New Sukuk Products
A Case for Microfinance Sector

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# Achievements of Current Global Islamic Finance

<table>
<thead>
<tr>
<th>Pluses</th>
<th>Minuses</th>
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<tbody>
<tr>
<td>• Grew from small and gaining in size and coverage</td>
<td>• Few investment opportunities for small savers</td>
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<tr>
<td>• Entered into financing of large-scale long-term projects</td>
<td>• Very little investment in venture financing</td>
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<tr>
<td>• Shariah compatible investment opportunities for high net-worth individuals</td>
<td>• Very little investment in small business enterprise</td>
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<tr>
<td>• Durable consumer goods financing for middle and upper-middle class</td>
<td>• Almost nil for financing of micro-enterprise</td>
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How to reach for broader economic sectors?

• Microfinance and Islamic finance objectives have many commonalities
  – Socially oriented
  – Promote economic development
  – Promote cooperation

• Awqaf Properties
  – Awqaf established for various social and religious purposes
  – However, many Awqaf properties because of neglect have become dormant non-earning assets.
  – Prime location but depleted by time and unable to earn or contribute to the original purpose.

• Big investment and earning projects in the Muslim world
  – Not accessible for investment by small investors due to large tick size or due to restrictions on cross broader movement of funds
Microfinance: A Profitable and Liquid Investment Proposition

- World Microfinance is growing at rate of 15% p.a.*
- MFI’s are twice as profitable as leading commercial banks *
- Solution to excess liquidity problem for Islamic banks
  - Good investment opportunities
  - Shorter-term

* CGAP
Funding side of microfinance is problematic

- Funding Side of microfinance is not secure and non-commercial
- Mostly donor-based funding and ad hoc arrangements
- Seed money and sometimes the running capital grant/donation from MDFIs
- In countries with state owned banks directed funding through state owned banking system provides the subsidy
- Most MFIs are small and unable to raise money on commercial terms
Sukuk provide an opportunity for Islamic Microfinance Institutions
Characteristics of MFI Financing

- Predominantly group-based lending
  - Ensures monitoring within group and reduces credit risk
- Small loan size, large number of borrowers (borrower-intensive lending)
- Mainly cash-based transactions
- Frequent repayment collections and short loan tenures
- High operating costs
- Dealings with clients having solid or time tested business plans
- High recovery rate
- Small size of the financier
Microfinance as an Asset Class

• High-yield assets
  – Typical yields between 20 to 36 % p.a.

• Unsecured
  – Generally not backed by collateral

• Short-tenor assets
  – Typically less than a year, even less than 6 months

• Very high granularity
  – Very small tick size >> can be scaled to size

• Good Credit quality
Requirements for an Attractive Asset Class

• Acceptable risk-return profile
  – Many MFIs are sound on this aspect
  – Returns uncorrelated with other asset classes
  – Stable even in financial crisis (case of Indonesia), affected by real economic shock (case of Sudan, crop failure and Salam financing)

• Ready access to information
  – Deficient in publicly available information
  – Some kind of credit enhancement can be a solution
  – Specialized rating agencies is another solution
Requirements for an Attractive Asset Class (cont)

Scale large enough for investment
- Individual MFIs are small
- MFIs collectively are large but non-standardization of financing and procedures are the issues for aggregation

• Liquidity (easy entry and exit)
  - No market at present but small tick size can be helpful for its liquidity
Risk Factors: Servicer Risk

• Microfinance assets are much sensitive to risk of non-performance by the servicer.

• Reasons:
  – Wide dispersion and high number of clients
  – High frequency of collections
  – Cash transactions

>> Impediments in servicer’s ability to perform can impair performance of the asset pool. However, the repayment rate has generally been quite high in this sector.
Securitization

• Basic Structure
Securitization vs ‘Sukukization’

Despite the closeness of overall concept, Sukuk is not equal to “Securitization” as it is known in its conventional sense.

- **Securitization:**
  Securitization generally relates to the converting of loans of various sorts into marketable securities by packaging the loans into pools and then selling shares of ownership in the pool itself.

- **Sukuk:**
  Investment Sukuk (as defined by AAOIFI) are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services
Two Key Issues in Sukuk

• Finding suitable financing devices compliant to Shariah and amiable to securitization

• Finding a way to make it useful or advantageous for securitization
Eligibility of Assets for Sukuk Issuance

- The most important step for issuing a Sukuk is to determine the underlying pool of assets i.e. the issuer must possess a pool of assets on its balance sheet that are transferable to the investors.
- Flexibility in the assets pool to have a blend of Ijara and Musharaka (equity) assets and other Shari’ah compatible assets (e.g. Murabaha or Istisna’a). Dominance of non-debt portion in the pool.
Eligibility of Assets for Sukuk Issuance (Cont.)

- List of assets most commonly eligible for the issuance of Sukuk are:
  - *Ijara* or Leasing
  - *Musharaka*
  - *Murabaha*
  - *Istisna’a*
  - *Salam*

Islamic MFIs are mostly using Murabaha
- Snadeeq in Jabl al-Hoss (Syria)
- Hodeidah Programme in Yemen
- Some MFIs are also in Micro-Leasing

For securitization with resalable sukuk they need to move towards greater use of other modes of finance
Possible Cases
**Bait al-Mal al-Tamweel (BMT)**  
**Indonesia (As of 1998)**

- 330,000 members, 2470 BMTs
- 187 Billion Rps in investments
- Average investment size under 1 million Rps
- Serving micro-enterprise (capital < 50 mill Rps)
- Funding Source of this 187 Billion Rps
- 83% funded by savings
- 14% by capital of cooperatives
- Approximately no bank funding
- Utilization rate 100%
- Overdue negligible, less than 1-3% more than a month overdue

Microfinance to Vegetable Vendors

• For fixed assets (such as cart)

Options:
- Interest-free loan
- MFI own a fleet of carts that are rented out to many vegetable vendors on weekly or monthly basis

Possibility of Securitization:
- Yes
- Securitization can be used to fund the initial purchase of carts by MFI, then returns paid by the rent stream pass-through

Risks:
- Liquidity and Price Risks are taken care by short term of the contract and fixed rental obligation
- Asset value risk can be handled by Ijarah muntahia bi-tamleek
- MFI knows the local market well, hence risk minimization possible
Microfinance to Vegetable Vendors

• For daily working capital

Options:
- Interest-free loan
- Mudarabah (on daily or weekly basis)

Possibility of Securitization:
- Yes
- Securitization can be used to fund the initial phase and Mudarabah payments can be passed-through

Risks:
- Liquidity and Price Risk are taken care of due to short term of the contract
- Lack of proper accounting. Mittigation through local market information
- Fraud mitigation through oath (Software copyright example)
Fig-1: Structure of *Ijarah-Sukuk* (pooling of multiple MFIs’ assets)

Micro Finance Institutions

1 2 3

Put option with investors. Exchange of Asset at an Exercise Price

Originator

SPV (Issuer)

Sukuk

Investors

IFIs need to use more non-debt creating modes to make asset pool securitizable with tradable securities
Fig-2: Structure of *Ijarah-Sukuk* (Single MFI, Micro-Finance assets)

- **Micro Enterprises**: A, B, C
- **Originator MFI**
- **SPV (Issuer)**
- **Sukuk**
- **Investors**

- **Assets**
- **Rent**
- **Price**
- **Put option with investors. Exchange of Asset at an Exercise Price**

- Assets Leased

- Rent
Examples of Recent Securitization of Microfinance Loans
(Conventional Finance)

Blue Orchard Finance and Developing World Market
- $40 million microfinance bond
- 7 year maturity
- $30 million credit guarantee by OPIC
- Senior notes 55bps above TBills, Junior tranches b/w 100 & 500 bps above TBills
- Serve 40,000 micro-entrepreneurs in four continents
- First Int’l issue 2004

Compartamos (Mexico)
- $44 million bond
- 5 year maturity
- Rated AA for local market
- 34% loan guarantee by IFC
- Target to raise funds from institutional investors, pension and mutual funds
- First Local Market issue in 2002. Since then reissued every year.

Source: ACCION InSight no. 18, April 2006.
Examples of Recent Securitization of Microfinance Loans
(Conventional Finance)

BRAC (Bangladesh) 2006

- BDT 12.6 billion (US$180 mm equivalent)
- Six year program of BDT 1 billion issuance every six months, each of 1 year maturity
- Rating AAA, local market securitization
- Underlying asset pool: 3.3 million short-term loans of average size US$95
- Software to track dynamic pool of receivables

http://www.thedailystar.net/2007/01/17/d70117050468.htm
Islamic Securitization needs more thought, it can serve better

- Other structures are also possible (such as participation sukuk)
- Sukuk for SMEs can also be worked out
- MFI and MFE financing ties directly with the real economic activity associated with provision of basic goods and services
- Islamic Finance helps in two way development: from grassroots to top and from the top to grassroots level
- Islamic Finance is not only a religious agenda but also vital for national development
Thank you

Comments and suggestions are welcome
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