# POVERTY REDUCTION
## SCALING UP LOCAL INNOVATIONS FOR TRANSFORMATIONAL CHANGE

United Nations Development Programme

# Scaling up Islamic Microfinance in Bangladesh through the Private Sector: Experience of Islami Bank Bangladesh Limited (IBBL)

## Summary


Islami Bank Bangladesh Limited, a private sector Islamic bank, developed the Rural Development Scheme (RDS), an innovative Islamic microfinance channel to answer the demand of the rural Muslim poor in Bangladesh who were left out from conventional micro financing due to religious beliefs. This case study analyses the key enablers that facilitated the expansion of RDS, from a pilot project covering four villages in 1995 to a widely recognized model in poverty alleviation benefiting more than 600,000 people. The RDS scaling up process was made possible by a number of key enablers: cultural environment, a conducive policy environment, institutional and organizational capacity and a dedicated management with the vision to scale up the RDS programme in Bangladesh.

This case study also attempts to promote south-south learning and knowledge exchange by highlighting the lessons learned from RDS which can serve as an example for countries to emulate it in terms of its sustainably and transferability. It also provides some of the challenges that are currently hindering the scaling up of Islamic microfinance programmes in many Muslim majority countries.

# FOREWORD

Scaling up local innovations for transformational change is key to achieving sustainable and equitable development, especially when these innovations are driven by national and local governments and actors. In order to best support countries to scale up proven local successes and achieve transformational changes, the UNDP Poverty Practice of the Bureau for Development Policy (BDP) works to build a solid knowledge base and to discover systematically the enabling environment and drivers for scaling up. In this context, the Poverty Practice has initiated a series of case studies of "scaled up" development cases. Learning from these country cases, we aim to identify key policy, institutional and political enablers and drivers for a successful scaling up process, and to inspire development partners to transform innovations into sustainable development results.

In 2011, the Poverty Practice launched its first series of case studies on successfully scaled up local development innovations from China, Costa Rica, Mexico, Mongolia and Nepal. While the case studies are about a range of different development challenges and responses, from agriculture extension, education, social protection, and micro-finance to energy provision and environmental protection, they all try to address the common question of development effectiveness: *how is it possible to scale up a pilot/seed initiative to achieve larger and sustainable development impact?* The case studies attempt to answer this question through describing the process of scaling up, capturing the key milestones, and distilling the main drivers for success. The common findings of the case studies point to scaling up enablers such as the political vision and commitment, internal and external 'catalysts,' and political, financial and policy enablers, as well as institutional arrangements and human capacities.

The 2012 series of country case studies provide examples of successfully scaled up innovations through usage of inclusive financial systems and leveraging public-private partnerships. Such successes would not have been possible without the involvement and commitment of government agencies, formal financial institutions, NGOs and the private sector. The case studies demonstrate successful examples from middle income countries to low income and least developed countries, including Bangladesh, Bhutan, China, Rwanda, and Timor-Leste. This case study is the second of the 2012 scaling up series. It outlines a successful innovation and scaling up of an Islamic microfinance scheme, Rural Development Scheme (RDS), which was introduced by a private commercial bank that targeted rural Muslim poor in Bangladesh who were left out from conventional micro-financing due to religious beliefs.

The findings of all the case studies will be further utilized in UNDP's ongoing UNDP efforts of strengthening an integrated approach for local development.

The Poverty Practice would like to expresses its sincere gratitude to the country offices and for the private sector and academia partners for their strong support to this initiative. Without their vision and commitment, this work would not have materialized. We also gratefully acknowledge the peer reviewers who helped improve the quality of the case studies, and authors of each country case. Their contributions are acknowledged in each case study. Lastly, in addition to facilitating this initiative, UNDP Poverty Practice colleagues have also compiled and edited all the case studies.

Selim Jahan

Selim Jahan<br>
Director, Poverty Practice<br>
Bureau for Development Policy<br>
United Nations Development Programme

## Contents


| | |
|---|---|
| Summary | 1 |
| Foreword | 2 |
| List of Acronyms and Abbreviations | 3 |
| Introduction | 4 |
| Why is there a need for Islamic Microfinance in Bangladesh? | 7 |
| The Rural Development Scheme (RDS) by Islami Bank Bangladesh Limited (IBBL) | 9 |
| Development of the Rural Development Scheme | 12 |
| Financial viability and sustainability of RDS | 16 |
| Development Benefits of RDS | 16 |
| Scaling Up of IBBL's RDS Programme: Key Enablers | 19 |
| RDS as an Opportunity for South-South Learning | 22 |
| Potential Challenges to the Growth of Islamic Microfinance | 24 |
| Conclusion | 26 |
| References | 27 |


## List of Acronyms and Abbreviations

| | |
|---|---|
| BMT | Bait Maal wat Tamwil (Indonesia) |
| CSR | Corporate Social Responsibility |
| GDP | Gross Domestic Product |
| HMFD | Al-Hudaidah Microfinance Programme (Yemen) |
| IBBL | Islami Bank Bangladesh Limited |
| IBTRA | Islami Bank Training and Research Academy |
| IFC | International Finance Cooperation |
| MFIs | Microfinance Institutions |
| MSME | Micro Small and Medium Enterprises |
| MDGs | Millennium Development Goals |
| NCD | Nationalized Commercial Bank |
| NGO | Non-governmental Organization |
| PRSP | Poverty Reduction Strategy Paper |
| RDS | Rural Development Scheme |
| SMEs | Small and Medium Enterprises |
| RCDP | Rural Community Development Project (Syria) |
| UNDP | United Nations Development Programme |
| VDF | Village Development Fund (Syria) |


## Acknowledgements

This case study was developed by Shams Banihani, Poverty Practice (UNDP), as part of a series of case studies on Scaling up Local Innovations for Transformational Change. Invaluable comments and advice were provided by Tuya Altangerel and Chanmi Kim (UNDP), Mohammad Pournik, Cairo Regional Centre (UNDP), Anuradha Rajivan, Niranjan Sarangi and Bishwa Tiwari, Asia Pacific Regional Centre (UNDP). Special thanks go to Xiaojun (Grace) Wang for her continued support and guidance. This publication was designed by S. Alex Majumder.

Cover Photo: Salman Saeed/UNDP Bangladesh.

## Introduction

According to CGAP (2008) 72 percent of people living in Muslim majority countries do not use formal financial services. Even when financial services are accessible some Muslims view conventional banking products as incompatible with Islamic principles and laws (Sharia law). Some microfinance institutions (MFI) have stepped in to service poor Muslim clients who demand financial products in accordance with Islamic financial principles leading to the development of Islamic microfinance as a new market niche. This new practice has the potential to not only respond to unmet demands of the Muslim poor but also to combine Islamic social principles of caring for the less fortunate. This new niche has the prospective to provide millions of poor Muslims, who reject conventional microfinance products, access to Sharia compliant financial products. It should be noted that Islamic MFIs have not yet materialized in many Muslim countries as commercial Islamic banks have. Islamic microfinance is currently mainly concentrated in Afghanistan, Bangladesh and Indonesia which account for 80 percent of the global outreach.[1]

Recognizing that microfinance can be an important channel in poverty alleviation, Islamic microfinance is increasingly seen, especially in Muslim majority countries, as an alternative to conventional microfinance to alleviate the poor out of poverty. Islamic MFIs have been developed with the sole purpose of providing the poor which have little or no access to capital from the commercial banking sector with viable financial services that are in accordance with Islamic principles. Based on Islamic Sharia principles it is not permissible to charge, pay or receive interest, known as "Riba". The Sharia law does not recognize the time value of money and it is therefore not permissible to make money by lending it. Money must be used to create real economic value in which the providers of the funds are not considered creditors but investors or financiers who share rewards as well as risks with the individual seeking micro financing. This prohibition is the main driving force behind the development of the modern Islamic finance industry, while conventional micro financing is mainly interest-based.

This ban on interest is derived from two essential Sharia principles: i) money has no intrinsic worth. Money is not an asset by itself and can increase in value only if it joins other resources to undertake productive activity. Therefore, money cannot be bought and sold as a commodity, and money not backed by assets cannot increase in value over time; and ii) fund providers (Islamic MFIs) must share the business risk. Providers of funds are not considered creditors (who are typically guaranteed a predetermined rate of return), but rather investors (who share the rewards as well as risks associated with their investment which is based on profit and loss principles).

Moreover, Islamic finance spreads beyond the ban of interest-based transactions. Supplementary vital financial principles encompass the following:

1. Material finality. All financial transactions must be linked, either directly or indirectly, to a real economic activity. In other words, transactions must be backed by assets, and investments may be made only in real, durable assets.

2. No contractual manipulation. Contracts are required to be by mutual agreement and must specify exact terms and conditions. Moreover, all involved parties must have detailed knowledge of the product or service that is being bought or sold.

Another characteristic of Islamic micro financing is that it was founded on the basis of ethical responsibility while promoting economic justice. To this end, the system places the responsibility on the financer (Islamic MFI) and the borrower (entrepreneur), as they both share the risks and benefits associated with the financial transaction. Many Islamic microfinance programmes also integrate the zakah principles (act of giving) in their financing model to ensure that the extreme poor are not left out. This is done by providing interest free-loans (Qard-hasan) to the poor by utilizing the funds provided through zakah (See table 1 which compares Islamic MFIs versus conventional MFIs).

The most used Islamic microfinance products by Islamic commercial banks and Islamic MFIs are illustrated in Box 1.

1 Nimrah Karim, Michael Tarazi and Xavier Reille, "Islamic Microfinance: An Emerging Market Niche," CGAP, Focus Note, No. 49: 1, (2008), accessed 25 April, 2012, *www.tinyurl.com/cgap-fn49*.

### Table 1: Differences between conventional MFIs and IMFIs

| | Conventional MFIs | Islamic MFIs |
|---|---|---|
| **Sources of Funds** | Foreign donors, multilateral and national agencies, government, central banks, savings of clients | Religious institutions, Islamic charitable sources, savings of clients, foreign donors, national agencies, private sector |
| **Mode of financing** | Interest-based | Non-interest bearing financial instruments |
| **Financing the poorest** | The extreme poor are usually left out of the financing model | The extreme poor are integrated in the financing model by integrating the Zakah (act of giving) principles in the model |
| **Funds transfer** | Cash | Goods |
| **Deductions at inception of contract** | Percentage of funds deducted from principle | No deductions from principle |
| **Methods of dealing with defaults** | Group/centre pressure | Group/spouse guarantee, and Islamic ethics |
| **Social development programme** | Secular, ethical and social development | Religious which includes behaviour, ethics, and social values |

***Source:*** *Habib Ahmed, 2002, Financing Microenterprises: An Analytical Study of Islamic Microfinance Institutions.*

### *Box 1: Islamic microfinance products*

**Murabaha Sale (cost plus markup sale contract).** Murabaha is an asset-based sale transaction used to finance goods needed as working capital. Typically, the client requests a specific commodity (tangible good) for purchase, which the financier procures directly from the market and subsequently resells to the client, after adding a fixed "mark-up" for the service provided. However, ownership of the commodity (and the risk inherent thereto) strictly lies with the financier until the client has fully paid the financier. In most cases, clients repay in equal instalments. The mark-up is distinct from interest because it remains fixed at the initial amount, even if the client repays past the due date.

**Musharaka and Mudaraba (profit and loss sharing).** The profit and loss sharing (PLS) schemes are the Islamic financial contracts most encouraged by Sharia scholars. Musharaka is equity participation in a business venture, in which the parties share the profits or losses according to a predetermined ratio. Musharaka can be used for assets or for working capital. Mudaraba denotes trustee financing, in which one party acts as financier by providing the funds, while the other party provides the managerial expertise in executing the project. In mudaraba, profits are shared according to a predetermined ratio; any losses are borne entirely by the financier. If the mudaraba joint venture results in a loss, the financier loses the contributed capital and the manager loses time and effort.

**Ijarah (leasing contract).** Ijarah is a leasing contract typically used for financing equipment, such as small machinery. Duration of the lease and related payments must be determined in advance to avoid any speculation. For the transaction to be considered Islamic (and not a sale with camouflaged interest), the ijarah contract must specify that the ownership of the asset, and responsibility for its maintenance, remains with the financier. An ijarah contract may be followed by a sale contract, in which event the ownership of the commodity is transferred to the lessee.

**Takaful (mutual insurance).** The equivalent of Islamic insurance, takaful is a mutual insurance scheme. The word originates from the Arabic word "kafala," which means guaranteeing each other or joint guarantee. Each participant contributes to a fund that is used to support the group in times of need, such as death, crop loss, or accidents. Paid premiums are invested in a Sharia-compliant manner to avoid interest.

***Source:*** *CGAP, Islamic Microfinance: An Emerging Market Niche, Focus Note, No. 40, 2008.*

*Photo: Md. Akhlas Uddin/ UNDP Bangladesh.*

Based on Islamic doctrines of social and economic justice, ethics, wealth distribution and public interest; Islamic microfinance advocates economic empowerment through entrepreneurship, risk sharing and financial inclusion. It also contributes to the reduction of inequalities in income and wealth. Thus, there is a great potential for Islamic micro financing to improve the business environment for small and medium enterprises (SMEs), empower women and accelerate the achievement of the Millennium Development Goals (MDGs).

In light of the above, conventional microfinance did indeed make headways in many countries. Approximately 44 percent of their clients reside in Muslim majority countries; however conventional microfinance was unable to fulfil the needs of many poor Muslim clients due to the above religious restrictions that prohibit financial transactions that involve interest, 'Riba'. Aside from the low availability of Islamic microfinance, recent studies are increasingly suggesting that conventional microfinance may not have fully met its objectives in graduating the poor out of poverty. This is attributed to the following factors:

1. **Distorted Information:** The main objective of targeting poor women as recipients of loans is to empower and engage them in income generating activities. However, in reality, the receivers of the funds are not necessarily the users of the funds. It has been reported that male household members are usually the initiators of taking loans and they tend to control the funds received by the female borrowers. Rahman (1999) reported that such targeting by MFIs creates tensions within the households and even increases violence against women. Once the loans are obtained by the female members, who are responsible for the repayments, male members tend to utilize such funds usually on non-income generating activities. This further adds pressure on women who are constantly being pressured by MFIs to repay the loan instalments, thus, increasing the likelihoods of loan defaults leading families to spiral further into poverty.

2. **Economic Sustainability of MFIs:** Due to the lack of resource mobilization and the high administrative costs, many MFIs are not economically sustainable in the long run. According to Ahmed (2004) administrative costs of five MFIs in South Asia range from 24 percent to more than 400 percent per dollar lent. He also added that Grameen Bank would operate at a loss without grants, and for it to breakeven without subsidies it would need to increase its interest rate by an additional 21 percent. In this context, many MFIs are at risk of long term instability without grants and subsidies.

3. **Debt Trap:** Since some of the loans received from MFIs by borrowers go to non-income generating activities (ex. household expenses), these borrowers (mostly women) take loans from other sources to pay their instalments (including interest incurred) thus trapping them further into poverty and in a spiralling debt cycle.

4. **High Drop-out Rate and Non Graduation from Poverty:** Several studies report that conventional MFIs do not necessarily service the very poor. They are either not given loans or drop out of the credit scheme.[2] Furthermore, some studies indicated that MFIs do not necessarily enhance the income level of the poor, and the current operations of those MFIs are not very effective in improving the livelihoods of the extreme poor. Also, financial services alone do not lift the poor out of poverty. They need to be combined with services that add to the accumulation of the poor people's human, social and natural capitals.

Despite the strong demand for Islamic microfinance products and services, the growth of the sector has been slow. This is mainly due to the fact that Islamic microfinance services are generally provided by non-governmental organizations (NGOs) who may not possess the adequate technical expertise or funding to ensure the proper implementation and sustainability in servicing the very poor. On the contrary, the Islamic commercial banking sector, which provides Islamic products to the non-poor, has seen tremendous growth in the past three decades.

2 Dropout rates for Grameen Bank, BRAC and ASA and other conventional MFIs in Bangladesh range between 10 and 15 percent per annum. (Richard L. Meyer, 2001).

Not only do Islamic commercial banks have the adequate technical expertise and capacities, but they are also increasingly becoming more resourceful and have been expanding at a fast rate. Unfortunately, the vast majority of Islamic commercial banks do not service the poor nor do they share their technical knowledge and expertise with Islamic MFIs.

In this context, it is necessary for national and local governments to introduce policies, encourage and provide incentives to Islamic commercial banks to start investing in the poor, share their knowledge, and to extend their services to unprivileged clients in order to lift communities out of poverty. Bangladesh is a prime example in which an Islamic commercial bank has introduced a microfinance window for the poor which is now operating in 61 out of 64 districts benefiting more than 600,000 people to date.

## Why is there a need for Islamic Microfinance in Bangladesh?

Islam is the official religion in Bangladesh, and it is the third largest Muslim country in the world in which 90 percent of the population belong to the Muslim faith. Islamic finance emerged in 1995, comprising of mostly Islamic commercial banks, a few Islamic NGOs and financial cooperatives. In 2010, it was estimated that 43.3 percent of the people living in Bangladesh live below the poverty line and more than 11 percent live in absolute poverty. The number of poor was 78.2 million in 1970 but by 2009 the number increased to 80.46 million.[3] They suffer from acute rural-urban economic disparity coupled with lack of adequate education and lack of proper health and sanitation facilities.

Bangladesh's economy is an agrarian economy with the vast majority of the population living in rural areas. The agriculture sector has not been able to provide decent employment to all rural people. The vast human resources have remained underutilized due to lack of education, access to land and natural capitals, vocational training, but most importantly economic opportunities especially among women. This vicious cycle the poor are caught in, has resulted in increased levels of inequality, uneven

3 World Bank, *World Development Indicators, 2009*, (2009).

distribution of income, and geographical growth with major risks to internal and external economic shocks.

In light of this, poverty alleviation and creation of employment opportunities especially for rural women and youth were prioritized in the government's development agendas. The government of Bangladesh has adopted a broad-based approach to poverty alleviation by putting more emphasis on macroeconomic stability, economic liberalization, and giving support to government agencies, NGOs and the private sector. Thus, micro credit or microfinance in its wider dimension became a much favoured intervention for poverty alleviation and was seen as an approach to alleviate rural poverty.

As a result, over 20,000 NGOs and MFIs are registered with the Bangladeshi Department of Social Affairs and have been working in poverty alleviation since the independence of Bangladesh in 1971. However the degree of success of those NGOs and MFIs in poverty alleviation through socio-economic means has been somewhat debatable. The sustainability of microfinance NGOs mainly depends on foreign grants and to some extent government grants. However due to funding fluctuations, high administrative and operational costs, NGO and MFIs, including Grammen Bank, tend to charge high interest rates, ranging from 20-35 percent, forcing the poor to dispose any assets they may have in order to repay their loans.

As an alternative, the government tried to introduce microfinance initiatives through its nationalized commercial banks (NCBs), however, NCBs outreach to the poor, especially the rural poor, was very low and unsuccessful. This was mainly due to weaknesses in the design, planning and management of such programmes combined

interest rates. With their greater socio-economic and political power, the non-poor were able to gain access to credit in a much easier manner than their poor counterparts, thus crowding out the latter. For example, the Special Agriculture Credit Programme in Bangladesh which was introduced and operated by the government fell under this trap.

Government programmes that attempted to make use of conventional banks to provide credit to the poor, often in the form of directives, have generally been unsuccessful. This is because they did not provide satisfactory incentives for the banks to make adequate profit from their loans to the poor.[5] Not only were the incentives low, but the costs associated with providing credit to the poor also proved to be very labour intensive with high transaction costs and risks. Additionally, the interest ceilings introduced in such programmes were not sufficient to generate enough profit to sustain the service delivery in comparison with the profits generated through alternative capital outlets. Understandably, conventional banks did not find such financial services to be profitable, and therefore, were discouraged from participating in such programmes.

Conventional banks that took part in the Special Agricultural Credit Programme for the poor for example, channelled the programme's loans to the rural elite. Additionally, politicians and influential figures were influencing the selection of beneficiaries, which in most cases, where not those who need it most, poor women and men. Even in cases where the poor were targeted, the banks were requesting collateral which the programme has specifically already waived. The lack of an appropriate and transparent credit delivery mechanism was a major contributor the programme's failure.