Islamic MSME Finance - Exploring market experience and potential

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1. Introduction

Triple Jump is a responsible investment manager that aims to improve livelihoods at the bottom of the pyramid. In our commitment to further the finance frontier we are exploring the possibility to offer funding and technical assistance to financial intermediaries targeting micro, small and medium-sized enterprises (MSMEs) through Islamic financial products and services. A total of 55 representative financial intermediaries in 28 countries[2] participated in a survey that we conducted to better understand existing experience in providing Islamic MSME[3] finance and potential of this market.

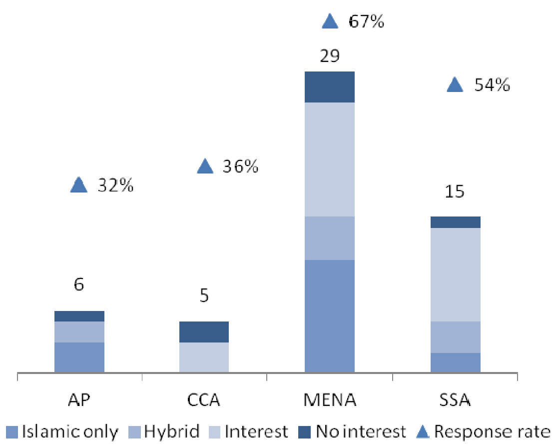
Table 1: Questionnaire responses

	Responses	Experienced		Interested	No interest
		Islamic	Hybrid		
Total	55	17	8	23	7

Forty six percent (25 financial intermediary) is already providing Islamic MSME finance ("experienced financial intermediaries"): 31% (17) consists of full-fledged Islamic finance providers ("Islamic only") and 15% (8) of providers of both conventional and Islamic finance ("hybrid"). Our analysis (including graphs) focuses on the 'Islamic only' and 'hybrid' sub-groups; however, where relevant, we include results of the interested financial intermediaries and also any regional variations in responses. Another 42% (23) indicated to have serious interest to venture into Islamic MSME finance in the near future ("interested financial intermediaries"). The final 13% percent (7 respondents) indicated not to have any interest in the topic.

In geographical terms, the response from the Middle East and North Africa ("MENA") was best in both absolute (29) and relative terms (67%), followed by Sub-Sahara Africa ("SSA") (15 and 54% respectively), Asia-Pacific ("AP"), and Caucasus & Central Asia ("CCA") (see Figure 1).[4]

Figure 1: Responses by region, no. and % response rate



Our sample covers primarily associations or non-governmental organizations ("NGOs") (23) and non-bank financial institutions ("NBFIs") (17), followed by commercial banks (10) and cooperatives (3). Interestingly, the last two groups dominate in terms of portfolio and outreach: commercial banks cover 41% of the total portfolio (mainly Sudan) followed by cooperatives (40%) (mainly Indonesia).

Box 1. Islamic finance

Islamic finance refers to financial arrangements that are governed by Islamic law (Sharia'a), the sources of which are the Holy Qur'an and the Sunnah[5], as well as the consensus of scholars (Ijma) and analogy (Qiyas). These sources prohibit interest (Riba) and promote the preservation of property rights, ethical standards, risk sharing, and social justice.[6]

[1] For questions or observations please contact Hoda@triplejump.eu and/or Marnix@triplejump.eu

[2] Triple Jump distributed the survey questionnaire to 104 financial intermediaries in 36 countries.

[3] For the purpose of this survey, we simplified our definition of SME financing to a minimum size of USD 10,000. However, some respondents declared their minimum size as USD 1,000-5,000.

[4] Responses were received from Afghanistan (1), Azerbaijan (2), Bangladesh (1), Benin (2), Cameroon (3), Chad (1), Egypt (4), The Gambia (1), Ghana (2), Indonesia (1), Iraq (1), Jordan (2), Kazakhstan (1), Kenya (1), Kyrgyzstan (1), Lebanon (1), Morocco (5), Nigeria (1), Pakistan (3), Palestine (4), Saudi Arabia (1), Senegal (2), Sudan (5), Tajikistan (1), Tanzania (2), Tunisia (1), Turkey (1), Yemen (4).

[5] 'Sunnah' is the teachings and practices of Prophet Muhammad (PBUH).

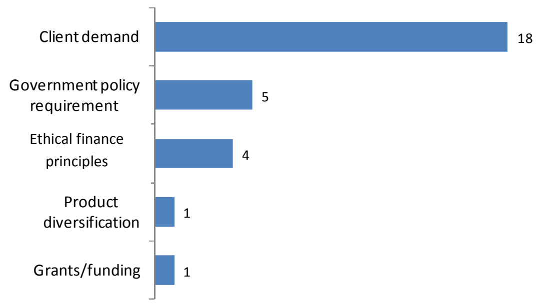
We thank all those who participated in this survey. It is our pleasure to share the findings with you in the next chapter. In the last chapter we present the conclusions that we have cautiously drawn from these findings.

2. Findings

Motivation

Financial intermediaries are providing Islamic MSME finance primarily as a result of perceived client demand from Muslim populations, motivated by religious considerations (see Figure 2).

Figure 2: Reasons for providing Islamic MSME finance



This perceived demand is sustained by findings from market studies conducted by these institutions themselves and other sources (e.g. Global Findex research[7]). Other significant reasons cited by "Islamic only" financial intermediaries are regulatory requirements (Sudan) and the perceived positive impact from the non-religious principles of Islamic finance (ethical and social principles) and the possible diversification of products to suit the different financing needs of their clients.

In contrast to this perceived strong market demand, four financial intermediaries have indicated no current interest in Islamic MSME finance reportedly due to very limited demand in their markets. This stance highlights the existing issue of incomplete and sometimes contradictory information on demand, not just on customer preferences but on their actual behaviour when faced with choices of conventional and Islamic MSME finance.

Portfolio

Our sample's outstanding outreach and portfolio size represent a significant Islamic MSME financial market of around 626K active clients and USD 213.8M in 13 countries (see table 2). These figures represent just under 50% of the estimated outreach by CGAP's survey in 2012[8].

Table 2: Outstanding Islamic financing portfolio

	Financial Institutions	Active Clients	Amount (USD, M)
Hybrid	8	29,835	17
Islamic only	13	595,974	197
Total Islamic portfolio	**21**	**625,809**	**214**

As expected, the outstanding Islamic financing portfolio is mostly concentrated in the MENA (Sudan) and AP regions (Indonesia), with financial intermediaries in SSA (specifically West Africa) only recently launching or piloting Islamic MSME finance products.

The total Islamic portfolio of the hybrid financial intermediaries makes up a small proportion, around 7-8%, of their total financing portfolio. This may be explained by the relatively recent entry of these financial intermediaries into this market and the challenges in differentiating and thus scaling up Islamic products where clients have a choice between Islamic and conventional credit products.

A small sample of hybrid financial intermediaries (8) seems to suggest that the average portfolio quality of the Islamic portfolio (1.6% portfolio at risk more than 30 days) is slightly better than that of a conventional loan portfolio (2.6%) of the same financial intermediary.

The outreach of Islamic MSME finance is small compared to the huge demand. So what keeps financial institutions from unlocking that potential market?

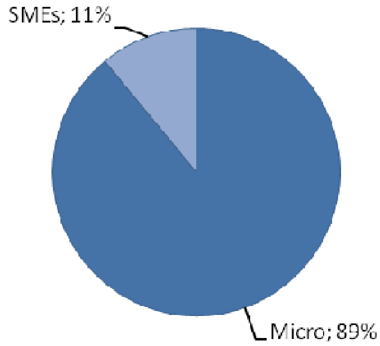
[6] Ismail, Abdul Ghafar and Edib Smolo (2010): A theory and contractual framework of Islamic micro-financial institutions' operations. Journal of Financial Services Marketing 15 (4), 287–295.
7 Demirguc-Kunt, Asli, Leora Klapper, Douglas Randall. 2013. "Islamic Finance and Financial Inclusion", Global Findex note 12.

[8] El-Zoghbi, Mayada, and Michael Tarazi. 2013. "Trends in Sharia-Compliant Financial Inclusion", CGAP Focus Note 84.

Clients

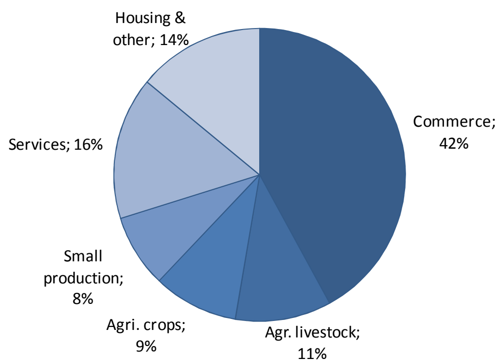
Islamic only intermediaries primarily target micro-enterprises (Figure 3) while hybrid financial intermediaries do so to a lesser extent. Their average finance sizes are relatively higher than Islamic only intermediaries.

Figure 3: Target Clients (Islamic finance portfolio)



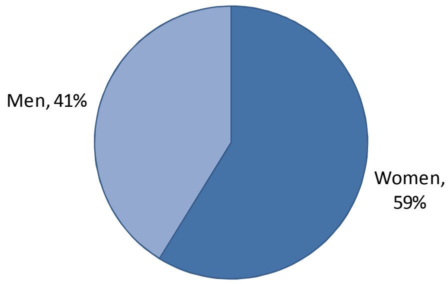
Experienced financial intermediaries aim primarily at clients from the commerce sector, followed by agriculture and services (Figure 4).

Figure 4: Target economic sectors by portfolio size



Almost 60% of all clients reached are women[9] (see Figure 5). This is slightly lower than the minimum 70% women outreach with conventional microfinance[10].

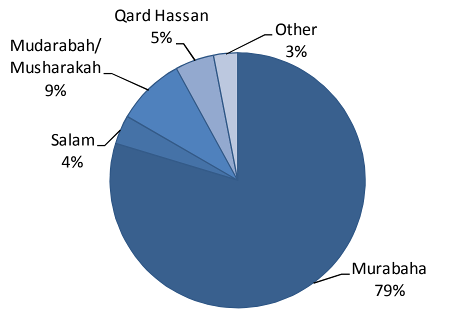
Figure 5: Women clients



Products and services

Murabaha is the major financial instrument offered by the financial intermediaries, to a total of around 483 thousand clients (or 77% of our sample's total Islamic portfolio outreach) with an outstanding portfolio of USD 170M (or 79%) (Figure 6).

Figure 6: Islamic financial products by portfolio size



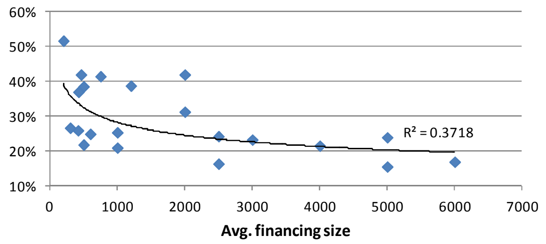
Murabaha most closely resembles a conventional (micro)loan (see Box 2 below for definitions of the products). The low proportion of Musharakah and Mudarabah is related to their higher risks and operational costs.

Seven to ten (under 20%) financial intermediaries offer Islamic deposits or investment accounts, intermediate in Takaful (Islamic insurance), or offer non-financial services such as client training and education.

Figure 7 displays the relationship between the average loan size and the effective profit margin of Murabaha (mark-up and fees) for clients.

[9] This excludes Indonesia as we do not have data on our sample financial intermediary's % women clients.
[10] CGAP blog, Mary Ellen Iskenderian, October 2013. "Prove It: Measuring Gender Performance in Microfinance".

Figure 7: Average financing size vs. effective profit margin



This relationship is best modeled with a power curve (R^2 =0.37). The dots above the line represent relatively expensive Murabaha products with very small sizes, mostly in countries with high inflation, or where financial intermediaries operate in low competition and/or rural areas (e.g. Pakistan, Yemen, Sudan, Afghanistan). The dots under the line represent cheaper Murabaha products, mostly in countries with well-performing microfinance markets and thus higher competition and/or relatively high average finance sizes (e.g. Bangladesh, Palestine). In most countries - where applicable - these profit rates compare with effective interest rates of similar size conventional loans.

Five financial intermediaries declared their products to be currently unsustainable, citing low scale, expensive non-Sharia'a compliant funding, and high operational costs (particularly a challenge for hybrid financial intermediaries when compared to their conventional loans).

Driving down operational costs and diversifying the product offering seem to be two key challenges to increase the outreach of Islamic MSME finance.

Box 2 – Islamic finance modes

Murabaha (mark-up sale) is a sales contract in which the FI purchases the client requested asset and sells it to the client. The client pays for the asset on a cost plus profit basis in installments.

Salam (advance financing) relates to a buyer paying in advance for assets that are to be delivered at a future date. **Istisna** is a contract in which a seller undertakes to manufacture a pre-specified commodity for an agreed price and delivery date.

Ijarah (lease financing) is a contract in which the FI leases a plant or equipment to the client in exchange for lease payments.

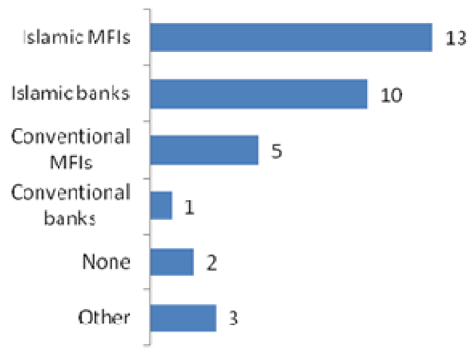
Profit-and-loss sharing instruments represent contracts in which the financial intermediary and the client share any profits arising from a business based on a pre-specified, mutually agreed ratio. In a **Mudarabah** contract the financial intermediary contributes capital to a project, which the client manages. Any losses are generally borne solely by the financial intermediary. In a **Musharakah** (partnership) contract both the financial intermediary and the client contribute capital and entrepreneurship to a project (the financial intermediary may opt for a silent partnership). Any losses are shared between the partners based on capital contribution. In a *Diminishing Musharakah* the client gradually buys back the financial intermediary's share in the equity of the business.

Qard Hassan is an interest-free, benevolent loan. [11]

Competition

In markets where the respondents operate, especially in countries with a relatively more developed Islamic financial services industry like in Yemen, Sudan, and Palestine, the main competitors are seen as being primarily Islamic financial institutions (microfinance institutions and banks) (see Figure 8).

Figure 8: Competitors

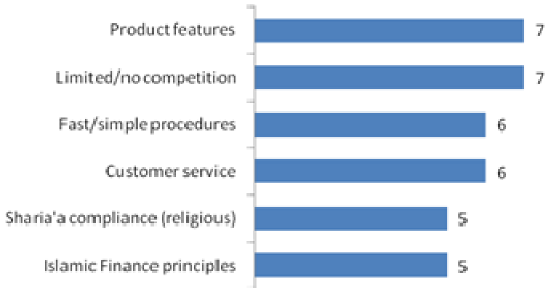


[11] See Footnote 6

Financial intermediaries that will be new to this market segment are mostly situated in countries where Islamic banking markets are rather underdeveloped or not yet existent (e.g. Egypt, Morocco, Tanzania). Hence, they expect less competition from Islamic financial intermediaries and more from conventional financial intermediaries, and possibly Islamic banks.

In terms of competitive advantages it is remarkable to see that many respondents claim to have limited or no competition (see Figure 9), in what might seem to be contrary to the previous point above. However, this confirms that these Islamic financial institutions operate in underserved markets. In more developed Islamic finance markets competitive advantage relates to typical features like product characteristics (e.g. larger funding size, low collateral requirements, low Murabaha fee) or customer service (speed, customer care).

Figure 9: Competitive advantages

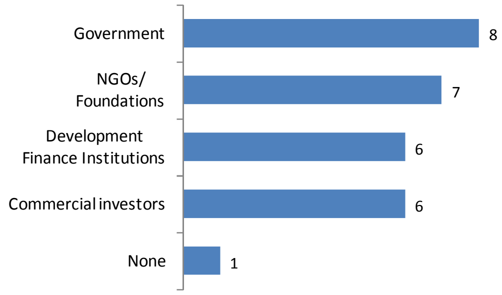


In some cases, compliance with Sharia'a and other underlying Islamic finance principles (i.e. no interest, risk sharing) were claimed to make finance more attractive for the end client.

Type of donors and funders

The highest number of responses shows that governments (specifically in Sudan, Pakistan, Yemen) followed by NGO/foundations and DFIs (mainly the Islamic Development Bank) are the most important sources of funding for experienced financial intermediaries (see Figure 10). This result is linked to the current state of the market in each country/region and some of the obstacles and challenges facing these institutions (see 'Obstacles & challenges' section).

Figure 10: Current donors and funders

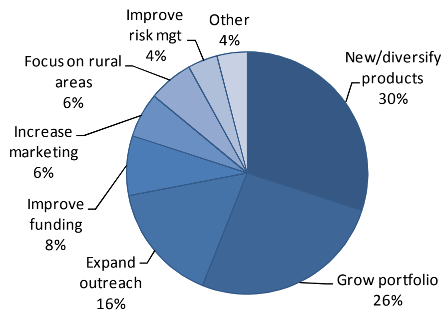


Interestingly, the significant involvement of commercial investors (Islamic banks and venture capitalists) in Indonesia are an indication of a relatively more advanced stage of Islamic microfinance specifically and Islamic banking generally in that country.

Future plans

Despite the limited outreach so far, the respondents have ambitious plans for the future (see Figure 11).

Figure 11: Future plans



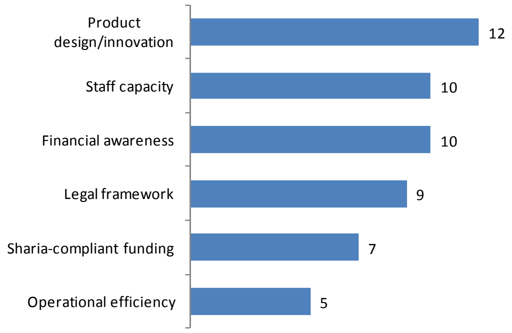
Both experienced and interested financial intermediaries expect double digit growth for Islamic MSME finance in terms of outreach and portfolio size, especially in MENA and SSA, while in the CCA financial institutions expect to commence Islamic MSME activities in a couple of years' time and once enabling legal frameworks are in place. Consequently, respondents report significant funding needs for the near future.

It is interesting to see that plans for growth in outreach are paired with diversification and innovation of product offering.

Obstacles & challenges

So, what keeps the financial intermediaries from unlocking this potential market? The number one challenge is to improve the products offering (see Figure 12), ensuring their Sharia'a-compliance and lowering costs.

Figure 12: Obstacles and challenges



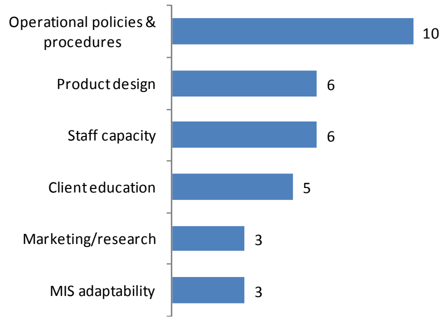
Staff capacity and market and financial awareness of end customers are seen as key challenges as well, which can be explained by the early stage of the market and relative complexity of Islamic products. It is interesting to see that financial institutions that are new to this market are concerned about staff capacity and less about product design or the financial awareness of their customers.

The legal framework and regulations for Islamic banking and finance are seen as challenges by many experienced financial intermediaries across all regions (e.g. unexpected state interference, non-existent or unclear regulations, no centralized Sharia'a governance board) and by interested financial intermediaries, particularly in CCA, where the lack of relevant regulations is the main hurdle.

Operational changes

The important operational changes made by the experienced financial intermediaries partly mirror the obstacles and challenges from the previous paragraph. The main difference is that these intermediaries had to re-engineer their operational processes and develop Sharia'a compliant policies and procedures, as shown in Figure 13.

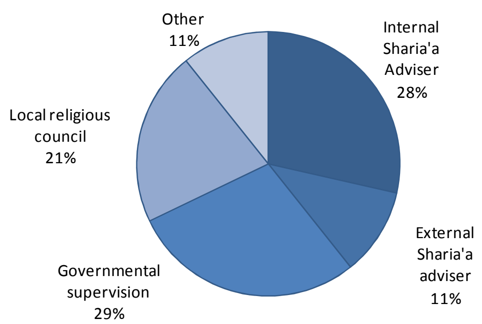
Figure 13: Main operational changes implemented



Half of the hybrid financial intermediaries stated having separated their Islamic finance activities either in the form of a separate legal entity, a dedicated unit or separate loan officers. Considering the complexity and specificities of Islamic finance we would expect a higher proportion of financial intermediaries to make such a separation of operations.

Internal Sharia'a advisors and/or governmental supervision are the most common ways of Sharia'a compliance certification, as influenced by Islamic NBFIs/banks (Figure 14).

Figure 14: Certification for Sharia'a compliance

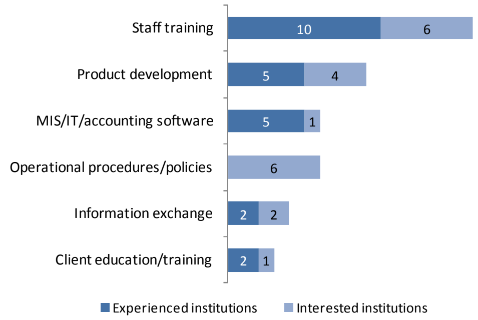


Local religious councils or committees play an important role, particularly in countries where government supervision is low or non-existent.

Technical assistance needs

Lastly we asked respondents how technical assistance can help them in realizing their future plans (Figure 15).

Figure 15: Technical assistance needs



Both groups of experienced and interested financial intermediaries have expressed technical assistance needs for training their staff and developing (new) products. Experienced financial intermediaries also requested support to customize/implement management information systems (MIS) that are compatible with Islamic finance product characteristics and accounting standards.

Interested financial intermediaries are primarily concerned with setting up the operational systems, policies and procedures needed to launch Islamic financial products and services.

3. Conclusions

Triple Jump conducted this survey to better understand the existing experience of financial institutions in providing Islamic MSME finance and the potential of this type of finance to further the finance frontier.

- The perceived demand is high and is mainly driven by religious considerations of the Islamic population. Customers' preferences do not seem to necessarily translate into buying behavior. Accordingly, the real demand needs to be better understood to allow for a more focused supply of products and services.
- The actual portfolio outstanding is small compared to the potential demand. Many respondents report no or limited competition which confirms that these financial intermediaries are operating in relatively young or underserved markets and as such are contributing to furthering the finance frontier.

So what is needed to unlock the potential of the market? The respondents report three main challenges:

1. *Product design/innovation*. Murabaha is the predominant instrument applied by almost all financial intermediaries. It resembles closely a conventional loan, but with less flexibility and higher costs. The key challenge is to design products that are Sharia compliant and client-oriented, and to lower cost. More advanced markets (Indonesia, Pakistan, Sudan) may serve as hunting grounds for better practices and products.
2. *Staffing capacity*. The availability of staff that know how to wield these relatively complex finance products in this young market is limited and considered an obstacle for growth. Industry building will primarily imply investing in human resources.
3. *Market and financial awareness.* The early stage of the market and the relative complexity of the products provide an extra hurdle for product sales. Investing in additional educational and awareness campaigns and aligning with knowledgeable local Islamic community leaders seems crucial to spur awareness of the customers.

It can be concluded that Islamic MSME finance is still at an early stage of development. It is an important instrument to reach underserved markets in regions where religion (or derived regulation) prohibits the use of conventional financial services.

To become an interesting alternative for conventional MSME services outside these areas serious innovation is needed. Trying to copy the conventional microloan as in the Murabaha product is not enough. It has taken (conventional) microfinance decades of trial and error and significant financial support to develop the scalable and sustainable models of today. Hopefully Islamic MSME finance can leapfrog this development and not only by learning from conventional microfinance but also by looking outside that field: benefitting from new cost saving technologies, leveraging traditional community structures or cross fertilizing with the value chain finance experiences, to name a few ideas.

If such innovation succeeds, then the conventional micro and SME finance industry and non-Muslims alike may also benefit from the social and ethical principles that underpin Islamic finance.