

## ***COMMUNITY DEVELOPMENT AMONG THE POOR THROUGH ISLAMIC FINANCE***

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The international interest-based system of finance is experiencing severe and recurrent crises, which have disastrous effects on both lenders and borrowers. The thunder of stock market crashes and the explosion of the Third World 'debt bomb' in the 1980s is still echoing around the international money markets.

### ***The rebirth of Islamic finance***

Fortunately these events, which fully exposed the weaknesses of the interest-based system of finance, were accompanied by the revival of a well-trying, but long-abandoned system of a very different nature. This is the Islamic system of finance which resurfaced during the 1970s when the first Islamic banks were established in a number of Muslim countries. During the eighties dozens of such banks were launched, some of which were located in Europe and North America.

Although it still occupies a small area of the world financial scene, the Islamic system of finance (ISF) has won worldwide recognition as a viable and effective system: an International Monetary Fund (IMF) sponsored study testified to this, and European banks, like Grindlays and Kleinwort Benson of the UK and the Union Bank of Switzerland, have set up divisions that experiment with ISF. But it is in the developing countries of the Muslim world that Islamic banks have won a fast-growing mass of savers and investors. This is because of the numerous attractions of interest-free dealing (which is a main feature of the ISF) to the suppliers and seekers of finance, particularly in the Third World. The purpose of this paper is to explain the nature, features and working of this system of finance, and to probe its relevance to community development, in particular.

### ***Illusions about interest rates***

For centuries, financiers thought to have discovered in interest-charging a safe method of multiplying their wealth: the interest rate is a predetermined gain guaranteed, together with the principal, by a lien on some of the borrower's assets. But at no time has this security been exposed as a mere mirage than under the present world financial system. The plight of holders of interest-bearing bonds demonstrates this adequately. Though assured of redemption of the principal upon the maturity of the bond and of receiving the contracted interest rate as scheduled, the bond-holder often ends up with much less than what s/he has paid. This is because an appreciation in the general level of interest rates depresses the market value of his/her bond, sometimes by much more than the rate earned by his/her bond. Capital losses of this nature may also occur as a result of high rates of inflation which erode the value of both the principal and the interest thereon. Variable interest rates may protect the bond-holders' contracted gains, but not the value of the investments. Also, rampant speculation in stock exchanges such as the one that caused the crash of 1987, which wiped out \$1.2 trillion of the value of securities, is a permanent reminder that safe interest-based lending is just an illusion. Besides, the vast sums that interest-charging lenders have lost in dealing with bankrupt corporations and states testify to the futility

of seeking to obtain security against default by borrowers.

Not only has this system of interest-based finance failed to give financiers the security they seek, but it has also proved to be quite detrimental to the recipients of finance, and to economies at large. This is particularly true of small producers and poor countries. Small borrowers suffer particularly from the tendency of interest-based lending to shift to them most of the risks attending the utilisation of loans. Risk-bearing is a task for which small operators such as farmers, fishermen, herdsman, artisans and petty traders are ill-equipped. They are already forced by social and economic necessity to operate in fields that are fraught with commercial risks arising from sudden climatic changes, poor market information, unpredictable changes in consumer purchasing power and tastes, frequent gluts in supply and shortages in inputs, and recurrent alterations in government policies and procedures.

Development exposes these small operators to additional risks stemming from experimentation with new products, techniques, systems and markets. Their ability to assume such risks is limited by the small size of their resources. Nor can they reduce their risks by diversifying their production, since they operate on a small scale. They are also denied the opportunity of shedding risks by incorporation with limited liability or hedging in futures markets, as their larger counterparts do. Yet they are required by their better-endowed financiers to bear the bulk of production risks and to present adequate securities for the interest-bearing loan they receive. Paradoxically, the larger the risks involved and the less their abilities to bear them are, the greater is the interest burden they have to carry.

Even more paradoxical is the fact that much of the funds earmarked for interest-bearing lending, at either national or international level, is provided by the poor borrowers. This is evident from examination of the balance sheets of financial institutions like banks. In countries like the Sudan, 75% of the deposits are in current accounts held mostly by small savers. Total deposits are more than ten times aggregate capital and reserves. Yet, advances to small farmers, artisans, productive families and cooperatives are no more than 5% of the total loans. Gross profits, which average around four times the paid-up capital, go to shareholders, time depositors and the tax department. Current depositors, who provide three quarters of the loanable funds are not only denied any dividend, but also have to pay ledger fees. The main beneficiaries of interest-based lending are the big borrowers whose profits are swollen by inflation which also turns the interest rates they are charged into negative ones. At the international level, we find a similar situation: there is massive capital flight from the developing countries to the industrial ones, which relend the same money at appreciably higher interest rates to many of the countries from which it originates.

Economies whose financial dealings are interest-centred suffer from considerable mis-allocation of their liquid resources. The traditional safety-minded financier whose main concern is to secure the repayment of his/her loan plus the contracted interest has little concern about what the borrower does with the loan. Indeed, his/her conviction that profits vary with the amount of risk accompanying investment will induce him/her to prefer the investment of his/her loan in a fairly safe operation that fetches less than optimal return. At the other extreme, we find speculators whose gambling spirit drives them to concentrate on the riskiest investments in the hope of

obtaining maximum gain. The actions of this type of financier heat up money markets, raise interest rates to perilous levels, and turn money exchanges into gambling casinos. The disastrous effects of the short-lived 'junk bonds' boom are a good illustration of this.

### ***The Islamic alternative***

Philanthropic organisations have played a commendable role in providing credit on easy terms to small borrowers. This credit is advanced to micro-enterprises either interest-free or at nominal interest rates that are intended to cover administrative charges, lest these expenses eat up the funds earmarked for lending. These charities also demand minimal security from borrowers, often contenting themselves with token guarantees (eg. by trade unions for members) or maintaining a lien on equipment supplied on credit to borrowers until it is repaid. But lending of this type can only be of limited magnitude. Many factors limit the supply of such charitable credit, not the least of which is that charity is itself of limited supply. More important is the need to sustain the resources of the charitable institutions by continuous infusions of funds lest they shrivel under the impact of administrative expenses, bad debts, and inflation. For in the absence of revenue generated by the operations of the institution, it can never be self-sustaining.

Charitable loans are an important component of the Islamic system of finance. But such loans, known as *qurud hassanah*, do not suffer from the numerous inhibitions that limit both the demand for and supply of charitable loans advanced by non-Islamic institutions. For the ISF contains many inducements for both savers and needy borrowers to engage in charitable financial dealings. Savers are encouraged to lend their savings interest-free by the exemption of the lent sums from *zakat*, which is a levy imposed on all hoardings. Jurists agree that loans must be repaid at their real (and not just the nominal) value: unless they are denominated in specie, stable currencies, or a widely used commodity. This is intended to protect lenders from inflation. Also, lenders are compensated for capital losses suffered in bona fide operations from the *zakat* fund earmarked for the compensation of the providers (and recipients) of genuinely irrepayable loans. Apart from benefiting from this fund, borrowers who fail to pay back their debts at the set date for some good reason must be granted a grace period, and no foreclosure of mortgages is allowed to take place. But a *mali'a* (able) borrower who refuses to pay back his/her debt is compelled to honour his/her obligations to his/her lender and may even be ordered to compensate the latter for any investment opportunities missed as a result of the borrower's evasive actions.

The above-mentioned inducements ensure that Islamic charitable loans are supplied and demanded in larger amounts than similar loans offered by non-Islamic institutions. Still, charitable loans should not be expected to be the predominant mode of business finance, even when they become the standard person-to-person type of loan.

While most Islamic banks have special *qard hassan* windows that have been established with the approval of their general assemblies the bulk of their financial dealings are profit-orientated (though not necessarily of a profit-maximising nature). The main type of financial arrangements through which these banks finance their clients are as follows:

*(a) Musharaka (Partnership)*

Under this arrangement, the Islamic bank (IB) contributes part of the finance required by a venture whose management subscribes the rest of the funding. The two sides agree to share profits and losses in specific ratios fixed before the commencement of operations.

The management of the venture is allotted a share for managing the enterprise, which is deducted from the share of the bank, plus another share of the remaining profits in proportion to his/her contribution to the funds. Thus, the manager may get as manager 24% of the profits (30% of the IB's share of 80% of the profits) plus 20% for paying 1/5th of the funds. IB's subscription equals 4/5ths of the finance. Losses are shared in the same 44/56 ratio.

*(b) Istisna'a (Order to make)*

This is an arrangement under which the IB finances the manufacturing of a specific commodity by buying it and paying for it in advance. The deal terminates when the manufacturer delivers the goods according to specifications at the agreed date. Neither party can revoke the deal once payment is made and delivery is done as agreed.

*(c) Salam (Forward purchase of produce)*

This contract enables a farmer to obtain finance from the bank by selling in advance a certain quantity of a specific crop for an agreed price, with the time of delivery in future fixed as precisely as possible. If the farmer fails to deliver the produce for any good reason, s/he is not compelled to return the money so long as s/he can make the delivery in the next season.

*(d) Murabaha (Order to supply on a cost-plus basis)*

Here the IB receives from a client an order to buy in its own name and on its account a specific commodity which it will then resell to him/her at a price, which covers its expenses and allows it a profit margin upon which the two agree in advance. Payment by the customer may be prompt on delivery, or deferred to a later date, or made in instalments, as agreed with the bank.

*(e) Mudaraba (Commissioned investment)*

An Islamic Bank may provide all the finance needed by a person or entity for investment on the understanding that any profit that accrues is shared in agreed ratios, and any loss suffered is incurred by the bank alone. It is worth adding here that Islamic banks' customers are not expected to make down-payments or present securities against possible loss. The only advance payment made is by a client who enters into a partnership (musharaka) with an IB: what s/he pays is his/her share of the funding of the venture. Any security demanded by an IB is against possible fraud or payment-evasion, and not against the risk of loss.

### *The advantages of risk-sharing*

From the above explanation of Islamic financial arrangements one may conclude that the ISF places the greater part of the risks of investment on the financier; this is in sharp contrast with the interest based system which exposes the financier to the minimum of risks. Basic to the ISF is the principle that financial gain has to be earned by risking either money or effort in investments where both profit and gain are likely to occur. This converts the financier into an investor who risks his/her funds to a varying degree according to the type of investment s/he chooses and the arrangement s/he enters into with whom s/he finances. His/her rate of return will vary with the amount of risk to which s/he exposes his/her funds in the selected field of investment. The same applies to the financed party, whose share of the profit will depend on how much (physical and/or mental) effort (and money in musharaka) s/he is ready to risk alongside what the financier is risking.

Looking more closely at the arrangements explained above we notice that the amount of risk assumed by the financier increases progressively as we move from arrangement (a) Musharaka to arrangement (e) Mudaraba. For under musharaka, the customer is risking both money and effort to an extent that exceeds in value the money risked by the financier. In the *istisna'a* and *salam* arrangements the financier is exposed to greater risk since s/he is paying in advance for goods that have not yet been produced. The risk is greater in the case of *salam* because the purchased goods are produce whose presence at the agreed time of delivery depends to a great extent on uncontrollable climatic conditions. An added risk is that s/he has to wait for another season for delivery if there has been a crop failure, and s/he cannot ask for the return of his/her money as can be done if the manufacturer fails to deliver the goods in the agreed manner. Another risk which these arrangements place on the financier is the fear that at the time of delivery s/he may find that s/he has paid for the goods more than the going price. As for the farmer and manufacturer who sells his/her product in advance, s/he would have secured for himself both finance and a guaranteed market ahead of production.

In *murabaha*, the financier is assured of a market for the goods s/he supplies to order, as well as of a reasonable profit margin. But s/he assumes all the risks that suppliers assume, like those of loss, damage, price change, delayed delivery etc. Where taking delivery is optional for the ordering purchaser, as some jurists insist, the supplier faces the risk of having to dispose of rejected goods at a loss. The risks which the former assume are negligible compared to those assumed by the supplier.

Under *mudaraba*, the assumption of the risk by the financier is at its maximum. S/he provides the whole of the risk capital, and grants the manager (*mudarib*) full authorisation to run the venture as s/he sees fit within the agreed scope and time duration. S/he is rewarded by a share of the profit, but bears any loss alone. The manager participates only in the profits, and is liable only for losses caused by his/her negligence, fraud or exceeding his/her terms of office.

As for the financed party -be s/he a farmer, an artisan, a firm manager, or investment expert - s/he enjoys many privileges denied by the interest-based system of finance. S/he receives finance without pledging to pay back whether s/he gains or loses. S/he is not required to give any

security for the money entrusted. S/he may receive finance prior to commencing production and becomes assured of marketing his/her products by simply selling goods in advance, or s/he may secure his/her supplies of goods without freezing his/her own capital or being occupied with the complications of procuring these goods: this is achieved by asking the financier to supply such goods at his/her expense and paying upon delivery or afterwards, as agreed. Finally, if the operation ends in a loss s/he does not bear this loss alone, and if s/he is unable to settle his/her bills, s/he is granted a period of grace without any additional fee.

The application of Islamic financial arrangements benefits not only the suppliers and recipients of finance, but also the economy as a whole. For the system enhances the ability of the investors to undertake risky activities which fetch high rates of return. Financiers will have a direct stake in the maximisation by investors of their returns, since the two share these returns. The economy will be free of fluctuations caused by erratic interest rate changes and oscillating bond prices. Unearned capital gain resulting from speculative activities will be minimal as resources are channelled into genuine investment operations that expand production and earn real profits. All this leads to more growth and better resource allocation than under a system of interest-based finance

As explained above, Islamic finance seems to be better suited to meeting the needs of small investors for funds, particularly in developing communities. The limited applications of ISF in the past few decades have been most encouraging, while various attempts to adapt the system of interest-based finance so as to cater for small borrowers have yet to produce the right formula. This is evident from the IBRD's world development reports for 1989 and 1990, which contained surveys of a variety of financial schemes introduced in a number of developing countries for funding small- and medium-scale enterprises. These included institutions like India's Integrated Rural Development Programme, Indonesia's Kupedes and Badan Kredit Kecamatan, Philippines Microfund, Zimbabwe's Agricultural Finance Corporation, Bangladesh's Grameen Bank, Ghana's *susus* associations, and Senegal's saving and loan clubs.

The two reports were quite critical of large-scale subsidised credit programmes and the justifications made for their creation. "Several rationales have been given for these policies", the authors wrote, ".....the poor cannot afford the market interest rates; formal lenders are too cautious; informal lenders are too exploitative. But this approach turned out to be misguided. Artificially low interest rates and credit regulation distort the allocation of resources and lend themselves to patronage and corruption. They have damaged the financial sector and have failed to extend credit to the poor. Studies of formal subsidised credit programs in sub-Saharan Africa, the Middle East, and Latin America have found that loans in arrears range from 30 to 95 per cent. Subsidised borrowers are less reliable than unsubsidised ones."

A better approach, the IBRD maintains, is to aim at "expanding informal finance, the most common source of credit for the poor". This is because experience has shown that "informal lenders, operating on low fixed costs, offer low-income clients small loans on the basis of personal or business acquaintance. Because informal lenders know a lot about their clients, they can be flexible about collateral and repayment schedules. There are lessons here for formal lenders." The 1990 report praises some "innovative credit programmes targeted at the poor"

which have been launched by governments, donors and NGOs. "These vary enormously in coverage", the report states, "but successful programs have certain features in common. Most have chosen not to subsidise interest rates. Instead they have tried to adapt themselves to the needs of the poor by reducing transaction costs to both lender and borrower. Programs with high borrowing rates and strict terms, especially those that link repayment to future lending, stand a better chance of reaching the poor. Group lending is one approach for reaching the poor people. Typically, under such schemes one member's failure jeopardises the group's access to future credit. Joint liability among a group of borrowers reduces the risk of default and makes it cheaper to reach dispersed clients." The World Bank report concluded that successful programs targeted to the poor "can become financially viable if they charge market-based interest rates and keep operating costs low". It recommends that "institutions of this kind should be supported with limited subsidies to help cover their initial administrative costs (but not interest rates)"

The World Bank's call for measures aimed at reducing lenders' administrative costs instead of reducing interest rates means that lenders' margins should be raised rather than having borrowers' debt servicing costs reduced. The rationale for this policy, it seems, is to increase the supply of credit to poor borrowers. As for borrowers' demand for credit, it is viewed by the World Bank's experts as quite inelastic: "experience shows that the poor are willing to pay market interest rates" they report, "Bangladesh found that farmers continue to demand loans even when the interest rate was about 30% a year. The poor, in any case, borrow routinely on the informal market, where rates are frequently very high." But, if borrowers' demand for credit is as inelastic as the experts of the Bank have noticed (quite correctly), then increased credit supply will depress interest rates quite sharply, unless there is a simultaneous expansion in demand by borrowers for credit. There is nothing to suggest that such demand expansion will occur spontaneously while interest rates remain unchanged.

Indeed, it is the demand side of the problem that interest-based systems of finance, such as the one advocated by the World Bank, tend to neglect while concentrating on stimulating supply. Stating this somewhat differently, the centre of concern in these systems is the lender, not the borrower. Paying a little attention to the latter will show that his/her willingness to pay any interest rate demanded by the lender relates to borrowing for sheer survival. But risking losing his/her very few belongings or the small fund from which s/he subsists and meets his/her production costs in the pursuit of greater income is another matter. Even if the interest rate at which s/he borrows drops sharply, wariness of losing everything in a quest for getting more will deter him/her from taking the risk. This is why the incomes of poor communities stagnate: interest-based systems of finance do not permit them to borrow and invest so as to improve their incomes when there is a likelihood, however slight, of forfeiting all possessions to lenders, if the ventures in which they invest fail.

The Islamic system of finance offers a solution for this particular problem of poor borrowers' reluctance to borrow so as to invest in risky ventures, even when risks are small and probably profits large. This solution is risk- and profit-sharing between the financier and the poor recipient-investor of funds, as explained earlier. The World Bank's Development Report 1990 devotes a few lines to Islamic Banking, referring to what it regards as difficulties on the lending side, ways of avoiding 'explicit' interest charges, and problems of issuing government securities.

It concludes "nevertheless, Islamic Banking can be made to work quite well and provides an interesting contrast to commercial banking practices elsewhere."

### *Switching to Islamic finance*

Many independent observers came to the same conclusion about the viability of ISF and its suitability for application by development agencies, particularly those which operate poor-focused programmes. Some actually apply techniques of finance which resemble those of ISF without expressing awareness of the semblance. This is the case with the Danish Industrialisation Fund for Developing Countries (IFU), whose chief instrument of finance is participation as a shareholder in the industrial enterprises it supports; its participation can reach up to 30% of equity capital and 25% of the sum invested in the project.

One agency which explicitly decided to apply Islamic methods of finance in at least one of its programmes is ACORD, a Euro-American NGO which operates the Port Sudan Small Scale Enterprises Programme (PSSSEP). This programme was launched in 1984 in the slums of Port Sudan with the aim of promoting small-scale income-generating enterprises and a host of inter-related services. These include vocational skills training, literacy classes, health education, enterprise advisory sessions, and kindergartens. But central to the programme's community development activities is a revolving fund which benefited 6,259 people between 1984 and the end of 1990. The loans offered were of three main types: short-term capital, hire-purchase, and home-improvement loans. Clients were charged a registration fee of 1% and a monthly charge of 2% on average. Repayment rates were very high (particularly among women and group borrowers), reaching 97.6% over the entire programme lifetime. Loans were estimated to have raised by 70% the incomes of borrowers.

However, the programme in general, and its revolving fund in particular, have been heavily subsidised by ACORD. About 90% of the annual budget consists of administrative expenses. Most of these expenses pertain to the revolving fund, whose revenue from fees and charges represents no more than 2% of its running costs. So it could only be sustained by annual capital infusions, which is becoming quite problematic since the sponsors intend to withdraw their support within about three years, and expect the programme to become self-sustaining by then. The problem is compounded by the high rates of inflation which have severely eroded the value of the loans advanced by fund managers to their clients: this reduced the number of beneficiaries from 1,800 in 1989 to 1,600 in 1990, despite a 6% increase in lending.

In 1991 ACORD approved the recommendations of a team of consultants which included myself and Colin Ball, the Chairperson of COMMACT, for the restructuring of the PSSSEP. One of the main recommendations was the substitution of Islamic arrangements of murabaha, musharaka, mudaraba and qurd hassan for the loans advanced in the forms of hire-purchase, working capital, and home improvement finance. The change was justified with these words:

*"A body of experience has grown up, since the time when concerted efforts have been made in Moslem countries to reintroduce Islamic financial practices, from around 1975, that shows two things. Firstly, that it can and does work. Secondly (and this is of particular relevance to the*

*circumstances and objectives of the Port Sudan and comparable projects), Islamic practices are particularly appropriate when dealing with the poor.*

*The International Monetary Fund has conducted two extensive surveys of the Islamic system of banking and concluded that it is viable, and, indeed, can fare better than other banking forms in unstable economic conditions.*

*In Islamic finance, sharing applies to profit as well as loss, and it is this feature that is more important than the absence of usury. When an Islamic bank provides finance to a customer, and likewise when a depositor places money with the bank to use in such an arrangement, profit and loss will be shared by financier (and hence, depositor too) and customer.*

*An Islamic bank takes a big share of the risks which an interest-charging bank shifts in total onto the customer, principally by seeking guarantees and securities. Thus the customer can get finance even when personal securities cannot be offered. The customer in turn is encouraged to undertake highly profitable and useful investments which would not have been undertaken if s/he would have had to assume all of the risks. Thus, in general terms, Islamic finance, by being based on the notion of sharing, encourages human endeavour and enterprise, and thus development.*

*Islamic banks have the further advantage that they do not suffer from inflation in the same way as interest-charging institutions do, since at least in musharaka and mudaraba, they share profits with their customers. This is clearly important in the Port Sudan context, where the value of money is constantly being eroded by inflation.*

*The objective of the changes suggested is not just to move the scheme towards what is an acceptable and achievable balance between local revenue generated self-sustainability and reliance upon external aid, but, as importantly, to enable the programme to reflect more completely Islamic values and practices which offer a very appropriate basis (because these values and practices are about partnership and sharing) not just for schemes such as this programme, but for any scheme which aims to assist the poor to improve the quality of life, in any country or culture.”*

To those remarks I would add here that what are now known as Islamic financial practices were also used in the past by people of different faiths and cultures, who also sought to base all human dealings on the basis of partnership and sharing. In the middle ages, Italians who played a key role in international trade, practiced mudaraba and musharaka under the terms *commenda* and *societas maris*.

In our times, we observe a growing tendency in international finance to turn away from interest-based lending to risk-sharing financing in the form of direct investment and multi-national equity-sharing. Of particular significance to developing countries is the spreading practice of debt-equity swap which is in essence a replacement of onerous interest-based arrangements between donor and debtor countries by more acceptable risk- and profit-sharing arrangements. This the champions of Islamic finance see as another landmark in the revival of Islamic finance,

which they see as the saviour of economic systems from stagnation and recurrent monetary crises.

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