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Exploring the Potential for Sharia-compliant Microfinance in Underwriting Jordan's Muslim Poor

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Exploring the Potential for Sharia-compliant Microfinance in Underwriting Jordan's Muslim Poor

—Austin Perea (Editor: Brigid C. Casellini)

In the developed, industrialized West, the idea of microfinance may strike the average person as somewhat distant. Microfinance offers small loans, often unsecured, to people who conventional banks will not lend to because they lack collateral or credit history. It wasn't until I arrived in Egypt, just a few weeks before a popular coup d'état unseated President Muhammad Morsi, that I understood why access to microfinance is so vital to the poor. While the informal sector operates on the fringes of the economy in the West—where the term "informal sector" is often synonymous with the black market—in Cairo, the informal sector provides livelihoods to many citizens. While walking the blistering streets of Cairo, scarcely five minutes would pass without my being solicited by a local street vendor. Using my broken Arabic, I would attempt to convey that I had no use for a dozen papyrus bookmarks, a copy of the Qur'an, a cup of Turkish coffee (or ahwa in Arabic; an offer I rarely rejected), or a miniature fanoos, the decorative lantern that symbolizes the Muslim holiday of Ramadan. While in Jordan, replacing the proposed inventory with a small Palestinian flag and kheffiya, a traditional Middle Eastern scarf often fashioned into a headdress, the scene was remarkably similar. It became clear to me then, while on the streets of Cairo and Amman, why access to finance was so integral to these economies. Access to credit is the lifeblood to the informal sector; its importance cannot be understated.

I had set out for Egypt on a grant from the International Research Opportunities Program (IROP) at UNH to better understand the economic environment in which this vital sector must operate. I also sought to address the role of religion in financial intermediation by asking: what characterizes Islamic banking, and what role does it have in financing the Muslim poor? I initially pursued my research in Cairo, as planned with Professor Sowers of the UNH Political Science Department and an Egyptian economist, Professor Muhammad El-Komi, at the American University in Cairo. However, a military-backed overthrow of the government prevented me from conducting my research in Egypt. After jerry-rigging a new contingency plan, I was evacuated from Cairo and flown to Amman, Jordan on July 4, 2013—American Independence Day.

The flag of Jordan flying in downtown Amman.

Why Study Microfinance?

Precise definitions for the micro, small, and medium-sized enterprises (or MSMEs) vary from country-to-country, but it is undeniable that this sector, which includes the informal sector, is vitally important to economic output, as it accounts for 80% of Egypt's employment and 65% of Jordan's (El-Ghamrawy 1; "Jordanian National Policy Framework for Microfinance" 5). However, MSMEs have significant trouble securing financing for their operations. Nowhere is this problem more acute than in the Middle East. According to the World Bank's "Ease of Doing Business" Index, which synthesizes data seen as conducive to economic activity, Jordan ranks as number 170 out of 189 countries surveyed on ease of access to credit–only the war-torn states of Yemen and Sudan rival Jordan for worse access to credit in the region. Considering that micro and small enterprises in Jordan—defined as businesses having four employees or less—account for almost two-thirds of the country's private non-agricultural employment, encouraging lending to this sector is paramount ("Jordan Nat'l Policy Framework" 5).

My research sought to understand why there is such a marked absence of Islamic microfinance in the Middle East and Jordan in particular. Islamic banks offer financial services deemed sharia-compliant—that is, in adherence to Islamic law as set out in the Qur'an. Based on a conventional interpretation that the Qur'an prohibits the lending of money with interest (similar norms against 'usury' are found in early Christianity), the Islamic banking industry spans much of the Islamic world. Curiously, this industry has not been able to successfully penetrate the Middle East market and only provides financial services to about 5% of the region's banked population, when excluding the more developed Gulf economies (Demiguc et. al). When conducting background research, I was struck by some key questions: does Islamic banking offer innovation in an otherwise un-dynamic financial market, making it a viable avenue for development finance in Jordan? Why is Islamic microfinance not more prevalent in the Middle East? To answer these questions, my research would require conducting personal interviews with experts in the field, including banking and microfinance professionals as well as Muslim sheikhs.

On the Ground in Amman

After being evacuated to Amman, acclimating to my new surroundings proved to be easier than anticipated. While the Jordanian dialect of Arabic (shami) was a little harder to understand than Egyptian Arabic (masri), I soon found that this made little functional difference given my rudimentary understanding of the language. Additionally, while the lack of overcrowding and general cleanliness of Amman was certainly a nice respite from the polluted, congested insanity of Cairo, I would be lying if I said I didn't come to miss the fast pace of Cairo. Many of their differences may be due to size, as Jordan is considerably smaller in population than Egypt, with only about 6.5 million next to Egypt's

85 million. However, the two countries also have wide political disparities. Jordan is a constitutional monarchy with sweeping executive authority resulting in relative political and economic stability. It also receives large inflows of foreign aid per capita and is not nearly as impoverished as Egypt, with about 14% of the population living under an absolute poverty line as opposed to 26.3% in Egypt (Al-Ahram Online).

A minaret (tower of a mosque) near the author's neighborhood in Amman.

Before long I found a flat in Amman and, with a little help from my contacts at the Carsey Institute at UNH, I also managed to find a new mentor in Alaa Abbassi, managing partner at Abbassi Law Office and a frequent microfinance consultant to international development organizations. He provided not only a wealth of information about Islamic and conventional microfinance, but also the contacts I would need to pursue my research. Our initial meeting marked the first incidence of what turned out to be a relatively consistent pattern —leaving an interview with more questions than when I entered.

Foundations of Islamic Banking and Finance

In our first research-related meeting, Abbassi explained to me in detail the foundations of Islamic finance and its practical implications. As in early Christian thought, the Qur’an contains a number of prescriptions regarding how to conduct business. The most well-known is regarding the levying of interest on loans, since the early Islamic community rejected the idea that money has intrinsic worth as a commodity in and of itself. Money was viewed in early Islamic thought as being only truly capitalized once it was put to productive use—e.g. used to purchase a real good or service.

It is from this well-known prohibition that most Islamic banks have adapted their financing methods. The most common sharia-compliant product in use is the murabaha agreement, a financial innovation remarkably similar to a debt instrument. Perhaps due to its relative simplicity, debt-like attributes, and consequent ease of exposition, this agreement has become the most popular contract in the Islamic financial system. The murabaha contract is essentially a cost plus markup contract where the creditor purchases a certain commodity for the entrepreneur whereby the entrepreneur must then pay the price of the commodity plus a markup fee (Presley & Mills 16). Estimates suggest that anywhere between 70-80% of Islamic microfinance institutions (MFIs) assets today are in murabaha agreements, making it by far the most popular contract in the industry, with 672,000 customers worldwide valued at USD 413 million (El-Zoghbi & Tarazi 4). As I discovered when I spoke to John Yancura, CEO of FINCA Jordan—the only MFI in Jordan offering sharia-compliant products—Jordan's sole experience with Islamic microfinance has been with the murabaha agreement.

The markup fee, however, is still a nominal percentage of the “loan” principle, the spot price of the commodity, and is therefore often criticized by sharia scholars as not truly emulating the risk-sharing principles of Islam. Abbassi, along with a sheikh I later interviewed, were among the most vociferous opponents of murabaha, claiming it was illegitimate in terms of Islamic law. This viewpoint is not necessarily shared by all, though many experts note its perceived lack of authenticity (Mills & Presley 16, 53; El-Zohhbi & Tarazi 4).

Profit-Loss Sharing Partnerships: The True Islamic Banking Model

What initially interested me in Islamic banking was not the reliance on murabaha, but the development of financial instruments stemming from a lesser known prohibition, which stipulates against speculative and excessive risk-taking, and encourages mutual sharing of risk in financial contracts (Mills & Presley 9-11). This idea has played out in practice through the development of the profit-loss sharing agreement, an equity-stake partnership similar to a venture capital agreement. My initial research hypothesis was that these contracts could lend a new and varied financial product to an otherwise stagnant market through a form of venture capital, which is currently unavailable to MSMEs in Jordan. A study by Jordan's Ministry of Planning and International Cooperation found that many recipients of microfinance believed microcredit products were not diversified nor well-adapted to their needs, and thus, I posited, perhaps sharia-compliant finance through the profit-loss sharing mechanism could meet this demand ("Microfinance Market Study" 4, 11).

Profit-loss sharing partnerships are unique in that they provide innovation to a microfinance industry that generally offers only loans to its clients. Due to their ability to mutualize risk, profit-loss sharing agreements allow for more risk-taking on the part of the entrepreneur. When investor returns are contingent on the success of the business, such as in venture capital, the investor devotes more resources to ensure that the business is profitable. Unlike in debt contracts, where the bank only cares about getting a fixed interest payment plus principal (or, in instances of default, collateral seizure), equity-stake partnerships guarantee that both parties are interested in the success of the business.

In my research, I found that the contracts known as musharaka and mudaraba are the most popular profit-loss sharing agreements used in Islamic financing, although they are a distant third in the microfinance industry in terms of usage (El-Zoghbi & Tarazi 4-5). A musharaka partnership is where the financier, who in practice takes the role of an investor, provides a certain ratio of the capital from which the investor and entrepreneur derive their share of profits and losses (Mills & Presley 15). In a mudaraba agreement the investor provides all the capital while the entrepreneur provides his time and managerial skills with the profit split in a predetermined ratio, but with losses born all by the investor (Mills & Presley 35-37). These equity-like agreements, in contrast to debt-like murabaha, are seen by many as the most important contribution to Islamic banking because they provide "better allocation of resources and a higher level of investment relative to the conventional banking system" (El-Ghamrawy 2). Additionally, they are also viewed by many sharia scholars as exemplifying the truest embodiment of Islam's risk sharing principles, an opinion shared universally by my interview subjects (El-Zoghbi & Tarazi 4-5).

One of my interview subjects, a sheikh belonging to Jordan's Circassian diaspora, which migrated from the Caucasus region centuries ago, also held this view. In the serenity of our meeting place, a mosque on the outskirts of Amman, we discussed what he saw as the religious imperative for an Islamic economy while my friend, Abed, translated the nuances of the discussion into English. In the view of this sheikh, the religious rationale for the Islamic structure of financial contracts stems from the belief that wealth should be distributed equally and fairly in an economy, which justifies the levying of zakat, a charitable wealth tax that is used to alleviate the sufferings of the poor, as well as the supererogatory to share risk in financial contracts. According to this sheikh, the best way to ensure just and equitable distributions of wealth is to simply prohibit capital from being distributed in any other fashion besides through equity. Interestingly, in the eyes of this sheikh, the ideal Islamic economy shared many characteristics with European social democracy in a manner that is a "middle way between capitalism and communism."

Challenges with the Profit-Loss Sharing Model

Despite being legitimately sharia-compliant according to Islamic scholars, profit-loss sharing (PLS) partnerships come with a lot of risk for the financial institution that underwrites the investment. According to research done by the Consultative Group on Assisting the Poor (CGAP), part of the reason for their infrequent use in the Middle East is because they are relatively costly for financial institutions to implement. This is due to a general lack of financial literacy in the region, costly oversight and audits required to prevent under-reporting of profits by the entrepreneurs, and general information asymmetry risks associated with financing the MSME sector in developing countries. Experts from the Central Bank of Jordan and FINCA Jordan whom I interviewed largely agreed with the outcomes of this study.

The author near the entrance to the ancient city of Petra, Jordan.

According to Dr. Waleed Qasrawi and Dr. Mohammad Adeeb Taani, two financial analysts from the Central Bank of Jordan (CBJ), the Bank is attempting to alleviate one of these impediments to PLS agreements–although not for the express purpose of incentivizing Islamic microfinance–by organizing a nation-wide financial literacy campaign to reduce risk to financial institutions and enhance consumer protection. However, the issue of financial literacy notwithstanding, John Yancura of FINCA Jordan contends that the costs presented by PLS agreements are indeed prohibitive, as microfinance organizations often do not have the resources to monitor such complex agreements. He explained that even the debt-like murabaha agreement is costly due to rigid regulations from independent accrediting agencies that require the bank to hold onto the purchased commodity for a fixed period of time before disbursal to the customer.

Another challenge with the PLS model is an apparent lack of demand for the product (El-Zoghbi & Tarazi 8). Yancura maintains that there is a severe lack of demand for sharia-compliant instruments in Jordan, evidenced by the fact that only one microfinance institution (the organization he heads) even offers Islamic products. These same sentiments are documented in Jordan's Ministry of Planning and International Cooperation Microfinance Market Study, where research found that only 20.4% of Jordanian microfinance recipients regard sharia-compliance as top priority, while interest rate concerns consistently top the list of priorities (25). This seems to indicate that cost concerns trump religious concerns in practice. Indeed, Alaa Abbassi remarked that while there is certainly interest in Islamic finance, a common response from clients was "Ok, I want sharia-compliant–but where's the cash?" This remark illuminates two residual issues regarding demand for sharia-compliant finance: a lack of education about Islamic financing methods, and significant consumer demand for liquid and flexible financial products that the Islamic finance industry has yet to offer.

Yancura remarked in our interview that while recipients of conventional microfinance often do use their loans for investment purposes, liquid credit products also allow the poor to smooth consumption spending when income gaps occur, which is acceptable as long as the loan is repaid and is mostly invested in productive activity. In its current state, Islamic financial institutions have not developed a product that can allow for the kind of flexibility that the poor require. Financial insecurity is an imposing implication of poverty that breeds a more volatile and uncertain set of circumstances than the average Westerner experiences. Thus, flexibility in financial products is imperative for any viable microfinance industry.

The Future of Sharia-compliant Microfinance in Jordan

Jordan still has a long way to go to bring financing to the MSME sector. In the secular space, Jordan's government has done a lot in the past few years to encourage more lending to this segment. The parliament recently passed a secured lending law that will expand the list of acceptable assets entrepreneurs can use for collateral, while the Central Bank will facilitate preferential loan agreements to institutions lending to MSMEs. Furthermore, Jordan's parliament has licensed an MSME credit bureau that will narrow the information asymmetry gap between borrowers and lenders by allowing MFIs to access and better analyze MSME borrowers' creditworthiness, thus significantly reducing the risk premium associated with lending to this underserved sector ("Private initiatives"). From what I learned on the ground, however, much work could be done on the policy-level to fully encourage Islamic microfinancing.

Indonesia offers a perfect example of a thriving Islamic banking industry, which Jordan could easily emulate if it so chooses. By legislating Islamic banking into prominence, developing the financial infrastructure needed to deal with the industry's unique liquidity needs, and offering preferential loan agreements and prudential incentives to cooperative institutions, Indonesia has taken the measures necessary to ensure viability of a non-interest-based system (El-Ghamrawy 25-27). All of this has been for Indonesia's betterment, where Islamic financing shares a causal positive relationship with GDP growth, much of this generated by MSMEs (Abduh and Omar). If Jordan can incentivize an Islamic banking system through proper regulation like what has been done in Indonesia, profit-loss sharing partnerships can provide access to a diverse credit supply and thereby encourage growth of the vital MSMSE sector.

Moving Forward

For someone who had never been outside of North America, pursuing independent research in the Middle East was an incredible experience. Conducting the research itself was particularly rewarding, but perhaps more transformative were the experiences and discussions I had with everyday Egyptians and Jordanians, especially during such a tumultuous period. Between the June coup d'état in Egypt, the ongoing conflict in neighboring Syria, and the general lack of development in the Middle East, I was exposed to many issues that are completely foreign to the average American. Through this experience I gained a much better understanding of the issues that plague the world. What makes IROP special is that, perhaps if only for a fleeting moment, I felt that I could somehow help solve those issues. My IROP experience not only strengthened my resolve to go back to the Middle East, it reaffirmed my desire to better understand the vast world outside of the West and to devote my life to its progress. While I don't foresee returning to the Middle East in the short term, I hope to begin a career that can invoke the same passion I felt while abroad. Where exactly this will take me, I am not sure, but I am excited to begin the journey.

There are many people I feel obliged to thank for making my first published article a reality. First and foremost, I must thank my UNH mentor, Jeannie Sowers, for her guidance, both formal and informal, during my tenure at the University. As a specialist on the Middle East, Professor Sowers is not only responsible for fostering my interest in the region, but was also instrumental in this research from the beginning: from the initial grant writing process to the editing of this piece almost a year and a half later. Without her mentorship, much of this would not be possible. I am immensely grateful to the staff at the Hamel Center, whose facilitation of IROP made this research possible. Georgeann Murphy, IROP's fearless and charismatic international research coordinator, deserves a special thanks for her constant championing of my cause and inexhaustible positivity–the Program would not be the same without her leadership. Alas, IROP would also not be possible if it weren't for its gracious donors. I must thank Dana Hamel and Ellis Woodward for their contribution to my research with a special thanks to Ellis for always taking a marked interest in my project and continued academic and professional development. Although I was forced to abandon my research efforts in Egypt, American University of Cairo Professor Muhammad El-Komi deserves thanks for agreeing to be my mentor initially and for his early contributions to my research. Additionally, while not formally taking on the role of foreign mentor, Alaa Abbassi of Abbassi Law Offices in Amman deserves much credit for his mentorship and connections, without which I could not have engaged with any of the experts I was lucky enough to speak with–I owe much to him for this research. Finally, to my interviewees, I offer my sincerest thanks for allowing me to pick your respective brains; without you all, much of this research would not exist.

There are also a number of people who, while not necessarily contributing directly to my research, were instrumental in the facilitation of this research in some capacity or another. To Beth Kilinc, my parents and I owe thanks for getting me out of Cairo alive, while fellow political science student and friend Andy Schafer deserves credit for offering up his couch for me in Amman in the weeks ensuing my evacuation from Egypt. Michael Swack of the Carsey Institute deserves acknowledgement for first exposing me to microfinance in his class my sophomore year and for his continued assistance in advising me on a lengthier version of this piece that has effectively served as my thesis. A very special thanks goes to all the friends I made while in the Middle East who made this trip not only edifying, but truly an enjoyable experience. My parents also deserve a little credit for not freaking out and making me come home when the Egyptian army staged a coup d'état–thanks, guys.

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Author and Mentor Bios

Senior **Austin Perea** is an ambitious, socially conscious individual whose experience researching Islamic microfinance has whetted his appetite for future research opportunities. While some individuals caught in the middle of a military coup may have become frightened of travelling abroad, for this native of Derry, NH, travelling the world is (still) part of his long term life goals. Austin will graduate in May of 2014 with a bachelor's degree in economics and political science. His experiences in Egypt and Jordan researching Middle Eastern microfinance were, in his words, "a confluence of all my relevant interests in politics, development, economics, social business, and the Middle East." Austin received an IROP grant to complete his research, and the project resulted in a longer paper, effectively his thesis. Austin is extremely passionate about social responsibility, particularly in business. His outlook on business and life are dictated by his central conviction that his generation has a responsibility to improve the world. Although he regrets not being able to speak with business policy-makers and practitioners while in Cairo, Austin learned a great deal about the dynamic nature of the Islamic banking system, and is pleased to share his finding with readers in Inquiry. Upon graduating from UNH, Austin will begin working as a research associate with Boston Consulting Group.

Dr. **Jeannie Sowers** is an associate professor and the MA program director in the Department of Political Science at the University of New Hampshire. Dr. Sowers has worked at UNH for since 2006, specializing in Middle East and comparative environmental politics. Dr. Sowers has mentored several students conducting field research in the Middle East through the IROP program. Her previous mentees include Trevor Mauck, Chelsea Moyer, and Hannah Lawrence, who conducted research in Morroco and Egypt. She has also mentored several students through theses, INCO courses, and independent studies. Dr. Sowers was an ideal match for Austin's interest in Middle East microfinance, and she sponsored his IROP grant. Dr. Sowers enjoys learning from students as they encounter new ideas and experiences while abroad. She enthusiastically supports student research writing. She, like Austin, was quite surprised when his research was interrupted by an unforeseen military coup, which made his research more challenging than most, as he had to start over in Jordan. Dr. Sowers recognizes the importance of writing for Inquiry for students, noting that, "In political science, you need to be able to make complex political issues accessible for a wider audience. Learning to present your research across disciplines and in multiple venues is an even more important skill with the spread of the internet and social media as important means of communication."

Dr. Sowers also mentored Inquiry author Trevor Mauck (2008).

Austin's foreign mentor, **Alaa Abbassi**, is currently a managing partner at Abbassi Law Offices in Amman, Jordan. He has also served as a policy advisory consultant to CGAP since 2007, where he has led diagnostic assessments and provided technical advice on the legal and regulatory environment surrounding financial inclusion in the Middle East.

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