



المعهد الإسلامي للبحوث والتدريب  
Islamic Research & Training Institute

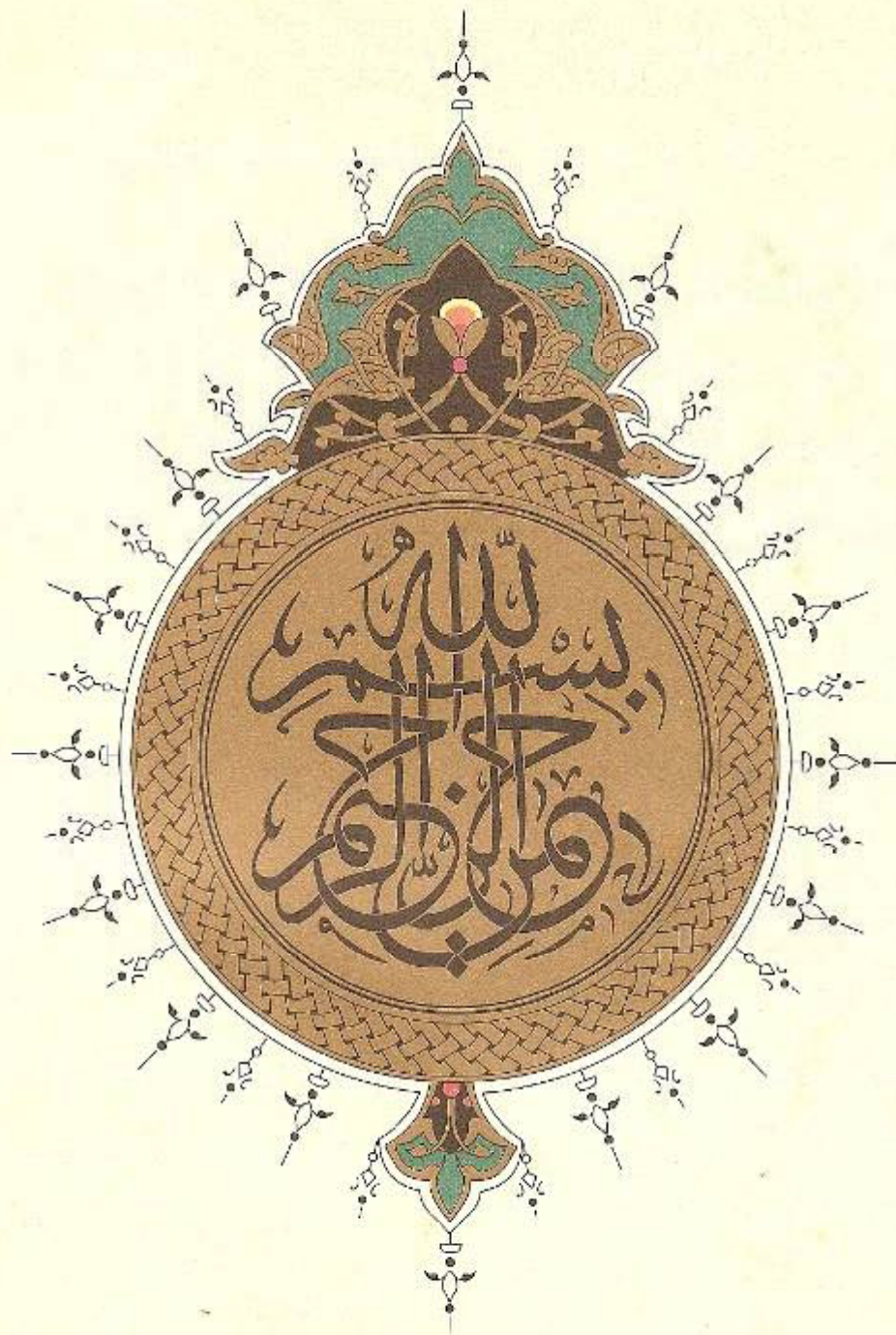
# New Sukuk Products A Case for Microfinance Sector

*Salman Syed Ali*

 **ISLAMIC FINANCIAL  
MARKETS CONFERENCE**  
*AND SPECIALIZED WORKSHOPS*

24~25 January, 2007  
Marriott Hotel, Karachi





# Achievements of Current Global Islamic Finance

## Pluses

- Grew from small and gaining in size and coverage
- Entered into financing of large-scale long-term projects
- Shariah compatible investment opportunities for high net-worth individuals
- Durable consumer goods financing for middle and upper-middle class

## Minuses

- Few investment opportunities for small savers
- Very little investment in venture financing
- Very little investment in small business enterprise
- Almost nil for financing of micro-enterprise

# 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

# 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

Sukuk 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

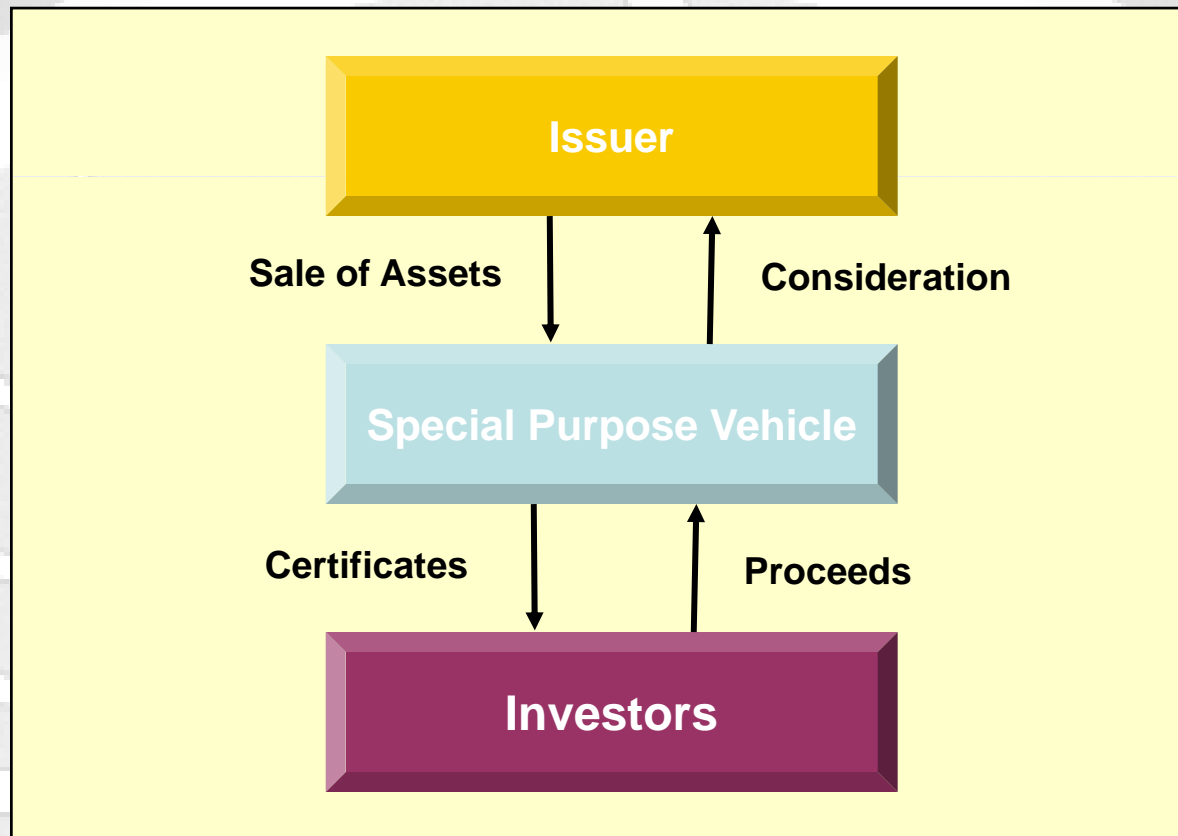
- Individual MFIs are small
- MFIs collectively are large but non-standardization of financing and procedures are the issues for aggregation
- Liquidity (easy entry and exit)
  - No market at present but small tick size can be helpful for its liquidity

# 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:

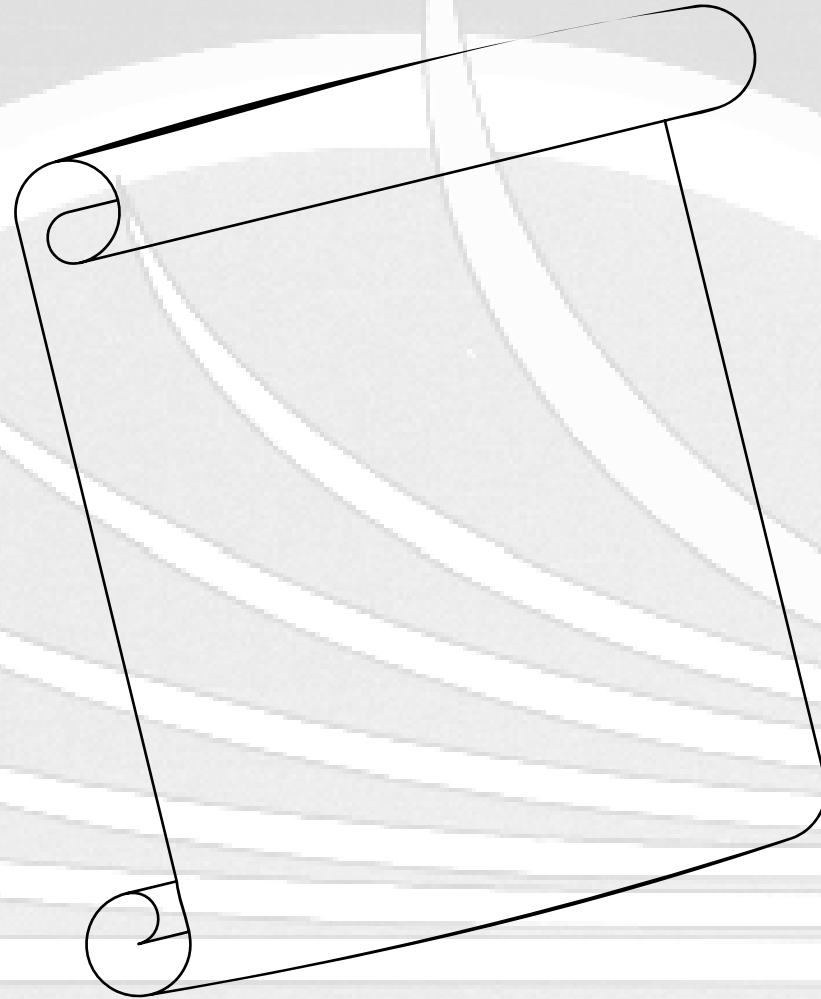
- *Ijara* or Leasing
- *Musharaka*
- *Murabaha*
- *Istisna'a*
- *Salam*

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)
- Exponential Growth: no. of BMTs 300 in 1995, 700 in 1996, 1501 in 1997, 2470 in 1998
- 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)

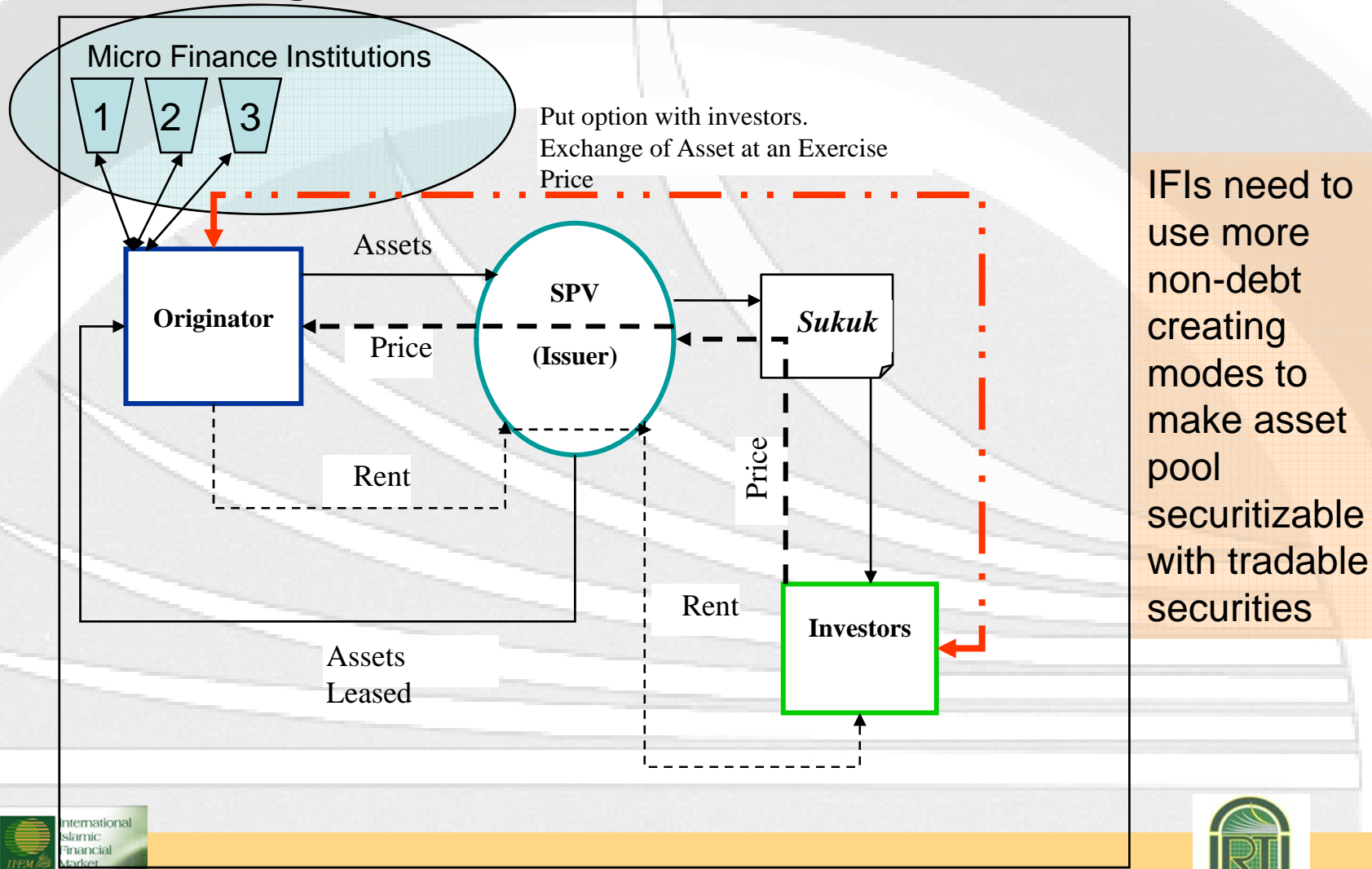
## Possibility of Securitization:

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

## Risks:

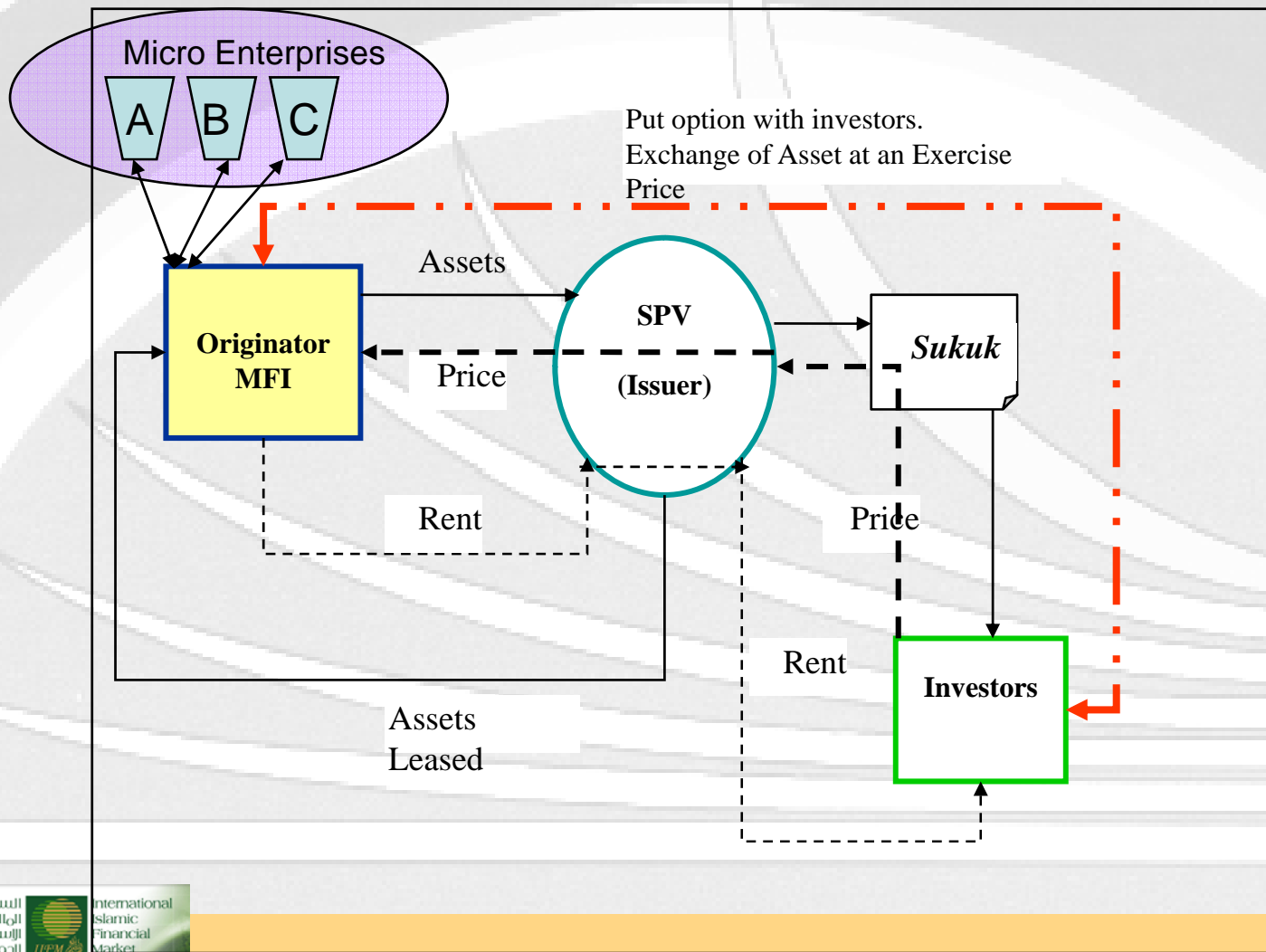
- Liquidity and Price Risk are taken care of due to short term of the contract
- Lack of proper accounting. Mitigation through local market information
- Fraud mitigation through oath (Software copyright example)

# Fig-1: Structure of *Ijarah-Sukuk* (pooling of multiple MFIs' assets)



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)



# 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.



# 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

Source: Daily Star, January 17, 2007. Vol.5 No.937.

<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  
Salman Syed Ali

Email: [ssyedali@isdb.org](mailto:ssyedali@isdb.org) Phone: (+966-2) 646-6332

Islamic Research and Training Institute  
Islamic Development Bank