

# ISLAMIC MICROFINANCE

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# HOW DOES ISLAMIC MICROFINANCE WORK

- Many similarities with conventional microfinance
- Overlap in product structures helps minimize additional costs, but raises questions of authenticity
- Most common structures are the same as macro Islamic finance
  - Murabaha
  - Ijara

# EQUITY-BASED MODEL USING GRAMEEN METHODOLOGY

- Presented at Harvard forum in 2008:
  - Clients provided financing in groups
  - Initial financing uses murabaha for ease of administration and ease of understanding for clients
  - If clients succeed in repaying financing, they have the option of receiving musharaka financing, but it is not required
  - Equity-based financing: could be mudaraba (MFI provides all the capital) or musharaka (if client can contribute capital in cash or in kind)
  - Diminishing partnership ends in client ownership

# PROBLEMS ASSOCIATED WITH MICROFINANCE USING DEBT

- Microbusinesses may not generate immediate cash-flow to repay debt, whereas equity is more flexible and patient
- While microfinance tends to have very high repayment rates, many studies of small businesses in developed markets shows high failure rate
- The goal of microfinance is to provide an exit from poverty, although in some cases (e.g. Andhra Pradesh) it has led MFIs to push borrowers to take on more debt than they can repay, leading to a worse outcome for clients

# BENEFITS FROM USING EQUITY

- Microfinance clients generate a high rate of return, which allows them to repay debt with interest rates of up to 100% (or debt from moneylenders which may be even more expensive)
- The debt structure caps the return for the MFI at the interest (or profit) rate, while also creating a potentially disastrous situation if the business fails to generate enough return to repay debt
- Using equity allows the MFI to profit more off of the successful businesses, while not putting an excessive burden on those who are not successful (excluding cases where the MFI can demonstrate fraud).

# CHALLENGES OF USING EQUITY

- Moral hazard: Clients will be incentivized to take greater risks since the MFI will bear the brunt of the losses (in contrast to debt-based products)
- Adverse selection: The equity-based model will attract lower clients who get a 'heads I win, tails you lose' product
- Difficulties in ensuring accurate reporting of income and expenses to calculate profit and loss
- As a result, equity-based microfinance is more difficult and costly to administer than debt-based microfinance, which may explain why it is not common.

# GROUP-BASED METHODOLOGY

- The Grameen Bank showed that using groups of clients whose own access to credit is dependent upon their fellow group members' repayment can exert pressure to deter non-payment
- In a similar way, a group methodology can be used to mitigate the moral hazard, adverse selection and reporting problems, but it is still more complex.

# AN ALTERNATIVE IDEA

- Replace individual financing with community lending
- Focus on providing cleaner, cheaper energy that can help address many issues:
  - Irrigation
  - Water pumps
  - Lighting
  - Refrigeration for food/vaccines
  - Cleaner sources of energy for cooking
- Provide an equity-based microfinance product that avoids many problems with individual financing

# ELECTRICITY DEMAND

- According to the International Energy Agency, 1.3 billion people in developing countries do not have access to electricity
- The electrification rate of 74.7% hides a significant rural-urban divide (63.2% vs. 90.6%)
- Rural areas are often off the grid, so there is a reliance on dirty diesel generators
- Diesel generators are inefficient and the emissions cause significant detrimental health effects

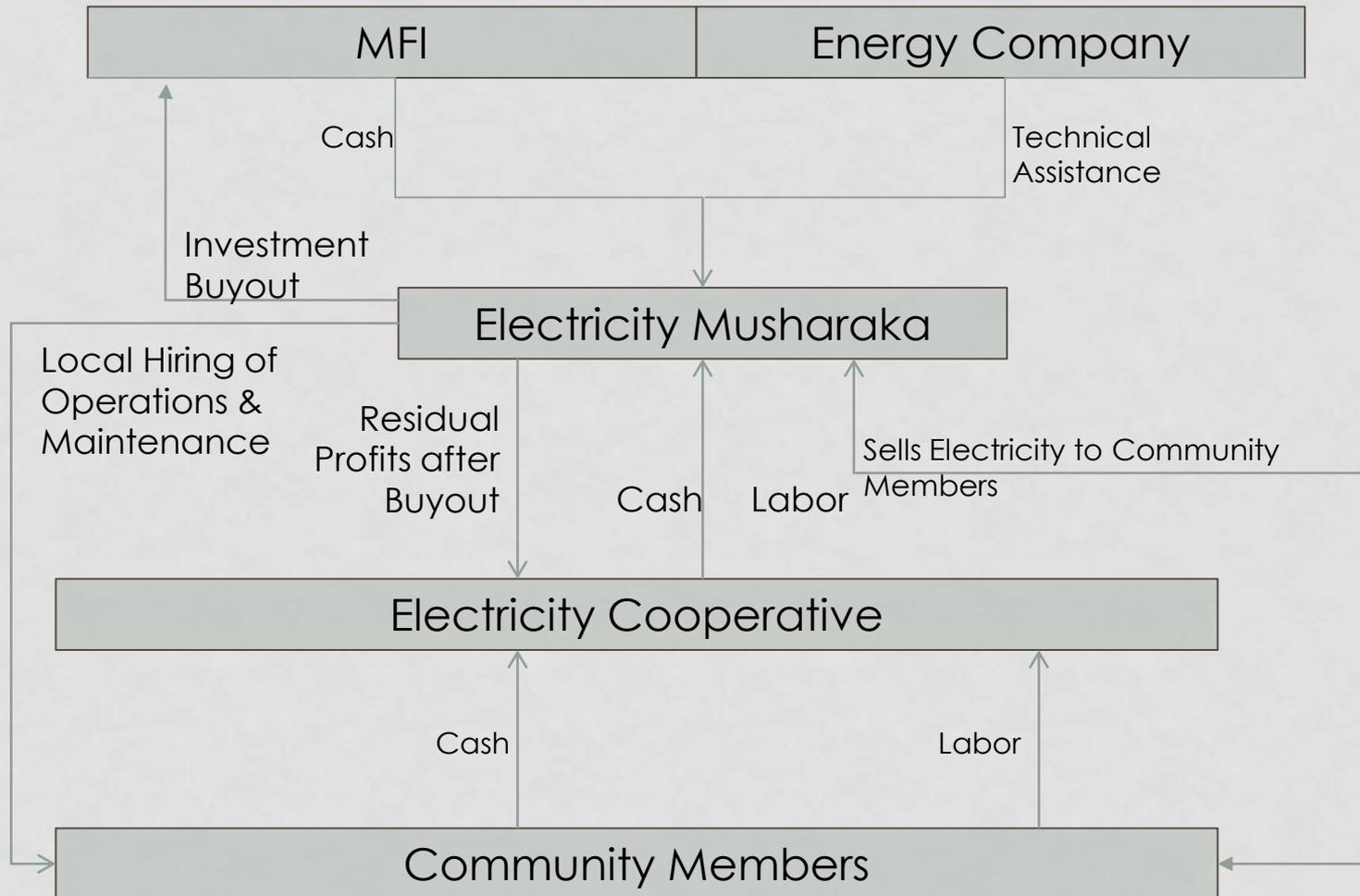
# ENERGY MICROFINANCE

- Many MFIs are beginning to offer specific microfinance for renewable energy, most offer solar, or cleaner cooking fuels like Liquid Petroleum Gas (LPG)
- One MFI, SEEDS in Sri Lanka, offers community-sized micro-hydro, which uses a community-owned electricity cooperative
- Community members provide a small amount of cash up front and in-kind contributions (labor) in installation
- The cooperative provides clean, cheap, reliable electricity to the community and uses the electricity sales to repay the cooperative's loans

# SELECTION OF RENEWABLE ENERGY SYSTEM

- System must be chosen so that the buyout of the funders provides significant working life after community takes full ownership
- System must be chosen to be able to be operated and maintained by local members of the community (to create jobs)
- Replacement parts for the system must be simple and easily available
- Electricity prices should be high enough to buy out funders, cover O&M, and generate a return for the community (but not too high to be unaffordable)

# BASIC STRUCTURE



# ISLAMIC ENERGY MICROFINANCE

- Funding organizations form partnership with energy company
- Community members contribute cash to fund an electricity cooperative
- Electricity cooperative enters diminishing musharaka (providing cash and labor) with funders (who provide cash), with the musharaka entity leveraging grants.
- System is purchased and installed with community labor; energy company provides training on operations & maintenance
- Electricity is sold to members; profits used to buy out funders' share of the musharaka
- System continues to generate profits after funders are bought out; these profits can be used to fund additional electricity generating capacity, be used for social projects in the community, or paid out as dividends

Thank You.

Blake Goud  
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