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A Proposed Regulatory Framework for Islamic Microfinance Model: Lesson from IFSA 2013

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ABSTRACT

Microfinance is an important mechanism to tackle poverty in current global society. The gap between the rich and poor is getting wider and wider. However, the method of ensuring a stable and functional microfinance institution is debated among academicians and policy makers. Some of taken the lending approach, while other might argue for the systematic approach, here the paper argue for a legal regulatory approach. The main idea is that the risk that conventional microfinance faces due to lack of regulatory framework is the same risk that Islamic microfinance will face, hence the need for an Islamic microfinance regulatory system. It is only through such system would the Islamic microfinance be able to develop at a sustainable pattern and be in line with Shariah. The suggestion here is to use IFSA 2013 as model in crafting a regulatory framework for Islamic microfinance due to its uniqueness and bindingness as the governing law for all Islamic financial institutions in Malaysia and it being developed under the Shariah governance supervision. From such model, its clauses can be redrafted to suit the complexities of Islamic microfinance system and its development.

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INTRODUCTION

Islamic microfinance comprises of two significant words, "Islamic" and "microfinance". Islam is a comprehensive way of life, addressing both the religious and secular needs; "it is a set of beliefs and a way of worship; it is a vast and integrated system of laws; it is a culture and civilization; it is an economic system and commercial norm; it is a polity and method of governance; it is a society and a family conduct; it is a spiritual and human totality; thus worldly and other worldly." (Ahmad & Ahmad, 2009: 218) In short, Islam encompasses all aspects of life and the ultimate aim in Islam is to free mankind from oppression (*zulm*) and misguidance (*dhalal*) in the general sense. It is worth noting here that Shariah, i.e., Islamic law, is only one aspect of Islam and hence, the reason for labeling it Islamic microfinance and not Shariah microfinance. Thus, it denotes an Islamic perspective of microfinance that is not merely based on Islamic legal system perspective only but an overall and general Islamic perspective, including ethical and *tawhidic* approach.

As for microfinance, it is correctly defined as "the provision of financial services and products to those whose low economic standing excludes them from conventional financial institutions or programs." (Choudhry, n.d.) This may include small business, micro insurance, micro entrepreneurs, micro credit financing and other small enterprises. The objective behind such small-scale financing is to create provision or access for people that are not within the reach of the established financial system due to various factors; whether it is due to them not having a banking account or them living in rural areas of the country without financial provisions. These are part of the many reasons for a need of small-scale services and micro financing for their activities. Hence, microfinance is a means of providing micro-credit to the poor whose income are minimum, if any. Microfinance can be used as an effective mechanism to reduce poverty in the developing countries and a means to help build and create self-dependence among the poor. Thus, allowing them to develop alternative access to funds and also create means to financial services. The activities of microfinance usually includes: Small loans for working capital and investments, collateral substitutes, access to regular loans, repayment mechanism, streamlined loan disbursement, secured savings products, etc. (Ledgerwood, 1999: 1) There are different types of microfinance facilities, microfinance banks, traditional commercial banks

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with microfinance operations, non-bank finance companies, self-help-groups (SHGs) linked to commercial banks, co-operatives and community-based financial institutions dedicated to providing microfinance services to the poor, operating side by side in most countries. In a general sense, microfinance can be best described as a mechanism that allows the low incomes citizens to gain from modern capitalism, even though it cannot be clearly stated as an alternative to capitalism (Hulme & Arun, 2009: 1).

Islamic Microfinance Departure from Conventional Microfinance:

The microfinance industry is the arena for those that are mostly facing financial difficulties. Hence, the people would look to the microfinance industry as a means to help them overcome their difficulties and be able to stand independently and on a much better financial ground. It should also be able to assist them with their overburden loans, if any, and allow them to obtain small loans that would be able to get them back on their feet without creating additional burdens. As for micro credits, the main providers usually do through either (Hulme & Arun, 2009: 187):

(i) lending to individuals on a non-profit (and often reciprocal) basis;
(ii) lending directly but intermittent lending to individuals with a temporary surplus;
(iii) lending to individuals specialized in lending, whether on the basis of their own funds or intermediated funds;
(iv) individuals who collect deposits or 'guard' money; and
(v) group finance

For Microfinance, the person associated with initiating this system in 1970 was the 2006 Nobel Peace Prize co-recipient, Dr. Muhammad Yunus. He was a lecture of economics in the Unites States before returning to his home town Bangladesh. After seeing the misery and havoc that the money lenders / "money-sharks" were causing in the area, he decided to take the initiative upon himself to help his poor fellow citizens. By this initiative, a noble one indeed, he was able to convince and secure support from the international development communities. He made a groundbreaking remark about the future perspective on poverty. He stated (Bateman, 2010: 6):

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. When school children will be on a tour of the poverty museum, they will be horrified to see the misery and indignity of human beings. They will blame their forefathers for tolerating this inhuman condition to continue in a massive way.

His words and enthusiasm to establishment an industry that would cater to the needs of the poor spread quickly and rapidly. However, time has change and no longer is it enough for microfinance industry to offer a single product, such as a microloan for a small enterprise (Rhyne, 2009: x). Hence, from a theoretical perspective, the main difference might be derived from a joint-liability approach. This basically means that parties engaging in micro financing can pull together resource, which increased their ability to make greater impact and generate more revenue; for example, a group of individuals pull together to form an organization or association that will entitle them to secure bigger larger loans. By this, they help each other to minimize the risk that would have been a major obstacle if one of them were to apply for such financing. They may now be more receptive to the different economic opportunities. The concept of joint liability is very efficient for small business.

Funds can then be distributed to micro-enterprises or micro-entrepreneurs, subjected to the consent of the other members within the organization. Since this is based on joint liability, all the members are responsible to ensure that each member repay their debt within the stipulated period. Therefore, as mentioned above, the risk is shifted from one individual to all the members. They will function like a single body, if one default all the other members will be affected. It's a rudimentary but effective credit scoring mechanism that may mean a temporary suspension from the program. Therefore, they will have no access to financing for the group or other penalties may apply as a means of warning them. Micro-financing on this level is usually for a short period, which means that the credit may be high however the repayment is needed with very short period (Choudhry, n.d.). This gives the creditor control over the loan borrowed and in many cases lead to creditor abusing the debtor, whether physically or financially, if the debt is not paid within the fixed short period.

Therefore, by having an effective mechanism in place that can reduce the default risk of the debtor, more financial services can be provided for the poor. Hence, the industry cannot rely merely on lending, especially with the conventional microfinance that is complacent with providing financing through lending with interest (*riba*). It was due to the high interest rates that some of the poor defaulted and plunge deeper into poverty, while in some cases due to lack of financial skills and opportunity.

Although, Muhammad Yunus, when initiating microfinance in Bangladesh did it on low interest rate basis, nevertheless, this is still impermissible according to Islamic law. Shariah prohibit interest (*riba*) in all its forms insignificant of the amount. Therefore, there is a necessity to create a more ethical financial method to develop the microfinance industry. This is where Islamic microfinance system and its financial engineering schemes can best play its role.

Islamic microfinance is the provision of financial services for low-income populations in which the services provided conform to the Islamic financing principles to make it Shariah-complaint. In simple terms, Islamic finance is simply religio-ethical financing. Islam sets out some broad principles that are applicable to all aspects commercial transactions in general and the provision of finance in particular. As a brief overview of the current Islamic microfinance industry, Asutay (n.d.) stated that:

Islamic microfinance is becoming an increasingly popular mechanism for alleviating poverty, especially in Muslim developing countries. The Islamic finance industry as a whole is expected to reach over $2 billion dollars at the end of 2012 and is a continually growing sector due to its ethical principles and prohibition of riba (interest). Islamic microfinance fits into the asset-based economic paradigm and equity objective of Islamic moral economy as well as fulfilling all other social expectations. Thus, there is a compability and complementarity between the objectives and operational mechanism of microfinance and of Islamic finance.

Developing countries are slowly creating microfinance facilities to help fight poverty in their countries, which the impact is more vivid compare to the developed countries. Islamic finance as being witnessing rapid growth, however, the gap between the rich and the poor is also rapid expanding although it takes a more ethical approach compared to its conventional counterpart. Therefore, growth and development in the Islamic finance industry can be seen on the macro level but not on the micro level. This is the role where Islamic microfinance will play its role to help develop the micro level to be at par with the growth of the macro level to fully achieve the true Islamic system and also the *maqasid al-Shariah* (objectives of Shariah) in all transactions.

Some Islamic scholars opined that microfinance can be commercially and financially sustainable while others argue that the objective of microfinance is not profit oriented but rather poverty reduction, so any microfinance that wants to provide services should not be profit oriented. However, the author is in favour of the former opinion, because poverty reduction does not mean that one cannot gain profit while providing services to the poor. It is unjustifiable and exploitive profit that should not be permitted because it contradicts the main purpose and objectives of Islamic microfinance, which is aim at minimizing and eradicating poverty. The importance of establishing a regulatory framework is to create a system that would help solve some of the major problems facing the Islamic microfinance industry and help to improve customer loyalty, credit scoring, follow up on loan arrears, updating and enforcing credit policies which will all add value to Islamic Microfinance institutions.

Need for Regulatory Framework:

One of the most important dilemmas faced by both Islamic microfinance and conventional microfinance today is the issue of regulation and supervision of the industry. Regulation, in this context of microfinance, refers to “a set of enforceable rules that restrict or direct the actions of participants and as a result alter the outcomes of this action.” (Hulme & Arun, 2009: 186) Hence, the necessity to tackling the lack of comprehensive regulation to govern the Islamic microfinance industry. The regulations that are provided by governments mostly apply to banks and other formal financial institutions and not applicable to microenterprises that also provide financial services. As rightly highlighted by Joanne Ledgerwood (1999: 20):

Many nonbank microfinance institutions, especially non-governmental organisations, operate on the fringes of existing regulations, especially with regard to deposit mobilisation. In some instances they do so with the knowledge of the authorities, who, for political reasons or simply for lack of time and resources, do not interfere. In other instances these nonbank microfinance institutions simply avoid dealing with the issues and proceed with deposit mobilization by calling it something else. All parties involved in microfinance in a particular country need to understand the dynamic of these legally ambiguous operations. One important danger is that as more bank and nonbank microfinance institutions begin operating, authorities who have been disposed to liberal interpretations of the regulations will be forced to invoke a much stricter construction of the laws, thus tipping the balance unfavorably from the point of view of those engaged in microfinance.

Therefore, if wider services are expected from the microfinance institutions, as mentioned above, creating a regulatory framework is necessary. It cannot be expect that individual depositors would be able to monitor the sustainability of a microfinance institution nor should they rely solely on the state supervision. Islamic microfinance institutions cannot be expected to rely on prudential practices, although prudential practices should be encouraged. However, a regulatory systematic approach would be a better for stability and governance (Ledgerwood, 1999: 21). This is also due to increasing number of countries that have an environment which is favourable for inclusive finance: political and economic stability, an improved regulatory framework, and a growing domestic market with increasing spending power (Rhyne, 2009: xiv).

Another possible argument for the need for a regulatory system is similar to the reason for a regulatory system on a macro level, which is to minimise the effect of the market failures; because big failure on a micro level will eventually cause an effect on the macro level and lead to instability and decline of the economy (Hulme & Arun, 2009: 186).

Therefore, if the Islamic microfinance industry was to be regulated, the regulators should take into consideration the differences among borrowers and methodologies to analyse them. Regulators must create a dynamic system that is not stringent but rather allow flexibility with regard to issues such as documentation and legal procedures (Hulme & Arun, 2009: 191). Regulators must allow the industry to expand and detract according to market needs and demands. Regulator must be able to highlight the Shari'ah needs of the industry and ensure that the implementation is in compliance with Shari'ah. The Shariah legal maxim of creating ease and facility must be employed to accommodate the need. The appointed of Shariah regulatory board or advisor must be established to ensure that the poor are not being exploited and oppressed. The approach should be on a country to country basis, because each country faces different policies and economic issues. Therefore, it does not have to base on a specific prototype that would be applied to all situations and circumstances (Hulme & Arun, 2009: 194).

As for the importance of having a regulatory system for the microfinance industry, the debate on this issue goes back as far as the 1990's with two major views being expressed concerning a regulatory approach, i.e. the financial approach and the poverty lending approach. The poverty lending approach is mainly focus on lending to the poor as means to eliminate poverty in the world, while the financial approach is more towards establishing methods which could help the industry to be self-sufficient and able to sustain itself (Robinson, 2001: 7). Such theories should be seriously analysed to see which is most suitable for the Islamic microfinance industry and its services. Although, as already stated above, the Islamic approach is not that poverty will be eliminated and eradicate instantly; however, it should be tackled through Islamic means, such as *zakah*, *waqf*, charity (*sadaqah*), *qard al-hasan* and other Islamic financial instruments. Therefore, the Islamic approach would be more towards empowering the poor and making the industry self-sufficient rather than the poverty lending approach, which at times create more difficulties and burden upon the poor. The Islamic microfinance is more in need of the former approach, a regulatory framework that can make the Islamic microfinance sustainable and independent. Hence, the need for a regulatory framework that is applicable to Islamic finance institutions.

Different Regulatory Approaches:

As for the regulatory approach for Islamic microfinance, it can be adapted from the already existing approach to create a framework of its own that would be in line with the Shariah and also has the ability to fulfill the objectives of the Shariah. In the conventional microfinance industry, there are different approaches towards establishing a regulatory framework. There is the approach of developing a prudential regulatory model, which is easily understood as following a best practice model of the already existing model of the developed countries (Hulme & Arun, 2009: 189). Hence, a country such as Niger that is battling with poverty would study different developed country and their method in reducing poverty and then adapt the one that is most similar to their situation as a model and template. On this, country such as Bolivia, Peru and Philippines have been among the pioneers, using this method as to grow their microfinance institutions (Vogel and Schulz, 2011: 3).

Another approach is the laissez faire approach. This approach is basically what is followed by most microfinance institutions. This approach is that the microfinance institutions adapt the financial regulatory laws of the country. The microfinance institutions would not create a regulatory framework for itself but rather merely rely on what regulation exists for the financial sector of the country. The sector-specific regulations along with prudential reforms may facilitate an environment which allows microfinance institutions to mobilize savings and also reduce the problems in enforcing normal banking regulations. The laissez faire approach has benefitted the development of sustainable microfinance in many countries by identifying pathways for microfinance institutions to access the resources from commercial markets. However, the regulatory approaches must incorporate the diversity among institutions and sector-specific requirements. Also, one needs to incorporate the specificities of countries in the regulatory approach and take into account the varied macroeconomic environments and different stages of development (Hulme & Arun, 2009: 195).

However, an alternative approach is that regulation for the microfinance sector can be achieved through the existing legal and regulatory framework (Hulme & Arun, 2009: 191). Hence, it will be a different approach from the method above, it must have its own legal and regulatory framework; as a conceptual example, Islamic Microfinance Act or any title that would establish its legality. Therefore, such legislation would be rephrased and redefined or tuned, to fit within the context of microfinance. This is mainly to suit the complexity and differences between the macro-economy and the micro-economy. A similar example of this would be Islamic Financial Services Act (IFSA), which is also the model example in this research. Due to the various distinctions and uniqueness of Islamic finance from the conventional finance, Bank Negara Malaysia (Central Bank of Malaysia) decided to allow for the Islamic finance industry to have their own act to govern their operation. At the initial stage the Central Bank of Malaysia Act 1958 (CBMA) was amended to suit the needs of the Islamic finance industry and so was the Banking Act 1973 (BA).

However, the amendments were not sufficient for the demand of the Islamic finance industry and the challenges it faces, hence the need for an independent Islamic regulation, the Islamic Banking Act 1983 (IBA) and Takaful Act 1984 (TO). However, in 2013 these two acts were repelled with the new Islamic regulation, i.e., Islamic Financial System Act 2013 (IFSA), which merged both Islamic banking industry and the *takaful* industry under one regulation.

Proposed Modification to IFSA 2013:

The paper proposes certain clauses from IFSA 2013 to be modified to be in conformity with the Islamic microfinance system. IFSA, being a robust regulatory framework that governs all Islamic financial institutions in Malaysia, act as the best suitable framework to craft a new framework for Islamic microfinance. The relevant clauses that are most suitable to be amended in creating an Islamic microfinance regulatory framework are registration and licensing, authorized business and business activities in accordance with Shariah, Shariah compliance, Shariah governance, establishment of Shariah committee, Audit on Shariah compliance, audit requirement, standards on prudential matters, transparency requirements, takaful, action in event of breach, maintaining proper record, business conduct, preparation of financial statement, Information and secrecy, corporate governance, establishment of financial ombudsman scheme, consumer protection, financial assistance, winding up, criminal offences and other clauses relevant to Islamic microfinance. The clauses are all beneficial; however, they should be amended to suit the Islamic microfinance system. Under such a regulatory framework, the true potential of the Islamic Microfinance can be achieved in line with Shariah.

Conclusion:

Microfinance has become an important tool to assist the poor or low income group. The emergence of micro financing has become more popular with the establishment of Grameen Bank in Bangladesh by Muhammad Yunus. Although the Grameen model is based on the conventional system, it has led to the successful establishment of Islamic Microfinance institutions initiatives in numerous countries, for example Amanah Ikhtiar Malaysia (AIM) in Malaysia.

As pointed out above, the purpose of Islamic microfinance is to assist the poor. Therefore, Islamic microfinance should be a means of facilitating easy for the micro-entrepreneurs and micro-enterprises and not to exploit or created burden upon them. Subsequently, the services provided through Islamic microfinance should be Shariah compliance. In this respect, there must be detailed Shariah regulatory framework to cater for Islamic Microfinance activity.

The principal regulatory objective of IFSA is to promote financial stability and compliance with Shariah. Therefore, there is similarity in the objectives of IFSA on the Islamic finance industry and what is expected from Islamic microfinance industry with a regulatory framework. The Islamic microfinance institutions should be regulated within its own regulatory framework while using IFSA as a holistic guide. With IFSA, which a robust regulatory framework for Islamic banking and takaful institutions in Malaysia, as the model to create an Islamic microfinance regulatory framework both the stability of the economy and Shariah governance would the taken into consideration. However, the model should be more flexible to allow the Islamic microfinance system to develop gradually and at a sustainable pace.

Several clauses under IFSA are beneficial for Islamic microfinance framework inclusive of registration and licensing, business activities in accordance with Shariah, establishment of Shariah committee, audit requirement, specific standard requirement, maintaining proper record, avoidance of forbidden business, preparation of financial statement, corporate governance requirement, establishment of financial ombudsman scheme, etc. Under such regulatory framework, the true potential of the Islamic Microfinance can be materialized and also in line with Shariah.

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