SHARED RISK & REWARD

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Islamic Microfinance for Renewable Electricity Generation

I have started thinking more about Islamic microfinance recently because I am speaking on the topic at an Islamic finance conference being held at the University of Maryland on March 11, 2012 and I was looking back at an idea that I first came across when I was researching for the paper I presented at the Harvard Islamic Finance Forum in 2008. It occurs worldwide, but the example I saw was a microfinance institution SEEDS in Sri Lanka. Their energy loan program was described in two reports that came out in 2007 [pdf] [pdf]. Their programs offer financing for three types of electricity provision across Sri Lanka: micro-solar financing, grid connection, and micro-hydro projects.

I think that all three could easily be used within an Islamic microfinance context with few changes in how they work. Both the grid connection and solar panels (for a single house) are just as easy to provide using a murabaha, so I'm going to focus on the micro-hydro project (which would be expanded to be used for other forms of renewable energy like a small wind turbine or small biomass plant).

In the SEEDS micro-hydro projects, the community forms an electricity cooperative and contributes sweat equity, as well as some initial cash outlay, with the remainder coming in the form of grants or loans. The cooperative collects payments for electricity use from the members of the cooperative, which pays for the operations & maintenance expenses, as well as repays the loan to SEEDS.

In an Islamic microfinance context, the basics of how the project works would not change, but the cooperative (owned either equally by members of the cooperative, or according to the share of initial capital each contributes) and the microfinance institution would form a musharaka with some cash contribution from the cooperative, as well as some sweat equity by the cooperative members (in the micro-hydro example, the community provides labor and in-kind contribution toward construction of the essential infrastructure, such as diversion channels and turbines).

After the project is constructed, the electricity usage charges would be collected and, after maintenance is covered, would be used to make profit-sharing payments according to the cooperative-MFI equity ownership ratio, with the cooperative's share used to purchase equity from the MFI in the project. At some point, the community would own the project entirely, and could decide whether to use the profits to either invest in additional projects, or to pay out to the members of the cooperative as profit payments.

This seems like the type of project which would both expand Islamic finance into projects that generate returns for investors, as well as contribute to helping lower-income communities and provide environmental and health benefits by reducing the reliance on gas or diesel generators. It is also a microfinance initiative that would be easier to implement with a profit-sharing model rather than relying on murabaha, which is used commonly by Islamic microfinance institutions, but attracts the same criticism on the micro level as it does on the macro level.

New Format for Newsletter

I started writing this newsletter in response to a reader of my blog who wanted a way of receiving posts by email, and I have done it now for over a year and a half. Through that time, I've wanted to make the newsletter look a bit nicer, and also make it easier to put up on my website (I have been slowly putting up back issues on my website, another thing I have been meaning to do for a long while, but finally got a few hours to work on this weekend).

I'm hoping to keep working on making the newsletter look good and we'll see what time allows over the next few months. I welcome feedback on the layout, as well as the content. Please feel free to forward the newsletter and if you have received a forwarded copy, you can sign up by either emailing me or on my blog: http://investhalal.blogspot.com (enter your email in the box on the right hand side of the blog).

Until next week,

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FROM THE BLOG…

SATURDAY
(Feb. 25)

Should conventional banks be prohibited from issuing sukuk?

There are two developments in Islamic finance that motivate this post. First, as I discussed on the blog (and in greater depth in my newsletter, which you can sign up for on the right side of the blog), the Qatar Central Bank's directive requiring conventional banks with Islamic windows went into effect, with the added stipulation that conventional banks are prohibited from investing in sukuk in the country. Secondly, the controversy around Goldman Sachs' sukuk program has led to questions about whether sukuk issuance by conventional banks leads to the financing of non-Shari'ah-compliant activities.

A recent article quotes Badlisyah Abdul Ghani, the chief executive of CIMB Islamic, a large Malaysian Islamic bank (an Islamic window at CIMB Bank), who said: "A conventional bank, with the exception of multilateral development banks like the World Bank and the Asian Development Bank, should not be allowed to issue sukuk". I have heard from other people in the industry, contrary explanations that the issuer's activities are not relevant for whether they can issue a sukuk, because investors are not investing in the equity of the company, and therefore they are not generating income from non-Shari'ah-compliant activities. While I accept the premise of the latter argument, I find it a bit too cynical to be convincing to many people not involved in the day-to-day activities of the industry.

But, back to Mr. Ghani's comments, I think that limiting issuance to Islamic banks and other companies (would a company be allowed to issue sukuk if one of its subsidiaries provided conventional financial services) is counterproductive because it limits the potential for growth of the industry. However, that is not the only consideration. The main point of contention with the Goldman sukuk was that there was no separation between the proceeds from the sukuk and the rest of the bank, nor were there specific assets which would be financed by the sukuk proceeds. Had there been a building that was owned by Goldman sold to an SPV and an ijara sukuk were issued (assuming Goldman has buildings it owns that house other businesses that are not conventional banking), there would probably be little in the way of criticism.

However, this comparison raises another issue: how can it be Shari'ah-compliant to finance a conventional bank by buying one of it's buildings and renting that building back and not by selling a commodity to the bank, with repayment of principal plus profit deferred? There is merit to this question because money is fungible (i.e. once the proceeds from the sukuk go into the company, they become indistinguishable from the other money held by the company). However, the whole way that Islamic finance has developed--right or wrong--is by separating investor's money from non-Shari'ah-compliant activities (using an SPV, for example). The criticism that Islamic finance is just adding layers (with added cost) is a criticism of the industry (for example, from Mahmoud El-Gamal).

The discussion at this point does not have a clean conclusion that I can point to and say X is ok, but Y is not. It is, instead, a starting point for further discussion about what Islamic finance is meant to achieve and whether the idea of strict literalism in viewing the construction of sukuk and other Islamic finance products. I think strict literalism is not useful, because it allows people to rely entirely on the form of a product and removes any grounds for intent to be considered by Shari'ah scholars (which, it has been pointed out widely, is an important consideration in terms of whether a product is Shari'ah-compliant or not). Hopefully now, we can get beyond the mechanical arguments about whether a product like Goldman's sukuk is Shari'ah-compliant or not and look deeper into how Islamic finance should be developed.

SUNDAY
(Feb. 26)

Can Islamic finance in Indonesia reach 10% by 2020?

There were a few articles about Indonesia (ht Islamic Finance Indonesia) that demonstrate the rapid growth potential for Islamic finance in Indonesia. The industry remains just a small part of the banking and finance marketplace in the country accounting for just 4% of total assets, but the growth rate has been astronomical (albeit, as is common in Islamic finance, from a small base). The goal from Bank Indonesia, the central bank, is for Islamic finance to increase in Indonesia to grow to 5% in 2013 and to 10% of total assets by 2020.

While this seems like a remarkable growth rate to sustain (and it would be set back greatly if the country's recent economic success that has led the country to have its sovereign debt upgraded to investment grade), it might be possible. The Islamic finance industry has become much more institutionalized and there are many more global heavyweights eying the Indonesian market (such as Al Rajhi Bank in Saudi Arabia and Standard Chartered Saadiq Islamic window), in addition to the interest from across the Strait of Malacca.

To get an idea of the required growth rates to hit these targets, I made a few very simplistic calculations, based on the historical growth rates in Islamic banking in Indonesia (36% per year 2005-2010 and 49% last year), as well as expectations for near-double digit growth rates for banking overall in Indonesia (according to a survey conducted by PwC [pdf]). My assumptions used 25% growth 2011-2014 for Islamic banking, slowing to 18% for 2015-2020, with growth rates for banking overall in the country of between 8-10% annually for the entire period of 2011-2020. Here's the evolution of the Islamic banking assets in the country under those (relatively unscientific, though probably lower for the next couple of years than Bank Indonesia's projections) assumptions:

Year	Low Estimate	High Estimate	Size ($bn)
2011	4.0%	4.0%	$16.1
2012	4.5%	4.6%	$20.1
2013	5.2%	5.4%	$25.2
2014	5.9%	6.2%	$31.5
2015	6.3%	6.8%	$37.1
2016	6.8%	7.4%	$43.8
2017	7.2%	8.1%	$51.7
2018	7.8%	8.8%	$61.0
2019	8.3%	9.7%	$71.9
2020	8.3%	10.6%	$84.9

While it is a bit presumptuous to project so far into the future on such flimsy evidence (I basically took the historical growth rate and subtracted 10% for the next few years and cut it in half for the out years). However, consider the projected size of Islamic banking assets in 2020 against the size of the entire banking sector today (est. at ~$400 billion, if the 4% number is correct): it would be about 21% (which happens to be the share of Islamic bank assets in Malaysia). That being said, while I don't have confidence in my numbers being at all accurate in predicting the future growth, I think the exercise points out the reasonableness of Bank Indonesia's targets, even if growth slows quite measurably in the next 8 years (and even total bank assets continue to grow rapidly).

One area where growth has been slow, at least in the non-sovereign space, is sukuk issuance. The sovereign sukuk could be boosted by plans from the government to use project-based sukuk to finance at least one of its development and infrastructure projects under its long-term economic development masterplan [pdf].

These articles further confirm my idea that Indonesia will be one of the primary growth areas in Islamic finance, something I mentioned in my newsletter at the beginning of 2012. On a related note, I am starting to put up the back issues of my newsletter on my website. It might take me a while to get them all up, but so far, I've put up the last 3 months of newsletters. It is still better to subscribe, which you can do on the right hand side of the blog, since going forward, there will be about a month lag in the newsletters up on my website.