

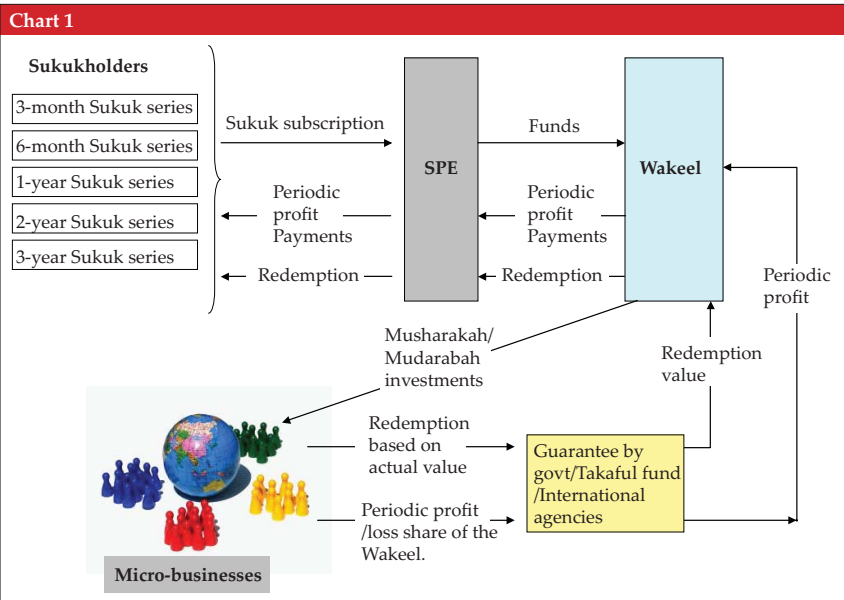
# Islamic microfinance securitization: Structuring a Sukuk Musharakah

SULEMAN MUHAMMAD ALI discusses how developing innovative Musharakah and Mudarabah Sukuk structures can help reduce risks and costs in Islamic microfinancing.

Microfinance is the provision of financial services (including but not restricted to microsaving products, small sized loans and microinsurance) to people who do not have access to or are neglected by mainstream commercial banks and financial institutions. The institutions providing microfinance facilities face problems of funding sustainability and economic viability. Revenues are low due to high credit risk and costs are high due to high operational costs. Costs include cost of financing and operating costs. Operating costs are usually quite high and include wages of field workers and other fixed costs such as rent and utilities.

Both microfinance and Islamic finance share the same goals and objectives to some extent. Both aim to reduce poverty and income disparities, and encourage equitable distribution of income and sustainable income growth for the poor. It is agreed among scholars that the real benefits and achievements of the socio-economic goals of Islam, such as equitable distribution of income, will not be achieved until and unless profit and loss sharing-based modes of pure Musharakah and Mudarabah are adopted. Mufti Taqi Usmani (1998) states: "The philosophy of Islamic economics cannot be translated into reality unless the use of Musharakah is expanded by the Islamic banks." Hence, venturing into the field of Islamic microfinance - particularly on the basis of Musharakah and Mudarabah - is a direct consequence of the purpose of existence of any Islamic bank and is an area on which governments of Muslim countries must focus.

Given the various costs involved with microfinance, the venture can become very unattractive when the costs, uncertainties and risks associated with true Musharakah and Mudarabah are added to the equation. However by taking a more proactive approach such issues of risk and high costs can be easily hedged by developing innovative Musharakah and Mudarabah Sukuk



structures in the following manner. First of all an interested government with a specific goal of poverty alleviation can set up a separate microfinance special purpose entity (SPE) which shall collect funds from investors through Sukuk issuances. Funds generated through issuances of Sukuk shall be used to provide financing to micro-enterprises on the basis of profit sharing modes of Musharakah or Mudarabah by the SPE.

## SPE manager

A separate investment management company, Islamic bank or microfinance bank can be appointed as an investment manager to manage the SPE and its investments with micro-enterprises on the basis of a Wakalah contract. Under this contract the investment manager shall act as a Wakeel (agent) of the Sukukholders to manage the portfolio in return for a fixed fee as a percentage of the size of the portfolio managed.

## Mitigation of risk

Under this structure the Sukukholders will be joint owners of the asset pool of the SPE and hence bear the complete risk of the performance of the asset

pool. Since the asset pool will be based on an equity-based financing of Musharakah or Mudarabah with micro-businesses the risk and return of the Sukukholders shall depend on the actual performance of these micro-businesses. Minimizing inherent risks associated with Musharakah and Mudarabah financing effectively is possible under this structure through the diversification of investments in a large number of micro-businesses. Financing to micro-entrepreneurs and entities involve funding of relatively very small sums.

Examples of businesses in which the investments would be made would likely be small-scale tea shops, taxi driving businesses, tailor shops, small farms, small buffalo dens producing milk and so on. Investing PKR100 million (US\$1.15 million) from the SPE funds in about 1,000 such businesses by providing equity on the basis of Musharakah would diversify the risk into a thousand different assets where the chance of making a loss on the complete pool size of PKR10 million (US\$114,787) would only be a theoretical possibility. Compared to this, a single corporate

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equity financing equal to the same amount of PKR100 million based on Musharakah to a new power plant or a garment factory unit, would have a huge probability of making a loss since there is no diversification of assets.

The risks can be further diversified by investing a portion of the SPE funds into other alternative avenues providing a fixed return, for instance Sukuk Ijarah; thereby ensuring a semblance of stability for the overall returns of the pool.

**“ Funds generated through issuances of Sukuk shall be used to provide financing to micro-enterprises on the basis of profit sharing modes of Musharakah or Mudarabah by the SPE ”**

**Provisions of a third party guarantee**

The risks associated with Musharakah and Mudarabah transactions executed by the SPE can also be hedged through the provision of a third party independent guarantee. Such guarantees can be against frauds or misappropriation by one of the partners as well as for the losses sustained by the micro-business. This is allowed as per the AAOIFI Shariah standard on Musharakah, No. 12 Clause 3/1/4/3 which states: “A third party may provide a guarantee to make up a loss of capital of some or all the partners...”

Hence certain arrangements can be made where an independent party (not being the investment management company or the microfinance customers who are entering into a Musharakah contract as partners) can guarantee the losses on a specific or all of the Musharakah transactions executed by the SPE. Many governments and donor agencies are

keen to promote the microfinance sector and services in order to fight poverty and for this purpose they provide various incentives.

For instance the Pakistan Poverty Alleviation Fund (PPAF), a World Bank-funded government-owned apex entity, provides guarantees and funding to various microfinance banks in Pakistan to boost the microfinance sector. Hence an arrangement can be made with such entities to guarantee the loss on all of the SPE Musharakah transactions or at least up to a certain portion of the SPE assets.

Alternatively, the government can also in its own capacity provide a sovereign non-recourse guarantee to the Sukukholders against the losses sustained by micro-businesses or the losses sustained by the SPE asset pool. The third party guarantee can also be arranged through a Takaful mechanism under which a Takaful company can give this guarantee, and certain contributions can be made by both the SPE and the micro-customer into the Takaful fund.

**Prospects of high returns**

Profits on loans to microfinance entities are generally very high since the amounts of financing are low and costs involved are high. The average nominal yield on the gross loan portfolio in Pakistan is 21.3% while in Africa, Latin America and the Middle East it is around 32%. This would ensure a very healthy return for Sukukholders; ideally within the range of 30% to 35% return on investment annually.

However the returns would vary depending upon the performance of the micro-enterprises: the better the performance of the micro-enterprises the higher the return for the Sukukholders and vice versa.

**Redemption of SPE's equity investments**

The equity investments of the SPE can be structured to be paid back through the following two methods:

**(i) Partial redemption on the basis of Musharakah Mutanaqisah**

Under Musharakah Mutanaqisah the microfinance customers would after each interval purchase a certain percentage of SPE's Musharakah/Mudarabah investment share in their micro-business

based on the actual value (AV) of this share which shall in turn depend on the performance of the micro-business over the period until the time of such purchase.

The AV at any time shall be calculated based on the following formula:

$$AV = \text{value of the initial investment} + \text{accrued and undistributed profit share of SPE as per the profit sharing ratio} - (\text{SPE's share in accumulated loss})$$

The value of percentage of SPE's investment share (VIS) to be purchased by the customer shall be the product of AV and percentage of SPE's investment share to be purchased by the customer.

Upon each such purchase the profit sharing ratio of SPE in the micro-business would reduce exactly in proportion to the percentage of SPE's investment share purchased by the customer. Ultimately the customer would completely purchase the Islamic bank's share and become the sole owner of the business. Mufti Taqi Usmani (1998) has also suggested Musharakah Mutanaqisah as an option for financing based on Musharakah or Shirkatul Aqd.

**(ii) Bullet redemption**

Under this mechanism the customer will after each agreed interval (for instance a month) pay to the SPE the amount of its share of profit for the interval as per the pre-agreed profit sharing ratio based on the actual profit earned by the micro-business during the interval.

On maturity of the Musharakah/Mudarabah financing period the customer shall purchase the SPE's investment share in their business at AV of this share based on the formula for calculating AV as mentioned above.

**Maturity profile and profit distribution of Sukuk**

A series of Sukuk with various maturity profiles can be issued against the SPE investment pool. Sukuk with short-term maturities of less than a year and long-term Sukuk with more than 12 months maturity can be issued. The relationship between Sukukholders shall be based on Shirkatul Aqd with each Sukukholder being a Musharakah partner to other Sukukholders. Based on this relationship,

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different profit sharing weightages can be assigned to different classes (based on maturity profile) of Sukukholders; with short-term Sukuk series having a lower weightage than the Sukuk classes with a longer maturity.

These profit sharing weightages need to be agreed at the time of the issuance of each series of Sukuk.

**Why wait for the government?**

By taking a more proactive role Islamic banks can also take the initiative by setting aside or earmarking a certain amount of funds as a separate asset pool to be used for financing microfinance customers on the basis of Musharakah/Mudarabah [we will call this a special microfinance Musharakah pool (SMMP)].

This SMMP can be marketed as a special deposit product which funds the microfinance customers and also earns a healthy return.

The funds can be received by the Islamic bank on the basis of Mudarabah, under which the Islamic bank shall work as a mudarib on behalf of the depositors and invest the funds in the pool.

In this case the risk of such initiatives would be directly be borne by the depositors, and the profits of the pool shared between the depositors and the Islamic bank at a pre-agreed profit sharing ratio.

Third party guarantee mechanisms as discussed above may also be procured to cover the risk of the asset pool.

**“ The risks associated with Musharakah and Mudarabah transactions executed by the SPE can also be hedged through the provision of a third party independent guarantee ”**

**Conclusion**

The above discussed mechanism provides a viable solution since most governments would be willing to give a guarantee if the SPE structure was capable of providing a sustainable quantum of funding for the purpose of microfinance, and also complied with

Shariah and was easily accepted by the target microfinance market.

Similarly for the investors it is a winning combination since it provides the three major attributes of a conventional bond within the ambit of Shariah in the following manner:

- 1) it provides the guarantee of principal inform of the third party guarantee;
- 2) it provides the option of liquidating the investment by selling the securities in the secondary market at the market value, as allowed by AAOIFI Shariah standard 17 on investment Sukuk, Clause 5/2/16, after the closing of subscription and commencement of activity with respect to investments based on Musharakah/Mudarabah with the micro-enterprises;
- 3) with regards to the returns although these will not be fixed as in the case of conventional bonds, diversification of the portfolio of Musharakah assets of the SPE, risk mitigating tools as discussed above and the possibility of higher returns in certain periods would largely negate this perceived risk of variability of returns.<sup>(2)</sup>

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