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Microfinance: A New Reach for Islamic Banks in Turkey

Muhammad Abunnaja*
Internal Auditor at Central Bank of Libya, P.O. Box 1103, Tripoli, Libya.
Certified Islamic Professional Accountant (CIPA)

Abstract:

Microfinance has been recognized by the World Bank as an approach to address poverty and income inequalities, where the social and economic problems of developing communities raised a global challenge to carry the mission of poverty alleviation. Recent researches argues that many elements of microfinance are considered to coincide with the Islamic banking broader goals, and thus, Islamic banks can be a more effective and efficient provider of financial services to the poor. The paper investigate the Islamic finance nexus with microfinance program and initiates a consideration which triggers and motivates further research and debates exploring more potential for Zakah and Waqf integration in microfinancing schemes. An application of a not for profit based microfinance model is more convenient and more befitting the ultimate and conclusive goal of microfinance according to the paper, several arguments standing in support of this believe will be discussed. Statistics shows that in 2014, 15% of the Turkish population was below poverty threshold, leaving the participation banks in Turkey with a responsibility to comply with the social objective of Islamic Finance and positively contribute as an efficient and dynamic provider of microfinance services and serve the mission of poverty alleviation. A Joint venture between the participation banks in Turkey is proposed with a strategic partnership with reputable charity institutions, in which a collaboration to establish a separate not for profit based institution to provide microfinance services.

Key Words: Microfinance, Islamic Finance, participation banks, Zakah, Waqf.

1. Introduction

Microfinance has been recognized globally as an effective and efficient tool for poverty alleviation, where it aims primarily to assist the poor to become economically independent (Rahman, 2007). Recent researches argues that the social objectives of Islamic Finance qualifies Islamic banks to be a more effective and efficient provider of financial services to the poor (Dusuki, 2007). Microfinance provides participation banks in Turkey a new domain to demonstrate its uniqueness as an Islamic Financial Institution and to confirm with its broader social responsibility.

The paper will be organized in the following manner:

1. The second section introduces briefly microfinance and Islamic finance and review available literature on Islamic microfinance.

2. Section three initiates a consideration which triggers and motivate further research and debates exploring more potential for Zakah and Waqf role in microfinancing, and hence, for poverty alleviation.

3. In section four, a proposed not for profit based model of Islamic microfinance is discussed where participation banks in Turkey could comply with the social objective of Islamic Finance and positively contribute to the mission of poverty alleviation.

4. Section five concludes the paper.

2. Literature review

2.1 Microfinance

Microfinance is platform where funds are effectively mobilized to outreach a wider range of poor people who normally do not have access to those funds.

The main and basic concept of microfinance, as explained by the Nobel Peace Prize winner Dr. Muhammad Yunus is that credit is a fundamental human right (Rahman, 2007). Traditional commercial banks and Financial Institutions consider poor people as non-creditworthy due to their high default risk and lack of collateral; as a result microfinance developed to satisfy this fundamental human right, Grameen Bank in Bangladesh in the

1970s is extensively believed to be the leading player in highlighting the immense potential of microfinance in extirpating poverty and giving rise to development.

The 1980s and 1990s witnessed an improvement throughout the world and showed that financing the poor is achievable, the General Secretary of the United Nations declared 2005 as the International year of Microcredit, however; poverty alleviation seems not to be an easy mission, according to Wilson (2007), poverty eradication is a complex expedition where social factors play a substantial role, including discrimination and lack of knowledge that continues from generation to generation.

Prominent and innovative features of microfinance are social intermediation where human capital is developed and invested in order to increase its capacity and prepare the beneficiaries to involve into formal financial services (Dusuki, 2007), programs have been developed by most of Microfinancial Institutions to raise consciousness through imposing behavioral changes, moral teaching and social customs as a prerequisites to receive the financial services (Ahmed, 2004). Group lending is another key feature, where a formation of a group of people with common interest in financial needs are giving a loan under the condition that a default from one of the group will deprive the whole group from receiving a second payment of the loan which impose peer pressure and peer monitoring among the group individuals, thus minimizing transaction costs related to monitoring and reduce default risk and serving as a social collateral.

Ahmed (2004) points out to a number of constrains facing the Microfinancial Institutions, in particular, the problem where the use of the loans advanced from the bank is diverted from its productive purpose to a consumption purpose which may increase the risk of default; besides increasing the rate of default this paper argues that it may divert the whole process from its core aim, that is for the poor to increase their income and prosperity by engaging into productive activities. A second problem mentioned by Ahmed (2004), is the viability of the Microfinancial Institutions where as he claims that recent studies demonstrate that most of the Microfinancial Institutions do not operate at a profit; a problem which support this study claim – among other reasons will be discussed in the due course - of operating microfinance activities in a not for profit scheme is more convenient and compatible. Other problems pointed out by Bennett (1998) in a study mentioned by Ahmed (2004) that accentuate the asymmetric information includes poor infrastructure. Concerns have been raised about the issue of high transaction costs related to searching and monitoring costs imposed by the asymmetric information problem (Dusuki, 2007), as well as the costs of training and preparation of the customers for receiving the loan as part of the social intermediation aspect of the microfinance process.

The microfinance does not include within its target group those who are mostly in need of food and health security; but instead it includes those who live at the border of the poverty line and have entrepreneurial skills with the lack access to formal finance (Segrado, 2005). However; possessing an entrepreneurial skills might be a condition that denies people lacking such skills from the opportunity to obtain proper home, education, health care and other wide range of financial services in order to improve their quality of life, a condition that this study may argue is not necessary, and will suggest latter a model where a more comprehensive and inclusive finance is achievable.

Two state banks provides microfinance services in Turkey which are Halk bank and Ziraat bank along with two NGOs, Turkish Grameen Microfinance program (TGMP) and Maya Enterprise for Microfinance (Maya) according to Turkey Islamic Finance Report 2014; according to the report estimated 5 million potential clients for microfinance services and only penetration rate estimated at 19%.

2.2 Islamic finance

The Islamic finance concept aroused from the ban of (Riba) usury in the Quran, where the logic behind this ban according to Dr. Yusuf Alqaradawi – A well-known Muslim scholar – is that money do not generate money, labor and effort is crucial in order to generate money (Alqaradawi, 1994, p.38). During the last four decades alternative methods have been developed to satisfy the financial needs of the Muslims community, using traditional trade contracts to innovate modern financial product where assets and real investment are involved and principles of profit and loss sharing, risk sharing, and bearing risk of ownership among others were key features of Islamic finance.

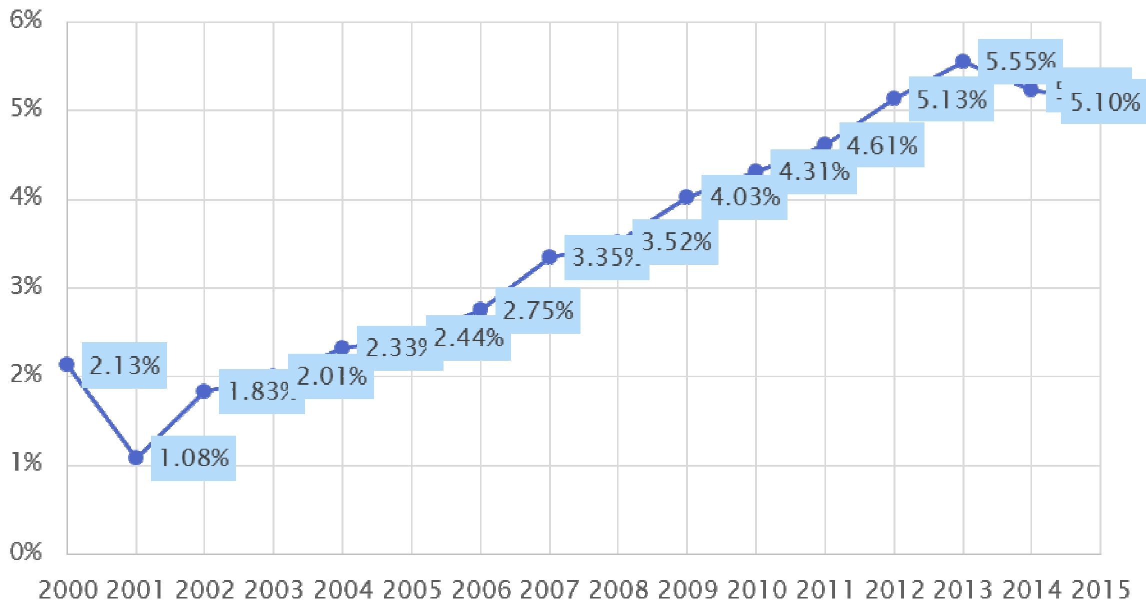
Islamic financial Institution begun to exist from the early 1960s, and major expansion in Islamic banking activities started in the 1970s, Islamic Development Bank was established by the Organization of Islamic Countries (OIC) (Rahman, 2007). Later in the 1990s Accounting and Auditing Organization For Islamic Financial Institutions (AAOIFI) was established by an agreement signed by Islamic financial institutions on the 26th of February in order to harmonize the Islamic finance industry by setting a number of Accounting, Regulatory, Corporate governance and Sharia standards which helped the industry among other factors to gain international recognition, in the last decade the interest in Islamic banking has increased not only in Islamic countries but also throughout the world, Chartered Institute of Management Accountants (CIMA) one of the world's largest and leading professional body of management accountants based in the UK have adopted a Diploma in Islamic finance qualification, Islamic financial industry grew at an annual rate of 10 – 12 % over the past decade, with assets estimated roughly at 2 trillion US$ according to the World Bank.

In Turkey a five year Cumulative Asset Growth Rate of 29% faster than conventional banking with market share of 5.6% according to the World Islamic Banking competitiveness report of 2013-2014 which makes Turkey one of the six Islamic rapid-growth markets that constitutes 78% of the international Islamic banking assets.

Until 2005 Participation banks – the terminology used for Islamic banking in Turkey due to the secular sensitivity of the constitution – was not recognized in the Turkish legal framework as banks, but as special finance house instead, the 2005 banking law was the first legal adoption of Participation banking. The pioneer for Participation banking in Turkey was Albaraka Turk established in 1984, followed by TurkiyeFinans, KuveytTürk and Bankasya.

The following graph shows the increase in the market share from year 2000 to year 2015, where the horizontal axis represents the years and the vertical axis represents the market share percentage, as we can see the rate continues to increase after a drop from 2.13% in 2000 to 1.08% in 2001 to reach 5.55% in 2013, growing annually between 0.11% to 0.75%, showing another drop to 5.1% in 2015 but with an overall growth of 4% as the graph from the Participation Banks Association of Turkey (TKBB) demonstrate.

Figure1: Market Share of the participation banks from 2000 to 2015



Source: Adapted from the Participation Bank Association of Turkey (TKBB), 2015. Retrieved from http://www.tkbb.org.tr/

In the following sections of this study we will attempt to illustrate and suggest a model where Islamic Finance in Turkey could lead a role in microfinance initiative.

2.3 Islamic microfinance

Ahmed (2004) claimed that the social role of Islamic banks is a fundamental distinguish from its conventional counterpart, and thus; it does not befit the Islamic banks not to be involved in microfinancing activities and schemes, he argues that Islamic banks can be a more effective and efficient provider of financial services to the poor, Microfinance approach are considered to coincide with the Islamic banking broader goals according to Dhumale and Sapcanin (1999). Barakat, Samhan, & Al-Nsoor (2014) consider Islamic finance industry short from success as long as social responsibility is not within its attention priority. Ahmed (2002, table2) briefs a number of differences between Conventional and Islamic Microfinance Institutions as shown in the following table:

Table1: Differences between Conventional and Islamic Microfinance Institutions

	Conventional MFI	Islamic MFI
Liabilities (source of funds)	External funds, saving of clients	External funds, saving of clients, Islamic charitable sources
Assets (Mode of financing)	Interest-based	Islamic Financial Instruments
Financing the Poorest	Poorest are left out	Poorest can included by integrating zakah with microfinancing
Funds transfer	Cash given	Good transferred
Deductions at inception of contract	Part of the funds deducted at inception	No deductions at inception
Target group	Women	Family
Objective of targeting Women	Empowerment of women	Ease of availability
Liability of the loan (when given to women)	Recipient	Recipient and spouse
Work incentive of employees	Monetary	Monetary and religious
Dealing with Default	Group/center pressure and threats	Group/center/spouse guarantee, and Islamic ethics
Social Development Program	Secular (or un-Islamic) behavioral, ethical, and social development.	Religious (includes behavior, ethics, and social)

Source: [Ahmed 2002, table2]

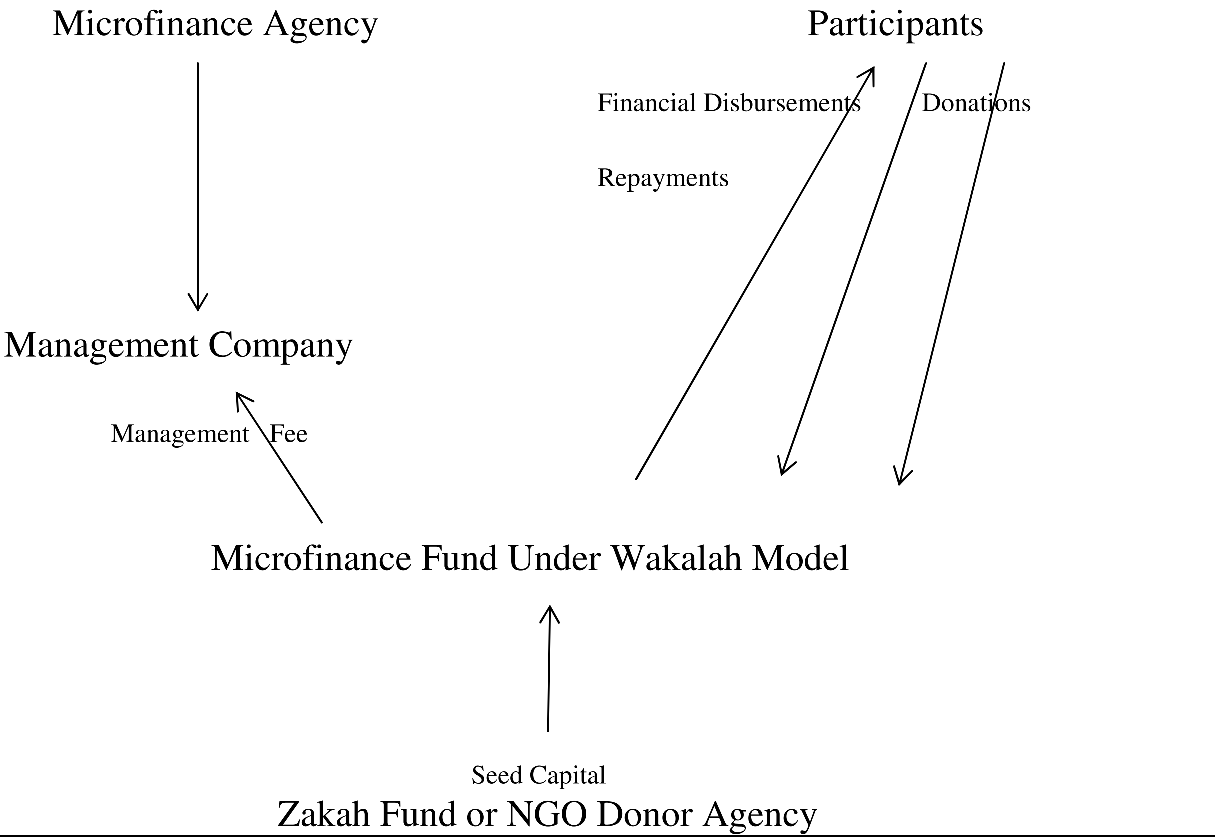
The table mentions some important differences between Islamic and Conventional microfinance, two in particular are considered to be key differences, the first difference is the target group, women being the most targeted by conventional microfinance in order to empower them and increase their participation among labor force, however, arguments raised by Nuruzzaman (1997) and Rahman (1999) as cited by Kaleem and Ahmed (2009) that socioeconomic problems and family tension and violence with high divorce rate are created by such empowerment, creating an environment where both male and female members of the family could cooperate is a better approach as suggested by Sadeq (2007) in a study mentioned by Kaleem & Ahmed (2009), therefore Islamic microfinance mostly targets the family in order to create a healthy environment of solidarity and care. Second difference is about the type of funds transferred, as conventional microfinance transfers cash creating the problem where the use of the loans advanced from the bank is diverted from its productive purpose to a consumption purpose, Islamic microfinance involves goods and assets, thus ensuring the productive usage of the funds.

Ahmed (2004) argues that financing microentrepreneurs through Islamic banks rather than specialized microfinance programs is more compatible and economically viable, fixed costs (rents, utilities, etc.) could be saved by using the Islamic bank existing branches, in addition it will not require a whole range of professionals at the top level reducing its operational costs. Wilson (2007) propose a Wakalah model that mimics the model widely used by Islamic Takaful schemes, in this model only the participants are entitled to financial disbursements from the fund, in return they donate to the fund under “tabarru” contract a term that literally means donation and refers to solidarity and stewardship, management is remunerated by a fixed fee. In order to prevent the depletion of the funds a rationing mechanism in prioritizing who can use their entitlements first is necessary, this raises the mater of transparency in showing how funds are allocated to ensure exploitation by management is eliminated and all participants are fairly approached, evaluating the business schemes presented by the participants is the main criteria in prioritizing who can use their entitlements first as proposed in Wilson’s Wakalah model, the funds are originated from five sources:

1. Donations from the participants giving them membership privileges.
2. Application fee when applying for financial support and management fee when obtaining the fund.
3. Repayments of obtained funds by participants.
4. Subsidies either from a NGO donor or from Zakah fund.
5. Income made on the financial assets held in the fund.

Figure2 below illustrates the Wakalah Model proposed by Wilson (2007):

Figure2: Wakalah Model



Source: Chart adapted by Rodney Wilson from a takaful structure (Wilson, R. 2007)

Questions could be raised about this model concerning the possibility of exploiting the participants by management, and the viability of the donations as a source of funding, and the deprivation and financial exclusion of a wide population who could not obtain membership of the Wakalah institution.

Despite the believe that Islamic finance can deliver microfinance services more effectively, however, CGAP survey conducted in 2007 shows that the outreach of Islamic Microfinance limited to only 300,000 clients through 126 institution in 14 countries, and over 70% of the products offered are murabaha, the results are discussed in more details in a study by Karim, Tarazi & Reille (2008).

While almost every study on the subject mentioned the opportunity of utilizing Zakah and Waqf in the Islamic microfinance models, however, no substantial discussion of the issue was done, Zakah is not merely a simple form of charity rather than a complete system where the channels of distribution are specified, and a fruitful and sophisticated literature have been developed by major Islamic schools throughout centuries, addressing the criteria of eligibility for Zakah and the principles and methods governing its collection, and the same applies for Islamic Waqf, therefore integrating both Zakah and Waqf in microfinancing activities requires a thorough and sound discussion, a mission this paper does not claim its accomplishment, however, it initiates in the following section a consideration which triggers and motivate further research and debates exploring more potential for Zakah and Waqf role in microfinancing, and hence, for poverty alleviation.

3. Zakah and Waqf integration in microfinance scheme: A theoretical discussion

3.1 Zakah

Zakah the third pillar of Islam is a financial obligation for Muslims where a determined share or percentage of wealth is disbursed to the poor and other Zakah distribution channels, this demonstrate the great emphasis on poverty alleviation and reduction in Islam and Islamic economic and financial system, Dr. Yusuf Alqaradawi in his book Fiqh Al Zakah - which became a main reference in this matter – illustrate that Zakah is a state implemented system where it tax the rich to give the poor and needy, and help in narrowing the gap between the have-nots and the haves where Zakah “ does not only provide relief to the poor but aims also at making the poor owns mean of production” (Alqaradawi, 2000, p.183).

Alqaradawi spreads a whole chapter - in his book mentioned above - for the discussion on the poor and the needy and their criteria that makes them eligible for Zakah, and it is worthwhile to draw attention to the argument of the eligibility of a full time student for Zakah, where perusing knowledge eventually will be for the benefit of the society, the student who devoted his full time to acquire a branch of knowledge and could not afford the cost of the education, or generate income in order to satisfy his essential needs, Zakah may be given to assist him or her to achieve this purpose including the cost of the books and the education fees. Scholars argue that seeking marriage and starting a family is also a legitimate purpose for Zakah, as maintaining the continuity of mankind through marriage is an object of the Islamic society in which an obligation of providing assistance is a must to those who lack the necessary financial resources (Alqaradawi, 2000, part four: Chapter one). It is obvious through the preceding discussion that Zakah is not only aimed to poorest of the poor, and could be only utilized for their basic needs as Dusuki (2007) states in his study, denying the capability of Zakah as a sustainable tool for financing productive activities as well as providing other financial services beyond basic consumption purpose.

Two major trends among Muslim jurists views in how much should the poor and needy be given, the first is to give what satisfy his needs, while the other is to give a certain amount, and Alqaradawi in his book favors the first trend where he notes that “The first trend seems to be more consistent with texts and objectives of Zakah” (Alqaradawi, 2000, p.12), and among this trend a question raised is whether to satisfy his needs for life time or for just one year, Alqaradawi – still gives room for the one year satisfaction opinion by stating it may be sometimes best when applied in the proper area - again adopts the satisfaction of the needs for life time where he argues “This opinion aims at giving the poor what is sufficient to remove them from the poverty level forever, in such a way that they would not need Zakah in the future.” (Alqaradawi, 2000, p.12). A goal, microfinance - according to Dr. Asyraf Dusuki in his study - should eventually aim to achieve by preparing groups to engage solid business relations with form financial institutions (Dusuki, 2007). In determining definition of the satisfaction of essential needs, Alqaradawi (2000) concluded that education, health care besides food and shelter and other social needs that can only be determined by time and locale.

Shams al Din al Ramli says as mentioned by Alqaradawi (2000) in his book that the poor “may be given a capital investment whose returns would be sufficient for their maintenance” (p.12), and not cash. One of the distinguishing features of Islamic microfinance from conventional microfinance (Ahmed, 2002).

The Quran mentions the distribution channels of Zakah as follow “That would have been the wise course. The sadaqat are for the poor and the needy, and those employed to administer the funds, for those whose hearts have been recently reconciled to Truth, for those in bondage and in debt, in the cause of God, and for the wayfarer. Thus is it ordained by God, and God is full of knowledge and wisdom." Al Tawba, 9:58-60.

Among these channels the poor and the needy, those employed to administer the funds and those in debt fits in the context of Islamic microfinance scheme, and serve as a base for legitimizing the integration of Zakah in a proposed structure of Islamic microfinance. Where the poor and the needy is a direct obvious target of the microfinance program, the employed to administer the funds would be the management of the Islamic microfinance Institution. Ownership of Zakah funds should be transferred to the eligible recipient with no liability to repay the fund back, as the distributing institution does not own the Zakah fund according to most Shari’ah scholars view, which makes Zakah funds not appropriate for financial products, Dr. Ali Qaradhagi -the general secretary of the International Union of Muslim Scholars (IUMS) - in response to the permissibility of using Zakah in microfinancing, contended that normally no liability originates from Zakah funding, however; in a recent research he conducted he concluded that Qard-Hassan could be used utilizing Zakah fund under the condition that when the institution responsible for distributing Zakah terminates the fund should be giving to the eligible Zakah recipients as a grant with no liability (personal communication, April 5, 2016). Salem Elsheikhy a member of IUMS highlighted the permissibility of using Zakah to hedge the risk of default facing the microfinance institution, as those who are in debt are legitimate recipients of Zakah, after a case of insolvency of Islamic Microfinance client is proved to be real eliminating cases of fraud liability (personal communication, April 5, 2016), the Zakah fund could be used to pay the clients debt as a legitimate Zakah channel, and thus, mitigating risk of default for the Islamic Microfinance Institution.

From the preceding discussion a conclusion of a potential harness of Zakah in microfinance activities could be summarized in the following points:

1. A free interest loan (Qard-Hassan) to satisfy a variety of needs for legitimate Zakah recipients, for example education, health care, and marriage as well as some productive activities.

2. A default risk mitigating tool utilizing the distributing channel of those who are in debt.

3. To cover part of the operating costs by covering part of the management fees for taking responsibility of administrating the Zakah fund utilizing the distributing channel of those employed to administer the funds.

3.2 Waqf

Waqf is to confine an asset of a perpetual nature to a certain philanthropic causes (Kaleem & Ahmed, 2009) a wide variety of philanthropic causes could be applied using Waqf concept, Waqf to Education, charity, health care, religious and social causes; according to Ahmet Albaqori the Egyptian minister of the Awqaf in his speech in the Egyptian parliament (1985) as cited by Alqaradawi (2015) a famous Waqf in the Islamic history was confined for angry wives, where an accommodation with daily food is available for them until they reconcile with their spouses and return to their home, also Waqf for broken ceramics where the servants who broke a ceramic and are afraid of their masters could bring the broken ceramic and replace it with a new one.

Immovable property is recognized as valid for Waqf by the majority of Muslim jurists due to its perpetuity nature, this perpetual nature is not clear in cash for most of classical jurist and thus, cash is not a valid source of Waqf according to those jurists, however, few of the past jurists and more contemporary scholars found cash Waqf permissible for the purpose of loans and investment (Mohammad, M. T. S. H. 2011), According to Shari'ah standard (33) issued by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) it is admissible for cash to be an object of Waqf on the condition that the principal amount of cash Waqf should be invested in order to maintain its perpetuity and the proceedings from the investment should be expensed to the Waqf objective.

Based on the above discussion the Islamic Microfinance Institution could utilize Waqf fund on the basis of Mudarabah contract providing liquidity to microfinancing activities, however, more safe and low risk investments should utilize Waqf funds.

4. Islamic Microfinance: a proposed model

4.1 Profit based vs. Not for profit based Microfinance model

Obaidullah and Khan (2008) Suggest a composite model where both not for profit and profit based features could be utilized, in his model the necessary needs are extended to the poor who falls in the category of economically inactive as grants forwarded from Zakah and Waqf funds, along with their basic needs programs of skills training are provided, after which beneficiaries graduate into profit based financing services. However; according to this paper applying a not for profit based microfinance model is more convenient and more befitting the ultimate and conclusive goal of microfinance, several arguments stands in support of this believe:

1. Economic viability of Microfinance Institutions: As mentioned above by Ahmed, (2004) most Microfinance Institutions are not profitable, thus advertising the idea of microfinance as profit scheme while serving the poor does not make a strong case and could be misleading.

2. Conflict of interests: Profit generating interest for Microfinance Institutions could place pressure on management, and thus diverting their attention from poverty alleviation interest, making them more conservative in client selection and eventually the funds might end up concentrating in the hands of skillful entrepreneurs with solid innovative business ideas and right relations; depriving the poorest from financing opportunities and mutating microfinance from its main course.

3. High financing costs: Profit based microfinance programs could charge high rates to compensate for the high administrative and transaction costs due to asymmetric information associated with microfinancing activities, Mannan (2007) pointed out in a study mentioned by Kaleem & Ahmed (2009) that Grameen Bank the pioneer of microfinance charges interest rate up to 54.95% on its loans if all hidden charges are included. This consequently increases the financing cost of the poor entrepreneurs making their business economically not viable making it difficult to compete in the market.

4. Zakah and Waqf convenience: The utilization of Zakah and Waqf funds in a not for profit microfinance programs could be more appropriate and more convincing to Muslim scholars and to Zakah and Waqf fund trustees rather than the profit microfinance model.

5. Ethical dilemma: Arguments could be raised questioning the ethical issue of exploiting the poor and profiting on their expense. Debates might extent to the indictment of most of the socially responsible schemes of merely using marketing techniques to attract new clients (Segrado, 2005).

Based on the preceding discussion, this paper suggest that a not for profit based microfinance model is more compatible, the objective of such an institution is the maximization of social benefits and increasing the financial inclusion where generating profit is not out of question, but instead being with less priority, and used to self-finance the Microfinance Institution in order to provide and maintain a sustainable financial services fighting against poverty and financial exclusion.

4.2 Islamic Microfinance products

A number of Sharia compliant financial products were proposed as effective and efficient instruments for conducting the microfinance activities, with Murabaha and Mudarabah being the most prominent products mentioned in most of the studies. In this section the paper will refer to some Islamic financial instruments that could be utilized in microfinancing activities with the emphasis on useful features beneficial to the Microfinance program:

1. Murabaha to the Purchase Orderer:

The definition of Murabaha according to Appendix (B) of the Financial Accounting Standard No. (2) (FAS (2)) issued by AAOIFI is a “sale of goods at cost plus an agreed profit markup.” This requires a full transparent disclosure of the cost incurred by the seller, Murabaha to the Purchase Orderer is defined according to the same appendix mentioned above as “an agreement according to which the orderer asks the purchaser to purchase an asset of which the latter will take legal possession. The orderer promises the purchaser to purchase the asset from him and give the ordered a profit thereon.” The Islamic Microfinance Institution act as the purchaser and the client act as the orderer, the purchaser should first acquire the asset under a valid sale contract between him and the vendor of the asset, after taking legal possession of the assets and risks of ownership are transferred to the purchaser, a new sale contract between the purchaser and the orderer according to the same conditions of the first mutual promise is conducted, where the settlement of the price could be done in installments, a complete ownership of the asset is transferred to the orderer once the sales contract takes place, and the full settlement of the price as a condition for legal possession as mentioned by Dhumale and Sapcanin (1999) and Rahman (2007) and other researchers is a not valid provision according to Shari’ah Standard No. (5) issued by AAOIFI which states that it is not permissible for the seller to stipulate full settlement of the price as a condition for ownership transfer. Dhumale and Sapcanin (1999) and other points out that the group liability mechanism common to microfinance where peer pressure and monitoring takes place to reduce default risk could be implemented in murabaha model, however; a real collateral rather than a social collateral could be used, a salient feature of murabaha is that it is an asset based product, this asset could be used as a collateral to mitigate the credit risk as stated by Shari’ah Standard No. (5). and this feature give Islamic Microfinance institution the advantage of providing the poor with both Finance and collateral.

2. Salam:

Salam is defined in appendix B of FAS (7) issued by AOOIFI as “sale of commodity for deferred delivery in exchange for immediate payment.” Where the Islamic Microfinance Institution pays the price in advance to the client in exchange of certain commodity to be delivered at a specific date in the future, a potential buyer for the commodity from the Islamic Microfinance Institution could be arranged on a deferred sale basis, Salam could be used for a variety of commodity, hence, it has been predominantly used in agricultural contexts allowing farmers to finance the advance purchase of inputs like seed (El-Zoghbi and Kaylene, 2013), the capital of Salam could be cash or asset or both, that gives the Islamic Microfinance Institution flexibility where part of the price could be asset (machinery, materials,…etc.) to hedge the risk of diverting the fund to consumption purposes, and the balance of the price could be settled in cash to satisfy the clients necessity to cash. A profitability analysis done by El-Zoghbi and Kaylene (2013) over Wasil Foundation Salam operations showed that the fixed cost associated with Salam product are relatively small leaving significant flexibility to grow and benefit from economies of scale.

3. Ijarah Muntahia Bittamleek:

The Financial Accounting Standard No. (8) issued by AAOIFI defines Ijarah Muntahia Bittamleek as “a lease that concludes with the legal title in the leased asset passing to the lessee”. The client request from the Islamic Microfinance Institution to purchase an asset which he desire and promise to lease, the legal title of the leased asset is transferred to the lessee under his option by one of the following methods:

a. Transfer of legal title at the end of the lease period through gift for no consideration.

b. Transfer of legal title at the end of the lease period through sale for a token consideration or other amount as agreed.

c. Transfer of legal title prior to the end of the lease period through sale for price equivalent to the remaining rent payments.

d. Transfer of legal title through gradual sale of the leased asset.

The Islamic Microfinance Institution recovers the cost of the asset with profit throughout the lease period, and it will be the owner of that asset until the transfer of the title to the lessee at the end of the lease period where at default of the rent payment the Institution could execute its right to cancel the lease contract and sell or rent the asset to recover its cost.

This product is suitable to finance the machinery or property needed for the business of a poor entrepreneur, or to finance a proper house for a family whom could afford the rent payment but do not have neither the financial resource nor the collateral to obtain one, with the advantage of using the gradual transfer of title providing the family the opportunity to use its share gained by time to mitigate against future financial risks.

4. Qard-Hassan:

Qard-Hassan is the only loan considered to be Shari’ah compliant, no interest is charged to the loan and the liability is limited to the principal amount, fees covering the actual administration and set-up cost could be arranged according to Shari’ah Standard No. (19) issued by AAOIFI, Zakah funds could be utilized for this purpose as mentioned in the preceding discussion on Zakah. This instrument could be applied for the following causes:

a. Health care: Health insurance based on Islamic takaful could be financed by the Islamic Microfinance Institution employing Qard-Hassan, and small repayment on a weekly or monthly basis could be arranged.

b. Marriage: Assistance to those who lack the necessary financial resources to marriage is a legitimate purpose for Zakah; Qard-Hassan could be applied for this purpose.

c. Education: Proper Education could be an efficient tool to recover from poverty, Qard-Hassan may be given to assist to achieve this purpose including the cost of the books and the education fees; repayment could take place after finishing the education process or during the process in micro payments according to the client financial status.

5. Mudarabah:

Mudarabah is a partnership between a capital provider from one side (Islamic Microfinance Institution) and entrepreneur skills and labor from another side (Poor entrepreneur), where both parties are entitled to a profit share and loss bored only by the capital provider. This model is difficult to employ where most microentrepreneurs do not keep accurate accountability (Segrado, 2005), which requires extensive monitoring raising the transactional costs, thus, conservative client selection should be applied.

The above mentioned financial instruments could be used separately or in combination to maximize the utilization of the products features. For example combining Murabaha for financing equipment to ensure the productive usage of funds and Salam for sale of commodity to provide the necessary cash for the business, a wide variety of combinations could be applied to maximize the benefit delivered to the client, and to provide a more effective and efficient microfinance platform for poverty reduction.

4.3 Islamic Microfinance Model in Turkey

According to Turkish Statistical Institute In 2014, 15% of the Turkish population was below poverty threshold, and 29.4% of the population suffered from material deprivation which is defined “as the percentage of population with an enforced lack of at least four out of nine material deprivation items. These items are arrears on mortgage or rent payments, utility bills or other loan payments, etc., capacity to afford paying for one week's annual holiday away from home, capacity to afford a meal with meat, chicken, fish every second day, capacity to face unexpected financial expenses, households cannot afford a telephone (including mobile phone), a color TV, a washing machine, a car and ability of the household to pay for keeping its home adequately warm." Turkey Islamic Finance Report 2014; estimates 5 million potential clients for microfinance services in Turkey and only penetration rate estimated at 19%. The above figures leave the participation banks in Turkey with both a responsibility and an opportunity, a responsibility to comply with the social objective of Islamic Finance and positively contribute to the mission of poverty alleviation, and an opportunity of graduating 5 million potential clients for microfinance services into clients for formal finance services as the microfinance program eventually aim, hence, a great opportunity to attract those clients to the participation banking sector.

This paper proposes a Joint venture between the participation banks in Turkey, in which a collaboration to establish a separate not for profit based institution to provide Islamic microfinance services.

A strategic partnership with a reputable charity institution or more could be established with the microfinance institution, this strategic partnership could perform the following functions:

1. Provide the microfinance institution with an organized large data of the poor in their region along with their skills, financial situation, integrity and social relations that could be utilized to reduce information asymmetry and save transaction costs related to searching process.

2. Play a vital role in providing training necessary for receiving microfinance services as part of the social intermediation program to generate personal and social consciousness among the poor, lowering the costs related to this process.

3. Assist in the process of monitoring the clients' use of funds keeping the related transaction costs low.

4. May act as a social guarantor especially with clients with well-established relationship and maintained records and history through which trust is built with the charity institution, or could go further to assist the client to repay his debt.

The charity institution could save the microfinance program a considerable portion of the transactional costs related to (searching, monitoring, training, etc.) and reduce information asymmetry, making the microfinance services economically more viable and sustainable, the established Islamic Microfinance Institution could provide microfinance services through the existing participation banks branches, saving fixed costs (rent, utilities, etc.) and advantaging from national level presence of 1122 branch according to the Participation Banks Association of Turkey. A last element of the proposed Microfinance Institution structure is the Shari'ah Supervisory Board as a governing independent body, to ensure compliance of the microfinancing activities with Shari'ah Rules and Principles, in addition to this main function the Shari'ah Supervisory Board should pay particular attention to supervising the Zakah and Waqf fund due to its sensitivity in terms of Shari'ah compliance.

The proposed Islamic Microfinance Institution could have the following Sources of funds:

1. Zakah Fund: The annual Zakah obligation of the participation banks are utilized in this fund as well as amounts of Zakah received from other sources should it be institutional or individual, according to FAS (9) and to Shari`ah Standard No. (35) issued by AAOIFI the Islamic bank are obliged to pay Zakah directly without transferring this obligation to the shareholders in one of the following cases; when there is a law requirement to satisfy such an obligation, if the bank charter or by-laws requires to pay Zakah and if there is a resolution passed by the general assembly of the shareholders. This fund as mentioned above could be used to extend Qard-Hassan to satisfy the needs for legitimate Zakah recipients, to pay part of the management salaries for taking responsibility of administrating the Zakah fund, and to hedge the risk of default by paying the debt after satisfying the requirement of insolvency for those who defaulted on their payments.

2. Waqf Fund: Islamic Microfinance Institution could utilize cash Waqf invested by Waqf institutions in order to maintain its perpetuity on the basis of Mudarabah contract providing liquidity to microfinancing activities, and the Waqf institutions share of the proceedings from the investment should be expensed to the Waqf objective, according to Shari`ah Standard No. (33) issued by AAOIFI the Waqf should be invested in low risk investments. In addition the Microfinance Institution could establish a Waqf endowment in which the Waqf is confined to pay the debt of insolvent microfinance clients, this Waqf endowment could benefit the microfinance program the following advantages:

a. The cash which institute the Waqf asset will be used in a variety of relatively low risk Microfinance investments and products.

b. The profit earned from investing the Waqf will be used to pay the debt of insolvent microfinance clients and thus, function as a credit risk mitigating tool.

c. The management of the microfinance institution is entitled to an administrative fee payed from the Waqf fund and thus, lowering operational costs of the microfinance program.

Similar Waqf endowment could be established by the microfinance institution for other objectives beneficial to the microfinance program, for example a Waqf confined to educate the poor where the proceedings of this Waqf could be used to provide proper education to the poor as an efficient tool to recover from poverty, or confining Waqf for the intent of providing training necessary for receiving microfinance services as part of the social intermediation program covering part of the cost of the microfinance institution, confining Waqf for infrastructure improvement as a condition to enhance the economic status of the poor communities, and a wide variety of other Waqf objectives could be set to contribute in serving the aim and operations of the microfinance institution.

3. Penalties on default: According to Shari`ah Standard No. (8) issued by AAOIFI the Islamic bank may impose penalty payments on default under the condition that these penalties are paid for charity, these penalties payment could be used by the microfinance program with no restriction or limitation on their usage as the main aim of the program qualifies it to use such funds for its activities.

4. NGOs and Government donations and subsidies: where the microfinance institution could utilize the donations and subsidies- with conditions that comply to Shari'ah- provided by the government and NGOs and some international programs.

5. Repayments of those clients who have obtained funding from the microfinance program.

6. Deposits from the participation banks with excess liquidity at almost zero cost using Qard-Hassan contract.

7. Fees and commissions for other services.

The funds could be channeled to the following main Usages:

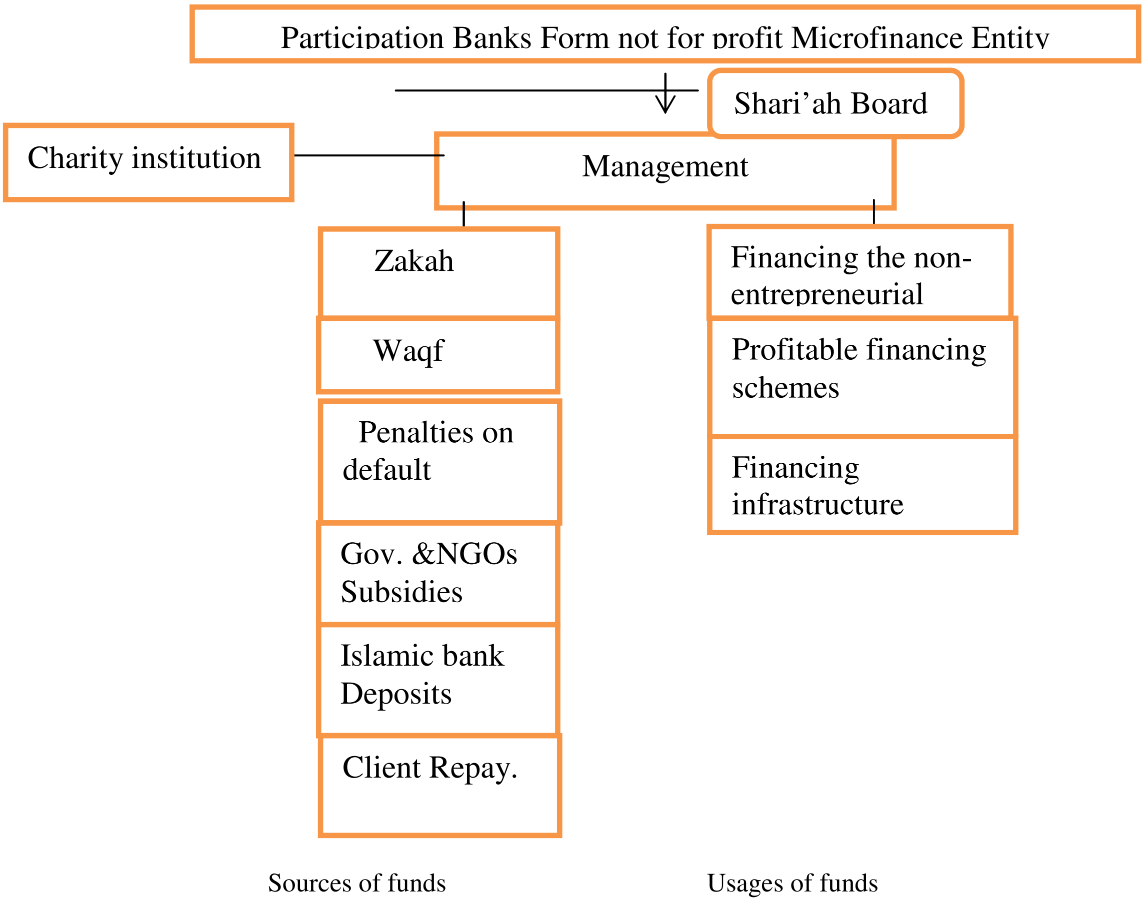
1. Profitable financing schemes: These schemes could be used to finance skillful poor entrepreneurs with solid innovative business ideas; a variety of financial products could be used to satisfy this purpose including as mentioned above Murabaha, Salam, Ijarah Muntahia Bittamleek and Mudarabah along with many combinations of these products to maximize the benefit expected from these instruments in serving the aim of the microfinance program.

2. Financing the non-entrepreneurial poor: The Islamic Microfinance Institutions do not confine its service to individuals possessing entrepreneurial skills, it provides poor people lacking such entrepreneurial skills the opportunity to obtain proper home, education, health care and other wide range of financial services in order to improve their quality of life, Qard-Hassan could be utilized for this purpose using Zakah fund, some other products could also be used like Murabaha and Ijarah Muntahia Bittamleek imposing low profit rates and long debt period with convenient installment schedule.

3. Financing infrastructure development: The Islamic Microfinance Institutions could contribute in financing infrastructure development necessary to enhance the economic conditions for the poor community including roads accessible to markets, electricity, schools, hospitals, telecommunication network and other developments that makes entrepreneurial and business activities possible and enhance its terms. A variety of financing schemes could be utilized for this purpose depending on the specific situation of each case.

A critical balance between the above mentioned usages of funds should be planned carefully and maintained to insure the sustainability of the microfinance program, and to avoid sudden depletion of the funds. The Islamic Microfinance Institution could always learn from the innovative approaches of the operational format of the conventional microfinance programs, benefiting from the advantage of having Ziraat participation Bank in the team with the experience of its parent Ziraat bank in providing microfinance services. Figure 3 depicts the structure of the proposed Islamic Microfinance Institution to be established by participation banks in Turkey:

Figure3: Structure of the proposed Islamic Microfinance Institution



5. Conclusion:

Poverty reduction and eradication is a paramount objective of Islamic economic system, microfinance program provides Islamic Financial Institutions with a compatible platform to confirm with its social goal. Zakah could be integrated in the microfinancing scheme providing free interest loan (Qard-Hassan) to satisfy a variety of needs for legitimate Zakah recipients, as well as a credit risk mitigating tool utilizing the distributing channel of those who are in debt. The paper discussed a number of arguments in support of applying a not for profit based microfinance model as a more convenient and more befitting model to the ultimate and conclusive goal of microfinance.

A Joint venture between the participation banks in Turkey is proposed, in which a collaboration to establish a separate not for profit based institution to provide microfinance services; Zakah, Waqf, Deposits from the participation banks, and other external and internal sources of funds could be channeled to finance skillful poor entrepreneurs with solid innovative business ideas, financing the non-entrepreneurial poor to obtain proper home, education, health care and other wide range of financial services in order to improve their quality of life, and to finance infrastructure development necessary to enhance the economic conditions for the poor community. A number of financial instruments could be utilized including Murabaha, Salam, Ijarah Muntahia Bittamleek, Qard-Hassan, and Mudarabah. Problems of high transaction and operation costs could be overcome by several arrangements including a strategic partnership with a reputable charity institution. The paper also suggest a number of credit risk mitigating tools benefiting from special features of the Islamic financial products as well as integrating Zakah and Waqf for this purpose.

Future researches could explore more potential for Zakah and Waqf role in microfinancing; in addition, researches considering innovative approaches to address the credit risk and the high cost of microfinance would further enrich the subject.

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