



**Two-staged Capital Structure: An Operational Guideline for  
Islamic Microfinance System**

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**Abstract:**

Islamic Microfinance (IMF) is a recently developed area of poverty alleviation practice; however, the system suffers from identifying usable operational structure and building up sustainable capital for the programs. This article proposes for a two-staged capital structure for IMF system, which would simultaneously overcome both limitations.

**Keywords:** Islamic Microfinance, Poverty Alleviation, Asset-Backed Lending System, Sustainable Social Capital, Zakah and Tabarru' Fund

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## **1. Introduction**

Traditional financial institutions usually avoid disbursing small loans due to high processing and monitoring cost, thus keeping away the poor people from getting financial support and improving their living standard. This gap in financial market induced the practice of high interest based microfinance system around the world. The conventional microfinance programs has been performing well in many countries for last three decades, however, a large portion of Muslim communities reject this financing practice due to involvement of Riba.<sup>1</sup> Thus many financially distressed Muslim families (particularly in countries where majority people are Muslims) are left out of the benefit of widely accepted micro financing practices, and stays away of the hope of poverty alleviation.

In recent years, some countries, such as Malaysia, Indonesia, Yemen have introduced the Islamic Microfinance (IMF) system as a tool for poverty alleviation (Imboden, 2005). The concept of IMF is welcomed among Muslim communities; however, the topic appears as an underdeveloped area of research. In practice, the system substantially suffers from two aspects: firstly, lack of usable operational structure and secondly, building up sustainable capital for the programs. In this note, we propose for a two-staged capital structure for IMF system, which would simultaneously overcome both limitations. Under this capital structure, the first-stage of capital should inherit from different compulsory donation funds (such as, zakah and waqf) as per Islamic law; and the second-stage of capital should inherit within the system through voluntary contributions of the users of first-stage capital.

## **2. Insight of IMF: The Capital Structure Issue**

IMF is a recently developed area of Microfinance system. The insight of IMF concept inherits from the idea of asset-backed financing system guided by Islamic law (Karim et al., 2008). The system is currently at initial stage, and severely suffers from identifying a usable operational structure. Existing literature often claims that IMF programs should not differ much from the conventional ones except replacement of the interest-based lending system by the asset-backed lending system (Goud, 2013; Imboden, 2005; Manzur, Meisami, & Roayae, 2013). However, apart from the Shari'ah-compliance issue of microfinance, some other remarkable differences between conventional microfinance and IMF are prominent. First, unlike conventional practice, Islamic economic system has inbuilt provision to finance the distressed group of the society through zakah, sadaqah, waqf and other voluntary charities,

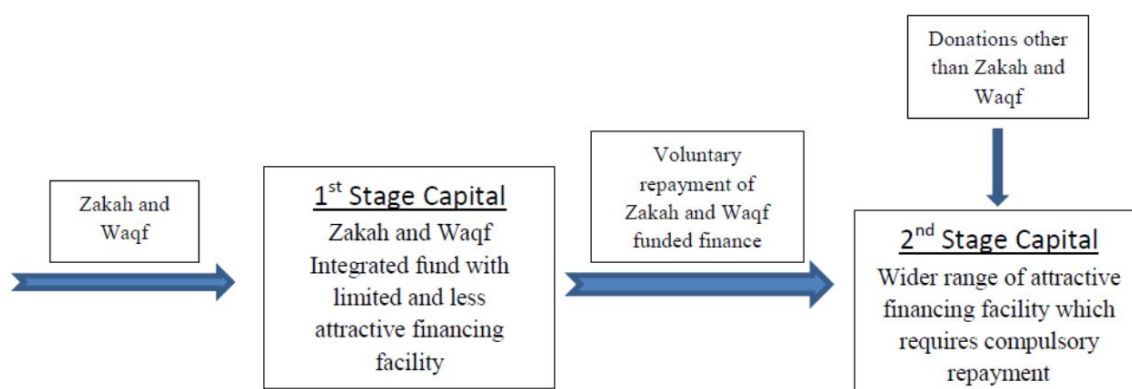
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<sup>1</sup> Riba means interest rate, which is strictly prohibited by Islamic law. Instead, Islamic financial system is asset backed, which means the investor agrees to share the risk of investment as well as the profit.

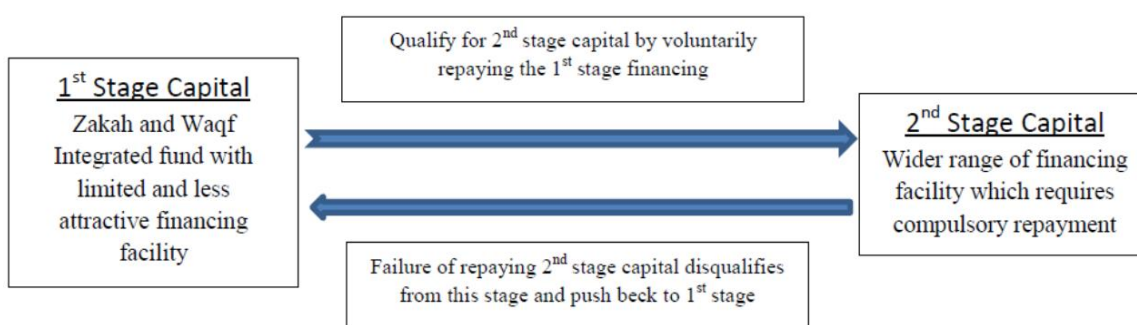
which would work as the major source of working capital for the microfinance programs (Wilson, 2007). Zakah is a special fund arrangement directed by Islamic law, which is made compulsory for the rich people to contribute a small portion of their annual savings for betterment of the distressed group of the society. Waqf is a kind of charity fund established under a trust, through which cash, land or real estate is used as deposited asset (which cannot be disposed of or the ownership cannot be changed). The asset is often arranged for generating income to support the society. Second, conventional microfinance programs are often criticized for charging high effective interest rate, which does not comply with the IMF system. Because, Islamic financing system is based on profit and loss concept, and does not oblige any intrinsic cost of money concept such as interest rate (Karim et al., 2008). Third, conventional microfinance privileges person (particularly women) as user of the microcredit. Instead, IMF privileges the family as a whole. This enhances the integrity of borrowers for being involved in economic activity and increases their urge to repay the loan. The religious obligations also work in fostering loan repayment. Considering these factors, designing an appropriate guideline for IMF system would be more successful in alleviating poverty compare to the conventional ones.

The IMF system struggles to discover a sustainable operational and capital structure for expansion of microfinance services. Many Islamic scholars suggest for incorporating zakah, waqf and other donation funds as working capital for IMF services (Wilson, 2007). But the problem is that these funds are non-refundable donations by Islamic law. Hence, sustainability of zakah and waqf integrated IMF programs is highly dependent on voluntary repayment of the funds. This creates challenges for IMF institutions to increase their working capital and expand their existing programs. Some microfinance funded projects try to encourage borrowers in making voluntary repayment by arranging training session for borrowers (thus replicating the conventional practice), but these attempts often suffer from low turnout due high attendance cost from borrowers' perspective.

**Figure 1: Concept of Two-staged Capital Structure**



**Panel A - Operational perspective**



**Panel B – Borrowers' perspective**

Instead, introduction of a two-staged capital structure can encourage receivers of zakah and waqf backed finance to participate in voluntary repayment. In this process, voluntary donation funds (known as tabarru' fund) should be separated from zakah and waqf integrated funds (Figure 1, Panel A). The zakah and waqf integrated fund will work as the first-stage capital for financing the less attractive and small sized murabahah contracts.<sup>2</sup> The second-stage capital will be the tabarru'-led (donation based) programs to finance mudarabah or musharakah contracts of larger loans.<sup>3</sup> Borrowers, who are able to make substantial contribution to tabarru' fund (through voluntary repayment of first-stage murabahah funds), should get access to the tabarru'-led programs (Figure 1, Panel B). On the other hand, those who fail to repay the second-stage capital (tabarru' fund) based loans should be sent back to first-stage of financing. This process will create mutual pressure on borrowers in building up

<sup>2</sup> In Murabaha contract, financier procures the asset and resale to the client with an added 'mark-up' (cost of service provided) which is fixed at the beginning of the contract (Karim et al., 2008).

<sup>3</sup> Musharaka and Mudaraba are mainly joint ventures under profit and loss sharing agreement, where both financier and client act as joint investor (in Musharaka) or financier provides the fund and client provides expertise (in Mudaraba) (Karim et al., 2008).

internal working capital, and thus increase the long term effectiveness of IMF programs. Besides, creating peer-pressure through group-lending technique and providing training in public meeting would help to increase the rate of success in this process.<sup>4</sup> In long run, the ability of members to access tabarru' fund will work as an indicator of poverty alleviation.

### **3. Benefit of two-staged Capital Structure: Comparison with Conventional Microfinance Concept**

Different forms of informal microfinance had been practiced over centuries (Roche & Rogaly, 1998). However, the concept of modern microfinance was the brainchild of Dr. Muhammad Yunus. The underlying perception of conventional microfinance was to eliminate the barrier of traditional banking system that is set for the distressed group of the society. Since this particular group of borrower does not hold any collateral, Dr. Yunus's idea is to borrow a large institutional loan from traditional banking system by a particular institution (Yunus, 1998). The borrowing institution carries on the risk of the loan and put some collateral against it. The large loan is then split into collateral free microloans and disbursed among the poor. The whole process inherits high required rate of return for two reasons. First, the borrowing institution tries to cover their risk by imposing high interest rate. Second, there is urgency to ensure repayment of microloans for covering own liabilities. This urgency leads to additional operational cost of monitoring and training. As a result, interest charged in conventional microfinance system is criticized for charging abnormally high interest rate.

High cost of capital of conventional microfinance is often minimized by using donation funds. However, two limitations are vital in donations dependence (Adams, Graham, & Pischke, 1984). First, sustainability of many donations based microfinance programs is questionable. Second, donation has got larger coverage area besides supporting microfinance programs. This is where IMF system can get inbuilt advantage if zakah funds are properly integrated with this system. Since zakah payment is mandatory for every capable Muslim, the IMF system can work as a structured process for disbursement of the zakah fund. The underlying concept is bringing the poor families of a particular area under the IMF program, and then to inject the collected zakah fund (as the first-stage capital) to that program. Disbursement of zakah fund should have restriction in terms of receiving and using the fund. The restriction should be gradually removed with voluntary repayment of the fund. Thus the second-stage of capital will be inherited within the system.

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<sup>4</sup> For detail about group-lending technique, please see Aghion & Morduch (2000); Besleya & Coate (1995)

The major advantage of two-staged capital structure is that the users of zakah fund will themselves build up the extension of the fund without causing any external cost of capital. When the extended fund will be disbursed for further loans, required rate of return will only be borne by the operational cost (including monitoring and training), which could be a lump sum payment. Thus, the borrowers will eventually pay back the principle amount of zakah and waqf integrated fund, which will be rolled over for creating further loan. This will enhance sustainability of IMF programs.

In recent literature, Dr. Yunus has suggested a similar concept of social capital build-up in his proposed social business system. The expectation of social business system is that firms will donate a portion of CSR in a parallel production line which will be dedicated as a non-profit production line for selling goods to distressed group. The markup for these products will be low just to cover the operational cost. This is a noble concept for increasing social equity without affecting efficiency; however, his concept fails to provide strong direction about sustainable growth of social business capital. Instead, our two-staged capital structure model would initiate social business activities using the Zakah fund and involve the user of Zakah fund in that particular production process. Additionally, the process would induce the users of the fund to expand their own working capital. In this process, IMF system will work as a mechanism for disbursement and control of the funds.

#### **4. Conclusion**

The article provides a broader guideline for operational structure and working capital build-up for IMF system. The implementation phase, however, would be challenging. We suggest for implementation of first-stage capital with smaller area particularly for monitoring purpose. Operational area could be gradually expanded in parallel to building-up of second-stage capital. Such gradual expansion technique should provide wider scope to handle initial challenges.

A successful implementation of two-stage capital structure would strengthen IMF system. This will benefit the society in two ways. First, it will bring a large portion of Muslim community above the poverty line and out of illiteracy. Second, more solvent and educated Muslim community of rural areas will be at less risk of being involved in anti-social activities. These benefits are indeed observed in non-Muslim countries where conventional microfinance is being widely and successfully operated. Eventually, a modified version of tow-staged capital structure concept could be applicable for building social business capital,

which is a recent expansion of Dr. Yunus's microfinance concept (for detail on social business capital, please see Yunus & Weber, 2010). For such, CSR contribution from business could play important role in building the first-stage capital.

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