in Bangladesh, Yunus showed the world that the poor are “bankable” and set a trend in the international development community.

The term microfinance refers to the provision of financial services, most commonly microcredit, to poor individuals around the world with the primary goal of poverty alleviation. The microcredit movement operates under the presumption that the poor lack access to formal financial services, and the current alternatives are loan sharks that charge usurious rates. Two potential strategies by which MFIs alleviate poverty are financial inclusion and the development of income-generating activities. The former strategy emphasizes the benefit to poor people of having an alternative to the abusive moneylenders that charge exorbitant interest rates. The latter strategy emphasizes generation of additional sources of income that permit individuals to permanently escape the trap of poverty.



As of December 31, 2010, 3,652 MFIs reported reaching over 205 million clients.<sup>2</sup> The Grameen Bank's success in Bangladesh became the face of microfinance, and the Bank served as a role model to other MFIs. As the industry developed, the expectations also evolved; MFIs were expected to be both sustainable and profitable. The commercialization of the industry exerted additional pressure on MFIs and in some cases resulted in questionable behavior by MFIs. Today, the image of the industry has been tarnished due to the pressure to achieve high levels of growth and profitability.

The epitome of this controversy occurred in India, where 68 percent of the growth in the number of microfinance clients took place over the past five years. Andhra Pradesh is home to the four largest MFIs in the country, as well as a state-supported program that promotes self-help groups (SHGs). By November 2010, SHGs and MFIs together reached more than 23 million clients in the state. However, an estimated 83 percent of clients had multiple loans from different sources, and the average debt per household was over \$1000, compared to the \$150 average per household in other states in India.<sup>3</sup>

In the midst of this over-indebtedness crisis, SKS Microfinance Ltd, the largest MFI in India, held an initial public offering (IPO) in July 2010. The IPO raised \$155 million and valued the company at \$1.5 billion, allowing the shareholders to receive handsome profits.<sup>4</sup> This IPO raised much controversy. SKS however justified the earnings by the cost of doing business, and also prided themselves on their ability to attract capital to the industry.

In October 2010 the Andhra Pradesh state government released "An Ordinance to protect the women self-help-groups from exploitation by MFIs in the State of Andhra

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<sup>2</sup> Jan Mayes and Larry Reed, *State of the Microcredit Summit Campaign Report 2012*, report, 2012, pg.3.

<sup>3</sup> Mayes and Reed, 5.

<sup>4</sup> Mayes and Reed, 5.

Pradesh.” This ordinance sets limits on the amount that MFIs can lend to their clients, requires that loan repayments be made monthly rather than weekly, and requires that all repayments be made at local offices.<sup>5</sup> This had clear implications for the operations of MFIs; recovery rate of loans came down to less than 10 percent, and local politicians have encouraged willful default.

The situation in Andhra Pradesh is nothing short of a crisis. In response, experts in the field have identified the need for a structure that better supports the sector, including credit bureaus and payment systems.<sup>6</sup> Furthermore, there is a need to “look honestly at the role that MFIs, donors, and investors played in the crisis and we must pay greater attention to basic building blocks, such as client protection, interest rate transparency, and social performance.”<sup>7</sup>

In the introduction to the 2011 *Microfinance Banana Skins*, published by the Centre for the Study of Financial Innovation (CSFI), CSFI director Andrew Hilton writes:<sup>8</sup>

A lot of people—well-meaning, thoughtful people who are in the microfinance industry—are now worried that microfinance has taken a wrong turn, that it has drifted away from its original mission, that it has been co-opted (or even corrupted) by the pursuit of size and profitability... This is new and...it leaves microfinance and individual MFIs at a ‘tipping point.’ Will the industry continue to evolve—to grow, to offer new products, to move up market—until it is essentially indistinguishable from conventional financial institutions (banks, consumer finance companies, etc.)? Or will it rediscover its roots as a more modest source of small-scale credit to a relatively limited market amongst lower-income groups in generally poor countries?

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<sup>5</sup> Mayes and Reed, 5.

<sup>6</sup> Mayes and Reed, 7.

<sup>7</sup> Mayes and Reed, 7.

<sup>8</sup> Mayes and Reed, 11.

## Measuring Success in the Industry

“We see the current challenges in the microfinance community as a chance to refocus our efforts on what our clients most want to achieve. They want regular meals for the whole family, a secure and safe place to live, and education that gives their children a better life.”<sup>9</sup>

As the scale of the microfinance industry rapidly grew and the industry became increasingly commercialized, the need arose to ensure accountability of MFIs. Isolated success stories were no longer sufficient, and repayment rates provided a limited perspective on the experience of the borrower. A movement emerged to measure the social impact of MFIs. The Social Performance Task Force (SPTF) was founded in 2005 to coordinate these efforts and recognized that “without quantitatively measuring poverty, an institution is either assuming it is achieving its goal, or its progress is unknown.”<sup>10</sup> Social values of the SPTF include serving increasing numbers of poorer and excluded people sustainably; improving the quality and appropriateness of financial services available; and creating benefits for clients of microfinance in terms of increasing social capital, assets, income, and access to services. Efforts of the SPTF are directed at MFIs, which request that MFIs, despite their limited resources, devote time and energy to report these metrics. Investors also began to provide incentives for organizations to report such metrics.

The academic community also began to scrutinize the industry in order to capture the social and economic effect of the microfinance industry. Randomized controlled trials (RCTs) became frequently used as academics attempted to measure the impact of microcredit. These studies have mixed, nuanced findings, and leave the microfinance

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<sup>9</sup> Mayes and Reed, 2.

<sup>10</sup> Social Performance Task Force, <http://sptf.info/sptaskforce>.

community unclear about the causal relationship between microfinance and poverty alleviation. As the policy director at Innovations for Poverty Action, Nathanael Goldberg, stated:

Randomized evaluations of microfinance are showing mixed results, with credit clearly not the panacea it has sometimes been made out to be, and savings looking promising. Both credit and savings, however, are showing evidence for helping households manage their financial portfolios: to smooth consumption or invest in enterprises.<sup>11</sup>

Furthermore, a recent publication by the Consultative Group to Assist the Poor (CGAP) titled *Latest Findings from Randomized Evaluations of Microfinance* summarizes the mixed results by recognizing that microcredit works for some populations — those who successfully grow businesses — but not for others. It emphasizes that capital can allow poor people to pursue small business opportunities, but that not everyone is a micro-entrepreneur.<sup>12</sup> In highlighting the clear benefits of microfinance, the publication states:

The industry has focused almost exclusively on the rhetoric of entrepreneurship and has overlooked the many important benefits to households that are using loans to accelerate consumption, absorb shocks, or make household investments, such as investments in durable goods, home improvements, or education for their children.<sup>13</sup>

These are important benefits of microfinance and have a clear effect on the lives of borrowers; however, this publication supports the conclusion that the industry is holding itself accountable for providing access to financial capital, not creating income-generating activities.

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<sup>11</sup> Mayes and Reed, 14.

<sup>12</sup> Jonathan Bauchet et al., *Latest Findings from Randomized Evaluations of Microfinance*, 2nd ed., Access to Finance Forum (Washington, DC: Consultative Group to Assist the Poor, 2011), pg. 1.

<sup>13</sup> Bauchet et al., 1.

While such evaluations often bring analytical rigor to the microfinance industry, many practitioners believe that RCTs fail to capture the heterogeneity of borrowers' experiences. The founder of MicroCredit Enterprises expresses his frustration with this growing reliance on impact studies:

Maddeningly, the anti-poverty impact evaluation craze is precariously close to inflicting an unrealistic hegemony over social change. The profession's conceit is that, until an academic evaluator evaluates it, every anti-poverty program is under suspicion. In the closed world of evaluation, what cannot be measured is invisible. What cannot be validated by an evaluator should not be funded.<sup>14</sup>

Furthermore, Christopher Dunford, president of Freedom from Hunger, states:

The results [from RCTs] are reported in terms of the average experience of borrowers, which obscures the variety of experience. A large proportion, although still a minority, are investing their loans in real businesses and often doing very well as a result. The majority seems to be benefiting only modestly, primarily from the consumption smoothing effects, and only a small minority is suffering as a result of borrowing.<sup>15</sup>

While the goal of microfinance poverty alleviation, it has become satisfied with the limited role of providing financial capital to allow consumption smoothing. Milford Bateman in his book *Why Doesn't Microfinance Work?* argues that the microfinance industry has grown at the expense of small and micro enterprises (SMEs), limiting their sources of funding. The crowding out of SMEs from financial capital is most concerning when one also recognizes that a large majority of microfinance funds are directed towards consumer loans. It is important for the industry to responsibly promote income-generating activities that fuel economic growth and generate employment opportunities.

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<sup>14</sup> Mayes and Reed, 14.

<sup>15</sup> Mayes and Reed, 14.

## The Role of Consumer Loans

“The practical dividing line between standard microfinance clients of today (the vast majority of whom are *not* entrepreneurs) and real businesspeople is the line between consumption and investment capital for business. Credit for the masses has been in the past (and is today) largely for and about consumption. Credit for real business is not for or about consumption, *nor does it need to be accessible to everybody.*”<sup>16</sup>

— Thomas Dichter

Thomas Dichter, in his paper titled *A Second Look at Microfinance: The Sequence of Growth and Credit in Economic History*, states that the expectations of the microfinance industry are unrealistic because most poor people are not entrepreneurs, and therefore mass credit will not necessarily lead to viable start-ups. Economic history shows that start-ups traditionally depend on savings and informal credit, and microcredit in developed countries is mostly used for consumption rather than investment. In developing countries, “democratic financial services” were led by the savings movement, and consumption credit *followed* this movement.<sup>17</sup>

In one of the earliest studies of the Grameen Bank, Aminur Rahman found that between 1994 and 1995 up to 70% of microloans in a sample of 217 in the study village were being used for purposes other than the income-generating activities specified. A similar study in India found that only 20-30% of loans are used for income-generating activities.<sup>18</sup> Consumer loans capture a growing portion of the microfinance industry’s resources since they are easier to disperse, in high demand, and more profitable.

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<sup>16</sup> Thomas Dichter, *A Second Look at Microfinance: The Sequence of Growth and Credit in Economic History*, issue brief no. 1 (Washington, DC: CATO Institute, 2007), pg. 6.

<sup>17</sup> Dichter, 11.

<sup>18</sup> Milford Bateman, *Why Doesn't Microfinance Work?: The Destructive Rise of Local Neoliberalism* (London: Zed Books, 2010), pg. 29.

While there is the benefit of consumption smoothing, borrowers pay high interest rates without any potential for return from the investment. Consumer lending cannot drive sustainable economic development and poverty alleviation without any productive use of capital. Some MFIs resist this shift in focus, such as Pro-Credit Bank Serbia. This MFI proudly proclaims in its mission statement: “unlike other banks, our bank does not promote consumer loans. Instead we focus on responsible banking, by building a savings culture and long-term partnership with our customers.”<sup>19</sup> While consumer loans are in high demand, they are less responsible than other forms of microfinance, and do not create sustainable economic growth. However, consumer loans are more profitable for the MFIs, and limited financial capital results in a tradeoff between consumer loans and income-generating activities, which comes at the expense of economic growth in these developing countries.

### III. Profit-Loss Sharing Models in Microfinance

Profit-loss sharing loans imply that the MFI serve as a partner or investor with the borrower as opposed to a mere lender. The payment amounts depend on the success of the business, and this inherently implies that the funds are used towards income-generating activities.

While the current microfinance model provides financial access to the previously unbankable, the PLS model moves beyond mere financial access and addresses poverty alleviation through its focus on income-generating activities and careful endorsement of entrepreneurial activity. Specific benefits of this alternative model include a better

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<sup>19</sup> Bateman, 39.

incentive structure for MFIs, rational demand by borrowers, and stronger social responsibility in line with the current efforts of the industry. The power dynamics naturally shift as the relationship transforms to a partnership. The borrower's hard work and skills produce profits for the partnership, and the MFI supplements these efforts with its unique resources.

### **Benefits of PLS Models**

#### *MFIs are better incentivized to promote business*

As discussed above, the ultimate goal of the microfinance movement is to alleviate poverty. Borrowers that engage with MFIs are similarly interested in improving their own quality of life. However, MFIs, the agents for the industry, have goals that are more ambiguous in regard to poverty alleviation, such as profitability. PLS models have the potential to better align the ultimate goal of poverty alleviation with the day-to-day operations of the MFI and loan officers.

At present, the microfinance industry's goals poorly align with the goals of individual loan officers. Branches focus on achieving high repayment rates, and loan officers sometimes struggle to meet quotas. While individuals in the field often enter with good intentions, the stressful environment and strenuous expectations limit the loan officer's impact. The PLS model better links the success of an MFI to the success of its clients. Loan officers assume the role of external consultants to ensure that a business can reach its full potential and have an incentive structure linked to the profitability of the business. Furthermore, the power dynamics in the relationship are transformed; the MFI relies on the work ethic of the borrower to successfully generate a profit from its investment, resulting in a partnership.



Most importantly, payments to the MFI depend on the profitability of the borrower's business, incentivizing the MFI to leverage human capital, networks, and resources to achieve this goal. The network created has the potential to help the entrepreneur enter a competitive market through information access, bargaining power, or business skills. Alex Counts, president of the Grameen Foundation, suggests that microfinance can have a much larger impact on clients' lives by:

leveraging its human and physical infrastructure, market knowledge, and client relationships to create value for clients: MFIs can provide access to welfare-enhancing products and services, such as improved cook stoves or knowledge about improved farming techniques and financing mechanisms to make these affordable.<sup>20</sup>

The use of such resources can increase the chances of a business owner becoming successful. Moreover, PLS models encourage a better understanding of the financial needs of the business. This understanding allows them to lend an appropriate amount for the entrepreneurial activity. Currently, most MFIs simply offer a range of loan sizes dependent upon criteria related to the borrower. A better match should be made between the size of the loan and the needs of the business. A \$500 loan can have a different marginal benefit to the borrower depending on the country, previous investments, and type of business. In cases where the loan amount is too small, the borrower would naturally seek other lending sources to fulfill its financial need, risking over-indebtedness. In PLS models the amount is better calculated to meet the needs of the borrower's business.

Money is lent not for the sake of lending money, but instead to sustain a profitable business. Loan officers are incentivized to identify profitable businesses rather than simply borrowers that are likely to repay their loan.

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<sup>20</sup> Quoted in Mayes and Reed, 27.

*Rational demand curve and entrepreneurial activity*

The high effective interest rates charged by MFIs sparks considerable criticism. Critics doubt whether a borrower can overcome the burden of high interest rates. However, MFIs justify the rates by their higher operating costs, which include a higher risk of default, smaller loan sizes, and increased responsibilities for loan officers. Economic theory suggests that both supply and demand dictate the price of a product, but current discussions concerning the effective interest rate of loans have focused solely on the supply side, with insufficient analysis of the demand curve for microfinance loans.

The high level of demand by borrowers discourages MFIs from analyzing the demand curve for microfinance loans. Instead, MFIs focus on increasing capacity to meet this excess demand. Theoretically, as long as individuals continue to demand the service at the set price, then they are benefitting from the service, in this case the loan.

This conclusion does not follow for the microfinance industry, however, because it assumes that the consumer is making a rational decision. The crisis in Andhra Pradesh shows that the consumption of microfinance loans can be based on an irrational decision, which often inevitably leads to over-indebtedness. This problem is clearly expressed in an article on the Andhra Pradesh crisis, where borrowing is equated to an addiction:

The microfinance business seems to have been equated with, say, trade in habit forming psychotropic drugs. The [new] law in Andhra Pradesh is based on the premise that MFI loans are addictive, available freely and can cause damage to the user over the long term. Hence, it seeks to control the availability, delivery process and price of MFI loans.<sup>21</sup>

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<sup>21</sup> Narasimhan Srinivasan, "Crisis by Invitation," *CGAP Microfinance Blog* (web log), November 19, 2010.

PLS models, a feasible alternative, give an MFI the ability to capture a fair price from the borrower that is linked to the benefit of the loan. PLS loans force the demand curve to be rational and hence ensure that the borrower is capable of repaying the loan. This is a sounder structure that allows borrowers to make realistic repayments to the MFI while also climbing out of poverty.

*Social responsibility of PLS models:*

Two tools for social performance management that incorporate the social values of the SPTF are Poverty Assessment Tools and Client Protection Tools. They use different methodologies to capture data relating to the social impact of an MFI. While industry leaders have developed these tools, their use depends on the goodwill and resources of individual MFIs. The social impact of a PLS model is discussed below in relation to these two tools, arguing that a PLS lending model has the inherent potential to advance the goals of the SPTF.

*Poverty Assessment Tools*

In line with the microfinance industry's underlying goal of alleviating poverty, Poverty Assessment Tools provide a quantitative measure of the efforts of MFIs to serve individuals at or below the poverty line and improve their economic situation over time. Their aim is to ensure that the poorest segments are being targeted by MFIs. An important role of the microfinance industry is to provide financial services to marginalized groups, and this metric ensures that MFIs are not focusing on more profitable, wealthier clients. A popular example is the Grameen Foundation's Progress out of Poverty Index (PPI), which includes ten simple, country-specific questions that are

statistically tested to measure the poverty level of the borrower and is capable of tracking changes over time. The tool operates on two levels, first measuring the percentage of clients that fall below a certain poverty line, and then tracking individual improvement over time.

A loan does not ensure that borrowers climb above the poverty line; to do that, the loan must create additional financial capital for the family. Furthermore, the definition of poverty is subjective, and many different metrics exist. Rather than utilizing traditional microfinance techniques and then attempting to track the change in a borrower's poverty level, a more direct path is to ensure that the MFI promotes income-generating activities that directly *cause* an improvement in poverty levels. The income generated by business activity provides a clear measure of impact. The subjective goal of poverty alleviation is replaced with the more objective one of income generation.

Financial capital invested properly can alleviate poverty, but in other cases it can spiral into a cycle of debt. It is most effective when given to the *entrepreneurial* poor who see an opportunity to generate profits. Such individuals use economic activities to increase their income stream and consequently improve their economic standing. In contrast, other individuals, mainly the *extremely* poor, require economic assistance to simply survive. When given a loan, they have difficulty investing it in a business; instead it is used for immediate family expenses. In such cases the high interest rates are unsustainable because there is no increase in income that enables them to repay the loan.<sup>22</sup> The selective nature of PLS models better ensures that the former group is receiving the loans, and that the latter group is prevented from entering a vicious cycle of

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<sup>22</sup> Alexandra Frasca, "A Further Niche Market: Islamic Microfinance in the Middle East and North Africa," 2008.

debt. There are more appropriate ways to help the latter group than a loan with a high interest rate.

An MFI will naturally become more conservative in its lending under such a model, performing due diligence to ensure that it does not become responsible for a portion of the entrepreneur's losses. Poverty Assessment Tools currently emphasize the development of a scalable model that reaches as many *poor* clients as possible. In contrast, a PLS model focuses on improving the income of its clients and ensuring their profitability. Rather than merely administering loans, under the PLS model, the MFI continues working with borrowers as they climb out of poverty. If they instead find themselves falling deeper into poverty as a result of an unforeseen problem with the business or a turbulent economy, the lending agency assumes a portion of the responsibility, helping the borrower to successfully rebound.

#### *Client Protection Tools*

Client Protection Tools (CPTs) focus on providing transparent and prudent services in a respectful manner. Rather than measuring social impact, CPTs ensure that an MFI does no harm to the client. Unlike Poverty Assessment Tools, CPTs are concerned not with who is being served, but instead with the experience of borrowers with the MFI.

The power imbalance created between the borrower and the financial institution can lead to the unacceptable subjection of borrowers to stressful situations in order to generate profits for the MFI. This phenomenon was identified by industry leaders and led to the coordination of efforts for better practices. One example is the SMART campaign, which is pursuing active efforts to encourage the following six client protection

principles: avoidance of over-indebtedness, transparent pricing, appropriate collections practices, ethical staff behavior, mechanisms for redress of grievances, and privacy of client data.<sup>23</sup>

How can a mechanism for poverty alleviation be accused of deceiving and harassing its clients? Of the six principles, perhaps the most difficult and important to follow is the prevention of over-indebtedness. One may assume that it is in the best interest of MFIs to ensure that borrowers are not over-indebted so that they can repay their loans. However, it must be acknowledged that an over-indebted individual may still repay a loan, sometimes by sacrificing family assets or even basic quality of life. In such cases, families find themselves worse off than before. More distressing still is that the same client may be labeled a “success” in figures that show high repayment rates for the MFI.

Over-indebtedness in the context of PLS models can be significantly better managed than in traditional microfinance practices. First, in order for the loan to be dispersed, there must be a profit-generating activity, a requirement that naturally avoids consumer loans. Most importantly, the profits of the business provide a guaranteed source to repay the loan. PLS models demand reasonable loan payments from borrowers that are linked to their *ability* to repay. This link is especially important for businesses that are seasonal and/or that require a period of investment before profits are extracted.

Second, making payment dependent on the profits of the business strongly encourages MFIs to be selective in choosing businesses to lend to. This selectivity will naturally lead to greater due diligence in regard to a client’s ability to embark on the business. Currently, collaboration between MFIs is weak and credit bureaus are rare in

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<sup>23</sup> “The Smart Campaign — Keeping Clients First in Microfinance,” <http://www.smartcampaign.org>.

developing countries. Financial institutions have no way of knowing a borrower's loan history, yet the industry has continued to grow at the expense of over-indebted individuals. Most importantly, rather than simply focusing on the number of loans that are dispersed, it is now important that the money be invested in profit generating activities.

The need for Client Protection Tools shows that social responsibility is not inherent in the microfinance industry, and instead depends on the specific practices employed by the MFI. In contrast, PLS models provide a more inherently socially responsible platform for lending.

### **Implementation Challenges of the PLS Model**

Despite the benefits mentioned above, the PLS model is extremely rare. A thorough examination of challenges associated with the model highlights the need for modifications in order to facilitate its use by MFIs. Ultimately, two main challenges must be addressed for such a model to be successful; a strong sense of trust must be established between the borrower and the lender, and the borrower must keep accurate business records.

#### *Establishing a Sense of Trust*

Because of the inevitable information asymmetry between the lender and borrower, a strong sense of mutual trust and reliability is required for a successful PLS model. PLS partnerships require that the MFI supply financial capital and the borrower supply expertise to develop a profitable business. A positive reputation in the community and a clear contract can easily encourage a borrower to trust the MFI. However, it is more difficult for the MFI to trust the borrower, not only because of typical management

problem evident in all firms, but because an MFI functions in a multitude of partnerships and is therefore incapable of conducting thorough due diligence during the contract period. It is essential for the MFI to trust its borrowers to responsibly manage the day-to-day operations of the investment and accurately report the profits.

The first challenge to overcome is to ensure that the borrower makes decisions and exerts adequate effort in the best interest of the enterprise and maximizes profitability. Although this challenge is present in the management structure of most companies today, PLS models have an advantage. It is common for a company to grant employees shares of stock as an incentive to maximize profits for the entire company. Similarly, the borrower in a PLS model receives a portion of the profits. This incentive is multiplied as the borrower also has his long-term interest in mind: the point at which he/she regains 100% of the company.

### *Reporting Financial Records*

The second challenge to overcome is the tendency to misreport financial records. Payments to the financial institution are linked to profits, therefore punishing more successful businesses with higher payments. Such a system inappropriately incentivizes borrowers to under-report profits. Another important cause of intentional misreporting of profits is a borrower's attempt to evade taxes. Ensuring honest financial records requires strong due diligence, which will further decrease the productivity of the loan officers and increase operating costs. These problems must be addressed in order for PLS models to gain credibility in microfinance.

Data on the profitability of microbusinesses is scarce because it is difficult to record. However, in order for a PLS model to operate successfully, the borrower must be



capable of keeping accurate business records, an ability which is rare amongst businesses in the developing world.

In order to understand the feasibility of requesting accurate business records, the researcher partnered with ten microfinance borrowers, and worked alongside their business operations for a month.<sup>24</sup> Personalized training was provided to each individual, with basic accounting forms. It soon became evident that the expenses of the business are simple to collect through receipts and personal records; however, collecting records of sales is more tedious. By the end of the period, the accuracy of the profit figures were acknowledged to be weak by both the researcher and the business owners, specifically regarding revenue streams. The borrowers did not fully buy into the idea of recording profits, and the lack of commitment discouraged the keeping of accurate records. Without a strong motivation to record business sales, it is easy for a business owner to become preoccupied with other dealings and settle for estimates of revenues. When justifying the inaccuracy of the records, one owner asserted, “you can easily tell if you are using your family’s livelihood to support the business or if the business is supporting your family — I don’t need financial records to know.” Without sincere dedication among the borrowers to record profitability, the traditional PLS model is unrealistic.

For the PLS model to be successfully implemented by MFIs, these challenges must be addressed. There is potential for modifications in the current PLS model to create a new product that addresses these challenges. Islamic microfinance’s limitations and prohibition of interest allows it to be a leader in the use of PLS models at the micro level. This paper advocates for Islamic microfinance to adopt PLS models through a

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<sup>24</sup> Sharakeh, The Palestinian Network for Small and Microfinance organized my visit and provided me with great insight to the industry, which I am very grateful for.

discussion of the concept of economic justice in Islam. The framework of Islamic finance can provide the foundation for the use of the PLS model at the micro level.

#### IV. Islamic Microfinance Overview

Islamic microfinance attempts to provide observant, poor Muslims with access to financial capital through the use of tools from both microfinance and Islamic finance. The development of Islamic microfinance has faced many obstacles and remains in its early stages; as a result, millions of poor Muslims remain excluded from the financial sector.

A 2007 survey by CGAP on Islamic microfinance revealed that total global coverage is only an estimated 380,000 customers, which is half of one percent of total microfinance coverage. Furthermore, over 80 percent of this small amount of borrowers is concentrated in Indonesia, Bangladesh and Afghanistan. Although Muslim majority countries encompass approximately 44 percent of total conventional microfinance clients worldwide,<sup>25</sup> the growth of *Islamic* microfinance has been incredibly slow. In Bangladesh the largest MFI that provides Islamic products has a reach of only 100,000 compared to the 22 million active borrowers reached by the MFIs Grameen Bank, BRAC and ASA.<sup>26</sup>

The lack of availability in Islamic microfinance products coincides with passionate demand by individuals in Muslim majority countries. A 2006 study in Algeria revealed that 20.7 percent of microenterprise owners do not apply for loans primarily for religious reasons.<sup>27</sup> Furthermore, a 2007 study shows that 60 percent of low-income survey respondents in Palestine prefer Sharia-compliant loans and products to

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<sup>25</sup> Nimrah Karim, Michael Tarazi, and Xavier Reille, *Islamic Microfinance: An Emerging Market Niche*, report (CGAP, 2008), pg. 5.

<sup>26</sup> Mohammed Khaled, "Why Has Islamic Microfinance Not Reached Scale Yet?," *CGAP Microfinance Blog* (web log), March 9, 2011.

<sup>27</sup> Karim et al., 5.

conventional ones, and over half of these respondents claim they would even pay a higher price for such products.<sup>28</sup> The strong demand for Islamic microfinance products remains unmet despite a vibrant conventional microfinance industry in those areas. The lack of growth of Islamic MFIs, despite the strong demand reported, could be the result of an over-exaggerated demand or a lack of supply, as discussed below.

Anecdotal evidence suggests that individuals may claim a preference for Sharia-compliant loans when surveyed in an attempt to appear more pious. Alternatively, potential borrowers may have a true desire to only use Sharia loans, but practical limitations, such as higher rates, may inhibit them from selecting Islamic loans. Notwithstanding likely exaggeration, however, the surveys referenced above indicate *potential* for growth in the Islamic microfinance industry.

Another explanation for the slow growth is that Islamic microfinance is used as a general term, and there is a lack of distinction between its financial products. Currently 70 percent of Islamic microfinance loans, an overwhelming majority, are Murabaha-based<sup>29</sup>. In contrast, the author is unaware of any MFIs that operate large-scale Sharia-compliant PLS models.<sup>30</sup> Some MFIs have run pilot programs to explore the feasibility of such structures, but efforts remain small, and MFIs avoid this riskier venture. For example, in Sudan, all lending, by law, must be Sharia-compliant, but only two percent of the loans are based on the PLS model. Murabaha loans remain the primary product supplied by MFIs because they imitate conventional financial products with little additional risk.

While Murabaha lending complies with Islamic law and is approved by Islamic

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<sup>28</sup> Karim et al., 5.

<sup>29</sup> For a discussion of Murabaha contracts, see page 26.

<sup>30</sup> Karim et al., 8.

jurists, its role in the microfinance industry is still ambiguous. A prevalent sentiment among borrowers is that Murabaha lending is simply conventional microfinance disguised in Islamic terminology, providing no added benefit beyond religious compliance, but coming at a higher price. The Islamic microfinance industry cannot expect poor Muslims to pay a higher price for a very similar product. While borrowers seek religious compliant financial products, the industry must creatively develop alternative Islamic financial products that provide an additional benefit to the borrower in exchange for the inevitably higher cost of a Sharia-compliant financial product. Only through this additional benefit — such as the sharing of risks or business development services — will the borrower turn intention into action and select the Islamic microfinance product over the conventional product. In order for the microfinance industry to reach its full potential and reach the large underserved microfinance market, the industry must take creative approaches that better cater to the needs of its consumers.

## V. Contracts in Islamic Finance

The basis of Islamic finance is its treatment of money; time by itself does not give a yield, but can only contribute to the creation of value when an economic activity is undertaken. The return on capital must be determined *ex post*, and its magnitude depends upon the return to the economic activity in which the funds were employed.<sup>31</sup> *Riba*, commonly translated as usury or interest, is strictly forbidden. Islamic jurisprudence concerning finance can be summarized in the following five points:

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<sup>31</sup> Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance: Theory and Practice* (Singapore: John Wiley & Sons (Asia), 2011), pg.18.

1. Money has no intrinsic value in and of itself.
2. Financial transactions must be linked directly or indirectly to economic activity.
3. Investors must share in the risk of their funding.
4. Contracts must be mutual and explicit.
5. All activities financed must be consistent with Sharia.<sup>32</sup>

Islamic financial tools fall under three main categories: partnership-based loans, trade-based loans, and lease-based loans, all of which entail either the ownership or use of commodities and physical assets. Four relevant Islamic finance contract structures that have a potential role in microfinance are explained below: Murabaha loans and three PLS loans: Mudarabah, Musharakah, and Diminishing Musharakah.

### **Murabaha Loans**

Murabaha loans are the most popular example of a trade-based loan. In Murabaha contracts a financier, the “lender”, purchases a product and then sells the item to the client-purchaser, the “borrower”, on credit, with a specified markup. The lender must clearly identify the cost at which he bought the item, and fully disclose the profit margin.

<sup>33</sup> Honest communication between the lender and the client is required for the sale to be valid. Ibn Rushd’s comparative text titled *Bidāyat al-Mujtahid wa Nihāyat al-Muqtaṣid* explores the slight disagreement between scholars of various Islamic schools concerning Murabaha loans. These scholars do not ever question the validity of this lending structure, but instead focus the discussion on specifics of the transaction, such as the costs

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<sup>32</sup> Mahmoud A. El-Gamal, *Islamic Finance Law, Economics, and Practice* (Cambridge: Cambridge University Press, 2009).

<sup>33</sup> Frank E. Vogel and Samuel L. Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Boston, MA: Kluwer Law International, 1998), pg. 140.

that can be included in the price of the item.<sup>34</sup>

Traditionally, individuals engaged in trade used this financial tool. The term Murabaha is derived from the Arabic word *rabiha*, which means to grow in business and succeed through the making of a profit.<sup>35</sup> This profit is associated with the success of a sales transaction through some means of trade, and the fact that the payments are made on credit. Ibn Rushd's discussion focuses on the items that can be sold on credit, and the forms that the contract can take. Although views Ibn Rushd surveys all accept the nature of the Murabaha contract, its form was different than it is today. In Murabaha contracts today, the bank plays an intermediary role and extends the credit to the borrower by purchasing something on his behalf, as opposed to the traditional method in which the original seller of the item extends the credit.

It was not until 1976 that banks began to use this financing method, which was developed by Sami Hassan Hamoud while a student in Jordan.<sup>36</sup> In 1987 he received the Islamic Development Bank's prize in Islamic Banking for this new mode of Murabaha financing. This unique tool is given a different name: *Al Murabaha lil aamer bil shira'a*, or "Murabaha for the Purchase Order." In this contract, the bank engages in trade only when it has an ensured buyer and derives its profit from the extension of credit in the second sale after the purchaser re-sells the item at an additional mark-up.

This is the financial contract commonly used in Islamic microfinance today. Murabaha contracts require the MFI to take an active role in the purchase and sale of assets, which entails an increase in operating costs and gives the MFI oversight in the use

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<sup>34</sup> Averroes, *The Distinguished Jurist's Primer*, trans. Imran Ahsan Khan Nyazee, ed. Muhammad Abdul-Rauf ([Doha, Qatar]: Centre for Muslim Contribution to Civilization, 2000), pg. 256.

<sup>35</sup> Muhammed S. Ebrahim and Hussam Sultan, "Murabaha," *Social Science Research Network*, September 7, 2011, pg. 1, <http://ssrn.com/abstract=1923606> or <http://dx.doi.org/10.2139/ssrn.1923606>.

<sup>36</sup> Ebrahim and Sultan, 2.

of the money. Costs associated with Murabaha go beyond the mere opportunity cost of money and include additional operational costs such as the employee's time to buy the products needed by the borrower. In addition, because late fees are prohibited in Islamic finance, MFIs must account for the possibility of late payments when they price their loan. This arguably makes Murabaha lending more responsible in the microfinance field because it inhibits the use of loans for wasteful behavior and encourages their use as working capital.

Although the modern form of Murabaha has support from most Islamic scholars, it is still controversial. Before discussing the controversy, it is first important to understand the details of Murabaha contracts. Strictly speaking, the Murabaha contract is a trade-based contract, and the main elements needed for a sale contract to be considered valid under Islamic law apply. These include:

- the subject of sale must be existing at the time of sale
- the subject of sale must be in the ownership of the seller at the time of sale
- the subject of sale must be in the physical or constructive possession of the seller when he sells it to another person
- the subject of sale must be a property of value
- the subject of sale should not be a thing used for a forbidden(haram) purpose such as pork or wine
- the subject of sale must be specifically known and identified to the buyer
- the delivery of the commodity sold to the buyer must be certain and should not depend on contingency or chance
- the certainty of price is a necessary condition for the validity of a sale. If the price is uncertain, the sale is void<sup>37</sup>

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<sup>37</sup> Ebrahim and Sultan, 3.

In additions, there are also specific requirements for validating the Murabaha contract in particular:<sup>38</sup>

- the seller-lender must expressly mention the cost incurred for the purchased commodity and the exact profit or markup
- the cost of the subject of sale must be known by the “borrower” and ascertained
- the profit in Murabaha can be determined by mutual consent, either as a fixed amount or through an agreed ratio of profit to be charged over the cost
- all the expenses incurred by the seller in acquiring the commodity freight, custom duty, etc., are included in the cost price and any markup can be applied to the aggregate cost

Concerns arise about the validity of this form of Murabaha because the bank does not adequately engage in the trade of the product, and therefore it is too similar to interest lending. Youssef Al-Qardawi, a prominent modern Egyptian cleric, outlines the main criticisms against this practice:

Murabaha sales by the banks are not real but only a stratagem to indirectly charge interest rates especially when benchmarked against LIBOR; the history of Islamic jurisprudence has no mention of this Banking Murabaha form; the Prophet has prohibited the conducting of two sales in one; the banks sometimes carelessly engage in the sale without actually possessing the good; the promises are perceived as binding and the borrower doesn't really have the option to not complete the contract after the bank purchases the goods.<sup>39</sup>

In response, supporters claim that there are clear differences, both legal and economic, between a loan secured through Murabaha and one involving interest. The greatest legal difference is that the bank owns the goods and bears the risk that the goods are destroyed or defective, or that the buyer-borrower will refuse the purchase of the goods for resale. This difference serves as the basis through which the Organization of

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<sup>38</sup> Ebrahim and Sultan, 3.

<sup>39</sup> Ebrahim and Sultan, 7.



the Islamic Conference (OIC) Academy approved the contract in 1988.<sup>40</sup> Under Islamic law, the borrower cannot bindingly agree to purchase the goods until the seller has possession of them. Therefore the bank does act as a *trade* agent. From an economic standpoint, Islamic law permits sale on credit and through which the time value of money can be recognized, and the use of Murabaha loans links the transfer of money to a transfer of goods. In Murabaha loans the financier has recourse only to the items financed; no penalty fee is permitted in the event of default.

These differences serve as the basis for the legal ruling by Islamic scholars that the modern form of Murabaha is permissible. However, it is important to note that while the OIC Academy approves Murabaha contracts, the Academy also include language that urges minimal use of such contracts and expresses a strong preference for PLS investments.<sup>41</sup> Because the Murabaha contract is easy to administer and carries little additional risk, the Islamic finance industry has embraced this financial tool at the expense of other forms of finance.

### **Profit-Loss Sharing (PLS) Loans**

The most widely accepted lending platform in Islamic finance is the PLS model, in which the lender and borrower enter into a partnership, sharing both the profits and the risks of the business endeavor. This is a partnership in which capital and labor from two sources are combined. Payments are determined *ex ante* and are based on the profitability of the business. According to tradition, the Prophet Muhammad borrowed capital on such terms when raising capital for trade caravans, a fact that confirms PLS's alignment with Islamic principles. Popular contracts in this category include Mudaraba, Musharaka, and

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<sup>40</sup> Vogel and Hayes, 141.

<sup>41</sup> Vogel and Hayes, 143.

Diminishing Musharaka, which are explained below. The main difference between these contracts is the role of the two parties in management and the sharing of profits.

1. ***Mudaraba*** is a form of partnership where the financier (lender) entrusts the capital to an agent (borrower) who is expected to return the principal plus an agreed upon percentage of the profits. Management is entrusted to the borrower, the lender does not interfere in the management and only supplies the capital, and losses are the exclusive responsibility of the lender. It is unlike most PLS models because the investor does not have any rights in the management unless stipulated in the beginning. If the agent acts contrary to the restrictions, by virtue of the trust that was placed in him, he is liable for any resulting loss or damage to the venture.<sup>42</sup>
2. ***Musharaka*** is a more versatile PLS model in which the partners both participate actively in the affairs of the business and share the profits in a pre-determined percentage. While the ratios of profit sharing must be pre-determined, losses are endured according to contributed capital: an investment of capital is subject to the loss of capital and an investment of time/labor is subject to the loss of time.
3. ***Diminishing Musharaka*** is a modified form of Musharaka that slowly transfers ownership from the financier to the borrower. The borrower's payments consist of two parts: one part is the payment to the financier based on his share of the property (which diminishes as the financier owns a smaller share), and the other part is a

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<sup>42</sup> Iqbal and Mirakhor, 103.

contribution to purchase the equity from the financier. By the end of the period, the borrower is able to buy out the financier's share and acquires complete ownership of the property.<sup>43</sup>

The remainder of this paper focuses on partnership-based Islamic loans, which have seen minimal growth within the microfinance industry in recent years. Partnership-based are similar to venture capital loans, which are more common among larger companies. The application of PLS loans at the microlevel requires overcoming of sizable obstacles presented by due diligence.

## VI. Charitable Giving

A large amount of financial capital is directed at assisting poor Muslim communities around the globe. Such resources should be incorporated into an Islamic microfinance model. Presently, the microfinance industry emphasizes providing the poorest segment of society with access to financial capital, despite the fact that they are commonly looking for sustenance and not capable of investing in working capital. Islamic microfinance should not attempt to be a panacea for poverty in Muslim communities, but instead engage in efforts to create sustainable economic growth. Furthermore, the large amount of charitable giving in the Muslim world, estimated between \$250 billion and \$1 trillion annually<sup>44</sup>, has the potential to support an Islamic microfinance model if it truly appears to advance the economic justice goals of Islam.

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<sup>43</sup> Iqbal and Mirakhor, 93.

<sup>44</sup> Nafis Alam, "Islamic Venture Philanthropy: A Tool for Sustainable Community Development," *Social Science Research Network*, March 5, 2010, pg. 1, <http://ssrn.com/abstract=1565859> or <http://dx.doi.org/10.2139/ssrn.1565859>.

Charity plays a significant role in Islamic society, and the giving of *zakah* (used interchangeably with *sadaqah*) is one of the five fundamental pillars of Islam. *Zakah* is translated in Islamic jurisprudence as a particular amount of money that God requires to be given to those that deserve it. *Zakah* comes from the root word زك ا which means to grow and increase; it augments the wealth of the giver and is thought to achieve the purification of wealth.<sup>45</sup> According to the prominent jurist and theologian Ibn Qayyim al-Jawziyya (d. 1350) the purpose of *zakah* is the development of the quality of kindness, brotherly love and goodwill among Muslims.<sup>46</sup> *Zakah* is only imposed on property that has the ability to increase, grow, or give a return, and the four categories of such property — each subject to a different rate — are cattle, crops and fruits, gold and silver, and merchandise.<sup>47</sup> Ibn al-Qayyim argues that the fixed rates one must pay, ranging from two and half to twenty percent, depend on the amount of labor required throughout the year involved in accumulating such property.<sup>48</sup>

*Zakah* is required of all Muslims, and many individuals give more than the minimum rate required. Other forms of charity include *infaq*, *waqf* and *qard-el-hasan*. All individuals are encouraged to take part in such activities and reap a greater reward in the hereafter for their charitable giving. In the following verse, the Qur'an specifies eight groups of people that are entitled to receive funds from the levying of *zakah*:

Alms are for the poor and the needy, and those employed to administer the (funds); for those whose hearts have been (recently) reconciled (to Truth); for those in bondage and in debt; in the cause of Allah and for the wayfarer: (thus is it) ordained by Allah, and Allah is full of knowledge and wisdom. [9:60]

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<sup>45</sup> Yusuf Al-Qardawi, *Fiqh Al Zakah* (1977), pg. 37.

<sup>46</sup> Abdul Aziz Islahi, "Economic Thought of Ibn Al-Qayyim (1292 — 1350 A.D.)," *International Center for Research in Islamic Economics*, 1984, pg. 6.

<sup>47</sup> Islahi, 6.

<sup>48</sup> Islahi, 6.

Ibn al-Qayyim divides these eight classes of beneficiaries mentioned in the Qur'an into two categories: those who receive *zakah* because they are needy, and those who receive it because of their utility<sup>49</sup> The diverse group of beneficiaries permitted to receive *zakah* has implications for the social order of the community. It could be argued that the latter group's claim to these funds is intended to promote sustainable economic growth within society, over and above the provision of immediate charitable assistance of the poor.

Yusuf Qardawi, in his book titled *Fiqh al-Zakah*, emphasizes the responsibility that God places on Muslims to care for the poor. He cites the following passage from the Qur'an to highlight the harsh punishment promised to those that fail to care for the poor:

And he that will be given his Record in his left hand, will say: "Ah! Would that my Record had not been given to me!  
 "And that I had never realised how my account (stood)!  
 "Ah! Would that (Death) had made an end of me!  
 "Of no profit to me has been my wealth!  
 "My power has perished from me!"...  
 (The stern command will say): "Seize ye him, and bind ye him,  
 "And burn ye him in the Blazing Fire.  
 "Further, make him march in a chain, whereof the length is seventy cubits!  
 "This was he that would not believe in Allah Most High.  
 "And would not encourage the feeding of the indigent!

[69:25-34]

The verb used by the Qur'an in the last verse above is *يَحْضُرُ*, which can be best translated as "to exhort" and Qardawi uses three other Arabic verbs to capture its meaning: to urge, to encourage, and to proselytize.<sup>50</sup> This interpretation implies an active effort to "feed the indigent" that goes beyond the mere supplying of food.

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<sup>49</sup> Islahi, 8.

<sup>50</sup> Al-Qardawi, 54.

## VII. Economic Justice in Islam

For Islamic microfinance to reach its true potential, a holistic approach must be taken to achieve poverty alleviation in Muslim majority countries. It requires the use of Islamic economics, as opposed to the mere use of Islamic finance. Islamic finance commonly refers to a set of financial tools and practices that comply with the Sharia's prohibition of interest and to the financial industry associated with such tools and practices. In contrast, Islamic economics refers to the economic system that incorporates a Muslim's entire understanding of Islam, which includes Islamic finance, in addition to ethics and morality. Islamic economics emphasis on economic justice will allow Islamic microfinance to advance its goal of poverty alleviation.

As discussed in the previous section, the main cause of Islamic microfinance's failure to appeal to the masses in Muslim majority countries is its unpopular dependence of Murabaha. Although this lending tool is legally permissible under the Sharia, Muslims do not see components of the Islamic economic system in its administration, which is why it is considered a form of 'disguised interest' among average Muslims. Initially, Islamic finance needed to appeal only to a small population of rich individuals that were seeking to find a religiously permissible method to invest their millions in the global economy, as the industry developed in the late 1970s. In contrast, Islamic microfinance must appeal to the masses. Furthermore, microfinance works on the community level, and thus needs a grassroots appeal. Therefore, the legal sophistication of Islamic finance is insufficient to advance the goals of microfinance, and a more holistic approach rooted in Islam's understanding of justice must be appropriated. Economic justice is one

component of justice in Islam, and its goals overlap with the goals of the microfinance industry.

The following section provides an overview of the role of economic justice in Islam. The arguments in this section are mainly supported with the use of the Qur'an and Hadith. The Qur'an is believed to be the direct word of God, revealed to the Prophet Muhammed and preserved today in its original form. The Hadith is a compilation of the sayings and actions of the Prophet, compiled after his death. These two sources are common knowledge to Muslims, and the average Muslim can recite various sections that directly influence his/her understanding of Islam. These sources encompass the divine law, and their human interpretation is explained in Islamic law. Justice plays an important role in Islam; it is one of the 99 attributes of God and the third most repeated word in the Qur'an. Although the definition for justice is unclear, it is a value that Muslims must strive to achieve in their society.

In his book *Social Justice in Islam*, Syed Qutb identifies the three foundations for justice: absolute freedom of conscience the complete equality of all men, and the firm mutual responsibility of society.<sup>51</sup> Accordingly to Qutb, it is the intricate balance of these three foundations that would result in a system unlike capitalism, socialism, or communism. Qutb's definition for economic justice in Islam is best explained by the following quote: "Economic equality is, to be precise, equality of opportunity combined with the freedom to develop one's talents within the boundaries set by the higher

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<sup>51</sup> Sayyid Qutb, *Social Justice in Islam*, trans. John B. Hardie, ed. Hamid Algar (Oneonta, N.Y./Teaneck, N.J.: Islamic Publications International, 2000), pg. 52.

purposes of life.”<sup>52</sup> This is one understanding of justice, but as mentioned above, there is no one definition of the manifestation of justice.

Arguably, poverty alleviation, the goal of the microfinance industry, can be a means of achieving economic justice in society. Therefore, Islamic microfinance should promote much more than the mere administration of interest-free loans; it should spawn a holistic grassroots movement to poverty alleviation. Individuals that reject conventional finance on religious grounds must also recognize the responsibility to advance justice in their community. The strong presence of morality and justice in Islam, coupled with the unique resources and experience of the microfinance industry, has the potential to truly advance the goal of poverty alleviation.

### **The role of morality in Islam**

The term Islam is commonly defined as the full submission to God; therefore all actions can be considered religious practices such that morality plays a central role in all actions of a Muslim, including economic decisions. *Perspectives on Morality and Human Well-Being* by Syed Naqvi lists five elements of Islam’s ethical system that he argues are universally believed by Muslims and significantly influence their economic behavior: (i) Islam is a complete way of life; (ii) Allah is omnipresent; (iii) Allah owns all wealth; (iv) Individuals must be committed; and (v) the poor have a right to the wealth of the rich.<sup>53</sup> With the support of the Qur’an and Hadith, these five principles are explained below.

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<sup>52</sup> Qutb, 47.

<sup>53</sup> Syed Nawab Haider Naqvi, *Perspectives on Morality and Human Well-being: A Contribution to Islamic Economics* (Leicester, UK: Islamic Foundation, 2003), pg. 104.



## (i) Islam is a complete way of life

The full submission to God required of all Muslims encompasses every component of an individual's life. Islam sets rules and expectations for a wide range of activities to guide this full submission. Almost every action can be an act of worship if it carries the appropriate intention. The following verse from the Qur'an demonstrates the holistic definition that is given to "righteousness":

It is not righteousness that ye turn your faces Towards east or West; but it is righteousness — to believe in God and the Last Day, and the Angels, and the Book, and the Messengers; to spend of your substance, out of love for Him, for your kin, for orphans, for the needy, for the wayfarer, for those who ask, and for the ransom of slaves; to be steadfast in prayer, and practice regular charity; to fulfill the contracts which ye have made; and to be firm and patient, in pain (or suffering) and adversity, and throughout all periods of panic. Such are the people of truth, the God-fearing. [2:177]

The reference to turning to the East or West is for the physical act of prayer. This verse reminds Muslims that worshipping God is not limited to religious activity in the narrow sense. There is no "checklist" of actions that would ensure admittance to heaven for Muslims. God is believed to be the most just of judges, and also the most merciful. Muslims strive for a "righteous" character that demonstrates itself in all aspects of life.

## (ii) Allah is omnipresent

Muslims believe that God knows every action, and every intention behind that action. The concept of *taqwa* commonly translates to God-consciousness and involves the remembrance of God's overarching presence in the universe. The following two verses illustrate the omnipresence of God in each individual's life.

It was We Who created man, and We know what dark suggestions his soul makes to him: for We are nearer to him than (his) jugular vein. [50:16]

He it is Who created the heavens and the earth in Six Days, and is moreover firmly established on the Throne (of Authority). He knows what enters within the earth and what comes forth out of it, what comes down from heaven and what mounts up to it. And He is with you wheresoever ye may be. And Allah sees well all that ye do. [57:4]

The active presence of God in all aspects of a Muslim's life has a clear effect on his/her individual behaviors, both in public and in private, serving as an additional source of due-diligence in financial contracts.

(iii) Allah owns all wealth

Man is an agent of God's wealth during his time in this life; ultimately all wealth belongs to God, and wealth serves as a test of character. It is clear in many verses that God is the creator of the universe and all things will return to Him. The following verse directly poses the questions to Muslims:

And what cause have ye why ye should not spend in the cause of Allah? — For to Allah belongs the heritage of the heavens and the earth. [57:10]

“The cause of Allah” is a common phrase in the Qur'an, and one interpretation of it is caring for the poor in society. In the following phrase, it is commanded that a Muslim care for her/his relatives (kindred), the needy, and travelers:

And render to the kindred their due rights, as (also) to those in want, and to the wayfarer: But squander not (your wealth) in the manner of a spendthrift. Verily spendthrifts are brothers of the Evil Ones; and the Evil One is to his Lord (himself) ungrateful. [17:26-27]

This verse also emphasizes the importance of not spending money wastefully. At the same time, Islam strongly condemns the hoarding of wealth. This careful balance of saving and spending is an important concept for any successful economic system. The

verse below illustrates the serious tones in which God condemns hoarding and announces a grave punishment for doing so.

And let not those who covetously withhold of the gifts which Allah Hath given them of His Grace, think that it is good for them: Nay, it will be the worse for them: soon shall the things which they covetously withheld be tied to their necks Like a twisted collar, on the Day of Judgment. To Allah belongs the heritage of the heavens and the earth; and Allah is well-acquainted with all that ye do. [3:180]

Wealth is considered the means to an end in Islam. Islam emphasizes the spending of wealth in moderation, and the fact that all wealth belongs to God means that such wealth should be spent in His cause.

(iv) Individuals must be committed

Islam rejects the concept of pure self-interest, and strongly promotes a commitment to the welfare of others. An individual carries great responsibility for his/her community. While Islam does recognize the inherent self-interest of man, it expects Muslims to overcome this and care for their community.

Islam places the responsibility of the community upon its very members. If an individual in a community goes hungry, the blame is placed upon the community,<sup>54</sup> and it is not the job of the community to judge the worthiness of a poor person's need. The Qur'an states that such actions will directly affect an individual's prosperity on the Day of Judgment, linking the giving of charity to one's own self-interest. The verse below promises a return for wealth given in the cause of God:

Whatever of good ye give benefits your own souls, and ye shall only do so seeking the "Face" of Allah. Whatever good ye give, shall be rendered back to you, and ye shall not Be dealt with unjustly. [2:272]

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<sup>54</sup> Qutb, 89.

Islam recognizes self-interest of all men. However, rather than selfishly loving worldly possessions, Muslims should be willing to sacrifice things they love most for the hereafter. Through a detachment from worldly possessions, an individual can truly share the things he/she loves most with the community. The following verse illustrates the fact that Muslims are expected to give from that which they love most:

By no means shall ye attain righteousness unless ye give (freely) of that which ye love; and whatever ye give, of a truth Allah knoweth it well. [3:92]

The commitment to the well-being of society must play a central role in the life of a Muslim, and this commitment requires that Muslims give freely and are detached from the material possessions of this life.

(v) The poor have a right to the wealth of the rich

The paying of *zakah*, or alms, is one of the five pillars of Islam, and continuously referenced in the Qur'an and Hadith. Charity is not a gift, but instead a *right* of the poor:

And in their wealth and possessions (was remembered) the right of the (needy,) him who asked, and him who (for some reason) was prevented (from asking). [51:19]

In this verse, the Qur'an references both the needy that ask, and the needy that do not ask. Helping the latter group requires that Muslims play a proactive role in the aid of others.

These five moral principles operate in tandem to shape the economic life of Muslims and encourage the advancement of a just economic system. The acceptance of these moral ethics is expected to advance a Muslim society's economic system. Today, no society unanimously embraces these principles; however, that does not restrict an individual from pursuing them. Doing so does not require the unanimous cooperation of

an entire society, and the principles can be successfully implemented at the individual or grassroots level. Muslims commonly believe that the economic ills in their society are a result of the failure to embrace these principles. The five principles presented above describe the moral responsibility of Muslims in a general framework, and the following section discusses other concepts relevant to economics.

### **Economic concepts in Islam**

Ibn al-Qayyim emphasizes the role of economic activity and its need to fulfill man's needs and requirements. He writes:

When it is preordained that grains will be obtained only after performing a certain chain of activities, it means that the produce cannot be obtained without the sowing of the seeds and the cultivation of the land. Likewise, quenching the thirst or satisfying the appetite depends on drinking water or taking food. Neither of these objectives can be achieved without the specific action it demands. The same is true of all affairs in this life and affairs pertaining to the life hereafter.<sup>55</sup>

The following section discusses certain components of this economic system, and focuses on the work ethic, role of debt, and the prohibition of *riba* in Islam.

#### Work ethic

“It is work that Islam sanctifies; making work the primary ground of possession and profit; and it does not permit wealth to grow through idleness, nor will it allow wealth to beget wealth. Only effort can beget wealth, otherwise wealth is unlawful.”<sup>56</sup>

—Syed Qutb

Both the Qur'an and the Hadith extol the work of an honest businessman. A society can be neither productive nor successful if its citizens are idle. Islam thus promotes a strong work ethic among its believers. Individuals are permitted to profit from their work, as

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<sup>55</sup> Islahi, 10.

<sup>56</sup> Qutb, 150.

long as the profits are extracted in a just, transparent and honest manner. The Hadith below extols the role of an honest businessman, raising him to the level of the most esteemed individuals in Islam:

A producer or a businessman whose behavior complies with Islamic rules is said to be like the prophets, martyrs, and the truthful friends of Allah (swt). He is ranked with the prophets because he, like the prophets, follows the path of justice; like martyrs because they both fight with heavy odds in the path of honesty and virtue; and like the truthful because both are steadfast in their resolves.<sup>57</sup>

Islam forbids dishonest dealings in business. Profits are permitted, and work is strongly encouraged when done in a lawful and honest manner. There are expectations for people when engaging in commercial transactions and the Qur'an warns against any unjust behavior in trade:

Give full measure when ye measure, and weigh with a balance that is straight: that is the most fitting and the most advantageous in the final determination. [17:35]

Individuals are expected to deal justly in all matters, especially regarding trade. God's omnipresence serves as a constant reminder for Muslims to deal honestly in their trade.

*The permission of debt:*

Islam recognizes the inevitable role of debt in financial transactions and therefore does not prohibit its use. But although it is permitted, it is discouraged, especially when debt becomes a burden and can hinder one's good judgment, as in the Hadith below, narrated by Muhammad's wife Aisha:

Allah's Apostle used to invoke Allah in the prayer saying, "O Allah, I seek refuge with you from all sins, and from being in debt." Someone said, O Allah's Apostle! (I see you) very often seeking refuge with Allah from being in debt. He replied, "If a person is in debt, he tells lies when he speaks, and breaks his promises when he promises."<sup>58</sup>

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<sup>57</sup> Quoted in Iqbal and Mirakhor, 61.

<sup>58</sup> Al-Bukhari, Muhammad ibn Ismail. *Sahih*, trans. Muhammad Muhsin Khan, (Medina: Islamic

However, if a Muslim does choose to be in debt, he/she is fully expected to repay the debt incurred. This is a serious responsibility, and observant Muslims do not take the matter lightly. The following Hadith, narrated by Abu Huraira, emphasizes the importance of the intention to pay one's debt:

The Prophet said, "Whoever takes the money of the people with the intention of repaying it, Allah will repay it on his behalf, and whoever takes it in order to spoil it, then Allah will spoil him."<sup>59</sup>

While this strict language is used concerning individuals in debt, the Qur'an and Hadith also praise creditors who show lenience and understanding to individuals in debt. Such an attitude is purely dependent upon the creditor's goodwill, and the debtor has no right to request forgiveness from a loan. If the creditor does choose to be lenient and forgive a loan, the forgiveness is reciprocated with God's forgiveness, as expressed in the Hadith below, narrated by Abu Hurayra:

The Prophet said, "There was a merchant who used to lend the people, and whenever his debtor was in straitened circumstances, he would say to his employees, 'Forgive him so that Allah may forgive us.' So, Allah forgave him."<sup>60</sup>

The following verse from the Qur'an prohibits any form of late payments, and also encourages leniency for people that are in debt:

If the debtor is in a difficulty, grant him time till it is easy for him to repay. But if ye remit it by way of charity, that is best for you if ye only knew. [2:280]

Finally, since debt is an inevitable occurrence, the Qur'an provides guidelines to ensure that the incurring of debt is done responsibly and justly:

O ye who believe! When ye deal with each other, in transactions involving future

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University; Chicago: Kazi, 1997), Volume 3, Book 41, Number 582.

<sup>59</sup> Al-Bukhari, Volume 3, Book 41, Number 572.

<sup>60</sup> Al-Bukhari, Volume 3, Book 34, Number 292.

obligations in a fixed period of time, reduce them to writing. Let a scribe write down faithfully as between the parties... Let him who incurs the liability dictate, but let him fear His Lord Allah, and not diminish aught of what he owes... [2:282]

The Sharia has a comprehensive set of rules on contracting; transaction must occur in an honest and just manner. The emphasis on how to record such transactions further supports the acceptance of debt in Islam. Despite the great differences in economic systems of eighth-century Arabia and those of today, the need for additional funds and financing to undertake economic activity continues. However, the form of the supply of these funds has changed. In the eighth-century, the lending system had a grassroots nature, and inherently affected interpersonal relationships. Today's banks serve the role of financial intermediaries. Therefore the interpersonal dynamics that previously resulted from issuing debt are no longer prevalent.

*The strict prohibition of riba*

*Riba* is considered by Ibn al-Qayyim and other scholars the opposite of *zakah* and thus also a cause of harm to society.<sup>61</sup> While there is no clear definition of *riba* in either the Qur'an or Hadith, it is strongly condemned in Islam. The books of fiqh define this term based on the Hadith below narrated by Ibn 'Umar:

The Prophet said, "The selling of wheat for wheat is Riba (usury) except if it is handed from hand to hand and equal in amount. Similarly the selling of barley for barley is Riba except if it is from hand to hand and equal in amount, and dates for dates is usury except if it is from hand to hand and equal in amount."<sup>62</sup>

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<sup>61</sup> Islahi, 8.

<sup>62</sup> Al-Bukhari, Volume 3, Book 34, Number 379.



Today, most individuals translate *riba* as “usury”, however *riba* is not limited to the monetary form of interest common today. As described above, the accumulation of debt is permitted; however, *riba* is not. God addresses this concern in the verse below:

Those who devour usury will not stand except as stand one whom the Evil one by his touch Hath driven to madness. That is because they say: “Trade is like usury,” but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (the offence) are companions of the Fire: They will abide therein (for ever). [2:275-279]

Ibn al-Qayyim believes the *riba* is not prohibited because of its name or form, but because of its nature, which is inherently different from trade. He argues that the form is not important, but it is instead the nature, aim and objective that should determine the legitimacy of a transaction.<sup>63</sup>

Individuals that administer *riba* are deprived of God’s blessings and called ungrateful. The gravity of one’s association with *riba* is expressed in the verse below:

Allah will deprive usury of all blessing, but will give increase for deeds of charity: For He loveth not creatures ungrateful and wicked. [2:276]

Fakhr al-Din al-Razi’s (d. 1209) presents three basic reasons for the unlawfulness of *riba* in the commentary titled *al-Tafsir al-Kabir*. The first is that, since the creditor can ensure his income from interest payments by the debtor, *riba* can lead to massive inequity and exploitation. It supports the possibility for wealth to accumulate in the hands of a few at the expense of the poor. Second, when interest is predetermined, the creditor is certain to receive his profit on capital, which discouraged from taking part in other productive activities. Finally, *riba* has the potential to lead to “an end of mutual sympathy, human

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<sup>63</sup> Islahi, 9.

goodliness and obligations...”<sup>64</sup> Together, these three reasons exemplify the role that the prohibition of *riba* has in the larger attempt to create an equal society that is both productive and humane. This explanation emphasizes the association of interest with economic inequality.

## VIII. The Role of Islamic Law

The technical rules that govern Islamic commercial transactions come from the vast body of Islamic commercial law. The Qur’an and Hadith urge the implementation of a just economic system. Such an order is realized in part by the implementation of Islamic law. The term *Sharia* is commonly used to refer to Islamic law; however a distinction must be made between *Sharia* and *fiqh*. The former exists in its perfect, divine form, inaccessible to man, while the latter is the result of human reason and interpretation. While Islamic law, *fiqh*, attempts to capture the essence and intentions of the *Sharia*, it remains the product of humans and therefore cannot reach the same level of perfection. The human legal system is merely an attempt to mediate the divine law to mankind. However, the responsibility of Islamic jurisprudence is not taken lightly, and jurists dedicate themselves to mastering a massive body of literature, spending volumes in the discussion of seemingly minute details. Classical Muslim jurisprudence includes two distinct disciplines known as *fiqh* and *usul-al-fiqh*. *Fiqh* is concerned with the articulation of the actual rules of law, also known as practical jurisprudence, while *usul-*

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<sup>64</sup> Abdul Rahim Rahman, “Islamic Microfinance: A Missing Component in Islamic Banking,” *Kyoto Bulletin of Islamic Area Studies* 1, no. 2 (2007): pg. 40, Microfinance Gateway.

*al-fiqh* is concerned with the theory of law and the methodological principles governing the formulation of rules of law.<sup>65</sup>

Ibn al-Qayyim explains the role of the Sharia as follows:

The basis of the Sharia is the wisdom and welfare for the people in this world as well as the Hereafter. This welfare lies in complete justice, mercy, well-being and wisdom. Anything that departs from justice to oppression, from mercy to harshness, from welfare to misery and from wisdom to folly, has nothing to do with the Sharia.<sup>66</sup>

The fundamental role of the Shari'a is to inform Muslims of duties necessary to please God in the hereafter. The primary purpose is obedience to God, and inherent in this obedience is the advancement of justice. The purpose of Islamic law is not to control or discipline humans, which is a necessary component of modern law in the modern state. Rather, in Muslim thinking, the purpose of the law is to foster living in peace, both with oneself and with society.<sup>67</sup> Furthermore, the quote below demonstrates the crucial need for a holistic approach to Islam. Qutb argues that Islam is a complete way of life, and an individual cannot be successful without the acceptance of this comprehensive social order that penetrates every aspect of living:

Islam has one universal and integrated theory which covers the universe and life and humanity, a theory in which are integrated all the different questions; in this Islam sums up all its beliefs, its laws and statues, and its modes of worship and of work. The treatment of all these matters emanates from this one universal and comprehensive theory, so that each question is not dealt with on an individual basis, nor is every problem with its needs treated in isolation from all other problems.<sup>68</sup>

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<sup>65</sup> Bernard G. Weiss, *The Spirit of Islamic Law* (Athens: University of Georgia Press, 1998), pg. 1.

<sup>66</sup>M. Umer Chapra, *Towards a Just Monetary System: A Discussion of Money, Banking, and Monetary Policy in the Light of Islamic Teachings* (Leicester, UK: Islamic Foundation, 1985), pg. 33.

<sup>67</sup> Wael B. Hallaq, *An Introduction to Islamic Law* (Cambridge, UK: Cambridge University Press, 2009), pg. 19.

<sup>68</sup> Qutb, 37.

Islamic jurists embrace a divine social vision that they firmly believe the law as always serving. While this social vision is not always explicit in the Qur'an and Hadith, it is implicit in the five cardinal values of Islamic law: religion, life, offspring, property, and rationality.<sup>69</sup> The discussion of these values is found within *usul-al-fiqh* and the values are the “indicators of the social vision that animated all the jurists.”<sup>70</sup> They believe these values to be firmly rooted in the foundational texts. While the values are straightforward, the most appropriate policies to manifest them are not, creating the need for the science of Islamic jurisprudence.

The Qur'an and Hadith are the two primary sources of law. The third source is *ijma* or consensus, which is defined as the agreement of the community as represented by its highly learned jurists living in a particular age or generation.<sup>71</sup> Consensus is a source of law in Islam, however the cases that have consensus surrounding them are extremely limited, amounting to less than one percent of the total body of Islamic law.<sup>72</sup>

The fourth source of law is *qiyas*, a type of legal reasoning, the most common and prominent method of which is analogy. One element of *qiyas* is *ratio legis*, which uses attributes common to both a new and an original case to draw conclusions about the new case. The speculative nature of *qiyas* is often the source of much discussion and controversy. Legal reasoning is an inevitable component of law, as the text cannot include a direct answer for every possible question that may arise. One example of such reasoning is when an individual asked the Prophet about the legality of bartering ripe dates for unripe ones. The Prophet asked, “Do unripe dates lose weight upon drying out?”

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<sup>69</sup> Weiss, 146.

<sup>70</sup> Weiss, 146.

<sup>71</sup> Hallaq, 21.

<sup>72</sup> Hallaq, 23.

and when this questions was answered in the affirmative, the Prophet remarked that such barter is unlawful. The *ratio* in this Hadith is based on the prohibition of transactions of unequal amounts or weights of the same commodity since that constitutes *riba*.<sup>73</sup>

A significant method to evaluate legal reasoning is *munasaba* or suitability, which restricts harmful consequences, the cause of many prohibitions in Islam, such as the consumption of alcohol.<sup>74</sup> However, the rule of suitability is only relevant to the law in certain instances, according to Islamic jurisprudence: “No *ratio* may be deemed suitable without being relevant, and any irrelevant *ratio* becomes unsuitable, precluding it from further juristic consideration.”<sup>75</sup> The goal of suitability can be seen as finding relevant ways to advance the *maslaha* of the people, or the public interest.<sup>76</sup> The entire body of Islamic law is seen as rational, and the spirit of the law is to prohibit what is harmful and to promote what is good for this life and the hereafter. Islamic law promotes the systemic exclusion of harm and inclusion of benefit, which includes the protection of life, religion, private property, mind, and offspring.<sup>77</sup>

In certain instances Islamic jurisprudence resorts to the use of *hiyal* or “legal devices” to circumvent prohibitions in the law. The casual observer can view such devices as an attempt to permit the forbidden; however, Islamic scholars never saw them as permitting the forbidden, but merely circumventing it.<sup>78</sup> The most commonly cited example is the “double sale” or *bay’atan fi bay’a*. In this arrangement, one person sells a particular object to another person at a certain price, and then he immediately buys the

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<sup>73</sup> Hallaq, 23.

<sup>74</sup> Hallaq, 25.

<sup>75</sup> Hallaq, 25.

<sup>76</sup> Hallaq, 25.

<sup>77</sup> Hallaq, 25.

<sup>78</sup> Weiss, 168.

object back from the other person at a greater price, payable at some future time. These two transactions produce the same result as the forbidden transaction of lending with interest; however, the altered form is now permissible according to Islamic scholars.

The *hiyal* provided legally permissible methods for Muslim merchants to engage in certain kinds of trade. The jurists developed hundreds of such legal devices that covered a wide range of human activity. Islamic jurists saw themselves not as engaging in trickery or deception, but merely as exploring different ways to look at a particular human transaction.<sup>79</sup> The delicate relationship between the strong adherence to the law and the social vision of Islam as practiced by Islamic jurists is best explained in the following passage:

Moralism, however, remains in the final analysis a moralism of obedience to the will of the one God and Lord of the universe. Inductive examination of the foundational texts could lead to the conviction that God's design was to effect the realization of a social order predicated upon preservation of religion, life, progeny, property, and rationality. But God knew best how to implement these purposes through concrete rules; it was not for man to create such rules. Faithfulness not only to God's purposes but also to God's rules was the best course for the jurist to follow. If a given transaction could be classified either as a loan with interest or as a double sale and the latter classification was chosen as the one most propitious in a given situation, no disobedience had occurred. A jurist might, in keeping with an animus shared by all jurists, abhor exploitation but remain convinced that a given transaction capable of classification either as usurious lending or double sale entailed no exploitation and in fact best served the interests of proprietors in the marketplace. Both the rule forbidding *riba* and the rule permitting sales (including double sales) were, after all, rules of divine law in the thinking of the jurists who accepted the device of the double sale. God knows best which rule applied in a given case, and it was the toilsome task of the jurist to read the mind of God to the best of his ability.<sup>80</sup>

This passage highlights the role of Islamic jurists as providing expertise in legal matters. While the earlier excerpt from Ibn al-Qayyim highlights Sharia's role as serving

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<sup>79</sup> Weiss, 170.

<sup>80</sup> Weiss, 171.

the welfare of the people, this passage seems to suggest that the role of jurists is purely analytical. Perhaps it is best to reconcile this seeming conflict by referring to the difference between Sharia and *fiqh*, as explained earlier. *Fiqh* is merely man's best ability to understand and expound the divine law, and therefore Islamic jurists adhere to their responsibility to master the legal components.

In a 13<sup>th</sup>-century Arabic text titled *Legal Devices of Fiqh in Financial Transactions*, Muhammaed Ibrahim admits his initial skepticism towards these legal devices, but then acknowledges the need to accommodate the harsh realities of the world.<sup>81</sup> Intelligence can allow an individual to both abide by the Shari'a and to exit from a difficult situation.<sup>82</sup> The role of *hiyal* is traced back to the Qur'an and the verse, "whoever fears Allah — He will make for him a way out" [65:2]. Therefore the legal device discovered or invented is actually a solution given by God to escape from a difficult situation. He emphasizes the importance of intention when using a legal device to circumvent a legal ruling; the practitioner's intention is an essential component of the use of *hiyal*.<sup>83</sup> This is in line with the general Islamic concept that the intention behind every action is crucial. Therefore, the use of such a legal device is prohibited if the practitioner's intentions are bad.

An important consideration in this discussion is that the average Muslim is mostly acquainted with the Qur'an and the Hadith; it is rare for a Muslim to be familiar with the specifics of legal rulings. While there is great respect for the scholarly community in Islam, the texts are not accessible to the average Muslim. The sophisticated legal methods

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<sup>81</sup> Muhammad Ibrahim, *Hiyal al-fiqhīyah fī al-mu'āmalāt al-mālīyah* (Al-Dār al-'Arabīyah lil-Kitāb 1983), pg. 8.

<sup>82</sup> Ibn Ibrahim, 25.

<sup>83</sup> Ibn Ibrahim, 74.

used to engage with legal matters, such as *hiyal*, are not commonly understood, and therefore the average Muslim is skeptical of their use. Although the Qur'an and Hadith are considered sources of divine law and require the sophisticated interpretation of legal scholars to take the form of an enforceable legal system, their accessible nature allows Muslims to use them as a basis for personal opinions on legal rulings. As mentioned above, these sources provide overarching guidance for the achievement of "righteousness" in a holistic sense.

Islamic finance has advanced in the past four decades with the use of *hiyal* to provide a permissible form for financial contracts in the global economy, mostly relevant to multi-million-dollar corporations. However, to appeal to the masses, Islamic microfinance must move beyond mere legal requirements and consider the implications of financial contracts on economic justice. The average Muslim is skeptical of these *hiyal*, and new methods that embrace the spirit of economic justice must be developed. Today, the Islamic finance industry is commonly accused of practicing a form-over-substance approach to finance, emphasizing Islamic labels and Arabic names while forgetting the substance required for a just economic system.<sup>84</sup> Wealth and any contract associated with it should be directed towards social justice, an underlying theme in Islam.

## IX. Proposed PLS Model

As discussed above, PLS models have unique benefits that can allow the microfinance industry to better achieve its goal of poverty alleviation through the promotion of income-generating activities. Furthermore, PLS loans are more accepted

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<sup>84</sup> El-Gamal, 2.



than Murabaha loans by average Muslims around the world. Therefore, Islamic microfinance has the potential to be the leader in PLS loans at the microlevel, which will require innovation to overcome challenges associated with due diligence. The challenges in implementing PLS loans at the microlevel arise from both information asymmetry and moral hazard. The small size of microfinance loans make the necessary due diligence impractical, since the costs incurred from the due diligence process are usually higher than the potential return.

Therefore, it is necessary to modify the structure of traditional PLS loans to better accommodate the small capital investments inherent to microfinance. A proposed alternative to the traditional PLS model is presented below. It is a hybrid of traditional Islamic finance tools and allows MFIs to feasibly administer PLS loans with less due diligence, resulting in a more sustainable operation. This modified model decreases the necessary due diligence required for contracts in the attempt to provide a more sustainable PLS option for the Islamic microfinance industry.

**New Lending Model: *Musharakah Mutawaqqi`a***

This model is a hybrid of the Murabaha and Musharakah lending models. The loan payments depend on the expected profitability of the business, which is the basis for the “markup.” If the actual profits are greater than the expected profits, then the borrower is not penalized in any way; the lender is satisfied with the agreed upon markup. This markup serves as an upper cap for the traditional PLS model. However, the markup can be revised based on the actual performance of the business. If the business does worse than expected, then it is the responsibility of the borrower to provide necessary financial records to a third-party auditor to make the appeal, and if the borrower successfully

validates his/her actual profits, then the lender will take responsibility for an agreed percentage of the losses.

### *Comparison with Other PLS Models*

To best explain this new PLS model, it is compared to two existing lending models. The first model is the traditional Musharakah model. As explained above, traditional Islamic finance PLS models have similar regulations for the division of profits; however, the difference arises in the management roles of the lender and borrower.

The second model is Habib Ahmed's *incentive-compatible profit-sharing contract*.<sup>85</sup> This alternative model was published in 2002 and aims to incentivize the borrower to report the true amount of profit through the use of the entrepreneur's assets as collateral to punish false reporting.

A comparison of these three models offers a stronger understanding of the unique characteristics of each.

To begin, the following assumptions are made:

1. The percent of profits shared by the MFI is  $P$
2. The percent of losses shared by the MFI is  $L$  (and it is common for  $P \geq L$ )
3. The expected profits of the entrepreneur is  $y_e$
4. The actual profits of the entrepreneur is  $y_a$
5. The reported profits of the entrepreneur is  $y_r$
6. If  $y_a \leq y_e$  then the cost to audit financial is  $A$

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<sup>85</sup> Habib Ahmed, "Incentive-compatible Profit-sharing Contracts: A Theoretical Framework," in *Islamic Banking and Finance: New Perspectives on Profit-Sharing and Risk*, ed. Munawar Iqbal and David Llewellyn (Northampton: Edward Elgar Publishing, 2002), pg. 40.

Table 1. Basic comparison of PLS models

	<i>Musharakah Mutawaqqi`a</i>	Traditional <i>Musharakah</i>	Incentive-Compatible Contract
If $y_a > y_e$	$P * y_e$	$P * y_a$	$P * y_a$
If $y_a < y_e$	$P * y_a + A$	$P * y_a$	$P * y_a + \frac{1}{2} A$
If $y_r < y_a < y_e$	$P * y_a + A$	$P * y_r$	$P * y_a + \frac{1}{2} A$

\* This table assumes that the only way to learn the actual earnings of the entrepreneur is to undergo an audit.

#### *Unique features of Musharakah Mutawaqqi`a*

The MFI's decision to invest in the entrepreneur is dependent on a variety of factors. The analysis below provides essential calculations that will allow the MFI to decide if such an investment is profitable. The calculation provided below is an extension of the analysis by Habib Ahmed's *incentive-compatible profit-sharing* model. The problems that the firm faces when disclosing the expected profits are discussed.

1. A firm (entrepreneur) plans to invest in a project in time period  $t = 0$
2. An investment of amount  $M$  is expected to yield a profit  $y_e$  in period  $t=1$
3. The investor (MFI) is risk neutral
4. Let  $r$  be the MFI's expected risk-free rate of return
5. In period  $t=1$ , the firm reports a profit  $y_r$
6. If  $y_r < y_e$  then the firm can appeal the profits and audit the accounts at a cost of  $A$

7. The audit reveals the actual profit  $y_a$ , and if this is less than  $y_e$  then the MFI reimburses the entrepreneur

### *Adverse Selection*

Adverse selection arises as a result of the difference in information between the MFI and the entrepreneur. The entrepreneur's information on a project is indexed and normalized to unity; the information that the MFI has on the firm is given by an index  $\lambda$  ( $0 < \lambda < 1$ ), then  $AS = 1/\lambda$ , is an index of the adverse selection problem. If the MFI has the same information as the entrepreneur then  $AS = 1$ . As the information gap between the MFI and the firm increases,  $\lambda$  becomes smaller and  $AS$  larger.

The value of  $AS$  is dependent on the relationship between the MFI and entrepreneur. If a previous relationship existed, through contracts such as Murabaha or through previous PLS contracts, then this value will be lower. Also, the size, age, and credibility of the firm will affect this value.

### *Expected Return*

The entrepreneur provides the expected return ( $y_e$ ) in the initial proposal. The firm prefers this number to be low to minimize the payment to the MFI; however, if  $y_e$  is too low, the venture will not look attractive to the MFI, and both factors must be carefully considered by the entrepreneur. If the firm overestimates profitability and wishes to appeal the earnings, it then bears the entire cost of auditing the financials,  $A$ .

The financial information provided by the entrepreneur in the application is then assessed by the MFI and indexed to the value  $I$ . This is the expected return that the MFI expects the entrepreneur to make during the loan period.

### *Risk Index*

After reviewing the application, the MFI uses the values for  $AS$  and  $I$  to characterize the borrower with a risk parameter,  $\theta$ . The closer the value of  $\theta$  is to 1, the higher the risk of the investment in the entrepreneur.

$$\theta = f(AS, I) \quad \theta_{AS}' > 0, \quad \theta_I' < 0$$

### *Decision to Fund*

A safety index is defined as  $\sigma = 1 - \theta$ . A risk-free project will have the safety index  $\sigma = 1$ . A risky project will have a small safety index. The MFI uses the safety index to appraise the expected return on the project,  $Y_e$ , given by the entrepreneur. The MFI then calculates the risk-adjusted expected return of a project,  $\sigma * Y_e$ . The MFI should be willing to fund the project if:

$$\sigma * Y_e > r * M$$

### *Profit-Sharing Ratio*

Assuming that the MFI is risk-neutral, the profit-ratio that goes to the MFI,  $P$ , is defined endogenously by the equation below.

$$P * (\sigma * Y_e) = r * M$$

The expected risk-adjusted profit share from an investment should equal the opportunity cost of the investment. In other terms,

$$P = r * M / (\sigma * Y_e)$$

### *Auditing*

In order for the MFI to know the actual profits,  $Y_a$ , a financial audit of the entrepreneur, must take place. If the actual profits are less than the expected profits, then the audit cost is the responsibility of the entrepreneur. Therefore, in order for the firm to appeal its profits, it must be the case that  $P * Y_a + A < P * Y_e$ . Most important, the burden lies on the entrepreneur to appeal the earnings. This strongly incentivizes the entrepreneur to keep accurate financial records.

This model modifies the financial contract to address the challenges associated with implementing PLS loans at the micro level. The Islamic microfinance industry needs to develop financial contracts that are relevant to its context, which is different than that of Islamic finance.

## X. Conclusion

Despite the microfinance industry's dedicated work to eradicate poverty, the industry has been the focus of much controversy in recent years. The industry advances the goal of poverty alleviation through the strategy of financial inclusion. While this is a legitimate strategy that benefits individuals in poverty-stricken regions, it can also do

much harm if individuals become trapped in a vicious cycle of debt. An alternative strategy to achieve poverty alleviation is a focus on income-generating activities. One method to implement the strategy of income generation is to administer profit-loss sharing (PLS) financial loans. The structure of these contracts incentivizes the loan officer to promote business development, since the payments to the MFI depend on the success of the entrepreneurial activity.

Islamic microfinance currently attempts to take the conventional microfinance model, disregarding its shortcomings, and create a Sharia-compliant product. The economic justice aspirations of Islam, together with the technical requirements for certain financial structures provided by Islamic law, offer many tools that could potentially enhance the effectiveness of the microfinance industry. The religious compliance of PLS models and the popular appeal that such structures would have for Muslims afford the Islamic microfinance industry the unique opportunity to promote the advancement of income generation to achieve poverty alleviation. As the Islamic microfinance industry attempts to grow, it is important to leverage its individual strengths to provide a service that takes an alternative approach to poverty alleviation.

The empirically slow growth of Islamic microfinance indicates that the Islamic microfinance industry cannot rely on Murabaha lending. CGAP expert Mohammed Khaled urges the industry to become creative, as it did at the time of its founding:

When the conventional microcredit/microfinance movement began in the late 70s, the pioneers at that time thought outside the box of the conventional banking and its business models and came up with new models which proved over the years that the poor are credit worthy and can take loans and pay them back without the need for the collaterals conventional banks ask for and can pay high enough interest rate to cover the cost of the operations and to allow the MFI/bank to make some profit. We need to think outside the box of conventional microfinance and its models and come up with new models that comply with the Sharia on the one

hand, and that can reach millions of poor Muslims with financial services on a sustainable basis.<sup>86</sup>

The alternative lending model presented in this essay, the *Musharakah Mutawaqqi`a* contract, is an attempt to address the due diligence problem in PLS models. It provides a stronger incentive for the entrepreneur to report his/her true profits, and places an upper cap on the payment to the financial institution. This is only one attempt to provide an innovative solution to the challenge of poverty alleviation through a focus on income-generating activities. Its implementation will be best received by Islamic microfinance efforts; however, such a lending tool could potentially be used in secular microfinance efforts as well to achieve poverty alleviation.

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<sup>86</sup> Mohammed Khaled, "Why Has Islamic Microfinance Not Reached Scale Yet?," *CGAP Microfinance Blog* (web log), March 9, 2011.



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