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The Combine Synergies Between Islamic Micro Finance Portfolio and Various Structured Finance Solutions

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Abstract: The objective of this study is to combine the both Islamic micro finance portfolio and structured finance within the limits of Shariah. However, sustainability and access to traditional funding sources by micro finance institutions (MFI) have remained a pressing issue for the finance industry. The traditional sources of finance such as commercial banks have been unwilling and reluctant to join hands with micro finance institutions. A unique structured proposal for business model is suggested in this paper. It combines synergies of structured finance solution for Islamic banks to join hands with existing micro finance providers. The proposed business model will enhance the financing capacity of the existing micro finance Industry by a staggering two thirds, simply by bringing in matching funds from traditional sources. These funds are based on the strong business model using synergies and financially innovative structured solution proposed for risk management etc. It is a commercially viable solution which is capable of being replicated for the entire industry with a huge win-win for all. The results reveal that helping hands for relief development (HHRD) would be providing its share of Rs.115 Million (1045454.54 US dollars) to be matched on 60:40 ratios with Meezan Bank Limited (MBL). Furthermore, Rs.76.667 Million (696972.72 US dollars) and the total Rs.191.667 Million (1742427.27 US dollars) have matched on 30:70 bases between both HHRD and MBL regarding challenges of financial innovation. This study highlights the issue, why financial institutions of Pakistan especially government sector banks avoided to joint hands with micro finance providers for various reason. These reasons are discussed in detail with proper solution in the paper.

Keywords: Funding, Micro Finance Institutions, Islamic Bank, Business Model, Risk Management.

Introduction

Microfinance is a source of financial services for entrepreneurs and small businesses that are lacking in access to banks and their related services. Moreover, this microfinance is a broad category of services including microcredit. The microcredit is a provision of credit service to underprivileged clients. It is one aspects of microfinance and rest of two are often confused (Field et, al. 2011). The concept of microcredit took a big leap in the 1960s and 1970s, when some groups such as ACCION International in Venezuela and Yunus's Grameen Bank in Bangladesh began to institutionalize the process. By formalizing and expanding the basic concept of sharing programs, these microfinance institutions helped to build capital for small businesses rather than just loaning for basic necessities such as food, water and clothing.

Dr. Muhammad Yunus first came across the idea of microcredit while studying the lives of poor entrepreneurs in his native Bangladesh during the famine of 1974. He began with loaning to groups of women and his program soon proved that small loans could not only quickly improve lives of the poor's but also sustain paid back on time with interest. The next step was setting up a consistent on-the-ground program. In the case of successful institutions that mean sending a representative or field manager to the prospective region to educate, advise and oversee the loans locally. When a few members of the group were accepted for a loan, the rest had to wait for that initial loan to be repaid before they can obtain their own loans. The peer pressure from the group to repay the initial loan helped to set the bar high. In 1961, another early pioneer ACCION opened its doors in Caracas and Venezuela, when law student Joseph Blatchford raised $90,000 to start a community development program to help the poor to jump-start their own business.

Over the next two decades, ACCION set up scores of independent microfinance institutions and expanded across Latin America. It also offered to people a choice besides the local loan shark, who would charge rates as high as 500 percent a year and often pushed people into permanent debt. However, the founders of ACCION and Dr. Yunus realized that if individuals who wanted to start their own businesses could not free themselves from start-up debt, they would never be able to grow. Since the Grameen Bank was founded, it had paid more than $5.7 and $5.1 billion as loans in different projects. The recovery rates of these loans are approximately 98.9 percent. It had made more than 0.95 billion loans and 6.7 million members around the world, whereas 96 percent members are women.

Since banking Industry as a whole has traditionally avoided joining hands with micro finance providers for various reason, which are primarily being addressed in the financially innovative proposed model. Furthermore, considering its immense potential for providing the above break-through it needs to be given a fair hearing chance and full support for deepening. However, there is availability in the existing market of micro finance funds for the agriculture-sector from traditional funding sources. Whereas, our study gives a contribution in existing literature through making a combine synergies between Islamic banks as Meezan bank and micro finance institution as HHRD to alleviate the poverty from Pakistan. Furthermore, this is first study, where Islamic banks involve and combine the hands with other institutions to promote Islamic micro financing in the context of Pakistan.

The dominance of western culture and values as well as plight and vulnerability of today's Islamic world, there has always been an incessant conflict between the two civilizations. Muslims have always been struggling for decades at almost every walk of real life to retain their values and culture. The feeling of this collective identity has urged Muslim scholars to find solutions of current economic problems to make their lives compatible with *Sharī'ah* and to safeguard the Muslim *Ummah* against the perils of the western culture. (Yusuf, 2006; pp.56-63). From affordable loans and insurance products to safe places to save, microfinance services have been powerful weapons in the fight against poverty, especially in Latin America and South Asia (CGAP News, 2008).

A report published by World Bank (2016) describes that there are over 7000 microfinance institutions, serving some 16 million poor people in developing countries. The total cash turnover of MFIs world-wide is estimated at US$2.5 billion and the potential for new growth is outstanding. The Microcredit Summit (2016) estimates that US$21.6 billion is needed to provide microfinance to 100 million of the world's poorest families. Other estimates throughout worldwide informed us that there are 13 million microcredit borrowers, with USD 13 billion in outstanding loans, and generating repayment rates of 93 percent; growing at a rate of 25 percent annual growth. Despite all this less than 18% of the world's poorest households have access for financial services (Grameen Foundation, 2015). Ahmad (2007) points out that Microfinance initiative is widely acclaimed as a new approach to alleviate poverty, to bring about economic development and to improve the living conditions of the poor.

Some of studies have investigated the impact of corporate social responsibility (CSR) on risk such as (El Goul et al. 2011) and (Bouslah et al. 2013). However, (El Goul et al. 2011) examined the impact of CSR on cost of equity capital from US firms. Their study indicates that firms with better CSR scores exhibit cheaper equity financing for large sample of US firms. Furthermore, (Bouslah et al. 2013) investigated the impact of the individual dimensions of social performance (SP) on firm risk (total and idiosyncratic) using 16,599 firm-year observations over the period 1991–2007. Their study concludes with these remarks that direction of causation between firm risk and SP depends on the dimension examined. Moreover, our study investigates the Islamic microfinancing with Islamic financial institution for poverty alleviation. Where our study consists of Islamic financial institutions and helping hands for relief development (HHRD) for poor in the context of Pakistan.

Literature Review

Microfinance is the provision of financial services for low-income populations in which the services provided are in accordance to Islamic financing principles. In many respects, Islamic finance is simply ethical finance. Islam sets out some broad principles that govern commercial transactions in general and the provision of finance in particular. The Interest is the one of the most important financing principles that prohibited under Islamic law. Many Muslims therefore refrain from using interest based microfinance services for fear of breaching their religious beliefs. Islamic microfinance programs cannot therefore imitate conventional microfinance programs and obliged to provide finance without charging interest. However, it does not mean that capital is free of charge, it should be made available without any cost, or there should be no return on the funds provided. Rather a return on capital is allowed, whether that capital participates in the productive process and exposed to business risk

The implementation of the Islamic economic system, which has been started since the early 1960's, increased the number of Islamic financial institutions both banks and non-banks (Zaheer and Hassan, 2001). One of the Islamic financial institutions is community-oriented Islamic bottom cooperative, which is known as Islamic microfinance. The birth of microfinance institutions (MFIs) is a solution for grassroots economic groups who need funding for small business development. MFI is a basic economic institution that seeks to develop productive ventures and investments in order to increase the economic activity of small entrepreneurs with Sharia and cooperative. In Islam this contains agency partnership, cooperation, family, and togetherness healthy business, and lawfulness Shabbir et al (2015). Allah says in surah Al-Maidah: (2) that those institutions are highly praised in Islam as the word of Allah, who cooperate in goodness and piety, and do not cooperate in sin and enmity. Similar teaching is reiterated in Sura An-Nisa, verse (*12*). The Holy Prophet Muhammad (peace be upon him) said Allah *will answer prayer of two people who collaborate and not betray each other* (Al-Bukhari).

The principle of the MFI business is based on the concept of mutual help and not monopolized by one of the owners of capital. Similarly, both in terms of gains or losses are divided equally and proportionally (Shabbir and Rehman, 2017). However, the purpose of such venture will not be the maximum and cannot be achieved if it is not accompanied by good risk management particularly the management of financial risk. Since the establishment of financial institutions, Islamic microfinance is a funding channel owned entity from the people, who have more money to those who need capital. Furthermore, financing or credit risk management is an integral part of overall risk management (Shabbir et al. 2015). The objectives of financial risk management include monitoring, identifying, measuring and controlling all risks arising from the provision of financing in focused, integrated and sustainable manners. Moreover, it also increases the revenues and minimizes the risk of granting financing through financial portfolio management and establishing policies, procedures and systems (Shabbir and Rehman, 2015).

According to Adam (2010) analyzing the financing, microfinance notices the results of provided finance, whether that gives permanent results or not. The financial institutions that provide permanent results obtained through contract of sale (Murabaha) and leasing (Ijara). While financing that provides temporary results are obtained from the contract of (Mudharabah) and (Musharaka). However, based on these two things, the product will provide funding in microfinance, which has a different risk from one contract to another. The most of investment or business run through financing activities which always associated with risk. The problem is how to manage that investment or business in the minimum financing risk. This risk can be minimized by using good risk management and it can also be initialized with screening to prospective clients through finance the projects. If financing has been realized, the risk control can be done by providing treatment in accordance with the character of clients and characteristics of projects (Shabbir et al. 2015).

Morduch and Wrenn (2005) claimed that they maintain a balance between commercial and social objectives of MFI and this can be achieved if client's needs are understood through market and administration of micro finance institutions (MFI) is performed well according to the behavior of the target market. Abbink (2006) examined that micro finance has no effect on poverty due to extreme poorness in the developing nations, which take a back seat with the needs of the poor to focus primarily on sustainability and profit for micro finance banks. Shabbir (2017) argue that "MFIs set new standards in poverty impact that maintain high standards of financial performance and it is now time to design and innovative services". Furthermore, microfinance has been identified as an important tool in increasing the productivity of the poor and in aiding economic development. It also describes and experimentally tests of Islamic-compliant microfinance products in the context of information asymmetry and costly state verification. They find significantly higher compliance rates for the Islamic-compliant contracts (profit-sharing and joint venture) than for the traditional contracts (interest-based) (Komi and Croson, 2012).

Hassan (2015) concluded that micro finance programs are not effective. However, financial depending and economic growth also promotes consumption smoothing by micro finance. It is noted that micro finance activities are improving client's economic status which accumulates through income. In turn results of reduced poverty on increased household income often measured via the impact of micro finance. However, several scholars such as Ferros (2005), Goud (2012), Chowdry (2006), Farook (2007), Ashraf(2007), Zafor (2007), (Dhumale and Sapcanin, 1999) ensure that they remain competitive and innovative ideas are more inclined for working of MFIs in Pakistan according to associated press of Pakistan. Whereas, so many similarities are also found like egalitarian and risk sharing. Moreover, Islamic micro finance needs to fulfill all highlighted areas which are indicated by scholars under the supervision of Shariah advisory board.

Nazirwan (2015) stated a controversy has risen about riba and its permissibility. However, riba is that amount charged on advances or interest paid by banks on deposits. Most of Muslim scholars believe that there are subtle differences in interpretation of riba and it is prohibited in Islam. Ayub (1995) said that the profit earned on those advances and it will be permissible, if someone indulges in trading. Meyer (2014) stated his arguments about diminishing men concern whereas small no of people have wealth to accumulate the tendency reinforces interest. However, the risk of potential loss is also exposed financial capital unless Islam does not allow gain from a financial activity.

According to (Shahzad and Rehman, 2015) international markets can assimilate Islamic institutions through the legal frame work and a standardized regulatory. Before the financial institutions are making new financial instruments, their religious boards and shariah adviser's approved from most of banks. Islamic principles are not based in some countries when attempting to explain their practices and Islamic bank occasionally experience major difficulties. They get access to finance unless may not strengthen through their productive base and without tangible collateral they didn't build a strong productive base Shabbir (2016). However, they offer sufficient collateral except in which micro entrepreneurs may not access the finance. Thus financial institutions create a vicious circle and their lack of tangible assets to offer as collateral by a major constraint to finance the poor Abdouli (1991). Agro- economic activity that generates irregular cash flows against the inherent seasonal trend among the rural poor through encounter promoting of non-firm activities by micro-financers.

The social-financial performance relation has also been studied from a "corporate" perspective as well as from a "portfolio" perspective. From Neo-classical approach, social performance represents a burden for shareholders, while from the stakeholder's perspective CSP constitutes a signal to the market concerning the quality of the management (McGuire et al., 1988; Waddock & Graves, 1997). Therefore, "A socially responsible firm may be perceived as being less prone to social crisis, and having better future positioning to be in compliance with regulations in social domains" (Bouslah et al., 2013). (Griffin and Mahon, 1997) suggested that different dimensions of CSP are not equally important and relevant and aggregation may confound the individual impact of each dimension on financial performance. Similarly, Rojas et al. (2009) argue that activist investors seem to grant different levels of importance to different dimensions of CSP. For example, environment seemed to be the most important dimension of CSP for activist investors in 1990s while human rights became the most relevant issue in 2001. Further, mattingly and Berman (2006) suggest that positive and negative social actions are conceptually distinct construct and should not be combined. This strongly suggests that not only each dimension of CSP must be considered individually (Hillman & Keim, 2001; Rehbein et al., 2004), but also positive and negative social actions must be dissociated and their respective relations with financial performance should be analyzed separately.

Bouslah et al. (2013) analyze the relation between individual dimensions of CSP and firm's risk and show that not all CSP dimensions are relevant for firm risk. Their result show that for S&P 500 firms, dimensions such as Employees' welfare, Governance and Community involvement affect negatively firms' risk while for non S&P 500 firms, Environment, Employees' welfare and Community involvement affect negatively firms' risk. It has also been argued in the literature, that different dimensions of social responsibility may have different relations with financial performance in different industries: "Different industries face different configurations of stakeholders with differing degrees of activism on issues" (Griffin & Mahon, 1997). Renneboog et al. (2008) conclude that whether CSR is priced by capital markets remains an open question. They thus join previous calls for research that directly examines how CSR influences firms' cost of equity capital (Kempf and Osthoff, 2007; Sharfman and Fernando, 2008).

Combining Synergies for Structured Finance Solutions

Figure 3.1. Promoting Islamic Micro Finance Portfolio

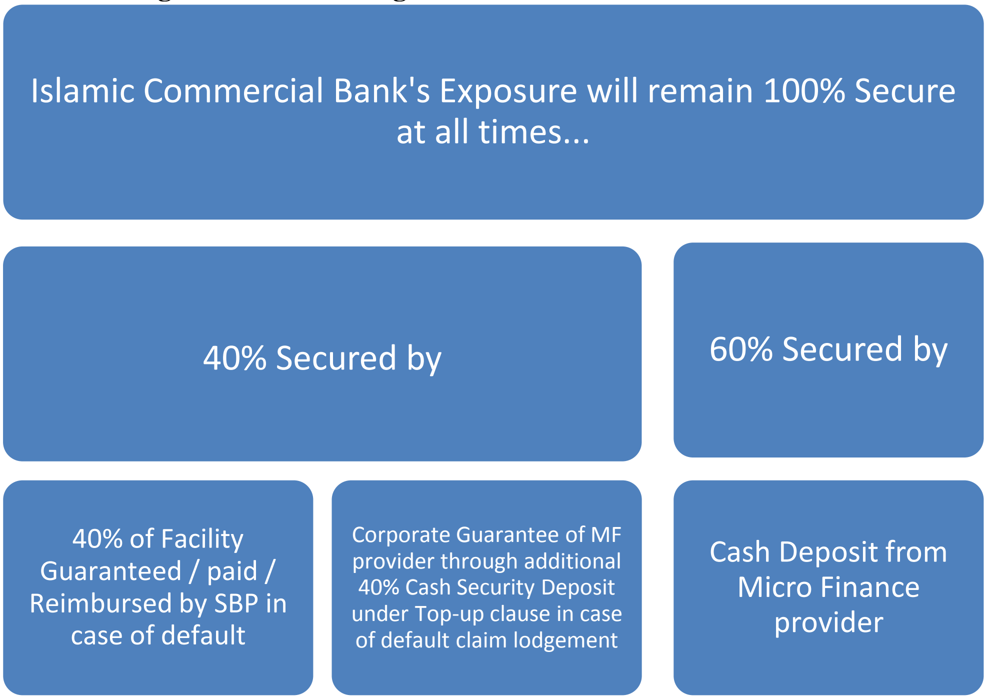
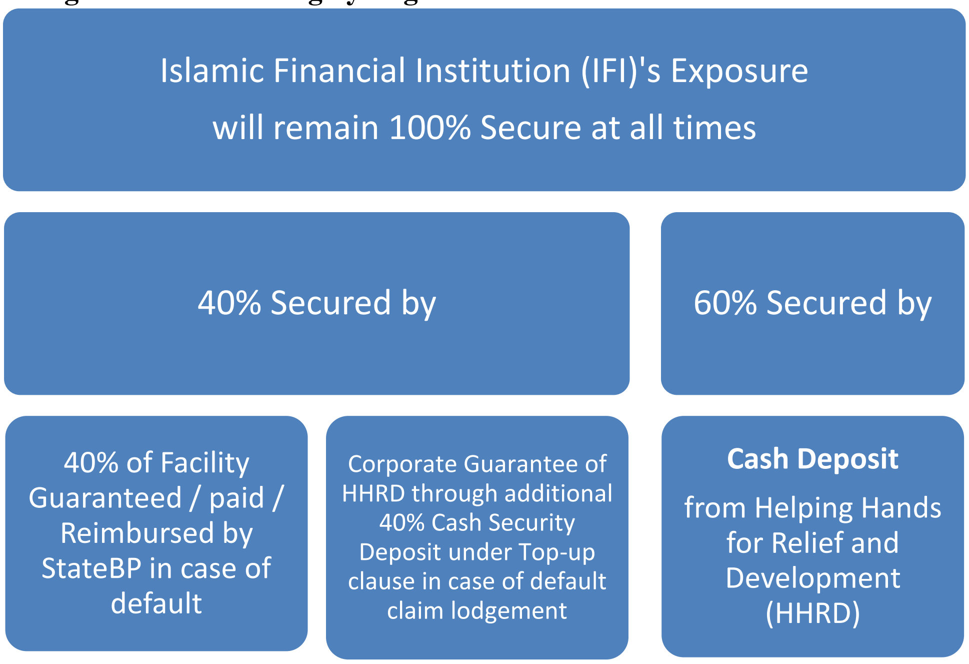


Figure 3.2: Combining Synergies for Structured Finance Solutions



Explanation of Structured Model and Discussion

Islamic Financial Institution (IFI):

Present Status:

Currently, Islamic financial institution does not have any Islamic micro finance portfolio. However, the objectives of IFI to build a new Islamic micro finance institution.

- Contribute and support Islamic micro finance (IMF) sector, inter alia, as part of corporate social responsibility (CSR).
- Building Islamic micro finance portfolio;
  - as a social and welfare cause
  - as a new source of revenue generation
  - Minimizing costs & risks and maximizing returns
  - Increasing outreach by combining and utilizing synergies of existing players without having to directly incur any network expansion and heavy human resource costs due to the inherent labor intensive nature of managing small ticket size micro finance portfolios and transactions.
  - Later on, the scope of this collaboration with helping hands for relief and development (HHRD) has the potential to result in the creation of a new Islamic Micro Finance Bank.

Helping Hands for Relief and Development (HHRD)

Present Status:

Islamic micro finance portfolio has approximately Rs.300 Million (4,002,000.00 US Dollar) comprising about 11,000 customers, doing both Interests free Micro Finance, as well as Shariah compliant Esar micro finance (EMF).

Objectives:

- Increase outreach and enhance IMF portfolio
- Significant tax savings are expected to accrue. However, they save 3.5 per cent tax presently payable on Murabaha transactions by routing these transactions through an Islamic Financial Institution (IFI). A saving of 3.5 per cent on cumulative portfolio of about Rs. 300 million (4,002,000.00 US Dollar) approximately is expected to yield a tax saving of about Rs. 10.5 million (95454 US Dollars).
- Increase ability to do business by about 66.66 per cent from about Rs. 300 million (4,002,000.00 US Dollar) existing cumulative portfolio to about Rs. 500 million (4545454.554 US Dollars) through the proposed structured finance solution simply by leveraging of significant synergies which already exist and can be innovatively combined in order to arrive at a major win-win solution for all.
- Presently, in case of default no part of existing HHRD portfolio is guaranteed. By simply routing this transaction through an acceptable IFI, access to State Bank of Pakistan (SBP) reimbursement of up to 40 per cent of default in each IMF case and portfolio becomes possible.
- Routing IMF transactions through IFI for small Agriculture-farmers with holdings of less than 12.5 acres of land may also be covered not just for 40 per cent of state bank of Pakistan (SBP) reimbursement but on seeking requisite permissions may also potentially qualify for reimbursement for up to 100 per cent via subsidized insurance cover arrangements applicable for small farmers.

- Later on, the scope of this collaboration between IFI and HHRD has to the potential and proposed to result in creation of a new Islamic Micro Finance Bank, preferably as a joint venture with the IFI or even by HHRD alone if the need arises.

Proposed Scheme of Arrangements / Transaction Structure

- IFI and HHRD will sign a memorandum of understanding (MOU) based on initially, the scheme of arrangements and then legal and Shariah vetted agreements and documents would be finalized.
- IFI will appoint HHRD as its agent to build Islamic micro finance portfolio. The IMF portfolio management, staffing, marketing, recoveries, etc. will be the sole responsibility of HHRD.
- IFI and HHRD will also enter into an MOU/syndication arrangement as co-financiers, whereby for each IMF customer 60 per cent financing will be provided by HHRD and the remaining 40 per cent will be provided by the IFI at a profit benchmark of up to one year Karachi inter-bank offering rate (KIBOR) plus 5 per cent per annum on a 'net of cash security deposit' basis.
- The disbursement would be done 'through IFI' by HHRD, in capacity as IFI's agent.
- IFI's exposure to each IMF customer would be secured by
    - Corporate guarantee of HHRD for 100 per cent of the original disbursement amount
    - However, 60 per cent Cash Security deposit made by HHRD (separately deposited for each IMF customer transaction at the time of each disbursement)
    - Remaining 40 per cent net of security deposit cash funded exposure of the IFI is secured by; whereas, an additional 40 per cent security SBP reimbursement is guaranteed up to 40 per cent in micro finance cases. On the other side, an additional 40 per cent cash security comfort for IFI. This is further secured by additional 40 per cent cash security deposit in top-up clause under which HHRD will give deposit of an additional 40 per cent Cash Security Deposit in each case of IMF default. This 40 per cent cash security deposit (CSD) made by HHRD (under Top-up clause, deposited in case of default by IMF customer will be simultaneously done at the time of reimbursement claim lodgment with SBP by HHRD through IFI. Since IFI would already have received 100 per cent security deposit in each default case. Hence, the benefit of any reimbursement up to 40 per cent received by the IFI would be passed on back to HHRD in the form of returning the 40 per cent security deposit obtained by IFI under the top up clause.
- The HHRD will market and obtain internal (HHRD) approvals for disbursement based on its existing internal approval process and product programs as applicable.

Proposed Process Flow

Once an Islamic Micro Finance (IMF) case is internally approved by HHRD,

- HHRD will deposit 60 per cent CSD separately as applicable for each HHRD approved IMF case with the IFI.
- After completion of requisite HHRD formalities, HHRD will issue a disbursement authorization certificate (DAC). This DAC will also be treated as
- A request from HHRD to the IFI to give disbursement to the customer for up to the amount stated therein.
- The DAC will contain confirmation that 60 per cent of the amount proposed to be disbursed has already been deposited with the IFI as security deposit.
- The DAC will also refer to top-up clause under which in case the IMF customer defaults at any later stage. HHRD agrees to indemnify and will top-up the security

deposit by 40 per cent, from 60 per cent to 100 per cent of the original amount disbursed to an IMF or outstanding whichever is higher.

- Simultaneously, at the time of making deposit of the additional 40 per cent security deposit by HHRD with the IFI (only in case of default claim lodgment). HHRD through the IFI will also Lodge a "Default Claim" with the SBP. Hence, it becomes effectively due to the top-up clause, IFI on a net of cash (security deposit) basis will never really be 'out of pocket' or 'out of funds' and will not face any internal 'cost of funds' issue on even the non-performing portfolio', at any stage even in the future.
- Since SBP guarantees and reimburses 40 per cent of the amount disbursed in IMF, agriculture and small medium enterprise's (SME) sectors. Hence, finally, on receipt of the 40 per cent reimbursement by the IFI from the SBP. The HHRD will also end up getting back its 40 per cent security deposit released from the IFI, which were deposited with the IFI, under the top up clause at the time of any claim lodgment with the SBP, through the IFI in default cases only.

Win-Win Position for IFI

- It has a new source of revenue generation for IFI
- However, building IMF portfolio, IFI will be able to build IMF portfolio and increase its outreach.
- The risks mitigated is the fact mitigated by corporate guarantee of HHRD, whereas, cash security deposit; initially 60 per cent, additional 40 per cent under top-up clause and SBP reimbursement guaranteeing 40 per cent in cases of default.
- No additional infrastructure costs since HHRD will develop market manage IMF portfolio and ensure recoveries as IFI's agent. Hence capital intensive infrastructure and staffing costs are not involved.
- The corporate social responsibility (CSR) IFI's CSR met for social welfare.
- However, the growth of IMF bank collaboration with HHRD can potentially result in creation of an IMF Bank.

It is pertinent to note that if the proposed transaction structure is not adopted, the above benefits may not be available to IFI.

Win-Win Position for HHRD

Just by simply routing transactions through the IFI in the manner proposed above will have potentially yield the following additional advantages:

- Substantial tax savings of 3.5 per cent on Murabaha transactions will potentially yield tax savings of up to Rs.10.5 Million on a cumulative Rs.300 million portfolio size on fresh disbursements.
- Increase IMF portfolio size increase HHRD's portfolio by 66.66 per cent, such as if it is at Rs. 300 million outstanding at present, then routing all future disbursements through IFI. The IFI disbursing 40 per cent share will increase cumulative capacity from Rs.300 to Rs.500 million.
- Increased funds availability will help increase outreach.
- The risks mitigated on defaults due to SBP guaranteeing 40 per cent of exposure even though HHRD will be issuing corporate guarantee in favor of IFI. The HHRD will also be making cash security deposit, initially 60 per cent and an additional 40 per cent under top-up clause with IFI in case of default. This is mitigated by the SBP reimbursement guaranteeing 40 per cent of the exposure in case of default. Hence this capacity enhancement is at no extra risk or cost. In fact any default on HHRD's existing IMF portfolio is presently not covered by 40 per cent SBP guarantee. Whereas, this advantage

will provide 40 per cent cushion for existing portfolio also whilst significantly enhancing capacity.

- The IMF agrees on 40 per cent also covered or may even also qualify for up to 100 per cent potential cover in case of default: If requisite permissions are sought and obtained routing IMF transactions through IFI for small agriculture farmers of less than 12.5 acres may potentially increase the guaranteed portion from 40 per cent to a potentially 100 per cent through insurance cover arrangement applicable for small farmers.
- The growth of IMF bank collaboration with IFI can potentially result in the creation of an IMF Bank, either as a joint venture or if required even by HHRD alone.

It is pertinent to note that if the proposed transaction structure is not adopted, the above benefits may not be available to HHRD.

Conclusion

The proposed model has the potential to offer a break-through scalable and replicable model for providing access to micro finance providers from traditional sources of funding like banks. Since banking industry as a whole has traditionally avoided joining hands with micro finance providers for various reasons, which are primarily being addressed in the financially innovative proposed model. However, considering its immense potential for providing the above break-through it needs to be given a fair hearing chance and full support for deepening. Moreover, it considered for matching grant from the financial innovation challenge fund in order to encourage and promote traditional providers of funds (Banks) to join hands with micro finance providers of up to 70 per cent matching grant. The HHRD would be providing its share of Rs.115 million to be matched on 60:40 ratios by Meezan bank limited about Rs.76.667 million and the total Rs.191.667 million may be matched on 30:70 bases by the financial innovative challenges.

However, sharing this percentage ratio between both HHRD and Meezan bank limit enhance them to save their actual as well as a long run investment relationship will develop in both institutions. This model will help to other Islamic financial institutions and micro financing organizations to join their hands for promotion of Islamic micro financing practice, not only in Pakistan but in across the world to relieving the poverty from developing countries. Furthermore, this model is also applicable for more than two Islamic financial institutions jointly adopt it with different micro financing groups within the country and its region because every countries have different circumstances and working environment with different Islamic school of thoughts and vision.

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