

# AN ISLAMIC MICROFINANCE BUSINESS MODEL FOR ISLAMIC BANKS: INSTRUMENTALIZING ISLAMIC INCOME REDISTRIBUTIVE INSTITUTIONS AND SECURITIZATION APPROACH

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*The reluctance of Islamic banks to extend their services to offer Islamic microfinance was largely caused by the pessimistic view on the profitability of the business. This view is supported by the dearth of viable and feasible Islamic microfinance business models which can potentially contribute to the amelioration of the less financially-able segments' state of well-being, and at the same time able to sustain the microfinance business. Furthermore, the growth of product innovations in Islamic microfinance has been slow, which limits Islamic MFIs from tapping larger segments of the market. Hence, the market potential for Islamic microfinance remains largely unserved.*

*This research analyzes the current business practices from the perspective of outreach and sustainability. Outreach represents the breadth of the microfinance services serving the poor, whilst sustainability represents the replicability of the business in the market. Amongst the models reviewed, "quasi financial institution" model demonstrates superior value proposition than "microfinance bank" model. In addition to that, this research proposes a model which supports the view of instrumentalization of Islamic income redistributive institutions and securitization mechanism as an effective financial inclusion tool. It is envisaged that this model would satisfy the microfinance outreach and sustainability objectives, as well as it being a commercially viable and feasible business proposition. Thus it is hoped that this model can potentially contribute to the amelioration of the less financially-able segments' state of well-being.*

**Key words:** Islamic Microfinance, Business Model, Islamic Income Redistributive Institutions, Securitization

## **1. BACKGROUND**

An increasing income inequality indicates a potentially serious income maldistribution problem in the current mechanism. It represents income gap between the rich and the poor in which the wealth is concentrated in the hands of the few rich

while the majority is impoverished. The poor segment of the economy remains at its existing state of affairs due to economic and social constraints which impede their participation in the economic process of production as well as consumption. At macro level, deficit government spending and tax cut during recession will set a barricade for the poor from moving to upper economic ladder whereas it will benefit the rich to move up even higher due to less paid tax. Likewise, during the inflationary period, the poor are also not better-off as the real wage declines. In addition, interest-based banking system squeezes the poor via excessive interest rate for micro credit –if not excluding them from the financial system. This places the less able in difficult position to conduct economic activities. Therefore amelioration of poor's economic and social conditions via financial inclusion, improvement of literacy, education, and other social skills, as well as rectification of the current income distribution mechanism; are a paramount agenda for any related organizations. This is to ensure that the potential of this segment in participating actively in real economic activities is materialized. In this context, it is the Islamic Microfinance Institutions (Islamic MFIs) which have the potential to pursue the agenda.

## **2. ISLAMIC MICROFINANCE: ITS PRIMA FACIE and ITS STATUS QUO**

Islamic microfinance is the provision of both financial and social services to less able segment of the society utilizing financial transactions which are governed by Islamic jurisprudence (*Shari'ah*). The prime focus of Islamic microfinance activities is to alleviate poverty through financial and social inclusion of the less able. CGAP (2008) mentioned that Islamic microfinance is expected not only to serve the unmet demand but also to achieve one of the *Shari'a* objectives of poverty eradication. Embarking from this, the concept is carried and shall be manifested through its products and services offering in order to overcome issues surrounding the poverty via means which are *shari'ah* compliant. It signifies that products and services which are instrumentalized are developed and innovated by the institutions, are from tools

which are recommended by *Shari'ah*, regardless the type of institutions which carry Islamic microfinance services.

Conceptually, Islamic microfinance services are services needed by the less able segment in order to assist this segment to gain the rights to use the resources which has endowed by Allah (swt) to mankind. This rights enables this segment to participate in economy activities thus ultimately strengthening the real markets. Services ranging from self-developmental services; such as soft skills training, business training, health care, mutual cooperation and protection; to the disbursement of *zakat*, *waqf* assets management, and other means of redistribution of income; as well as the common practices of a financial intermediaries, such as savings and financing, shall be on the shelf of products and services offered by Islamic MFIs. It can be implied from one of the hadith from Prophet (s.a.w.w.s.) which reads:

*Narrated Anas ibn Malik: A man of the Ansar came to the Prophet (peace be upon him) and begged from him. He (the Prophet) asked: Have you nothing in your house? He replied: Yes, a piece of cloth, a part of which we wear and a part of which we spread (on the ground), and a wooden bowl from which we drink water. He said: Bring them to me. He then brought these articles to him and he (the Prophet) took them in his hands and asked: Who will buy these? A man said: I shall buy them for one dirham. He said twice or thrice: Who will offer more than one dirham? A man said: I shall buy them for two dirhams. He gave these to him and too the two dirhams and, giving them to the Ansari, he said: Buy food with one of them and hand it to your family, and buy an axe and bring it to me. He then brought it to him. The apostle of Allah (s.a.w.w.s.) fixed a handle on it with his own hands and said: Go, gather firewood and sell it, and do not let me see you for a fortnight. The man went away and gathered firewood and sold it. When he had earned ten dirhams, he came to him and bought a garment with some of them and food with others. The apostle of Allah (s.a.w.w.s.) then said: This is better for you than that begging should*

*come as a spot on your face on the Day of Judgment. Begging is right only for three people; one who is in grinding poverty, one who is seriously in debt, or one who is responsible for compensation and finds it difficult to pay.*

Source: Sunan Abu Dawood, Kitab al-Zakah, Book 9, Number 1637

Prima facie of the *hadith* envisioned the whole business spectrum of Islamic microfinance. The real locus of Islamic microfinance is the self-development of the poor through a total financial and social inclusion which enable them to attain the right of use of the resources. It is also envisaged that Islamic MFIs should be the forefront to facilitate trading amongst the small business enterprises since these SMEs shall be in the list of Islamic MFIs' clientele. The improvement of the less able who are commonly characterized as self-inferior due to social exclusion could be undertaken intensively by the Islamic MFIs, and not by the government. The latter institution has huge constraints as well as limited resources since Islamic microfinance demands focus and attention dedicated solely for this activities. Considering this, one may imagine that conceptually there are plenty of hidden business potentials for Islamic MFIs, of which each of instrumentalization of the institutions (i.e. the realization of the business potentials) will reflect the comprehensiveness of Islam for reaching to the ends of poverty eradication.

Albeit the continuous development of Islamic MFIs, it is evidenced that the market has largely remained unserved. For comparison, CGAP estimation in 2008 on the market size of Islamic microfinance is amounted to 2/3 of the total microfinance markets in the Muslim world which insist or prefers Islamic microfinancing. Meanwhile, current business models serve only about 1% of the total microfinance clients of which there were 380,000 clients served by 126 Islamic MFIs in 14 countries, of which 80,000 clients were served alone by the network of Indonesian Islamic cooperatives and 100,000 clients were served by 2 Islamic MFIs in Bangladesh. This low demand sends a signal to revisit the current model of Islamic

MFIs as well as to evaluate their strategies. It also urges Islamic MFIs to spend efforts in understanding their potential clients.

From the upstream perspective, Mohieldin *et.al.* (2011) asserts that the supply-fund for Islamic microfinance is concentrated to mainly three countries namely; Bangladesh, Indonesia, and Afghanistan, neglecting other regions. On the regards to products and services innovation, CGAP (2008) recorded that 70% of financing portfolio of Islamic MFIs are dominated by *murabahah* (cost-plus margin financing) contracts with the end result is *bay' muajjal* (deferred payment/credit sale). This implies that current Islamic MFIs needs to be more innovative in deploying Islamic measures in order to make Islamic MFIs closer as Islamic institutions and ashtray from being commensurate with conventional.

Henceforth, this study is exploratory in nature in order to answer the problems mentioned earlier. It is so as to suit the objective of the study that is to propose a new business model of Islamic microfinance which envisions a remedy of income distribution and redistribution problems in the societies. Secondary data collection and literature reviews are employed in order to analyze and draw further inferences. Secondary data is employed to capture business performance of current business models, if available. Meanwhile, literature reviews cover various models of Islamic MFI, Islamic income redistributive institutions, and securitization. Thus, this study follows the mainstream of microfinance studies of a qualitative fashion research.

### **3. CURRENT BUSINESS MODELS of ISLAMIC MICROFINANCE INSTITUTIONS**

Business model is a term often used to describe the key components of a given business (Hedman and Kalling, 2003). Timmer (1998) as it is quoted in Weill *et.al.* (2005) defines a business model more rigidly as he defined it to be the key components of business which include the architecture for the product, service, information flows, a description of the benefits for the business actors involved, and a description of the sources of revenue. This definition by Timmer is deemed to be

adequate to reflect the internal as well as the external elements of the entity which drive the business. In general, a business model describes how an entity converge objectives of all stakeholders; i.e. shareholders, managements, employees, suppliers, and customers; in order to support the purposeful activities of the entity for serving more clients in the long-term.

Based on its *modus operandi*, current Islamic microfinance business models can be classified into two general classifications, namely; (1) Islamic Microfinance Bank model, and (2) Quasi-financial institutions model. Islamic microfinance bank is a model of which Islamic MFIs perform the function of a bank by providing a typical bank's services such as financing, savings, remittance, term deposits, and so forth, all of which are subjected to the local's regulations and guideline issued by authority. On the other hand, quasi financial model are model which are principally engaged in financial intermediation and or in auxiliary financial activities, yet are regulated under separate institutional units other than bank. Furthermore, each category will be deliberated using the example of several microfinance worlds' best-practices by means of literature review as well as analysis of secondary data available from valid and reliable sources.

### **3.1. Islamic Microfinance Bank Model**

In order to deliberate this model, examples of practices in the gulf as well as Indonesia are used. Starting from Indonesia, Islamic microfinance bank model is represented by Islamic rural banks or Islamic credit banks (Bahasa: *Bank Perkreditan Rakyat Shari'ah*, henceforth is BPRS). BPRS holds the license as a bank from the Central Bank, with an initial capital as low as Rp 500 million (or equivalent to US \$ 52,219<sup>1</sup>). At the beginning, BPRS is established to serve potential market at the rural areas, in particular SMEs, as a strategic step to penetrate financial inclusion agenda. Nevertheless, the growing demands of BPRS amongst poor artisans in the big cities

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<sup>1</sup> Rp 9,575.00 = US \$ 1

are sensed thus captured by BPRS through allocating branches office in the cities (see Table 1). Like a bank, BPRS products and services are ranging from savings account to investment financing as well as mortgage financing. BPRS, however, are restricted from offering remittance or participating in inter-bank money market or foreign exchange transactions.

**[Table 1.]**

It is worth to note that statistical data which is shown in Table 1 includes also the total number of conventional BPR. Despite such, various sources indicated that the total number of BPRS and its offices/branches is still promising.

Albeit the positive growth, some studies indicated that the conventional BPR accelerated faster than BPRS (Seibel, 2005). Masyita and Ahmed (2011) mentioned the fact that during its early inception in 1991, 71 BPRS were established within 5 years. The number stagnated and by 2003, total only 84 BPRS were operating. During 2003-2011, the number of BPRS has increased by 69 BPRS to total of 153 BPRS (which its average growth per year is 8.625 BPRS/year) and offices/braches has reached to 299 offices, per May 2011 (Republika, 2011). Comparing these figures with Table 1, it supports the view that the growth of BPRS is still less significant than the conventional.

Karim (2009) argued that this phenomenon is influenced by the injection of capital funding to boost the conventional BPRS is more than it is injected to BPRS. Conventional BPR which are supported by the conventional banks, local government, and private investors have more power than the BPRS which are mainly stemmed from grass-root initiatives. Indeed, conventional banks have long history and experience to be the key drivers of microfinance industry in Indonesia; another competitive advantage of the conventional MFIs. Meanwhile, Islamic banks are still dubious to enter this market. Henceforth, Karim (2009) suggested that Islamic banks should also extend their focus to serve microfinance market as the capital provider for

BPRS, thus ensuring the growth of BPRS to be further accelerated. The growth is necessary as it implies the coverage (outreach) as well as sustainability of BPRS in contributing to the development of society through *shari'ah* compliant products and services.

From MENA region, the first initiative of Islamic microfinance bank in the region is Al Amal Microfinance Bank (henceforth, AMB) in Yemen. Established in 2009, AMB gained spotlights immediately after its birth. It becomes the first Islamic MFI which holds a “bank” license in MENA region. Within 2.5 years, its captured 25% of Yemenis banking market and confirmed their stand to be the largest MFI in the region. AMB is also driven by its innovative products and services of which acknowledged through the award from CGAP, Deutsche Bank, Islamic Development Bank (henceforth, IsDB), and Grameen Jameel in 2010. One of the innovations is the innovative mode of financing based on *ijarah* with ownership to the lessee at the end of leasing period. Other innovative strategy is the inclusion of youth segment in their portfolio clients. Unlike other banks which tend to perceive youth segment (or young poor artisans) as “risky” portfolio, AMB indeed encourages entrepreneurship to the young people in Yemen. Table 2 depicts its achievement in 2010 and Table 3 shows its products offered.

Concurrent with the initiation of AMB, a microfinance bank, “Family Bank”, marked the first initiative in the GCC region. Established in Bahrain, Family Bank received its license to operate as bank and was launched in 2010. Nothing much is known regarding the performance of Family Bank since its birth, however, similar to AMB, Family Bank is well supported by the Bahraini government to achieve the agenda of poverty eradication.

**[Table 2.]**

**[Table 3.]**



### **3.2. Quasi Financial Institutions Model**

Despite the fact that they provide financial services to its clients, quasi financial institutions are treated under separate acts in order to carry the mandated agenda. The distinct feature which distinguishes bank model and this model lies on the prime activity (or the business focus), as bank model focuses on financial intermediation or smoothening the payment system for small medium enterprises (microcreditors/microentrepreneurs) whilst quasi financial institutions' mandate may vary. Tabung Haji of Malaysia (Malaysian Pilgrimage Savings, henceforth TH), for instance, is a quasi-bank institution which is given mandate to manage the pilgrimage funds of Malaysian. TH is an independent and autonomous since it is governed under Tabung Haji Act 1995.

Many Islamic MFIs are categorized under this model. There are Islamic credit unions, *Ar-Rahn* (Islamic pawnshop), micro-*takaful* providers, and so forth. There are also institutions which fall under “Islamic microfinance providers”, such as *akhuwat* in Pakistan and *Amanah Ikhtiar Malaysia* (AIM) in Malaysia. There are also Islamic cooperatives, which receive spotlight in Indonesia in last few years due to its success as a new comers. An Islamic MFI which is ruled under cooperative acts has the prime focus to serve Indonesian microenterprises as well as improve the social and business skills of the members. This institution is called *Baitul Maal wa Tamwil* (henceforth, BMT) (PINBUK, 2011). BMT is known as a fast growing MFI which is fully supported politically and socio-religiously by the government as well as the Muslims (Masyita and Ahmed, 2011). BMT is seen to be “cheaper” way to access the poor and extending financial and social benefits to the entrepreneurs, since its initial capital is lot less than initial capital for establishing BPRS. More importantly, the idea cooperatives are politically and culture-wise in alignment with the economic ideology of Indonesia, which depends on the dynamics of collective participation in the real market.

A BMT performs a combination of *Baitul Maal* (House of Wealth) and *Baitul Tamwil* (House of Financing). Due to this double function, a BMT is allowed to collect and receive Islamic redistributive institutions, such as *zakah*, *infaq*, *sadaqah*, *waqf*, as well as *fidyah*, from any party, manage the funds, and distribute the funds to the less able, in addition to offer financial services such savings and financing to its members. Unless governance issue hinder its performance, one may imagine that empowered by funds from Islamic redistributive institutions as well as loyal membership, there is strong positive output for BMT activities to be aggressive in the market as such the fallout of BMT presence in real markets could be appraised. However, such efforts are still cumbersome considering reliable data is not available yet (Seibel, 2005).

Moving from Indonesia to Pakistan, business model of quasi financial institution for microfinance is the model of *akhuwat*. *Akhuwat* is an Islamic MFI registered under Societies Registration Act of 1860 whereby its prime program is to extend microcredit through *Qard-al-Hassan* to the less able segment. *Akhuwat* was initiated by Dr. Muhammad Amjad Saqib in 2001 which has the vision to enact a poverty free society built on the principles of compassion and equity. In order to realize this mandate, *akhuwat* established several guiding principles which is shown in Figure 1.

**[Figure 1.]**

Established with strong principles and leadership, *akhuwat* expands rapidly. The first *qard-al-hassan* disbursement was Rs. 10,000 and within 2 years, *akhuwat* has received Rs. 1,5 million donations with loan recovery rate of 100 percent (Akhuwat, 2006). In order to satisfy growing needs of portfolio diversification, *akhuwat* has now incorporated some of microfinance best-practices and lessons, such as group-lending approach and cost-efficiency strategy. Board members work on honorary basis, organization structure is kept slim, top management works out of

benevolence, students as volunteers are welcome, modest office arrangement, and no corporate vehicle (reimbursement is given to staff's vehicle once it is used for official duties) are all implemented in order to keep their operating costs down. Nevertheless, The number of staff has reached 400 people in 49 cities and towns providing services for 167,527 underprivileged. Table 4 shows *akhuwat* performance in terms of outreach and fees structure.

**[Table 4.]**

From Table 4, it can be implied that majority of *akhuwat* clients are men. This is unlike the mainstream MFIs which tend to target women as their clients. *Akhuwat* learnt from a recent study done by Harper (2007) that targeting solely on women creates a fraction in family as it is happened in many cases Bangladesh and any other places. Hence, *akhuwat* targets the family as a unit and imposes a requirement that the consent of loan application shall be given by one male and one female head of the family. It is to ensure that the loan will be benefited for activities which benefit a whole family member. It is also meant to avoid conflicts and duplication of loans (Harper, 2007 as quoted in Siddiqi, 2008). Despite such, *akhuwat* indeed paid a special attention to women client. One of the programs offered in Heera Mandi in Lahore contributes to safeguards women dignity. *Akhuwat* targeted women from the sex trade in order to assist these women to ameliorate their living condition into a decent living by providing alternative jobs than what currently they do. Henceforth, it is implied that *akhuwat* does not excluding a particular gender from its service, rather focus solely on the objective.

Besides *qard-al-hassan* loan, *akhuwat* also provides medical camps and educational support to its members and their direct family members. For medical camps, *akhuwat* established a subsidiary, *Akhuwat* Health Services, which has aim to develop affordable, efficient and effective health care services for the poor. For educational support, *akhuwat* introduced two flagship programs; Punjab Educational

Endowment Fund, and Punjab Welfare Trust for the Disabled, alongside with some ad hoc soft skills, literacy skills, and business trainings activities. Both medical camps and educational support facilities could be accessed freely for members of *akhuwat* who is amounted to 5.5% of the loan given, for the loan value more than Rs. 4000, or at the affordable rate where the less able segment could afford.

#### **4. ANALYSIS OF CURRENT BUSINESS MODELS**

Analysis of the business models reviewed in earlier session is made based on two parameters; (1) sustainability, and (2) outreach. Sustainability of the institution is defined as the continuous ability of the institutions to ensure their long-term social performance whilst sustainability of model means how well the ideas of the Islamic MFI is being accepted by others, as so the other may replicate the model so long as this model conform with the country jurisdiction. In commercial microfinance sphere, the word “sustainability” and “profitability” is often used interchangeably, due to the axioms of its system which consider profit to be the best proxy for sustainability, as in the case of money to be the best proxy for happiness. Since Islamic microfinance emphasizes on the principles and ideas of what microfinance should be, thus, it is suggested that the best proxy for measuring sustainability of model for Islamic MFIs is the replicability of the model in serving the market.

On the other hand, outreach represents the breadth of the microfinance services serve more clients. In the context of Islamic microfinance, the services offered shall include both financial and social services such as education and health supports. It is such because the realm of Islamic microfinance is to enhance the quality living of the less able segment through improving the distribution rights of use of the resources which will enable them to participate actively in the real sector economy. To do such a services, it is envisaged that Islamic MFIs should mobilize funds generated from income redistributive institutions as its instruments to reach more poor segment. However, *mu'amalat* institutions are still applicable and shall be

utilized in appropriate case for different market segments. Henceforth, the best proxy to measure the outreach shall be the total number of current clients.

In the earlier section, four current models of Islamic MFIs in different countries are reviewed, namely; BPRS in Indonesia, AMB in Yemen, BMT in Indonesia, and *Akhuwat* in Pakistan. Amongst the models, it is found that BMT model is more replicable model than the Islamic Microfinance Bank model or the other quasi-financial institution model. The reasons for this might be due to the legal form of BMT as a cooperative which has low initial capital from mutual contribution of minimum 20 persons. In addition to that, cooperative is more well-received in a collective society such as Indonesia. Despite such, worth to note that *akhuwat* comes at the second place after BMT, in terms of replicability. Established in 2001, there are 13 local organizations in Pakistan which currently have replicated its idea and business model. Furthermore, the continuous donations from donators and supports seem to be ever flowing for this model associated with its founder. The rationale comes from credibility of the institution to carry the mandate given by the society. Dr. Amjad Saqib has successfully built the trust and confidence of the donators through its continuous efforts to provide *Qard-al-Hassan* to the poor. Therefore, without such leader who possesses high determination and focus, *akhuwat* model is less likely to gain its credibility and sustainability which is received today.

For outreach, the figures show that *akhuwat* serves more clients than other models. This is might be due to the unique concept of business that *akhuwat* offers pulls less able segment nearer to the institution. *Akhuwat* model offers a new paradigm in conducting financial transactions which in line with the Muslims faith in Pakistan. In addition to that, *akhuwat* business strategies are perceived to be “less formal” by their client, since they utilize public places such as traditional markets, masjids, and churches as their point of meeting people. Buzz marketing enables *akhuwat* to save its marketing costs while still meeting its objective of enhancing the awareness of the less able segment of *akhuwat* programs. Moreover, clients are also

served from its medical camps, the *akhuwat* health care, as well as educational training which attracts more poor people to come and participate in *akhuwat* programs. This holistic care of the poor enables *akhuwat* to serve 167,527 families in Pakistan.

This study found that with the basis of two parameters; sustainability and outreach, quasi financial institutions models are indeed more superior to Islamic microfinance activities. This discovery is indeed intriguing since it is presupposed that Islamic financial institutions, in particular Islamic Banks should have more infrastructures and more potential to develop Islamic microfinance industry even at faster rate. The otherwise result does not negate the impotence of Islamic microfinance banks model, but shows that Islamic Microfinance banks do indeed have the necessary infrastructures and capital, and potentially to penetrate the market at even deeper and faster, such as AMB in Yemen, provided that government endorses its activities. Government supports distinguishes AMB and BPRS, as the latter is not supported by the government.

This finding implies important implication for policy makers to improve the current Islamic financial system landscape by including Islamic microfinance as an important element in the system. Inclusion of Islamic microfinance in a nation's financial landscape is foreseen to make Islamic microfinance movement in more organized ways with clear missions –rather than being sporadic and spontaneous initiatives- as such empirical evidences of the impact of Islamic microfinance development could be captured. Although being dominance in their respective regions, quasi financial model has yet able to tap the large potential market of Islamic microfinance which remains largely unserved and fail compete head-to-head with conventional microfinance. Considering the challenges and the potential, a business model which employs Islamic banks and quasi financial institutions model with instrumentalization of income redistribution measures is proposed in the next section.

## **5. ISLAMIC MICROFINANCE BUSINESS MODEL for ISLAMIC BANKS: A PROPOSAL**

It is envisaged that besides the mainstream *mu'amalat* contracts, this proposed model shall also instrumentalize Islamic income redistributive measures, that are *zakat*, *infaq*, *sadaqat*, *waqf*, as well as *qard-al-hassan*, in their products and services portfolio. Instrumentalize these measures is meant to realize the potentials of these measure which have been proven to be effective in alleviating poverty as it is evidenced in the Qur'an and Sunnah of the Prophet (s.a.w.w.s.) as well as historical factsheet during caliphs Umar ibn Abd Aziz era. Furthermore, studies done by Mohieldin *et.al.* (2011) and Mohsin (2012) has also demonstrated empirically the potential of *zakat* of which had the funds is realized and mobilized, may eradicate the current problem of income inequality. Again, the combat against income inequality signifies the rectification of distribution mechanism of rights to use the resources. As it is asserted by Mirakhor (2004) that it is pertinent for these institutions to be instrumentalized by Islamic financial institutions to mobilize substantial resources for poverty alleviation and economic empowerment to the less able segment of population in Muslim countries. This spirit, therefore, becomes the basis for the proposal of business model for Islamic banks.

The proposal of business model suggests that Islamic banks to open Islamic MFIs as its subsidiaries. Islamic MFIs as the subsidiaries of the Islamic banks would be able to be more dedicated to serve the markets. Having the advantage of Islamic banks infrastructures, Islamic MFIs may utilize Islamic banks information system as well as ATMs, e-banking, m-banking, and other potentials from current Islamic banks infrastructures to receive collection from *zakat*, *infaq*, *sadaqat*, and cash *waqf*, and using the same infrastructure, disbursement of these funds could be allocated accordingly to the recipient with shorter time lag between the collection and disbursement. In addition to that, by having Islamic MFIs as subsidiaries create competitive advantage for the Islamic banks since the risks associated with micro

financing activities could be segregated and isolated within the Islamic MFIs through securitization mechanism which will be elaborated further in next discussion. Figure 2 is the proposal of Islamic Microfinance Business Model for Islamic Banks.

**[Figure 2]**

As illustrated in Figure 2, Islamic MFIs products and services are not limited only to collect and disburse funds from the Islamic redistributive measures, but extended to social services, such as medical cares, educational centers, business laboratory and consultancy, as well as financial services such as savings and financing. Medical cares, educational centers, business lab and consultancy, are all services offered by Islamic MFIs in order to develop the less able segment so they shall be more confidence and accepted in the society. On the other hand, savings shall be limited purpose and kept 100% reserves in order to ensure security for depositors. Meanwhile financing services employ *mu'amalat* contracts as it is ruled under *Shari'ah*. The vast range of products and services implies that this Islamic MFIs shall be classified as quasi financial institutions, and not a "bank".

From the upstream, Islamic MFIs may receive one source of their funding from the Islamic bank in form of endowment, Corporate Social Responsibility (henceforth CSR funds), *zakat*, *infaq*, *sadaqat*, fees from *waqf* assets management, repayment from credit financing, and repayment from interest-free loan which are plowed back to the cycle. Special treatment may be given to *Zakat* funds, as it may be extended directly to recipients of *zakat*. This sources of funding is not limited only to the listed sources of funds. Islamic MFIs may also receive donations from donators domestically or internationally.

Furthermore, this Islamic MFIs may also advice the poor on the regards of utilization of *zakat* funds, as small portion of *zakat* funds could be suggested to be put into *tabarru'* (donation) funds in a micro-*takaful* scheme. This is pertinent as the poor often times do not have cushions to absorb the shock against ad hoc events, such as



death of their family member, sickness, sudden business loss, *force majeure* and so forth. On the *waqf* management, Islamic MFIs may be the managers of *waqf* assets since Islamic MFIs have the necessary resources, especially managerial skills, to manage and optimize the *waqf* assets. Islamic MFIs may leverage from the expertise and human resources of Islamic banks that are capable and versatile in business and management. Currently, return from *waqf* assets could not be said to be optimum and the reason for this usually from lack of managerial skills of the *waqf* managers.

### **5.1. Securitization**

Nonetheless, in order to enhance supply-funds for this project as well as to minimize the level of risk of undertaking this project from Islamic banks, it is envisaged that securitization method may help. Securitization is often referred to as the process of enhancing marketability, negotiability, and liquidity of an otherwise dormant asset (Iqbal, 1999). It implies that this method enables illiquid assets/securities to be transformed into liquid assets/securities where the latter could provide an additional benefit to capital formation of the originator. The originator sold the asset(s) or collateralized the asset(s) to an entity called Special Purpose Vehicle (henceforth SPV). This SPV would then issues a bundle of securities backed or collateralized by the asset(s) to the interested investors. As the return, the investors receive a set of payments directly dependent on the cash-flow of the underlying assets -not the credit worthiness of the originator. The SPV is also the trustee or agent to collect the proceeds from investors as well as collect the receivables for the investors. This securities is known as *sukuk*. Table 5 shows the prerequisites of *Sukuk* structuring.

### **[Table 5]**

After considering the prerequisites of *sukuk* structure, there are six steps which needs to be undertaken by the Islamic banks. These six steps are proposed by Dr. Zamir Iqbal in his paper "Economics of *Sukuk*" (undated). The 6 steps are;

**Step 1.** Pool of Assets is transferred to SPV via a true sale for a predetermined purchase price.

First and foremost, the pool of assets must be identified. It is envisaged that the assets which will be securitized will consist of real and financial assets. Real assets such as properties, vehicles, IT hardware and software, and other possible assets which are normally found in brick-and-mortar company are combined with financial assets such as receivables from management fees and profits as well as from income redistributive measures such as *zakat*. These assets are pooled, making it as heterogeneous assets pool. After pool of asset is identified, Islamic MFI will transfer the pool of assets to the SPV at a predetermined price.

**Step 2.** *Sukuk* issuance

Once the transfer of assets is done, the assets will be brought to the balance sheet of the SPV whilst assets shall be taken-off from the balance sheet of Islamic MFIs. Subsequently, the SPV will issue certificate of participation on the pool of assets (*sukuk*) to investors in amount equal to the predetermined price of assets pool. The *sukuk* represents the ownership stake of the *sukuk* holder to the pool of asset.

**Step 3.** Assets are delegated back to the originator

The SPV, on behalf of the investors as the legal owners of the assets, will sell, lease back, or appoint Islamic MFIs as a trustee in order to delegate the economic performance of the assets. As a return, future payment or periodic rental will be exchanged to the SPV.

Notwithstanding this, it is proposed that *musharakah* contract shall be used as the underlying contracts in this model. The rationale behind this option is due to the nature and characteristics of *musharakah* contract which is deemed to be appropriate for the nature of the business. It is worth noting that this microfinance assets are used to ameliorate social welfare, thus *musharakah* should be the ideal contract to share

both profitability as well as risks of these Islamic microfinance activities. *Musharakah* is a contract based on mutual partnership in a business whereby the partners share profit at the pre-agreed ratios and loss according to the equity participation. It is also envisaged that this *sukuk* shall aim for retail markets with low denomination, hence society contribution would ensure the success of this project.

**Step 4.** Credit enhancement to improve quality

It is understood that marketability, negotiability, and quality of a *sukuk* is defined through the (potential) performance of the underlying assets, as well as the perceived risks of the performance of the underlying assets against the market risk. Since investors are becoming more sensitive in order to lower the perceived risks, the SPV shall be required to provide guarantee mechanism against the performance of the underlying assets or a guarantee to buy or replace the asset in the event of default. Therefore, it is proposed that for the *musharakah sukuk*, a credit enhancement via *qard-al-hassan* from the Islamic bank, as the guarantor, shall be placed in the case of the project default. "Default" in *musharakah sukuk* is defined as the performance of the underlying projects does not yield positive returns as expected in some consecutive periods. The credit enhancement would add additional safety for the *sukuk* holder, hence would increase the marketability of this certificate in Islamic capital market.

**Step 5.** Periodic payments from the benefactor of the assets to be the issuer and from the issuer transferred to the investors.

Pay-offs shall be linked to the performance of the project. For the case of proposed structure of *musharakah sukuk*, the profit ratios must be pre-agreed in front whilst the loss-ratio is according to the equity participation between the issuer, the SPV, and the *sukuk* holders. In addition, the flow of profit payment would be from the Islamic MFIs to the SPV, and from the SPV to the *sukuk* holders accordingly.

**Step 6.** In the case of maturity or distress.

In a *musharakah* contract, *Shari'ah* recognizes pre-emption right (*al-Shuf'a*) that endows a priority right for a partner to buy the share of other partners in the case whereby the latter party want to exit from the partnership. *Al-Shuf'a* may be utilized in the case of maturity or distress that the SPV will exercise the priority right to buy the *sukuk* from the *sukuk* holders at original price. Subsequently, the SPV starts selling the assets back to the originator at a predetermined price and pays back to the *sukuk* holders. Price is predetermined as to protect against capital loss to *sukuk* holders. Nonetheless, the *Qard-al-hassan* credit enhancement to Islamic MFIs would ensure that the financial resources to acquire the shares back from the *sukuk* holders is available. Figure 3 shows the structure of *musharakah sukuk*.

**[Figure 3]**

## **5.2. Islamic Income Redistributive Measures**

*Shari'ah*, as the unique system which just is the first and foremost element observed, provides mankind the necessary income distributive (endorsement of real sector financing and prohibition of *riba*) and redistributive measures (*sadaqat*, *infaq*, *waqf*, *qard-al-hassan*, *faraid*, etc) which is envisaged to enable better human economic development. At macro level, real sector economy through entrepreneurship, equity financing, and other risk-sharing mechanisms are encouraged by Allah (swt) and was manifested by the Archetype –Prophet Muhammad (s.a.w.w.s.) as the legitimate income distribution. It is suggested that governments' and regulators' policies shall be made in order to ensure the expansion of real markets, of which will allow more participation in economic activities. On the other hand, the presence of financial markets is to serve the real market by providing a sophisticated payment system which smoothen the transactions in the real markets. Meanwhile, *riba* dealings is denounced through incentive mechanism of forgiveness by Allah (swt), The Almighty. Albeit it is to observe justice in the system, this rule is

also being commanded in order to make every economic activities which are presence in this system are always remains intact with the transactions in real markets.

In addition to the macro level, *Shari'ah* places the income redistributive measures into several ladders of “portfolio behavior”, i.e. from “obligatory” to “recommended” activities (*fardh* to *sunnah*) at individual level. *Zakat*, for instance, is considered as to be one component of *sadaqat* and is placed as obligatory for Muslim to perform when his/her wealth has met its weight/measurement (*nisab*). However, *zakat* does not imply that Islam disallows individuals’ possession more than the minimum amount (*nisab*). Indeed, individual property right is sanctified and protected by the *shari'ah*. Mirakhor (2004) mentioned that *zakat* (and other redistributive measures) is essentially redemption of less able rights in the final products. The reason for this stems from understanding that Allah (s.w.t.) is The ultimate Owner of all resources and the right of possession of the resources is a collective right of which individual can merely attain priority in the use of the resources (Mirakhor, 2004). Allah (s.w.t.), indeed, places paying *zakat* commensurate with five-time obligatory prayers to emphasize its importance as one of pillars of the religion. Once the collection done, *zakat* funds are collected and distributed to the recipient of *zakat*. These recipient of *zakat* are mostly those who do not have appropriate access to the resources due to his/her financial and social barriers. Due to its stand, *zakat* could not be classified as charity which is voluntary in nature. Since it is obligatory, it is easier to estimate potential of *zakat* to optimize the mobilization of the funds for microfinance activities before adding it up with funds from other “voluntary” redistributive measures. Therefore, one may foresee that Islamic redistributive measures have the potential to rectify income distribution mechanism by empowering them to join into economic activities.

## **6. CONCLUSION**

This study documents various business models in different countries and proposes an Islamic MFI business model for Islamic banks. The business model employs a possible combination of instrumentalization of Islamic redistributive institutions, such as *zakat*, *infaq*, *sadaqat*, *waqf*, and *qard-al-hassan*, and securitization of Islamic MFI projects. Instrumentalization of Islamic redistributive institutions is suggested in order to mobilize and distribute the funds at faster so that the less able may enjoy the benefits faster. On top of that, Islamic MFIs is viewed to be the appropriate institutions to carry such activities since it is accordance with what has been mandated unto these institutions, thus instrumentalization of these institutions is foreseen to unlock the Islamic MFIs potential. On the other hand, the retail *sukuk musharakah* issuance at low denomination is hoped to be increase the viability as well as the sustainability of the project. Retail *musharakah sukuk* is seen to be more appropriate due to realization of mutual reinforcement benefit, whereby the society ultimately owns the project. This relationship will help to ensure a continuous positive growth of the project and the Islamic MFIs in terms of sustainability as well as outreach.

## FORMAT PENILAIAN KETENTUAN PENULISAN

KODE: A86D6

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| ITEM                           |   | SESUAI | TIDAK SESUAI | KETERANGAN |
|--------------------------------|---|--------|--------------|------------|
| Ruang<br>Lingkup<br>Pembahasan | <p>Abstract</p> <p>Abstract should be in English. Abstract briefly explains the purpose of the study, methods, results, and main conclusions.</p> <p>Avoid the citation in the abstract!</p> <p>Abstract should be less than two hundred words.</p> <p>Abstract describes the overall content of the manuscript and intended to be easily understood by various stakeholders, both researchers and practitioners.</p> | ✓      |              |            |
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|  |  |   |   |  |
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| 12, Times New Roman, Spasi 1,5   |  | ✓ |   |  |
| Halaman Minimal 20 dan maksimal 25 halaman (tidak termasuk grafik, tabel, daftar |  |   | ✓ | <b>More than 25 pages</b>                                |



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| Format Penulisan   | Judul Naskah              | ✓ |   |  |
| 1.5 space typed manuscript, font Times New Roman 12 pt printed straight and normal. A4 paper and about 20-25 pages (not including tables, charts, images and bibliography) with the left margin and bottom: 4 cm, above and right margin: 3 cm | Nama Penulis dan Afiliasi | ✓ |   |  |
|  | Abstrak                   | ✓ |   |  |
|  | Judul Bab                 | ✓ |   |  |
|  | Judul Subbab              | ✓ |   |  |

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## KETENTUAN PENULISAN

1. Tulisan sesuai dengan ruang lingkup yang telah ditentukan dengan menggunakan format dan kaidah penulisan ilmiah yang lazim serta meng-elaborasi sumber-sumber pustaka yang memadai.
2. Paper dapat ditulis dalam bahasa Indonesia dan bahasa Inggris.
3. Karya tulis minimal memiliki ruang lingkup pembahasan:
  - i. Abstrak (wajib dalam bahasa Inggris)
  - ii. Latar Belakang, identifikasi masalah, tujuan penelitian
  - iii. Tinjauan Pustaka (jurnal dan buku mutakhir)
  - iv. Metode Penelitian
  - v. Analisa dan Pembahasan
  - vi. Kesimpulan dan Rekomendasi
  - vii. Daftar Pustaka
4. Ditulis dalam kertas ukuran A4 satu sisi, 1,5 spasi, font 12 Times New Roman dan minimal 20 dan maksimal 25 halaman (tidak termasuk tabel atau grafik dan daftar pustaka). Margin kiri dan bawah: 4 cm; margin atas dan kanan: 3 cm.
5. Format Penulisan sebagai berikut:

| No. | Item                      | Keterangan  |
|-----|---------------------------|---|
| 1   | Judul Naskah              | 14 pt, capital, tegak dan tebal; center, 1 spasi  |
| 2   | Nama Penulis dan Afiliasi | 10 pt, tegak dan normal; <i>justify</i> , 1 spasi |
| 3   | Abstrak                   | 9 pt, tegak dan normal; <i>justify</i> , 1 spasi  |

|   |               |  |
|---|---------------|--|
| 4 | Judul Bab     | 11 pt; tegak dan tebal; <i>“title case”</i> .  |
| 5 | Judul sub-bab | 11 pt; tegak dan tebal; <i>“sentence case”</i> |

6. Jika membutuhkan kutipan (*note*) maka ditulis dalam format penulisan *footnote* bukan dalam format *bodynote* dan *endnote*.