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A two-stage approach in Islamic micro-finance: Lessons for Islamic banking system in Iran

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This study presents a two-stage (phasic) approach in the application of Islamic participation (Musharakah) contracts in Islamic micro-finance. According to the model, at the first phase, trade-based contracts, such as Murabaha are applied, and at the second phase, participation contracts are applied. The usage of trade contracts at the first phase, provides the Islamic micro-finance institution with the chance to recognize and select qualified groups for Musharakah loans. The results of this theoretical analysis show that phasic approach is applicable and has various advantages for the Islamic micro-finance institutions. The model presented in this study, piloted primarily and in a limited form in Sri-Lanka, provides the necessary bases for the establishment of Islamic micro-finance institutes in Iran. In addition, the phasic model can bring about good lessons for banks and interest-free institutions working under the Usury-free banking law in Iran.

Key words: Islamic micro-finance, Islamic participation contracts, Islamic transaction contracts, Iran, Sri-Lanka.

INTRODUCTION

Micro-finance can be described as a tool to extend various financial services to lower income groups such as artisans, small farmers and contractors. Since this group of people has a low credit-worthiness, they are not regarded as good borrowers by banks and other conventional financial institutes. In addition, because of high assessment and supervision costs of micro-loans, lack of proper collateral and the high default probability rate involving the poor, banks and financial institutes usually do not extend loan to them (Kaleem and Ahmed, 2009: 3).

In addition, the growth of Islamic micro-finance in recent decades is a fact. In fact, since when Professor Mohammad Yuness and Gramin bank obtained noble prize for their activities in micro-finance, micro-finance practice in Bangladesh and other developing countries has gained impressive growth. For instance, Gramin bank total extended loans showed 113.5% increase, and its micro-loans has increased from $229.14 million in 2001 to $448.41 million in 2002 (Ahmed, 2002).

It can be claimed that the main reason for the success and expansion of micro-finance is that this kind of financing is based upon two main elements which can be regarded as strong points of it. These points are: “group lending” and “inside peer pressure”. By group lending we mean that in micro-finance structure, people are classified in different groups by their own choice and loans are extended to these groups. The incentive structure of the loans is so designed that extending loan to each member of the group is conditioned to the paying back the loans obtained by other members of the group, and in this way, the challenge of providing collateral for poor people has been removed. By inside peer group we mean the regulations of structure of micro-finance is designed in such a way that each member of the group persuade each other to pay back the loan and therefore, there is no need of external enforcement (Besley and Coate, 1995; MacAsaac, 1997).

In spite of these positive strong priorities of this method, because of its traditional problems, especially
because of involvement of interest in this method, Islamic financial economists decided to adjust it in compliance with Islamic structure. In this regard, several researches have been conducted in Islamic micro-finance. Reviewing the available literature shows that in most cases, Islamic finance institutes emphasis on application of Islamic transaction contracts (such as hire-purchase and installment sale) and the application of Islamic participation contracts have been proposed only in a few studies for micro-finance (Ahmed, 2007; Clark, 2002; Dhumale and Sapcanin, 1999; Nelson, 2006). The reason behind this is that Islamic transaction contracts have similar characteristics with traditional Usury system (for example, the pre-fixed rate of return) which enables traditional interest-based structures to be used in Islamic transaction contracts. But it seems that Islamic participation contracts could also be used in micro-finance. In fact, by designing a convenient structure, it is possible to make use of the frame-work applied by Gramin bank; micro-finance can be carried out by the use of Islamic participation contracts.

This study tries to provide a phasic approach to the application of Islamic participation contracts in Islamic micro-finance. In this model, at the first phase, transaction contracts such as Murabaha are suggested to be applied, and at the second phase, participation contracts. The results of this study show that not only phasic approach is applicable, but also has various privileges for micro-financing institutes and borrowers.

After this introduction, the literature concerning Islamic micro-finance will be discussed, explanation of the main characteristics of Islamic micro-finance follows, then the phasic approach of Islamic micro-finance will be explained while explanation of the expected privileges of the approach will be next thereafter discussion of the limited experience of application of phasic approach in some of the Islamic micro-finance institutes in Sri-Lanka and then conclusion. Policy recommendations and the perspective of further researches on the subject are also included.

BACKGROUND OF THE STUDY

Regarding the expansion and partial success of Islamic micro-finance at international level, various researches have been carried out in this field. Some of the most important studies would be discussed.

In Iran, Hassanzadeh and Ghavidel (2005) have studied the challenges facing micro-finance in rural areas of the country and have compared interest-free funds with Gramin bank of Bangladesh. The ratio of penetration, financial self-sufficiency, deposit to loan ratio, value added to extended loans, and value added to number of employees have been studied in this study. The comparison of these interest-free funds with Gramin bank as a successful financial institute shows that interest-free funds have had a weaker performance in some aspects and in general had a smaller role in poverty alleviation and in enabling needy people.

Najafi (2003) has regarded micro-finance as an effort to optimize the accessibility of the poor to loan and saving in a paper. In this paper, the practices of Gramin bank of Bangladesh and Rakiat bank of Indonesia have been studied as the most successful financial institutes providing micro-finance.

Najfi and Yaghoubi (2005) have explained official and un-official financial institutes of Farce province in a field study. The results of their study show that the main reason of obtaining micro-finance by farmers (from official and un-official sources) is production needs. The study of covered costs of obtaining credit also shows that the by-costs of obtaining credit from official sources are higher than un-official sources. It also shows that rural lower income groups have a higher share in obtaining un-official sources and their tendency to deal with micro-finance institutes were higher, which shows that rural area farmers are ready for establishment of micro-finance institutes.

Mirza (2005) has studied the social responsibilities of Bank Keshavarzi with regard to extending micro-finance to women in a paper. The results show that the bank has fulfilled his social responsibilities in this regard.

Eftekhari and Einali (2004) show in a paper that the rural and agricultural finance for small farmers have been very effective which shows the success of micro-credit in rural development.

Hassanzadeh and Arshadi (2003) in a comparative study have reviewed the rural finance experiments in Iran and some other Asian countries. The results show that the penetration of loans extended to rural families has increased during past two decades. In addition, although the average yield of micro-loans was less than the yield of total investment in agricultural sector, but the effectiveness of micro-finance on gross capital formation, in comparison with total extended credit was higher.

Arab and Motamed (2003) have put forward the new methods of micro-finance in enabling low income group, especially women. While comparing the characteristics of micro-finance methods of Bank Keshavarzi, this study have analyzed these credits in the framework of four plans implemented in this bank.

Motamed and Nematian (2004) have shown in their paper that although micro-finance is extended as a service by financial institutes, but also can provide gains for the institutes. Hassanzadeh et al. (2006) have studied the effectiveness of micro-finance on alleviation of poverty and in-equality in different provinces of Iran by panel data.
method. The results which use interest-free loans as a substitute for total extended micro-finance variable, shows that micro-finance can only alleviate poverty if the lower income group is well distinguished, and the credit is spent for job creation.

As seen in the available Persian literature about micro-finance, the main concentration is on the application of this method in practice and studies precisely about Islamic micro-finance, its characteristics and models are very rare. But foreign literature on this subject shows that concentration on Islamic micro-finance is more than in Persian. In fact, researches are focused on subjects set forth in Islamic micro-finance.

Some researches have considered the essence of Islamic micro-finance. Ahmed (2001) and Otiti (2002) have considered the essence of Islamic micro-finance and have discussed the characteristics of this kind of financing. They present the theoretic and practical basis of establishing Islamic micro-finance institutes according to Islamic transaction contracts (usually hire purchase and installment sell contracts).

Some other researches explain the relation and the share of Islamic micro-finance and Islamic banking. Dhumale and Sapcanin (1999) show that from legal and Islamic jurisprudence point of view, the relations and Islamic contracts (especially transaction Islamic contracts) which are used in Islamic banking, can be applied to in Islamic micro-finance. Islamic banking and Islamic micro-finance can jointly complete the responsibility of Islamic finance according to their view.

Some of the researches deal with the experiments of Islamic micro-finance institutes. Al-Zamzami and Grace (2003) and Al-Harran (1995, 2002) show that although various Islamic transaction and participation contracts are applicable in Islamic micro-finance, but since participation has difficulties such as supervision, micro-finance institutes mainly use Islamic transaction contracts such as murabeha or hire-purchase.

Some researchers have considered the application of other Islamic structures such as Vaghf, interest-free loan, Zakat and others in Islamic microfinance. In this regard, Cizakca (2004) has offered a model which is based upon cash-Vaghf which fulfills social goals. Elgari (2004) proposed the establishment of a non-profit financial institution called interest-free bank which helps the poor by extending interest-free loans to them. The capital of this bank will be provided by cash- vaghfs of affluent people of the society. Kahf (2004) and Ahmed (2007) have proposed the establishment of a micro-finance institute on the basis of Zakat, Vaghf and charity.

As seen, the main part of the literature on Islamic micro-finance have emphasized on the application of Islamic transaction contracts (reason will be explained in the next part of the paper) and therefore, there is little study available about the phasic approach of application of Islamic participation contracts in Islamic micro-finance, and this shapes the contribution of the paper to the available literature of Islamic micro-finance.

**DEFINITION AND CHARACTERISTICS OF ISLAMIC MICRO-FINANCE**

Although there are different definitions for micro-finance (thereof for Islamic micro-finance) (Imboden, 2005; Conroy, 2002), but we can define Islamic micro-finance as: “providing cash or non-cash loan on the basis of Islamic contracts to poor entrepreneurs to start or maintain commercial activities in the direction of Islamic economic goals” (Smolo, 2007: 6).

Although they have certainly similar characteristics such as offering group loans, Islamic micro-finance is characteristically different from conventional micro-finance in various dimensions. Here we refer to some of these differences:

**Elimination of interest**

The most important challenge in conventional micro-finance is certainly the problem of interest. In fact, conventional micro-finance institutes offer interest based credit and it seems that their rate of interest is higher than current interest rates in the economy. For example, some studies show that even in Bangladesh which is a pioneer in extending micro-credit, the rate of interest is 25 to 30% (Hassan and Alamgir, 2005; Sadeq, 2007). Some other studies (while looking through the experience of some micro-finance institutes), show that if we add the extra indirect charges to usual current interest rates, the real interest rate for the poor is about 55% which is much higher than bank interest rates (Mannan, 2007). But in Islamic micro-finance, interest rate is replaced by participation and transaction profit rate.

**Application of Islamic contracts in extending loan facilities**

As it was mentioned before, the conventional micro-finance basically involve interest (Reba). But regarding the prohibition of Reba in Islamic economy, it is necessary to use various Islamic contracts for extending Islamic micro-finance in Islamic financial system. These contracts (which are also used in Islamic banks) can be classified in four basic groups as follows (Mousavian, 2004: 166-175):

**Participation contracts:** In these contracts a share or the whole capital needed for an economic activity (production, commerce or service) is provided by financial institute and finally the profit is divided between the institute and the entrepreneur according to the contract agreement. These Islamic contracts in usury-free banking system are2: civil partnership, legal partnership,

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2. We should note that the Islamic micro-finance model in this paper is in the framework of Shiite and Iranian usury-free banking model (the usury-free
As researches on micro-finance show, micro-finance paying attention to lower income groups etcetera include vaghf, interest-free loan, khoms, zakot, anfal and interest, or from exogenous sources such as government accepting deposits through loan contracts by paying conventional financial institutes obtain their funds by obtaining funds earlier explained). In addition, they can obtain sources or international funds (Habib, 2002). But Islamic financial institutes provide funds for a production firm or a needy family and restrains oneself to a commission. The profit of the financing institute provides funds for a production firm or a needy family and restrains oneself to a commission.

Interest-free loan: According to this contract, the financial institute provides funds for a production firm or a needy family and restrains oneself to a commission.

Contracts with constant yield: Also in this kind of Islamic contracts, the financial institute provides a part or the total capital needed for an economic activity or needs of a needy family; but the difference is that the profit is known before the end of economic activity. Therefore, future developments and variations have no relation with profit and the claims of the financial institute. These contracts are: selling by installments, debt purchase, and hire purchase.

Contracts with variable return: Also in this kind of Islamic contracts, the financial institute provides a part or the total capital needed for an economic activity or needs of a needy family. The profit of the financing institute varies according to the nature of these contracts and is related to economic developments and relative prices in real sector. It may happen that the institute obtains no profit and even obtain loss. These contracts include forward deals and Joalah (working on behalf).

Application of Islamic contracts and institutions in obtaining funds

Conventional financial institutes obtain their funds by accepting deposits through loan contracts by paying interest, or from exogenous sources such as government or international funds (Habib, 2002). But Islamic financial institutes obtain funds through Islamic contracts (as earlier explained). In addition, they can obtain sources from other Islamic institutes. Islamic funding sources include vaghf, interest-free loan, khoms, zakot, anfal and etcetera.

Paying attention to lower income groups

As researches on micro-finance show, micro-finance institutes do not pay attention to lower income groups (the poorest of the poor) (Nuruzzaman, 2008; Chowdhury, 2010; Karanshawy, 2007). Their justification in this regard is: “providing the poor with micro-finance does not bail them out, but makes them more indebted and poor in future since they cannot afford to pay back the loan” (Borny, 2008: 189). But in Islamic economy, regarding the available Islamic institutions (such as zakot and interest-free loan) micro-finance institutes are in a better position for helping the poor.

Lower probability of deviation of production loans

One of the problems facing conventional institutes is that borrowers may spend their production loans in personal consumption. However, there is a defined relation between real sector and monetary sector and there must be a transfer of commodities in Islamic financing. In other words, the application of Islamic contracts leads to lower probability of deviation of production loans. This is because most of Islamic contracts are based upon real goods and services and hence commodities (not cash money) are transferred to the entrepreneur. When the real goods are transferred to the investor, it is less probable that this good be deviated to consumption needs (Eivaslou and Meisami, 2008: 13).

PHASIC APPROACH TO ISLAMIC MICRO-FINANCE

As discussed in the literature review, a large part of the available studies in Islamic micro-finance, has proposed the use of Islamic transaction contracts and researches on the application of participation contracts are very rare; while there are several researches which show that application of participation contracts in Islamic micro-finance will lead to better achievement of Islamic economic goals (Seddighi, 2004; Mousavian, 2004; Eivazlou and Meisami, 2008; Ighbal, 2008). It seems that it is possible to put forward various approaches for application of participation contracts in micro-finance. One of these approaches, which is the focus of this paper, is “phasic approach”. Here we will explain this approach. Phasic approach means that instead of financing the whole amount at a time, the micro-finance institute finances the borrower in two phases through a Shariah compliant contract. That is to say, it is necessary for the financing institute finance the borrower through a transaction contract with fixed rate of return as we read in previous parts of the paper (the purpose of this phase is

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3 - In addition to the above mentioned characteristics of Islamic micro-finance, we can put forward other cases. For example, the emphasis on the family as a whole instead of financing women, having social goals in addition to physical goal, accounting Islamic and divine goals to employees and others. The explanation of these items is far away from the scope of the current study and could be subject to further studies.

4 - The strong points of this approach and the limited practice of Seri Lanka will be referred to in the next part.
to start the economic plan of the borrower), and then, if
the borrower proved to be capable of handling the plan
and making good use of the financed fund and will be
able to pay back the borrowed finance7, the financing
institute will pay the rest of the financial fund to develop
the plan. The characteristics of participation contracts
which were put forward in previous parts of the paper are
that their profit rates are not pre-fixed and the borrower
and financier are sharing in the production or commercial
activity and the profit or loss of the activity will be divided
between them according to their agreed contract.

The empirical arrangement of phasic approach in the
framework of usury-free banking system can be
described in this way that a group of people (for example
5 people) who have agreed on a joint economic plan,
apply to a financing institute8. The financing institute
will first go through a transaction contract (for example,
installment sell) with two members of the group. That is to
say, the financier will buy the goods demanded by the
leader of the group after assessing and obtaining
quotas9. The he will sell the goods to the borrowers at a
higher price through installment sell contract. If these two
members pay back their loans within maturity of contract,
the finance will go through another similar contract with
two other members of the group and finance them. If
these two new borrowers do the same in paying back the
borrowed fund, then the company will go through a
contract with the fifth member of the group and finance
him.

It is necessary for the financing company to obtain
information about the ability of the borrowers to pay back
the loan, and their plan before going through phasic
approach. This information will define the qualification of
the group for obtaining the finance. The financing
company may define a supervisor and oblige the
borrowing group to furnish him with information and have
monthly meetings10. These meetings in addition to giving
information to the supervisor help the members to find
out about the activities of other members. The supervisor
will ask questions about the methods of handling their
plan and offer them recommendations which will help the
members to improve their practices.

If a group of borrowers finishes the first phase
successfully, the financing institute will decide how to
extend the remaining finance to it through different
participation contract. If the group is qualified for
participation contract, then the institute will start the
participation finance. The process of the second phase
starts with asking the group about the detail of their
activities during the first phase and their plan of activities
for the second phase for which they are borrowing. If their
planned activities seem profitable and the supervisor is
also satisfied by their activities in the first phase, then the
financer will extend the credit through participation
contract (with special criteria).

Although any kind of participation contract can be used
in this phase, it seems that “decreasing participation
contract” is more convenient because of its wide range of
capacity as will be discussed subsequently in this paper.
In this special kind of participation contract, after the
details of the planned economic activity of the second
phase were assessed by the supervisor11, they will
finance the group for the second phase. There are also
terms in the contract which obliges the group to pay back
the capital and its profits after certain time intervals and
safeguard the economic plan and the capital up to the
end of contract. Accordingly, the share of the bank
reduces, while the share of the group increases until the
capital and its profit is obtained by the financier, and the
group becomes the owner of the economic activity.

It is necessary the contract should contain at least the
following items:

1) The kind of activity at the first phase which is to be
developed.
2) The capital needed in the second phase.
3) The ratio for dividing profit and loss between the
financing institute and the group.
4) Pricing the plan (evaluating).
5) The plan to buy the stocks of the institute by the client.

It is necessary to mention that pricing can be applied by
credit-transaction index or the forecast of prices in the
future and then arrange for payment by installment
(Masouminia and Shahidinasab, 2009: 4-8). In order to
make sure about receiving the payment from the group,
the institute can make use of the capacities of the
“decreasing participation contract”. For example the
institute can put terms in the contract concerning the
delay in installment payments which allows the institute to
change the ratios agreed in the contract. This action does
not have any problem from Shariah point of view
(Mousavian, 2004: 223).

THE BENEFITS OF TWO-PHASE APPROACH

It seems that phasic approach has benefits. Some of
most important benefits will be discussed here12.

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7 - It is necessary to mention that members of a group of borrowers can invest
together or separately in production activities. But since the share of each
borrower is very small, their joint investment can be more productive and
profitable. The financing institute can arrange incentives for the borrowers to
invest jointly. For example, it can give these jointly working groups better
privileges.

8 - It should be mentioned that the group may have agreed on more than a plan.
Even some of the members can have separate plans. But since the amount of
finance is small, it is better to have a joint plan to obtain more profit.

9 - For convenience, the financing company can obtain a mandate from a
member of the group to buy the goods.

10 - It should be mentioned that because of the smallness of these activities, the
supervisor can supervise more than one group.

11 - It should be mentioned that, similar assessment is carried out at the
beginning of the first phase.

12 - It should be considered that these benefits are specified only to our
proposed model. Therefore, we do not explain the general benefits of group
financing.
Compliance with Shariah

The proposed phasic model has no problems from Islamic banking law and Shariah point of view. This is because the application of transaction contracts in the first phase and participation contracts in the second phase is in compliance with fegh. There is no discussion about the rightness of transaction contracts; but regarding the decreasing participation contract it should be mentioned that this is an ordinary partnership transaction with a term included in it (Masouminia and Shahidinasab, 2009). Other items explained in phasic model also seem in compliance with Shariah. For example, from religious jurisprudence point of view, there is no problem with not entering into the second phase of activity by the institute; this is because, both sides can put terms in participation contract for not acting of one of the parties (Al Imam, 1911: 625).

Strengthening the incentive structure

It seems that the application of “decreasing participation contract” in the second phase will strengthen the incentive of members of group and the financing institute to try hard for the success of the economic plan. This is because in “decreasing participation contract” the members of the group know that they will be the owner of the share of the financing institute at last, and therefore, they do their best to implement the economic plan successfully. In addition, the authorities of the financing institute and their supervisor know that they participated in the profit and loss of the plan and therefore, they guide the group to succeed. While it seems that the applications of transaction contracts in micro-finance do not strengthen the incentive structure of neither side.

Freeing the institute sources

The application of proposed model will free the sources provided by the institute for the group during the contract period. This is important because the sources of micro-finance institute are limited and the institute has to provide this limited resource for more needy people by managing it correctly. In decreasing participation model, the principle fund plus its profit will return back to the institute and the institute can offer it to other people. This will provide the continuity of the micro-finance institute.

Invulnerability of the institute against bad loans

In the proposed plan if members of the group do not pay back the share of the institute, it will not face any problem because according to the contract, the institute owns a share of the plan and can decide upon it to compensate its claim.

Involving both sides of the contract with real sector

One of the characteristics of this approach is that the benefits of the both parts of the contract are related to the facts of real sector of the economy. In fact, if after signing the contract enters prosperity and profitability of the plan increases, both sides of the contract will share the profit and during recession they will share the loss as well. While if they use loan contract or transaction contracts to finance the plan, the relation of the financing institute with real sector fades.

Increase of economic efficiency

Efficiency means producing more with less inputs and allocative efficiency which is under focus here, means the allocation of resources in such a way to maximize total production. This is achieved when the marginal efficiency of all industries in the economy become equal. The result of this rather ideal situation is that capital is invested where the efficiency (profitability) is higher (Aljarhi, 2002). But when the financing institute uses loan contract or transaction contract in group financing, it will not be certain about the receiving back the extended loan (but is not worried about the success of the economic plan). These worries are best removed when before receiving the loan; members of the group have enough sources to pay back the loan and are not dependant on the success of the plan for compensating the loan. That is why the credibility of the members of the group is the first consideration of the financier. Of course, success and profitability forecast of the members of the group are important; but this is a secondary criteria considered by the financier. But the first criteria considered by financier through other financing plans, is the forecast of success and profitability of the plan and creditworthiness of the group members has a secondary importance (Seddighi, 2004: 103).

Distribution of uncertainty and increase of risk taking

In spite of loan and transaction contracts, when participation contract is used in financing, group's member view will affect positively on the economic plan. This is because, in this case, since members of the group know that if the plan fails, the institute will accept a share of the losses, they will have the incentive to venture more profitable (and of course, more risky) plans.

Decrease of bankruptcy risk

One of the reasons banks and Islamic micro-financing institutes do not welcome participation contracts is bankruptcy risk of the financing plan and losing institutes funds. This is because although financing institutes and
banks assess the profitability of the proposed plan and the credibility of the borrowers before signing a contract, but in practice there may be different possibilities and risk of losses (Nasr and Shabani, 2009). But it seems that in the proposed plan we do not face this problem. This is because in phasic approach, the financier goes through a transaction contract and assesses the abilities of the borrowers; and if they are not capable of handling the job, will not enter the participation phase.

Asymmetric information

Asymmetric information is created when the borrower is not willing to give the necessary information about costs and income of his economic activities to the lender (Kara, 1999: 101). It seems that the challenge of asymmetric information which is another reason for Islamic banks for not entering participation contracts fade in phasic approach model. This is because during the first phase, the financier obtains the full information through the supervisor in the transaction contract and knows everything about the rightness of information given to the financier.

Adverse selection

Another challenge facing Islamic banks in offering finance through participation contract is the adverse selection. This is because banks are worried to finance low profits plans, or do not finance high profit ones (Farooq, 2006). The reason behind this is the fact that because of limitation of funds and the huge number of borrowers, all borrowers claim to have a complete profitable plan. In these situations, banks have two choices: assessing all offered plans and selecting the plans with higher profit and lower risk which takes a long time and is expensive for the bank, or accepting the claims of borrowers and selecting among them which may face adverse selection. It seems that the adverse selection challenge is not significant in phasic model. This is because the micro-finance institute is facing with numerous quests from borrowing groups. Therefore, after preliminary assessing several proposals, the financier goes through transaction contracts with some of them. If these selected groups are successful at this phase of activity, then they will receive the second phase finance through a participation contract to develop their activities. Certainly in this phase, some of the groups will not be able to obtain further finance.

Moral hazard

This means that the existence of a contract may change the behavior of both or one of the contracting sides. In fact, Moral hazard occurs when the activity is finished and in order to obtain more profit, the borrower would not report the amount of profit he has obtained (Farough, 2006). It seems that the phasic model smoothens this problem. This is because a delegate of the financier as supervisor and advisor is present in both phases and is aware of the amount of profit and therefore, the moral hazard risk fades. It should be noted that the cost of supervision is not so much in microfinance because the businesses financed by the microfinance institute are usually small and hence the institute can consider one supervisor for more than one business plan.

Experiment of Sri Lanka in application of phasic approach

Sri Lanka is a country with 20 million population and gross per capita income of $1658 (in 2009). This country has many economic problems including poverty and income inequality as the most important. In addition, rural poverty is higher and about 88% of the poor live in rural area. This justifies the poverty alleviation programs such as micro-finance (Consultative Group to Assist the Poor (CGAP), 2008: 3). Because of historic role of the government in this country, a major part of the micro-finance sources are governmental, or use governmental facilities and resources. In fact, statistics show that more than 50% of the micro-finance is provided by government institutes. Active government institutes work under two titles: “Rural Development Banks (RDBs)”, and “Welfare Bank” which is called “Samurdhhi Banks” in local language. The successful welfare program which includes the establishment of welfare banks started in 1994 for alleviation of poverty and brings together other social programs. Welfare banks which offer micro-finance are under the supervision of Welfare Ministry. The number of these small banks in 2008 was 2136 and had 5 million depositors; they have also extended 500000 small loans. Rural development banks are organized by Cooperation Ministry and have impressive development in recent years after the decrease of the number of cooperatives.

There are also few private banks acting in micro-finance with similar structure of financing as governmental institutes. Hotton National Bank is one of these private banks which is more active in Islamic micro-finance, but only 12500 borrowers have been able to obtain micro-finance from it until now.

Sri Lanka has lots of success in Islamic micro-finance. One of the considerable projects in connection with Islamic micro-finance which has been started in this country in recent years and still is going on is the implementation of phasic approach to Islamic micro-finance in production (not consumption). This project has been carried out by Muslims Aid in Sri Lanka (MAISL) organization. The project has been applied in one of the districts of Colombo (the capital of Sri Lanka) (Feroz and Goud, 2008: 12). The method used by this organization is quite similar with the proposed model in this paper.
MAISL with the corporation of two other organization, are conducting two phase micro-finance. In the first stage, micro-finance is offered through a transaction contract (which has a constant rate), and if the borrowing group succeeds in the first phase and proves its abilities to make best use of sources and paying back the loan, then, the institute will offer a participation loan to this successful group.

In practice, MAISL has financed 40 people in 6 groups in two phases by Murabeha contracts up to now. The amount of each finance agreements varies from 56 to $1289 according to their needs. The clients are selected after consulting with other Islamic centers. In addition to financing the clients, the institute also provides the some training (CGEP, 2008: 15).

CONCLUSION, POLICY RECOMMENDATIONS AND FUTURE RESEARCH OUTLOOK

In fact, Islamic banking system of Iran and the world have been focused on Shairah and performance problems and are far from its social, humanitarian and Islamic goals such as fairness, alleviation of unjust social inequalities and alleviation of poverty. By necessary adjustments and improvements, the practice of micro-finance can be one of the institutions which is capable of being applied in Islamic banking to help the fulfillment of social goals of Islamic banks. 32 years experience of micro-finance institutes which started by Dr. Younes in Bangladesh by extending small loans, show that micro-finance is a method for poverty alleviation of many poor. The micro-finance industry has created loan access for many poor people who had no access to credit facilities because they were poor and had no collaterals to guarantee their loans. In spite of the success of conventional micro-finance, this method has several criticisms; the leading criticism is the doubt of usury involvement. This problem, together with other challenges, makes it necessary to use Islamic banking capacities in applying this tool.

The present study presents a phasic approach through Islamic participation contract for applying Islamic micro-finance. At the first stage, one of transaction contracts such as Murabeha is used, and at the second stage, “decreasing participation contract” is applied. The application of transaction contract at first phase gives the financier the chance to supervise the implementation of the plan and its success in accordance with the contract, and find the successful groups to finance through participation contract. The results of this study show that not only the phasic approach is applicable, but also has various advantages for financier and borrowers.

It seems that the proposed model in this study which has been applied in a limited area in Sri Lanka can have useful lessons for application in Islamic banking systems of Iran and other countries. Therefore, we propose: by compiling a suitable application process, the active banks in the economy of Iran can apply the proposed model in micro-finance. In addition, interest-free funds and other credit institutes of the country can use this model in consumption micro-finance as well as production micro-finance. At a higher level, we propose to monetary authorities of the country to create facilities for establishment of Islamic- Iranian micro-finance institutes for applying phasic approach.

The future studies can complete the subjects presented here. Specifically, we propose that the future studies should try to answer the followings:

1) How can we apply the proposed model of this paper in Islamic banking and financial system of Iran?
2) What are the practices of other countries (excluding Sri Lanka) in application of participation contracts in Islamic micro-finance?
3) What are the challenges of the present interest-free system of Iran? How can phasic approach decrease these challenges?
4) Is there the possibility (economic, Shariah, and legal) of establishment of Islamic micro-finance according to the phasic model in Iran?
5) What are the costs and benefits of the establishment of Islamic micro-finance in Iran?
6) How can we create relation between Islamic micro-finance and Islamic banking system?
7) How can the contract theory literature in the conventional economics be used to develop the two-stage model theoretically?

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