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TIJARA
PROVINCIAL ECONOMIC GROWTH PROGRAM

IRAQ'S EXPERIENCE WITH AL-MURABAHA ISLAMIC MICROFINANCE

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COVER PHOTOS: In Iraq, small business development and microfinance go hand in hand. After taking an entrepreneurial training course at the Al-Murshed SBDC in Kirkuk, 32-year old Ashwaq Jomaa Abdel Allah (left) applied for a $2,100 Al-Murabaha loan from Kirkuk's Al-Aman Center. Today, she and her cousin Ahmed Hushiar Ismail (center) manage a successful mini-market on the highway south of Kirkuk .

ISLAMIC MICROFINANCE AL-MURABAHA: IRAQ'S EXPERIENCE

All data and information in this report is current as of October 2010

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LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ADIB	Abu Dhabi Islamic Bank
AusAid	Australian Agency for International Development
CBI	Central Bank of Iraq
DFID	United Kingdom Department for International Development
FSS	Financial Self Sufficiency
HSBC	Hong Kong and Shanghai Banking Corporation
ICF-SME	Iraqi Company for Financing SMEs
IDP	Internally Displaced People
ID	Iraqi Dinar
MENA	Middle East & North Africa
MFI	Microfinance Institution
OSS	Operational Self Sufficiency
PAR	Portfolio at Risk
PCMS	Performance Classification Monitoring System
PRT	Provincial Reconstruction Team
RI	Relief International
SBB	Shari'a Supervisory Board
SBDC	Small Business Development Center
SME	Small and Medium Enterprise
TDMN	Al Tadamun
TEDC	Talafar Economic Development Center
UAE	United Arab Emirates
USAID	United States Agency for International Development
US	United States

EXECUTIVE SUMMARY

MFIs offering Islamic microfinance have prospered due to increased demand for Shari'a- compliant products in Iraq. The demand for such products, however, exceeds the current ability to supply. Together, the six MFIs providing Murabaha Islamic financing serve less than one percent of a total market potential of 820,000 households in the country. The Islamic microfinance Murabaha portfolio grew at a rate of 68% compared to the average industry growth rate for all lending of 36%. Despite this high growth rate, at only 10% of the total industry portfolio, scale is vital to driving down cost-income ratios for Islamic MFIs.

This report provides an analytical overview on the performance of Murabaha financing vis-à-vis conventional microfinance products in Iraq. Shari'a-compliant microfinance has the potential to not only respond to unmet demand but also to combine the Islamic social principle of caring for the less fortunate with microfinance's power to provide financial access to the poor. Unlocking this potential in Iraq is the key to providing financial access to the Muslim poor who currently reject microfinance products that do not comply with Islamic law or those who use conventional products but prefer Islamic ones.

In Iraq, Islamic finance is still in its infancy. Business models are just emerging. The range of Islamic finance products available and their outreach is influenced by a variety of factors, with the legal and regulatory framework, and the enabling environment surrounding Islamic finance as critical constraints. For each activity Islamic Murabaha finances, it places special emphasis on income generation, empowerment and skills enhancement. One of the distinguishing features of Islamic microfinance is the role played by Shari'a scholars. Religious sheikhs exercise tremendous power by underpinning – or undermining – an institution's credibility and ability to operate within the Islamic community.

The report highlights the tremendous opportunities as well as significant challenges that donors and industry stakeholders can jointly address to support the development of Islamic microfinance in Iraq.

CHAPTER 2

ISLAMIC MICROFINANCE MURABAHA – BRIDGING THE GAP IN IRAQ

Six years ago, Karbala resident Karar Husain was an unpaid foot soldier in the Mahdi army. He soon realized that gainful employment was preferable to sectarian violence and applied for a group loan with two other friends. Each received $600 from Relief International and together they began selling religious souvenirs beside the road leading to the Imam Hussein mosque.

1.1. THE BEGINNING – ALTERNATIVE NEEDS AND CHALLENGES OF MAINSTREAMED MICROFINANCE

The demand for Islamic microfinance products, also referred to as Shari'a compliant financial products, in Iraq varies across 18 provinces with the total demand estimated at 820,000[1] households of a total of 1.03 million Iraqi households[2] living below the poverty line. [3] Within this population segment, many prefer Islamic microfinance products due largely to adherence to religious principles. However, many access mainstream microfinance products based on the non-availability of Islamic loans. Shari'a compliance in some societies may be less a religious principle than a cultural one – even the less religiously observant may prefer Shari'a compliant products, as noted across the provinces of Iraq.

TABLE 1 – TOTAL DEMAND FOR ISLAMIC MICROFINANCE AMONG THE LOW-INCOME PEOPLE IN IRAQ

Demand for Shari'a Compliant Islamic Microfinance	Total
Number of Households: Demand or Prefer Shari'a Islamic Microfinance Products	0.82 million

Shari'a Law

Shari'a (or Islamic) law is meant to regulate all aspects of a Muslim's way of life. It is broadly divided into two sets of rules: one relates to the obligatory worship of God (ibadah) and the other relates to daily life outside the context of obligatory worship (muamalat), including commercial and financial dealings. Shari'a is not a codified body of law. It consists of general rules and principles derived from the Qur'an (the Muslim Holy Book), the practices (sunnah) and sayings (ahadith) of the Prophet Mohammed. These general principles are capable of interpretation and development to address new issues or circumstances that arise from time to time. Indeed, the Shari'a has been supplemented by extensive Islamic jurisprudence (fiqh) developed over centuries by different schools of thought (the madhaa'hib). The key point to note is that, while all the schools of thought agree on the fundamental Shari'a principles enshrined in the Qur'an, sunnah and hadith, they sometimes hold differing views on their interpretation and application.

Islamic microfinance represents a confluence of two rapidly growing industries: microfinance and Islamic finance.[4] It is therefore imperative to understand the trends of Islamic finance in Iraq to draw upon the influence of its rise and challenges for Islamic microfinance. Across other Islamic countries, including those in the Middle East & North Africa (MENA) region, the rise of Islamic finance has positively propagated the rise of Islamic microfinance. For example, the Central Bank of Pakistan issued guidelines for Islamic microfinance based on the growing popularity of Islamic finance in the country[5] and the need to provide options for offering Islamic microfinance services. The growing popularity of Islamic banking in the country required options for providing Islamic microfinance services by microfinance and commercial banks, as well as allowing full-fledged Islamic microfinance banks in countries such as Pakistan, Sudan, and Jordan among others.

Shari'a-compliant microfinance has the potential to not only respond to unmet demand but also to combine the Islamic social principle of caring for the less fortunate with microfinance's power to provide financial access to the poor. Unlocking this potential in Iraq is the key to providing financial access to the Muslim poor who currently reject microfinance products that do not comply with Islamic law or those who use conventional products but prefer Islamic ones. In Iraq, Islamic finance is still in its infancy, and business models are just emerging. The range of Islamic finance products available and their outreach is influenced by a variety of factors, with regulatory environment surrounding Islamic finance as critical point of constraint. However, the Central Bank of Iraq (CBI) recognizes the tremendous potential of Islamic finance in Iraq, and since 2009 has been looking for ways to encourage the sector's growth.[6]

1 Up to 80% of Iraq's population of 31.2 million people are Muslims (35% Sunnis and 65% Sheas), 15% Kurds and 5% other ethnic groups. http://en.wikipedia.org/wiki/Demographics_of_Iraq. Based on the 23% poverty rate in Iraq (7.2 million people) and the percentage of Muslims to total population, it is assumed that 80% of the poor are Muslims. Therefore, the number of poor Muslims is 5.76 million or 820,000 households.

2 Average Iraqi household number is estimated to be seven. There has not been a census since 1997, but the household expenditure survey in 2007 covered 127,189 individuals in 18,144 households which comes up to 7 per household.

3 Poverty line based on World Bank definition of household income of $2.20 per day.

4 Today, the total assets of Islamic financial products is estimated at $500.5 billion (The Banker 2007) and the Islamic finance industry's 100 largest banks have posted an annual asset growth rate of 26.7 percent, outpacing the 19.3 percent growth rate of other conventional counterparts (Kapur 2008).

5 In just three years, from end-year 2003 to end-year 2006, the number of Islamic banking branches in the country has increased from 17 to 150. From the Third to the Fourth Quarter 2006, the total assets in the Islamic banking sector increased 24 percent to 118.2 billion rupees (US$ 1.95 billion). The same quarter, total deposits grew from 66 billion rupees ($1.1 billion) to 83.7 billion rupees ($1.4 billion), a boost of 27 percent.

6 http://www.cibafi.org/newcenter/english/details.aspx?Id=3587&Cat=4&RetId=101

While Islamic banks in Iraq began in the 1990s with seven in the country, their current outreach is limited (see Table 2) at 18% of total private banking sector loans of $1,724 million.[7] As Iraq is emerging out of conflict, the overall banking infrastructure remains weak, including Islamic banks. CBI currently does not differentiate between regular and Islamic banks. For Islamic finance to thrive in Iraq, regulatory rules would need to be changed to address taxation concerns and to bridge the gap in regulation between conventional and Islamic banking. CBI's undertaking to review a new legal framework for Islamic banks is in response to their requests to loosen broader banking rules on the size and type of investments they can make relative to capital and cash reserves. The rules are meant to ensure banks are solvent, but Islamic banks derive much of their profits from investments, which are distributed among account holders in place of interest. Iraqi law restricts investment in real estate, where Islamic banks in the Middle East have concentrated much of their cash in recent years, to up to 15 percent of capital.[8] Such modifications in the banking law would enable Iraqi Islamic banks to scale-up as well as diversify their product portfolio.

TABLE 2 - IRAQI PRIVATE SECTOR ISLAMIC BANKS

Islamic Bank	Loans Extended ($Million)
Iraq Islamic Bank for Investment & Development	6.1
Elaf Islamic Bank	18.63
Kurdistan Islamic Bank for Investment & Finance	12.31
Al Bilad Islamic Bank for Investment & Finance	157.8
Dijla & Furat Bank for Development & Investment	46.8
Islamic Regional Cooperation Bank for Development & Investment	67.2
Islamic National Bank	0.013

Together, the seven banks offer Murabaha, Musharaka (partnership), and Mudaraba (trust financing). They, concentrate primarily on Murabaha financing based on low risks associated with this product in the absence of clear regulatory frameworks. Wholesale and retail trade forms the highest percentage of outreach at 63%, followed by building and construction at 29%. In May 2010, Iraq's Ashur International Bank announced plans to provide Islamic banking services in Iraq amid growing interest in Shari'a-compliant financing.[9] The Abu Dhabi Islamic Bank (AIDB) planned to open a branch in Baghdad in June 2010, becoming the first United Arab Emirates (UAE) bank to establish presence in Iraq. The new branch will be followed by others across the country in the provinces of Basra, Erbil, Najaf, Karbala and Mosul.[10]

Across the globe, finance that complies with Shari'a accounts for around $1 trillion of assets and is growing at 10% to 30% a year.[11] Islamic finance is concentrated in the Middle East region and Muslim parts of South and Southeast Asia such as Indonesia and Malaysia but is also spreading into North Africa and Europe. Comparatively, the supply of Islamic microfinance is concentrated in a few countries, with Indonesia, Bangladesh and Afghanistan ranking in the top three. Over 125 microfinance institutions (MFIs) in over 19 Muslim countries provide Islamic microfinance products, however their outreach represents only 380,000 customers and accounts for an estimated one-half of one percent[12] of total microfinance outreach. In all Muslim countries, Islamic microfinance still accounts for a very small portion of the country's total microfinance outreach. For example, in Syria and Indonesia, Islamic financing instruments were only 3% and 2% respectively of outstanding microfinance loans in 2006.[13] In the Iraqi microfinance industry, Islamic Murabaha clients represent 10% of total outreach and 9% of total outstanding portfolio. Similar to experiences from other Muslim countries, MFIs started Murabaha in Iraq as a tool to alleviate poverty for those poor who cite religious reasons for not accessing conventional microloans.

7 Central Bank of Iraq, 2009
8 http://ifresource.com/2009/05/30/islamic-banking-in-iraq-law-reforms-needed-to-boost-growth/
9 http://www.reuters.com/article/idUSLDE64H11Z20100518
10 http://www.ameinfo.com/231204.html
11 Moody's Investors Service.
12 Based on an estimated 77 million microcredit clients (Microfinance Information eXchange 2007)
13 Sanabel Microfinance Network data

Principles of Islamic Finance

- Prohibition of usury or interest. It is not permissible to charge, pay or receive interest. The Sharia does not recognize the time value of money and it is therefore not permissible to make money by lending it.
- Money has no intrinsic worth. Money is not an asset by itself and can increase in value only if it joins other resources to undertake productive activity. For this reason, money cannot be bought and sold as a commodity. If not backed by assets, money cannot increase in value over time.
- Fund providers must share the business risk. Providers of funds are not considered creditors but rather investors who share the rewards as well as the risks associated with their investments.
- Material finality. All financial transactions must be linked, either directly or indirectly, to a real economic activity.
- Investment activity. Activities deemed inconsistent with Sharia, such as those relating to the consumption of alcohol or pork and those relating to gambling and the development of weapons of mass destruction, cannot be financed. In broader terms, Sharia prohibits the financing of any activity that is considered harmful to society as a whole.
- No contractual exploitation. Contracts are required to be by mutual agreement and must stipulate exact terms and conditions. Additionally, all involved parties must have precise knowledge of the product or services that is being sold or bought.

The Sanabel Microfinance Network of Arab Countries recently conducted a survey of MFIs across the MENA region to solicit their feedback on whether Islamic microfinance attracts new clients and to assess their needs for risk management training courses related to Islamic micro-lending. According to feedback collected by USAID-*Tijara* from the Iraqi MFIs, institutions are losing clients to other organizations that provide Islamic microfinance, including Murabaha. Participatory schemes such as Musharaka and Mudarabah (refer to Glossary for descriptions of each) also have great potential for microfinance purposes as these schemes can satisfy the risk sharing needs of the micro entrepreneurs. These schemes however require specialized skills in managing risks inherent in the structure of the contract. The thorough reporting and transparency requirements surrounding the just distribution of any profit and loss in the Mudaraba and Musharaka financing can result in substantial operating burdens and costs on small enterprises unaccustomed to formal accounting.[14]

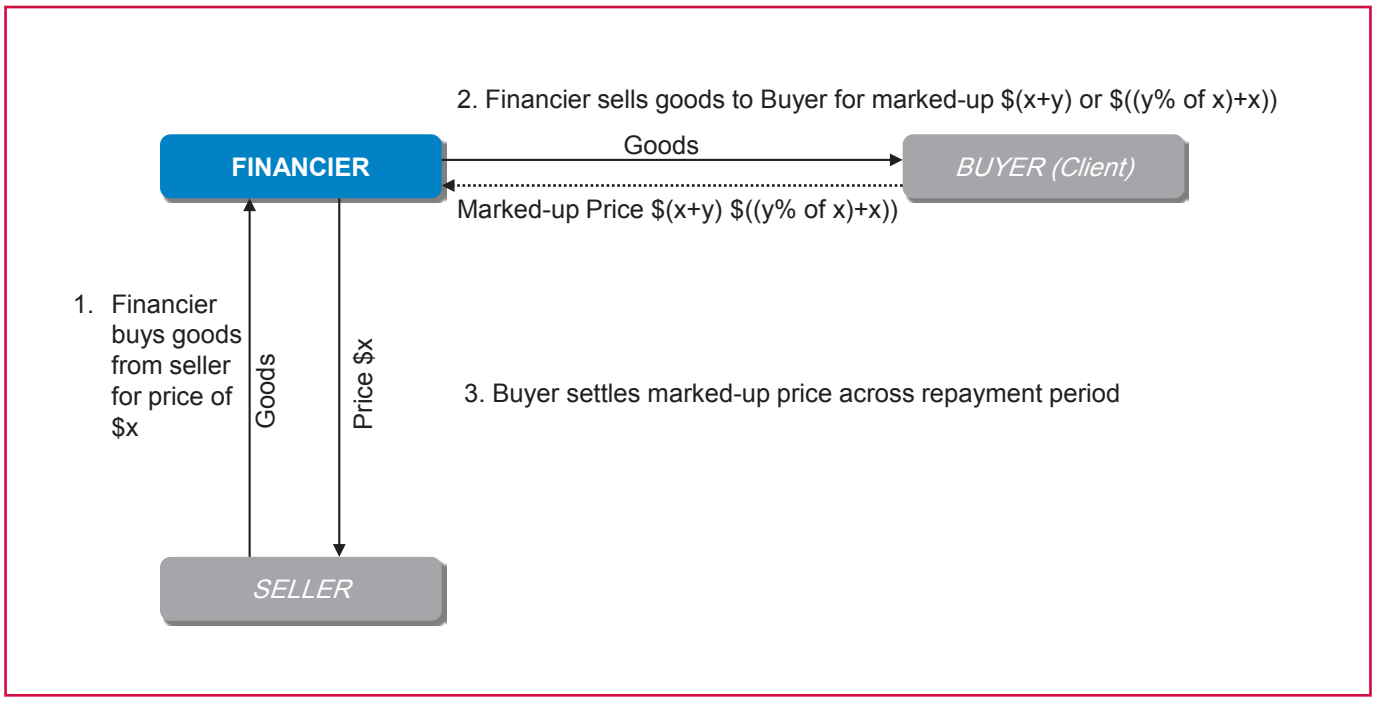
This report focuses on Iraqi microfinance industry's experience in Murabaha lending. While there are at least four MFIs offering Jouala[15] microfinance product, popular in south central provinces, the discussion on the aforementioned Islamic microfinance product is outside the scope of this paper. USAID-*Tijara*, with the mandate to facilitate the development of the Iraqi microfinance industry at the macro, meso and micro levels, continues to support growth and performance of Islamic Murabaha lending through technical assistance, funding and regulatory level engagement with the CBI for Islamic microfinance framework through a national Shari'a board.

Murabaha is the most popular and flexible Shari'a-compliant structure. It is used in microfinance activities across Afghanistan, Bangladesh, Indonesia, Sudan, Syria and Yemen as well as Iraq. Murabaha is recognized as a financing scheme for start-ups and small companies whose businesses involve the sale and purchase of commodities. It is for those which do not have sufficient surplus funds to be credibly investing in commodities. Murabaha involves a finance party (for example, an MFI) purchasing tangible assets from a seller and then re-selling them to a buyer (for example, a microfinance client) at a predetermined profit margin or mark-up. In Iraq, Shari'a compliance as approved by religious leaders requires the buyer to settle the marked-up purchase price by way of installments across an agreed upon period (typically one year for microfinance). Murabaha is relatively easier to manage and ensures the capital needs for potential micro-entrepreneurs and the poor.

14 Islamic Microfinance: A Missing Component in Islamic Banking; Abdul Rahim Abdul Rahman; Kyoto Bulletin of Islamic Area Studies

15 Jouala also referred to as 'service charge' product is offered by MFIs CHF, Amalkom, Relief International and Izdiharona. However, the discussion on this product is outside the scope of this paper.

FIGURE 1 – MURABAHA STRUCTURE



1.2. ISLAMIC FINANCE NEEDS OF SMALL AND MEDIUM-SCALE ENTERPRISES IN IRAQ

Small and medium enterprises (SMEs) are recognized as integral contributors to economic growth through several pathways that go beyond job creation, such as entrepreneurship, economic dynamism, value chain linkages, and societal development. The Iraqi Company for Financing SMEs (ICF-SME), a non-banking financial institution established in 2009 through seed capital provided by USAID-*Tijara*, has been working with a range of donors and government agencies to offer low-cost financing to SMEs through its network of partner banks. As of August 2010, ICF-SME has intermediated financing for 646 SMEs with an outstanding loan portfolio of $8.5 million.[16]

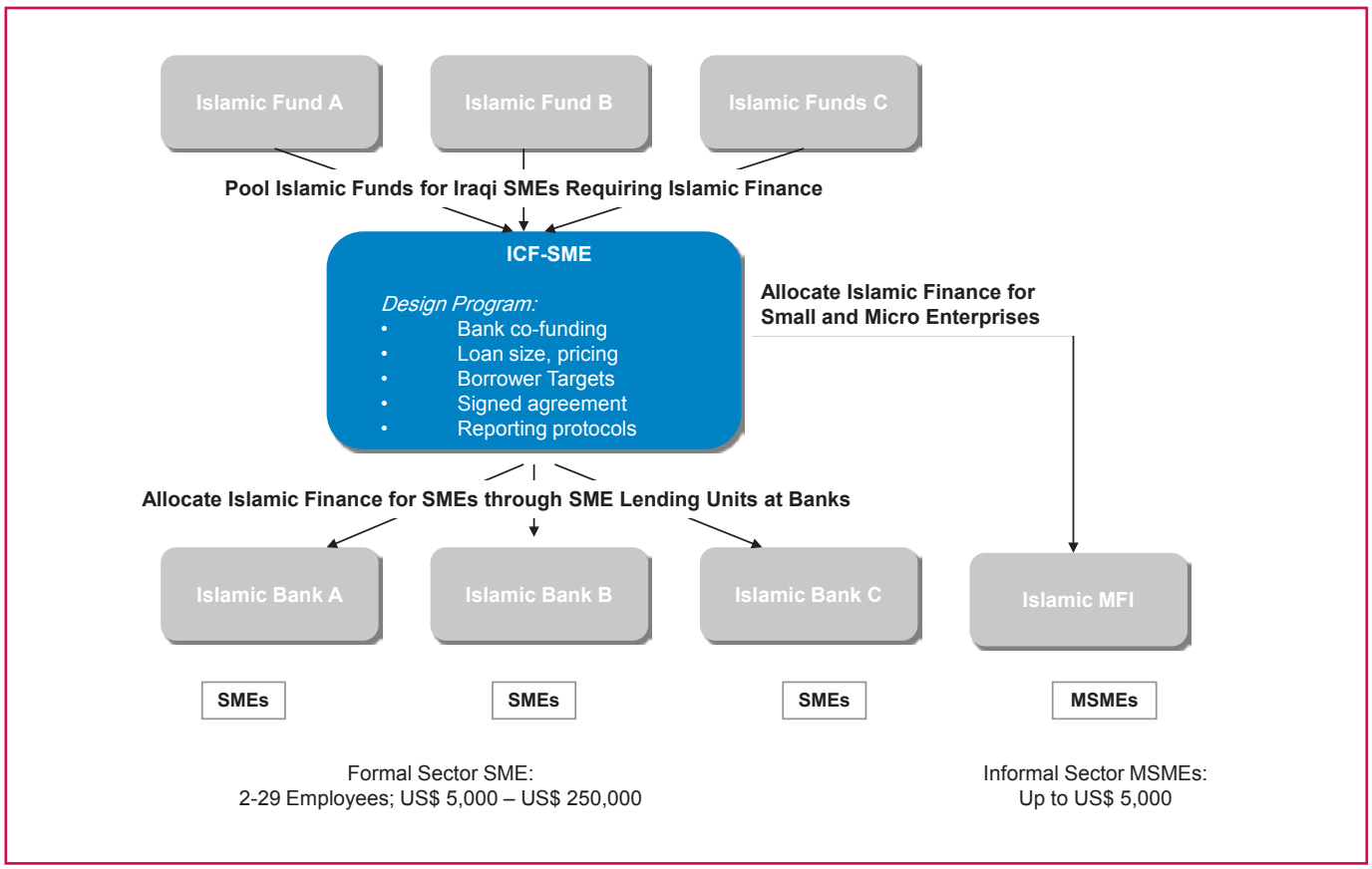
ICF-SME, with its overall mandate to promote financing for SMEs in Iraq, recognizes that a large proportion of SMEs require or prefer Islamic finance that is Shari'a compliant. In Iraq, Islamic financing for small and medium enterprises is largely missing. There are six microfinance institutions (MFIs) operating in western and northern provinces that provide Islamic microfinance Murabaha to micro and small enterprises. There are seven Islamic banks in the country, with few mainstream commercial banks planning to provide Islamic banking services amid growing interest in Shari'a-compliant financing. ICF-SME aims to leverage the presence of these banks and the network of Islamic MFIs to facilitate access to Islamic finance for SMEs across Iraq. ICF-SME believes that SME financing is a natural niche for Islamic banking in that it deals directly with the real economy; creates employment; involves the productive use of resources especially capital and finance; and contributes directly toward poverty alleviation.

SMEs are widely recognized as the backbone of local economies and have recently received a major boost especially in the Islamic banking and finance sector. Countries such as Saudi Arabia and Malaysia are encouraging greater allocation of Islamic financing for SMEs by the banking sector in an effort to stimulate the private sector. The methodology also helps to achieve rural and inner city poverty alleviation policy goals. Conducting business in accordance with Shari'a law is important to many SMEs in the Middle East.

ICF-SME aims to catalyze Islamic financing for SMEs through pooling regional Shari'a- compliant funds for financing them through partner Islamic banks and MFIs operating in the Kurdistan Region of northern Iraq and across the country over the next few years.

16 Data as of August 31, 2010

FIGURE 2 – ICF-SME BRIDGING THE GAP OF ISLAMIC FINANCE FOR MICRO, SMALL AND MEDIUM ENTERPRISES



Globally, there have been some novel experiences of Islamic banks partnering with MFIs offering Islamic microfinance to scale-up outreach and impact in local Muslim communities. For example, HSBC Amanah, the global Islamic finance services arm of the HSBC Group, in 2010 entered into a partnership with Islamic Relief. Islamic Relief is a major international relief and development charity implementing a pilot Islamic microfinance scheme in Pakistan. HSBC Amanah will be providing funding towards Islamic Relief's microfinance projects in Rawalpindi, Pakistan. This partnership combines HSBC Amanah's Islamic finance expertise with Islamic Relief's understanding of the dynamics of less privileged environments and constant interaction with the poor.

The Islamic finance industry in Iraq also needs to adapt its product set and operating models—not fundamentally, since the basic structures are already there—to meet the needs of the poor which make up the target groups of microfinance.

1.3. Establishing Islamic Microfinance Al-Murabaha in Iraq – Overcoming Hurdles in the Post Conflict Environment

Islamic microfinance in Iraq commenced as a demand-driven initiative through multiple dialogues with religious Sheikhs and market surveys undertaken in local communities to understand financing requirements.

Microfinance based on international standards of best practices in Iraq[17] started in 2003 mainly as a tool primarily by the U.S. military to mitigate the affects of war, and promote security and socio-economic stabilization. It now serves as the sole provider of sustainable financial services for the poor and those excluded from the financial sector, including MSMEs. MFIs such as CHF International, the ACDI/VOCA-supported MFI Al-Thiqa, and Relief International (RI) established operations in Iraq in 2003, 2004 and 2006 respectively, through funding received from U.S. Government sources[18]. Their operations, however, were limited to more stable areas in south and central Iraq, and the semi-autonomous provinces of the Kurdistan region in northern Iraq.

17 To read more about the Iraqi microfinance industry, visit www.imfi.org to download the Iraqi microfinance industry report 2010.
18 Initial capital was provided by U.S. Coalition Forces, significantly augmented by support from USAID on a continuous basis.

USAID-*Izdihar*[19], a provincial economic growth project funded by USAID from 2004 to 2008 collaborated with the U.S. and coalition militaries in late 2006 to establish indigenous MFIs in order to ensure the presence of at least one MFI in each governorate to enable private sector growth. In supporting the development of indigenous MFIs, USAID envisioned local institutions serving communities through strategies for delivering locally acceptable financial services such as loan products, fulfilling a market gap unmet by the larger players. USAID-*Tijara*, a follow-on project funded by USAID from 2008 onwards continues to build the operational and technical capacity of indigenous MFIs, including MFIs offering Murabaha financing.

As a predominantly Muslim country, mainstream microfinance was initially resisted in various pockets of Iraq, particularly in the provinces of Anbar, Ninawa, and Salah Ad Din. Of 12 MFIs in Iraq, six offer Islamic finance Murabaha as a strategy to overcome constraints set forth in Islam on interest or riba. Two MFIs offer only Murabaha whereas the other four institutions offer conventional micro-loans along with Murabaha. In order to continue serving the target population of 820,000 poor households[20] living in Iraq without prejudice, these six MFIs perceived Murabaha as a viable strategy for enabling access to financial services for the poor Muslims who reject conventional microfinance products in Iraq. As of August 31, 2010, these MFIs serve nearly 7,000 clients with Murabaha financing, representing 10% of total microfinance clients in Iraq.

TABLE 3 – STATUS OF ISLAMIC MICROFINANCE OUTREACH BY IRAQI MFIS

MFI	Active Clients	% Total Active Clients	Outstanding Portfolio	Number of Loans Since Inception	Value of Loans Since Inception	Female Clients (%)
Al-Takadum	5,105	100%	$ 6,643,828	9,867	$ 21,581,550	14.5%
Al-Mosaned	1,176	100%	$ 1,356,431	2,456	$ 5,012,820	29%
Al-Aman	524	16%	$ 638,290	557	$ 677,305	25%
Al-Thiqa	31	.0024%	$ 32,174	69	$ 70,750	0%
TEDC	1	.0011%	$ 1,450	1	$ 1,450	0%
TDMN	86	13%	$ 162,215	86	$ 162,215	21%
Total	6,927	10% (of total active clients)	$ 8,832,938	13,040	$ 27,504,640	9% (of total active female clients)

Islamic microfinance Murabaha supports a diverse range of economic activities, targeting youth, women and internally displaced people (IDP). Youth[21] form approximately 90% of the total Murabaha portfolio. Women customers are particularly appealing to these MFIs because they generally have a lower appetite for risk and repay their debts in a manner that protects the financial interests of their families and the futures of their children. In Al Mosaned and Al Aman, women represent 29% and 25% respectively of the Murabaha microfinance portfolio.

In 2007, USAID-*Tijara* met with Al-Qaim mayor Farhan Ftekan Al Farhan (center), tribal Sheikh Askuri Nader Mawlood (right) and several local imams to agree upon a system of Al-Murabaha Islamic lending suited to the people of Anbar province. Adapting loan programs to local culture remains a priority for USAID-*Tijara* and its provincial economic growth partners.

The Anbar Province is one of the most security-challenged provinces in Iraq, especially due to the continuing insurgency. When the Al Takadum Microfinance Institution was established in 2007, it faced enormous resistance from religious

19 *Izdihar* was a USAID funded private sector growth and employment generation project implemented by the Louis Berger Group and its joint venture partners in Iraq to support microfinance, SME lending, trade policy, investment promotion and business development services. The project worked at the federal and provincial levels in collaboration with the central government, provincial governments, and provincial reconstruction teams (PRTs), Military and other local NGOs. This multidisciplinary program ended in March 2008. A follow-on USAID program (named *Tijara*) is continuing the initiatives undertaken by the Izdihar project, building on the successes and addressing sector level challenges through a sector development approach.

20 http://www.irinnews.org/Report.aspx?ReportId=84526

21 Youth clients are defined within the age group of 18-35 according to USAID endorsed definition in Iraq.

leaders who perceived microfinance as 'haram' or forbidden. The Al Takadum team along with USAID held 23 meetings with a number of religious sheikhs to build consensus on Islamic microfinance principles and traveled across the province to dialogue with local communities and people from the Religious Awakening Councils. The support of the Provincial Reconstruction Team (PRT)[22] and US Army was tremendous in coordinating meetings with mayors of Anbar's main towns of Ramadi, Fallujah and Qaim.

Al Mosaned started Murabaha lending in 2008 in the Salah ad Din Province. Al Takadum's experience of establishing Islamic microfinance Murabaha provided Al Mosaned with lessons and frameworks through which Al Mosaned engaged with local religious leaders to promote micro-lending and inclusive economic development. Al Aman and Al Thiqa had been offering conventional microfinance products since 2008 and 2005 respectively. In 2009, however, both institutions were receiving feedback on the need for Islamic microfinance as they opened new branches in and around Kirkuk and Sulaymaniyah. Al Aman perceived an opportunity for Islamic microfinance products in Kirkuk province and also noted the threat of being defamed by religious sheikhs for their conventional microfinance loan products. The MFI engaged in multiple discussions with the local sheikhs and since July 2009 has grown to over 500 clients accessing Murabaha financing.

TABLE 4 – ISLAMIC MURABAHA OPERATIONS BY IRAQI MFIS

	Province of Operation	Established (Islamic Lending Only)	Number of Branches (Islamic Lending Only)	Sector Financed	Mark-up%
Al-Takadum	Anbar	2007	All Branches - 12	• Business Start-ups • Housing/Home Improvement • Agriculture	12%
Al-Mosaned	Salah ad Din	2008	All Branches - 4	• Business Start-ups • Housing/Home Improvement • Agriculture	12%
Al-Aman	Kirkuk	2009	2	• Housing/Home Improvement	12%
Al-Thiqa	Kirkuk, Sulaymaniyah	2009	2	• Housing/Home Improvement	20%
TEDC	Ninewa	2010	1	• Agriculture • Trade • Housing	12%
TDMN	Ninewa	2010	2	• Agriculture • Trade • Housing	12%

Mark-Up

In Anbar, the mark-up of 12% is agreed upon with religious sheikhs. This mark-up is based on the market rate in the area in which the MFI operates.[23] Similarly, all MFIs offering Islamic microfinance Murabaha have adopted a mark-up of 12% with the exception of Al Thiqa at 20%. Mark-up levels are not specified in the Fatwas issued by religious sheikhs. They reserve the right, however, to issue a Fatwa if the mark-up charged by the MFI is considered too high. In general, the MFI has to specify that the mark-up is for the services that the financier provides, namely, seeking out, locating, and purchasing the required goods at the best price. This is a recognized service for which a fee can be charged and paid for, and whose value is predetermined.

Types of Businesses Financed

To ensure that the client accepts the quality or the price of the goods, the Fatwa includes key requirements that have to be met in order for a Murabaha contract to be legal. These include the entrepreneur submitting an application in detail describing the commodity to be purchased; the financier buying the commodity and physically taking possession; and the entrepreneur having the right to refuse to accept the commodity when offered sale by the financier. Murabaha loans finance assets or working capital inputs, such as raw materials, machinery or

22 PRTs are small civil-military units of the US Army to serve as intermediaries with local MFIs in conflict-prone regions and help promote microfinance services within local communities.

23 According to field reports from Al-Anbar, there are big merchants who provide goods to small shops or street vendors, and charge a mark-up of up to 12%.

equipment for micro and small enterprises as well as housing/home improvement loans.

Each MFI has built a network of 10 to 20 suppliers who provide the goods to the MFI at wholesale prices. If the requested goods are unavailable in their areas of operations, the MFI may seek to procure them outside their province, which increases their operating cost. In some cases such as with Al Mosaned, the Murabaha contract allows buyers to resell their goods for cash in cases when the desired commodity cannot be sourced from local markets.

Collateral Options

The collateral option for Murabaha in Iraq is similar to that of other microfinance loan products: a third-party guarantee, typically a government employee. However, as with other micro-loan products, MFIs are innovating in their use of collateral options with trust receipts and solidarity group loan (SGL) guarantees. Some institutions may also hold off the transfer of asset ownership to the client until the last installment is paid. Here, the commodity itself is the guarantee. Many Islamic MFIs disburse Murabaha-based financing to individuals based on a combination of personal guarantors, co-signers and community recommendations to ensure repayment. These guarantee mechanisms are highly efficient and repayment levels are in the range of 95% to 99%.

Repayment

In Murabaha, the borrower must repay in installments, including the mark-up, divided equally over the loan period of one year. In contrast, other MFIs in Iraq recover the interest payment upfront at disbursement.

Application Fees

The application fee of $10 was rejected by the sheikhs in Anbar Province on the basis that the mark-up was enough to cover operational expenses of the MFI. The MFI Al Mosaned and few others are allowed to charge the application fee.

Religion plays an integral role in Islamic MFIs' repayment success. In the province of Salah-ad-Din, Al Mosaned provides the Fatwa issued by the local Sheikh to each client's loan contract to encourage religious responsibility to repay in Beiji district.

The introduction of Murabaha lending in the Iraqi microfinance sector has enabled MFIs to reach out to a larger number of clients traditionally excluded from the financial sector. Given the young history of the industry against the backdrop of insecurity, microfinance is increasingly recognized as the only channel through which people without tangible collateral can access financing. It is imperative for the Iraqi microfinance sector to continue providing religiously acceptable loan products to achieve the overall objective of poverty reduction and entrepreneurship. The need to conform to certain religious principles affects the structure and development of Islamic MFIs. It is essential, therefore, to seek approval from qualified Islamic scholars particularly before developing new financial instruments. Indeed, most Islamic banks have standing religious boards and Shari'a advisors for this purpose.

Table 5 – Differences between Conventional MFI and Islamic MFI Offering Murabaha

	Mainstream MFI	Islamic MFI
Sources of Funds – Current & Potential	External Funds	External Funds, Islamic Funds, Islamic Charitable Sources
Mode of Financing	Interest Based	Islamic Financial Instrument
Deduction at the Inception of Contract	Upfront, Declining, Across Repayment Period etc	Across Repayment Period
Target Group	Poor	Poor Families
Liability of the Loan	Client & Guarantor	Client & Guarantor
Work Incentive of Employees	Monetary	Monetary and Religion
Interest Rate or Mark-up Range	12-24%	12-20%
Dealing with Default	Late Fees From 1st Date Overdue	No Late Fees with one exception of late fees past 18 days due

In Islamic microfinance Murabaha, all micro-lending is based on trust, requires no tangible collateral or commercial registration for acceptance, is forgiven in the event of death or grave disability. As a pioneer Islamic microfinance institution, Al Takadum is actively fulfilling its responsibility to set high standards and craft a successful, replicable model across Iraq and in the Middle East. In early 2010, Al Takadum through funding and technical assistance provided by USAID-*Tijara* organized an Islamic finance site visit for MFIs operating in the Ninewa Province. As a direct outcome of the cross-fertilization visit, MFIs TDMN and TEDC started Murabaha lending in July 2010.

For each activity Islamic Murabaha finances, it places special emphasis on income generation, empowerment, and skills enhancement. In other countries, clients are often obligated to open an account into which mandatory monthly savings deposits are made to encourage sound financial management and good savings discipline. In Iraq, the lack of clear regulations on savings and on Islamic finance limits the scope of this service for the industry as a whole.

Funded by USAID and facilitated by USAID-*Tijara*, Iraqi MFIs in 2010 partnered with local small business development centers (SBDCs) to offer non-financial support in the form of entrepreneurial and vocational training, business counseling, and professional networking to their clients and students. Young entrepreneurs targeted receive training in their business sectors as well as in financial literacy. Their ability to access Shari'a-compliant financing along with value-addition inputs allows Iraqi youth to integrate into the economy and participate as productive citizens in their communities.

1.4. RELIGIOUS SHEIKHS AND FATWAS – ENGAGEMENT FOR FINANCIAL INCLUSION

Fatwa is an authoritative legal opinion based on Shari'a law.

One key distinguishing feature of Islamic finance and Islamic microfinance is the role played by Shari'a scholars. They are both advisors and supervisors. They are ultimately responsible for determining whether a particular transaction or product complies with Shari'a law. In various microfinance industries, Islamic microfinance is governed by separate legal and regulatory frameworks, predominantly in countries where the central bank has legal and regulatory framework for microfinance. The presence of national Shari'a boards also provides a useful framework through which Islamic microfinance can comply with national religious authorities' view on what constitutes Shari'a compliance. A transaction or product will generally be treated as being Shari'a-compliant if a Shari'a scholar or board issues a Fatwa to confirm that in his/their opinion that transaction or product is Shari'a compliant. However, a Fatwa does not ensure that the relevant transaction or product will be accepted as Shari'a-compliant by every Shari'a scholar. There are different schools of thought within Islamic jurisprudence. While all of them agree on the fundamental Shari'a principles, they can (and sometimes do) hold different views on their interpretation and application.

Islamic financial services originally operated in an unclear regulatory landscape. However, as they expanded, they presented several regulatory challenges that governments have attempted to address to various degrees. A question often raised when entering into contracts or financing transactions is to what extent would Shari'a law apply to contractual obligations. The answer varies from jurisdiction to jurisdiction and often depends on the religious and social structure of the society, the legal system, the provisions of the constitution and the civil code of each jurisdiction. Shari'a law may apply directly as the governing law of a jurisdiction where there is no fully developed, codified legal system, or indirectly through the application of statute law based fully or partially on Shari'a law, or as a source of law to fill legislative gaps.

One approach has been to proactively encourage, even mandate, Islamic financial services by law. Northern Sudan, for example adopted a Shari'a-compliant regulatory framework for the entire banking sector in 1984. Indonesia broke new ground in the realm of Islamic finance by creating in 1992 a formal, regulated Shari'a banking sector alongside and not instead of, its conventional banking sector. New regulations in Pakistan, Malaysia and others have supported the expansion of an Islamic finance industry alongside conventional financial services.

A second regulatory approach has been to address the growth of Islamic finance by separately regulating unique aspects of Islamic banking, such as Shari'a supervisory boards (SBBs). For example, several countries (Kuwait, Jordan, Lebanon and Thailand) have regulated the competence and composition of SBBs, as well as related rules governing appointment, dismissal, and qualifications of SBB members. All Islamic banks, including those in Iraq, have

Role of a Shari'a Board

Shari'a boards are typically responsible for reviewing an institution's Islamic operations, products and transactions in order to ensure that they comply with Shari'a law. The role of a Shari'a board varies from one institution to another, and across jurisdictions. Most jurisdictions have yet to develop a detailed regulatory framework governing the appointment of Shari'a boards, the scope of their duties or the qualifications required for someone to become a Shari'a scholar. Decisions of a Shari'a board, as to whether a particular transaction or product is Shari'a-compliant, are generally arrived at by consensus. The Shari'a board will then issue a pronouncement (fatwa) to confirm that the transaction or product is Shari'a-compliant. If a single scholar has been engaged to review a transaction or product, then he will issue a fatwa after he is satisfied that the proposed transaction or product complies with the requirements of Shari'a law.

a separate Shari'a advisory board or committee in addition to a traditional board, and an Islamic internal audit department to monitor Shari'a compliance.

In Iraq, Islamic finance is not governed by a separate regulatory framework as discussed earlier. The CBI views Islamic banks similar to how it views commercial banks. While each Islamic bank has its own Shari'a boards, there is tremendous information asymmetry on Shari'a compliance across banks as well as the missing regulatory frameworks for deepening Shari'a products and investments in the country. In the absence of Central Bank laws pertaining to Islamic finance and Islamic microfinance, Islamic MFIs rely on Fatwas issued by religious leaders of a province. Consequently, Islamic MFIs and others offering Islamic microfinance Murabaha products often face challenges in understanding what constitutes Shari'a compliance. Since Shari'a law is not a single codified body of law and is open to interpretation, the opinions of Shari'a scholars may differ on the same question of Shari'a law depending on the school of thought to which particular scholars belong. In addition, scholars' views on questions of Shari'a law may change over time. This can lead to uncertainty and inconsistency of interpretation and application of Shari'a law. Experience in Al Takadum MFI, one of the pioneers of Islamic microfinance in Iraq, demonstrates the time consuming process the MFI had to undergo in order meet with different local sheikhs in different cities of the same province in order to discuss what constitutes Murabaha transaction. The sheikhs exercise tremendous power by underpinning – or undermining – an institution's credibility with the Islamic community.

Based on the numerous sheikhs governing small localities, MFIs offering Islamic-principled financial products in Iraq show some key differences in the structuring of the Murabaha product. Some of these differences include the mark-up charged to the client, payment of mark-up upfront versus in installments across the repayment period, collection of late fees, and the nature in which the commodities are delivered to the client.

TABLE 6 – COMPARING AL-MURABAHA ACROSS MFIS IN IRAQ AND OUTSIDE IRAQ

	Al-Takadum	Al-Mosaned	Al-Thiqa	Al-Aman	TDMN/ TEDC	Global Islamic MFIs
Mark-up	12%	12%	20%	12%	12%	• Bangladesh: 12-15% • Sudan: 12% • Pakistan: 24%
Repayment of Mark-up	Across Repayment Period	Across Repayment Period	Across Repayment Period	Across Repayment Period	Across Repayment Period	Across Repayment Period
Repayment Frequency	Monthly	Monthly	Monthly	Monthly	Monthly	Weekly
Application Fees	None	$10	$10	$10	$10	None
Late Fees	None	None	None	Yes: Late fees above 19 days past due	None	None

Delivery of Commodities	MFI brings goods to its own place (owned or rented by MFI); the client then picks up from MFI	Client and MFI visit Supplier together to pick up goods and pay supplier, respectively	MFI takes ownership and possession of the goods and delivers to the client at his/her business site	Client picks up from supplier. Supplier visit MFI for money	Client and MFI visit supplier together to pick up goods and pay supplier, respectively	MFI takes ownership and possession of the goods and delivers to client at his/her business site
Free to Resell Commodity for Cash	No	Yes – only in cases when the desired product is unavailable in the local market	No	No	No	Case by Case
Collateral Options	• Government employee • Purchased commodity ownership retained by MFI until last repayment	• Government employee	• Government employee guarantee • Solidarity group	• Government employee	• Government employee guarantee • Solidarity group	
Average Outreach (clients)	5,105	1,176	-	-	-	2,400
Average Loan Size	$1,301	$1,153	$1,037	$1,218	$1,632	$541
Sourcing Desired Commodity	Clients identify vendors but MFI makes the final decision	Clients identify vendor but MFI makes the final decision .	Clients identify vendors but MFI makes the final decision	Clients identify vendors but MFI makes the final decision	Clients identify vendors but MFI makes the final decision	Clients identify vendor but MFI makes the final decision

Al Aman is the only Iraqi MFI that charges late fees on repayments past 19 days due, as agreed with the local Sheikh of Kirkuk province. Juxtaposed against existing practice in the Islamic finance industry, banks cannot charge above the original amount if the customer makes late payments because the additional fee would be considered interest. But a few Islamic banks can charge late fees on the basis that the proceeds of late repayments must be donated to charity.[24] Al Takadum has had to adhere to stricter interpretation of the Shari'a law for Murabaha as demonstrated in practices stipulated under the Murabaha contract in Table x. While interpretation of Shari'a varies based on the province, it is also an indication of the level of 'piety' across provinces. All MFIs offering Islamic microfinance Murabaha have been issued a Fatwa by religious sheikhs belonging to the Iraqi Scientist Society, a national organizations with representative groups across the provinces, providing them permission to engage in Shari'a-compliant financing as well as providing directions on what they interpret as Shari'a compliance.

When Al Takadum MFI first met with the local religious sheikh of Al-Qaim, one of the cities in Anbar Province, in early 2007, the one overseeing the province issued a Fatwa declaring that "dealing with Al Takadum MFI is not acceptable – from a religious standpoint – because their contracts and regulations do not agree with the teachings of Islam and with its guidance." The Fatwa did not agree with Al Takadum calling the mark-up 'a profit' and instead suggested that the mark-up should only be used to cover operational and administrative costs. With technical assistance from USAID-*Izdihar*, Al Takadum explained the process of Murabaha and demonstrated their commitment to providing Islamic finance that was acceptable by the communities and considered compliant by religious leaders. The initial loan contract put forth by Al Takadum underwent changes in the following areas:

- Late fees
- No mention of profit rate, but the sale price

24 McKinsey Quarterly October 2005 Report on Islamic Banking

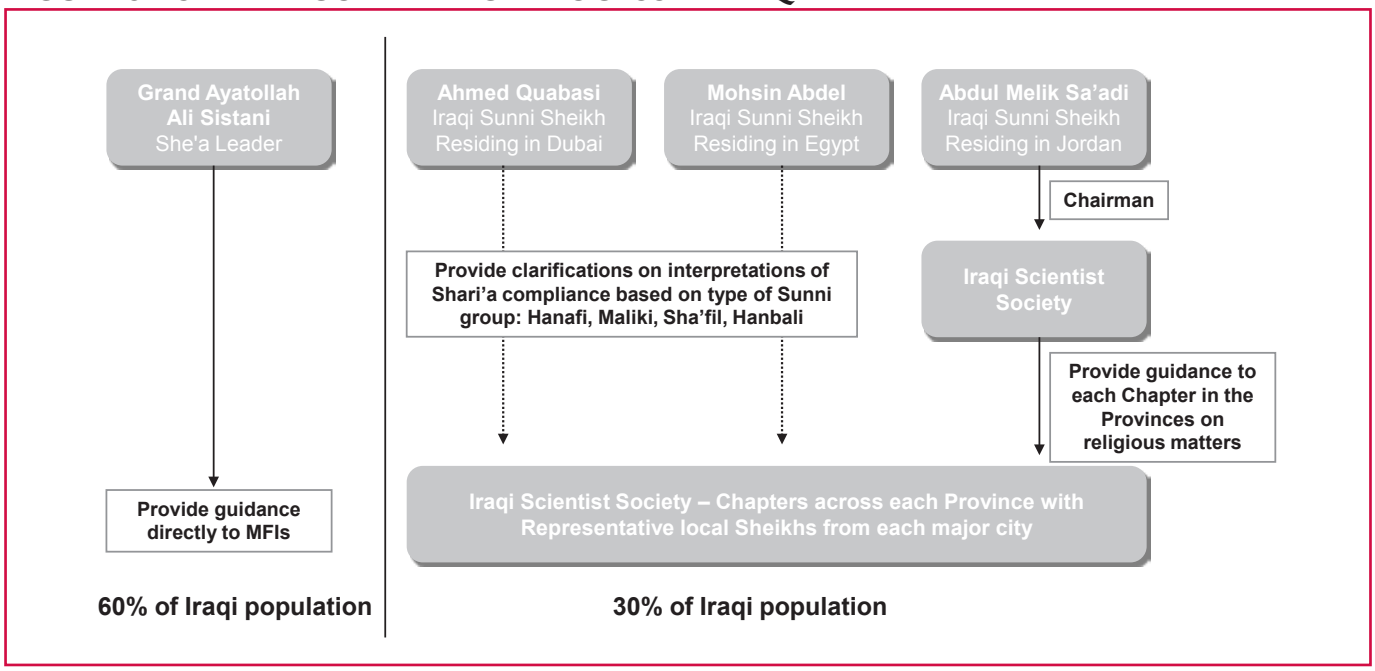
- Mark-up was limited to 12%

Another Fatwa issued by the local sheikh in Al-Qaim dealt with how commodities should be delivered to the client. According to the Fatwa, "the client should determine the product they want to purchase/buy, specify its quality and characters, and then the MFI will purchase these goods, own it, and then resell the goods to the client in a different location owned/rented by the MFI." Such aspect of Shari'a compliance adds additional layers of expenditure on an MFI's cost structure particularly as it is constantly looking at ways in which to maintain its low mark-up in order to enable access to a larger number of poor. In addition, the Fatwa limits opportunities for the MFI to purchase a large quantity of a particular good to be sold to interested clients. For example, the MFI may not be able to buy 1,000 bicycles at wholesale price and resell them to interested clients since the client did not predetermine the product.

In Iraq, there are regional differences in the interpretation of Shari'a law. Shari'a compliance monitoring is informally organized through the Iraqi Scientist Society for the Sunni Muslim sect and by the ruling Grand Sheikh Ayatollah Syed Ali Sistani for the Muslim Shia sect. In the absence of a national Shari'a board, Islamic finance is defined by a broad spectrum of religious leaders and can create significant challenges leading to misinterpretation and malpractice.

MFIs that offer Murabaha and operate in more than one province in Iraq have to engage with the religious sheikh of that province in order to issue a separate Fatwa allowing the MFI to provide Islamic finance in it. The process of identifying the 'right' sheikh and the challenge of dealing with several from the same province is a time consuming process. In addition, many sheikhs lack the financial knowledge in order to effectively incorporate the idea of sustainable Islamic finance institutions within the jurisdiction of Shari'a compliance.

FIGURE 3 – SHARI'A COMPLIANCE PROCESS IN IRAQ



With the CBI looking into introducing an enabling framework to scale-up Islamic finance in Iraq based on the latent demand, USAID-*Tijara* aims to work with it to include governing parameters for Islamic microfinance through a national Shari'a board. The envisaged board would consist of Islamic scholars who are both respected in the religious community and knowledgeable enough about modern finance to evaluate new products and to communicate their opinions effectively. Along with getting the basics of microfinance right, Islamic MFIs – either pure plays or as arms of conventional MFIs – must address specific problems linked to faithfulness to Shari'a, in areas ranging from organization to branding.

MICROFINANCE LOANS BRING THE IRAQI CITY OF FALLUJA BACK TO LIFE

Fourteen microfinance institutions supported by the USAID-*Tijara* Provincial Economic Growth Program are working to rebuild Iraq one business at a time. The loan capital is especially appreciated in towns like Falluja, which prior to the Sunni Awakening was plagued by terrorist attacks and random violence. Microfinance loans ranging from $500 to $3,000 provide the needed financing to start a business - or save one when adversity strikes. Small loans made by Al Anbar province companies like Al-Takadum add up to a big investment in the future of towns like Falluja, which now has a modern photographic studio to capture life's important family moments on film.

BEFORE: In 2009, a bomb placed at a nearby political party office destroyed Mohammad Ali Nasrallah's photography studio. Gone in a flash was $2,000 worth of equipment he had purchased with a loan from the Al Takadum microfinance institution.

AFTER: Today, Mohammad is back in business thanks to a second microfinance loan for $3,000 from Al Takadum that allowed him to rebuild his shop, replace lost cameras and plan for future growth.

CHAPTER 2

TRENDS AND IMPACT OF ISLAMIC MICROFINANCE AL-MURABAHA IN IRAQ

A Women Entrepreneurs Small Business Training and Development course at the Al-Murshed SBDC brought Amera Omar Asad, 30, and Sanaa Najah Kudra, 41, together. A $2,100 Murabaha loan from Kirkuk's Al-Aman Center allowed them to start a boutique selling dresses. cosmetics and baby clothes.

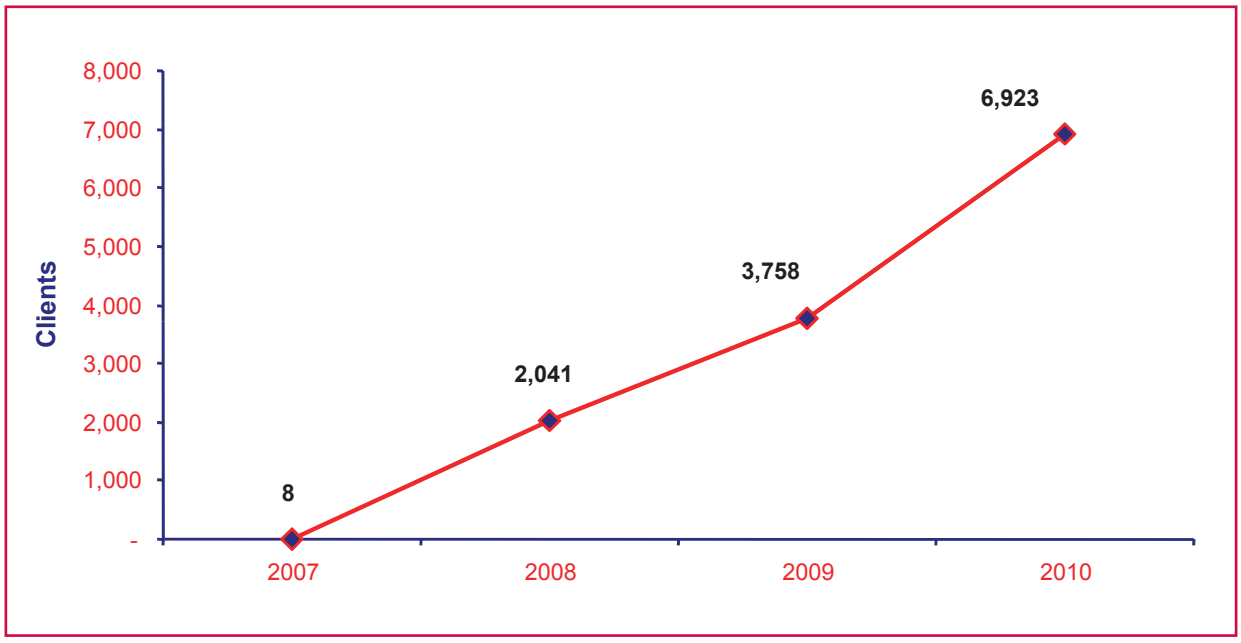
2.1. OUTREACH AND IMPACT OF MURABAHA – TREND ANALYSIS

As of August 2010, microfinance clients accessing Islamic Murabaha financing recorded an annual increase of 68% with an increase of 68% in portfolio size. Comparatively, the overall industry recorded an annual growth of 36% in active clients and 27% in outstanding portfolio.

TABLE 7 – GROWTH COMPARISON OF MURABAHA AND OVERALL INDUSTRY

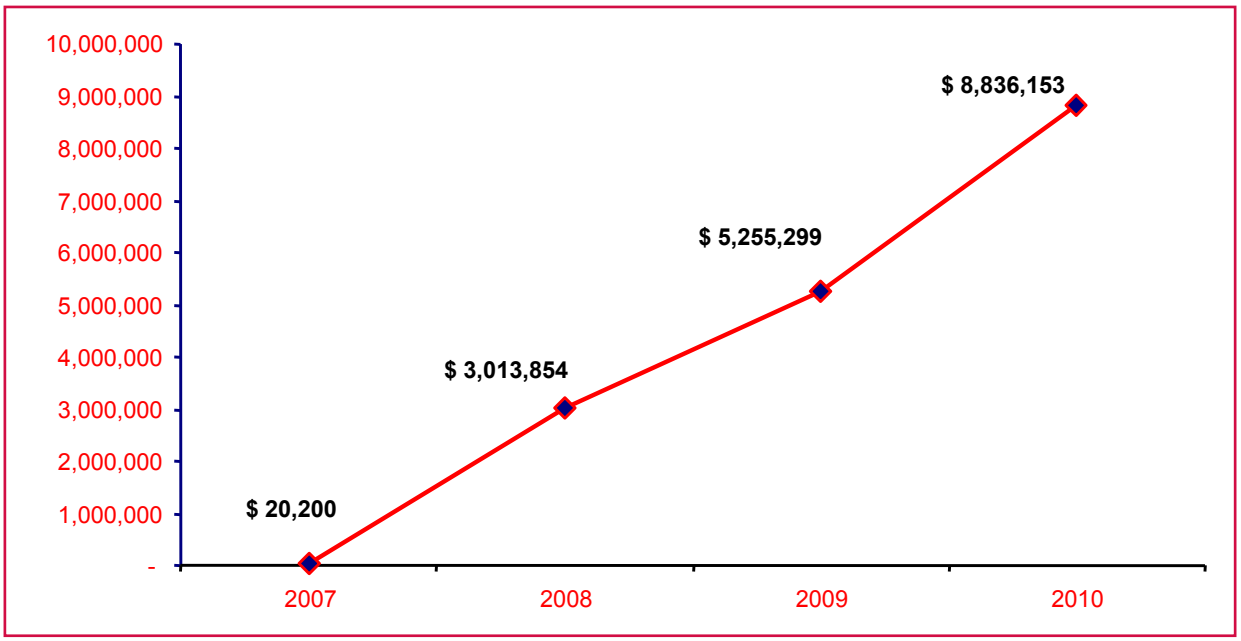
Islamic Finance	August 2009	August 2010
Active Clients – Murabaha	3,758	6,923
Year on Year Growth	79%	68%
Active Clients – Total Industry	51,318	69,598
Year on Year Growth- Total Industry	45%	36%
Outstanding Loan Portfolio – Murabaha	$ 5,255,299	$ 8,836,153
Year on Year Growth	74%	68%
Outstanding Loan Portfolio - Total Industry	77,299,522	98,481,970
Year on Year Growth	50%	27%

FIGURE 4 – ANNUAL GROWTH IN ACTIVE CLIENTS FOR ISLAMIC FINANCE MURABAHA



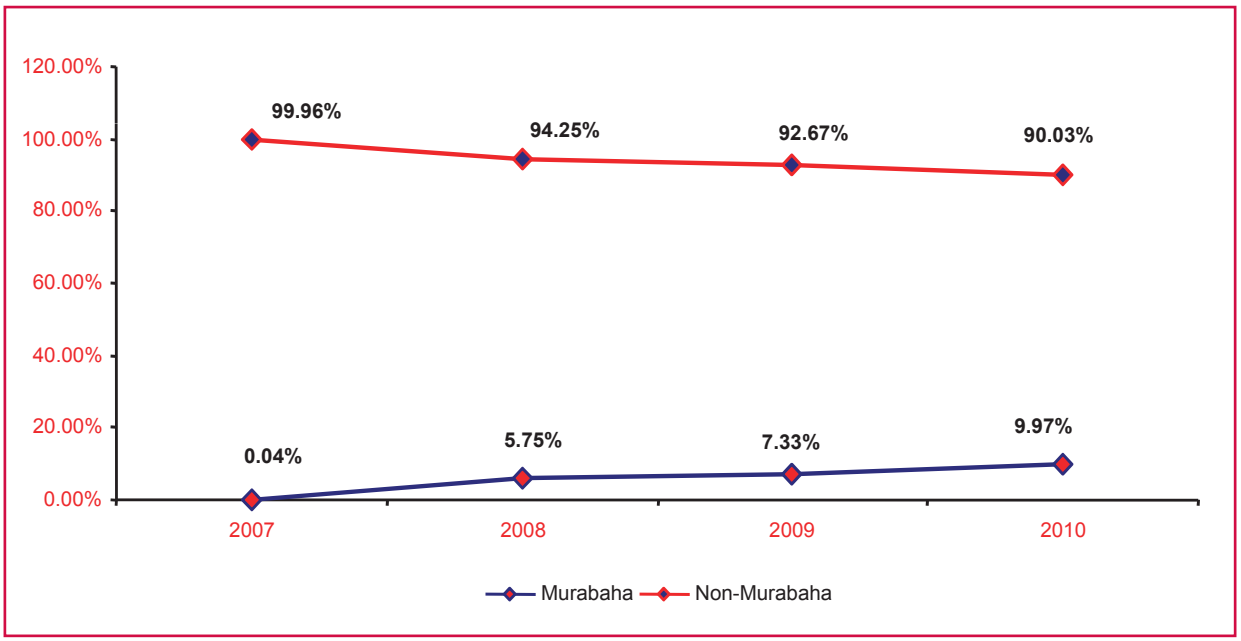
Islamic microfinance Murabaha is scaling-up outreach at a faster pace, albeit its ability to expand is constrained by availability of on-lending funds. Of the total $104 million microfinance grants disbursed to Iraqi MFIs since 2003, Murabaha hold only 9%. While the industry has witnessed a growing diversity in funders (such as AusAid, DFID, and United Nations agencies) supporting the MFIs operating in the country, scaling-up of Murabaha is supported, both in terms of funds and technical assistance, only through USAID grants totaling $9.5 million.

FIGURE 5 – ANNUAL GROWTH IN OUTSTANDING PORTFOLIO FOR ISLAMIC FINANCE MURABAHA



The proportion of clients accessing Murabaha to total clients in the Iraqi microfinance industry increased from 7% in 2009 to 10% in 2010. The 2009 to 2010 increase of 3% demonstrates a slight improvement from the 2008 to 2009 increase of 2%, largely attributed to the consistent growth rate maintained by Islamic MFIs and the introduction of Islamic finance Murabaha by MFIs Al Aman, TEDC and TDMN in 2009 to 2008. Comparatively, the proportion of Murabaha portfolio to total portfolio is 9%, lower than the proportion of Murabaha clients to total clients due to the lower average loan sizes by Islamic MFIs.

FIGURE 6 – ANNUAL PROPORTION OF MURABAHA & NON-MURABAHA CLIENTS TO TOTAL INDUSTRY

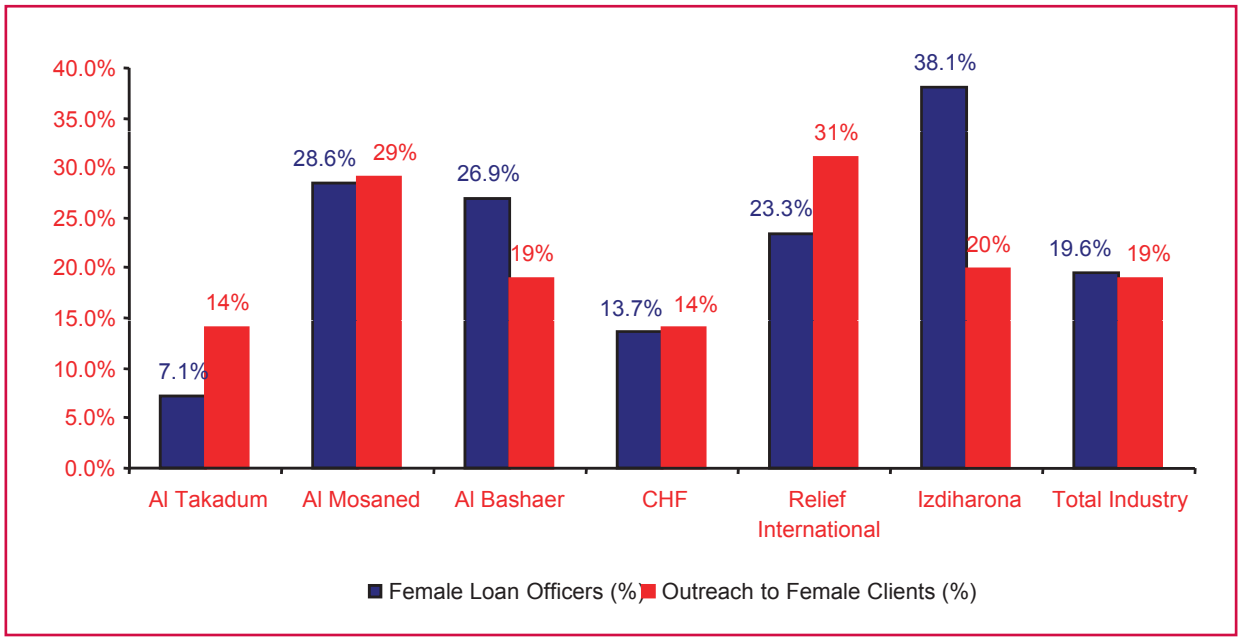


The average outstanding loan size in Murabaha at $1,227 is lower than the average loan size for overall industry average of $1,415. For most microfinance industries, the average Islamic microloan amount is similar to conventional microloans. There are notable exceptions however where the average Islamic microloan is on average 45% higher than conventional microloans, such as in Indonesia, the West Bank and Gaza.[25] In Iraq, the average Murabaha microloan amount is 15% less than overall industry average.

25 Microfinance Information eXchange

Al Mosaned records a 29% outreach to female clients compared to Al Takadum at 14%. Outreach to female clients is directly proportional to the number of female loan officers in the institution for both Murabaha lending and non-Murabaha lending. The percentage of female loan officers at 19% is the same for the overall industry.

FIGURE 7 – COMPARING PERCENTAGE OF FEMALE LOAN OFFICERS TO OUTREACH TO WOMEN



2.2. MURABAHA PORTFOLIO QUALITY AND PERFORMANCE

In order to compare performance of Islamic microfinance Murabaha portfolio with non-Murabaha microfinance portfolio across years, this report uses data from the following institutions under each of the aforementioned categories. The Islamic portfolio represents MFIs offering only Murabaha, compared to other MFIs based on the Performance Classification and Monitoring Systems (PCMS)[26] indicators. Of the 14[27] MFIs graded by the PCMS on a quarterly basis, all are graded 'A' with a score range between 73 to 96 while only four MFIs are graded as 'B' with a score range of 49 to 72, of which two MFIs are Islamic ones offering Murabaha and another that started Murabaha in 2010.

Islamic Murabaha Sample	PCMS Grade	Non-Murabaha Sample	PCMS Grade
Al Takadum - Ramadi	A	Al Bashaer	A
Al Takadum – Fallujah	A	Izdiharona	A
Al Takadum - Qaim	B	Relief International	A
Al-Mosaned	B	CHF	A

Islamic MFIs' financial self sufficiency (FSS) and operational self sufficiency (OSS) are significantly below the total industry and sample mainstream MFI average. However, their FSS and OSS have improved remarkably when compared annually, with 29% in 2008 to 99% in 2010 (see Figure 8).

TABLE 9 – COMPARISON OF PERFORMANCE INDICATORS OF ISLAMIC AND NON-ISLAMIC MFIS

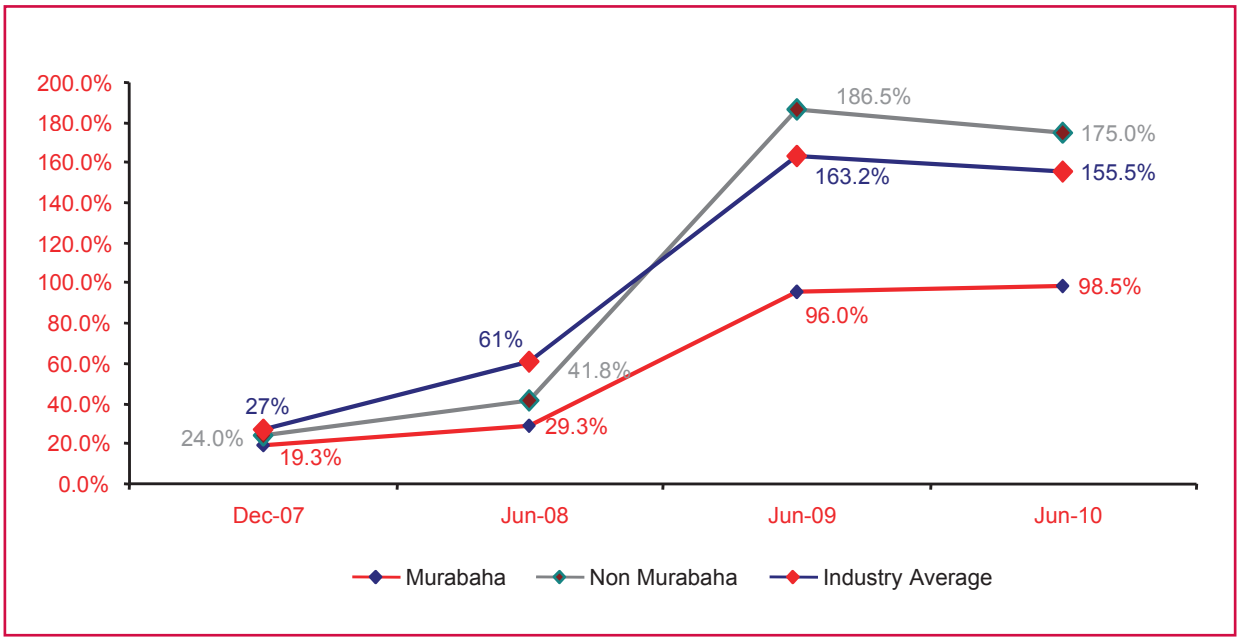
Indicators	Murabaha Average	Non Murabaha Average	Total Industry Average
Financial Self Sufficiency	99%	175%	156%

26 To assist the industry in tracking its own progress and to report to funders and stakeholders more broadly, the PCMS was designed and tested by USAID-Tijara. The goal of the performance classification and monitoring at the industry level is for the industry to be able to "self- regulate" by producing and presenting accurate and regular information on industry performance to stakeholders (clients, donors and potential commercial funders); setting accurate benchmarks (actual performance averages); monitoring and documenting progress against benchmarks over time; providing feedback to individual MFIs on their performance against peer group averages

27 Al-Takadum MFI' 3 main branches are graded as three separate institutions in the PCMS in order to track each branch and accompanying satellites' performance across years.

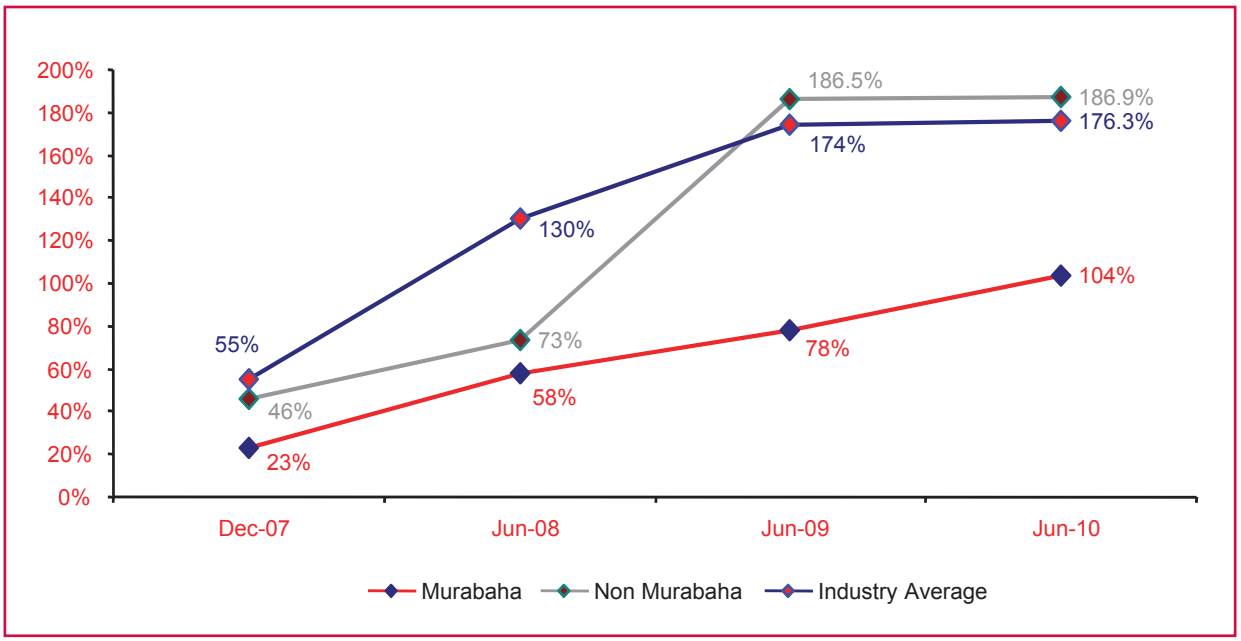
Operational Self Sufficiency	104%	187%	176%
Cost Per Borrower	$ 186	$ 173	$ 166
Loans Outstanding per Loan Officer	165	223	201
Operating Cost Ratio	16%	14%	14%
PAR>30 Days	2%	2%	1%
Average Loan Size	$1,227	$1,209	$1,415

FIGURE 8 – ANNUAL COMPARISON OF FSS



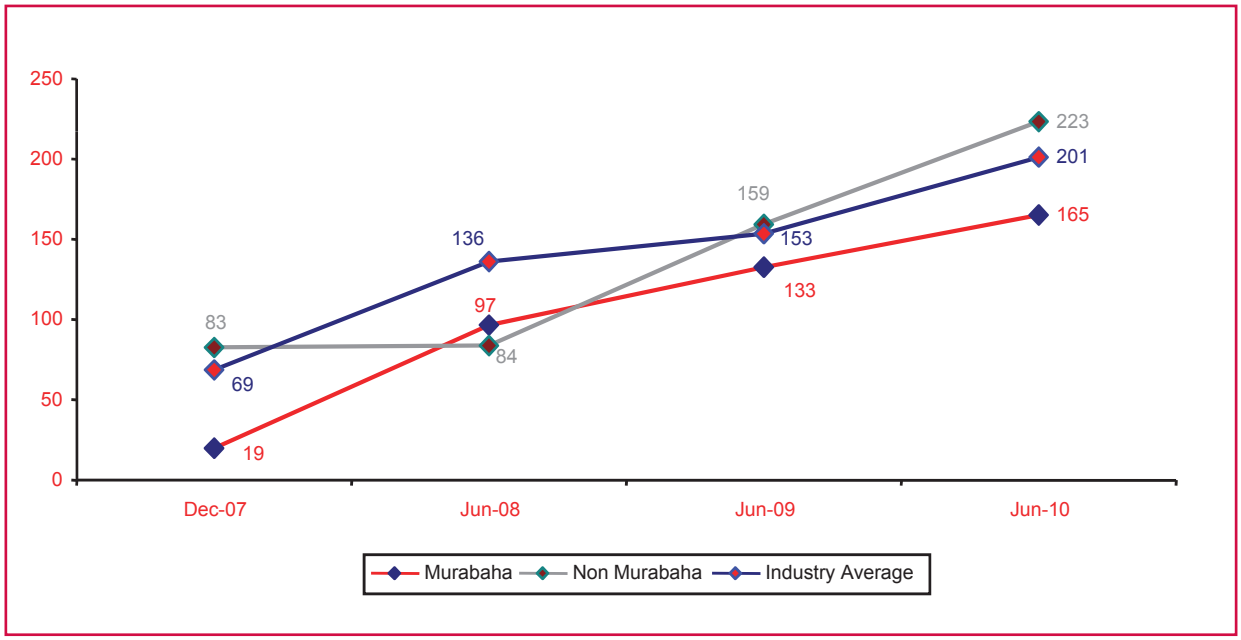
The OSS of the Islamic MFIs improved significantly from 78% in 2009 to 104% by August 2010 compared to 174% in 2009 to 176% in 2010 for the overall industry. While the OSS of Islamic MFIs lags behind mainstream MFIs as well as the overall industry, the significance is the rate of change in OSS for the Islamic MFIs, demonstrating these MFIs ability to cover its direct costs.

FIGURE 9 – ANNUAL COMPARISON OF OSS



The case load of Islamic Murabaha loan officers have improved overtime with the average number of 165 clients per loan officer. The role of loan officers in Islamic MFIs requires them to spend time sourcing and procuring goods listed in the Murabaha contract signed with the client.

FIGURE 10 – COMPARISON OF OUTSTANDING LOANS PER LOAN OFFICER ACROSS YEARS

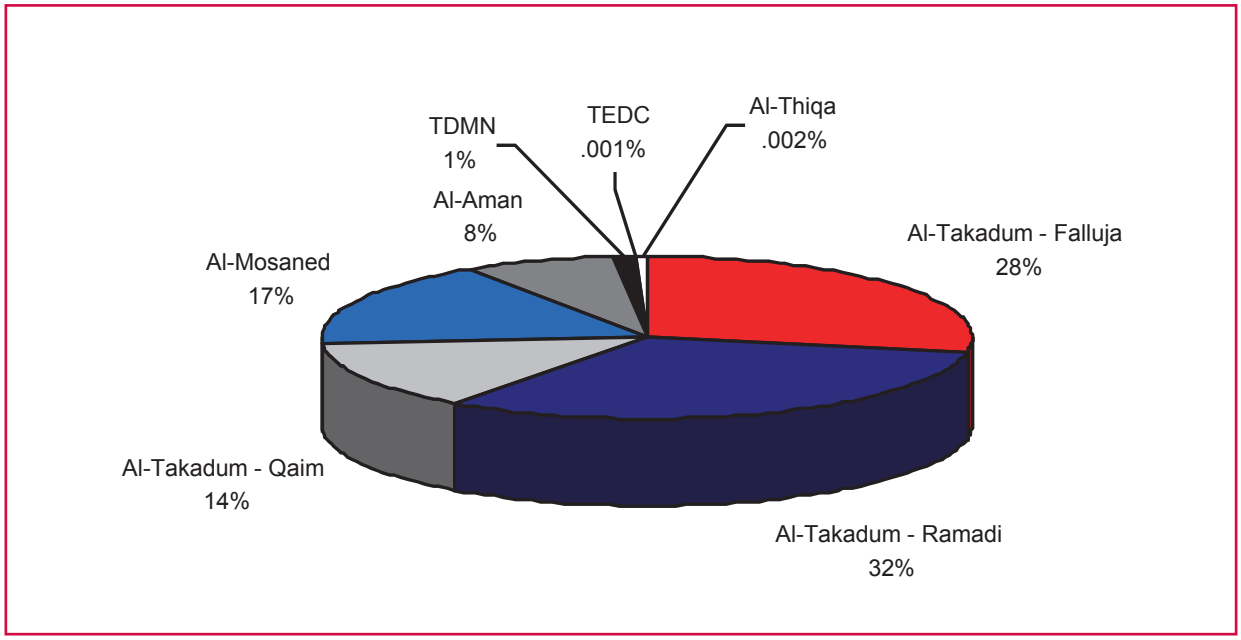


The average PAR of Islamic Murabaha is 2.3%, slightly higher than the industry average of 1.2% as well as the sample non-Murabaha MFIs' average of 1.7%. But over time, late payments seem to be recovered and long-term loss (defined as payments more than 180 days overdue) reported as less than 1%. Consequently, portfolio delinquency does not generate significant long-term loss.

2.3. GROWTH AND PERFORMANCE TRENDS AMONG MURABAHA LENDERS

Islamic MFIs have demonstrated differences in growth and performance. This section elaborates further on this diversity in order to effectively capture the influences and significance of such factors in their overall growth and that of the overall Iraqi microfinance industry.

FIGURE 11 – PORTFOLIO SHARE BY MFIS IN MURABAHA



Of the Islamic MFIs, Al Takadum Falluja recorded the highest growth rate of 117% for 2009 to 2010, from over 800 clients to approximately 2,000 clients. Al Takadum Ramadi holds the highest market share of Islamic microfinance with 2,242 clients, with a growth rate of 67% in 2009 to 2010.

TABLE 10 – COMPARISON OF PERFORMANCE BETWEEN MURABAHA FINANCIER MFIS

Islamic MFI	OSS	FSS	Case Load	Cost Per Borrower	Operating Cost Ratio
Al Takadum - Ramadi	100%	95%	220	$134	15%
Al Takadum – Fallujah	117%	108%	157	$175	11%
Al Takadum - Qaim	90%	86%	128	$285	23%
Al-Mosaned	110%	105%	154	$151	14%

While the operating cost ratio of all Islamic MFIs decreased annually, Al Takadum Qaim recorded a significant increase from 2009 to 2010, from 18% in June 2009 to 23% in June 2010. Al Takadum Qaim slowed down disbursements during the period while its costs increased as it opened a new branch in the district of Annah. The decrease in disbursements was due to low capital liquidity.

FIGURE 12 – COMPARISON OF OPERATING COST RATIO OF MURABAHA ACROSS YEARS

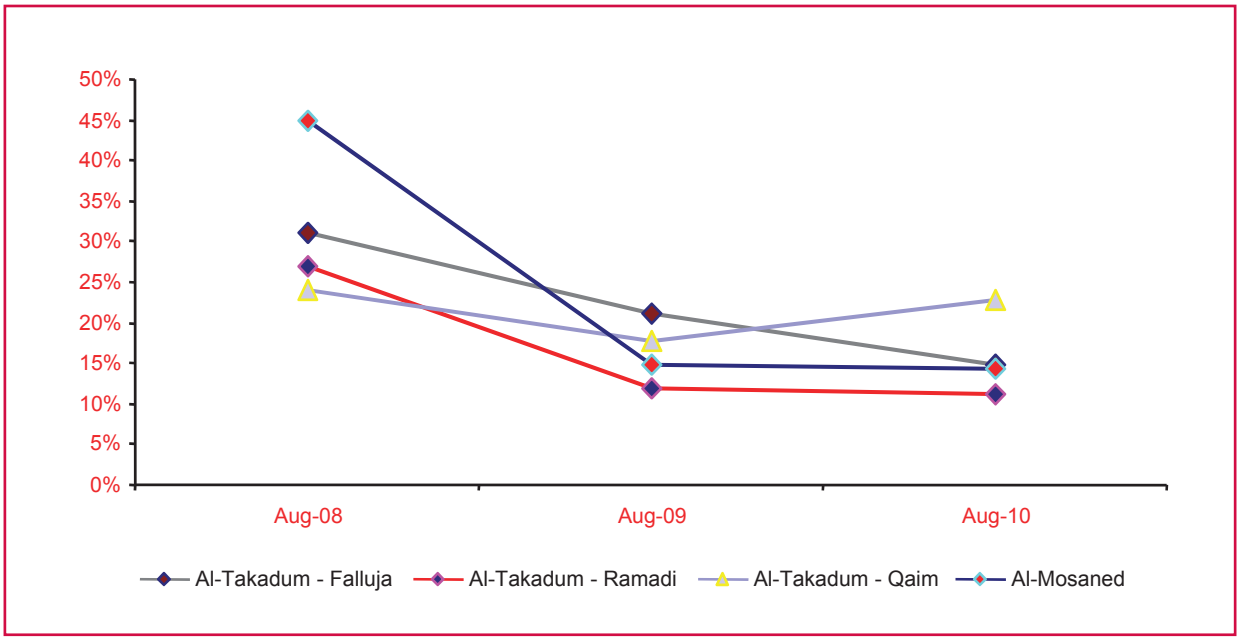
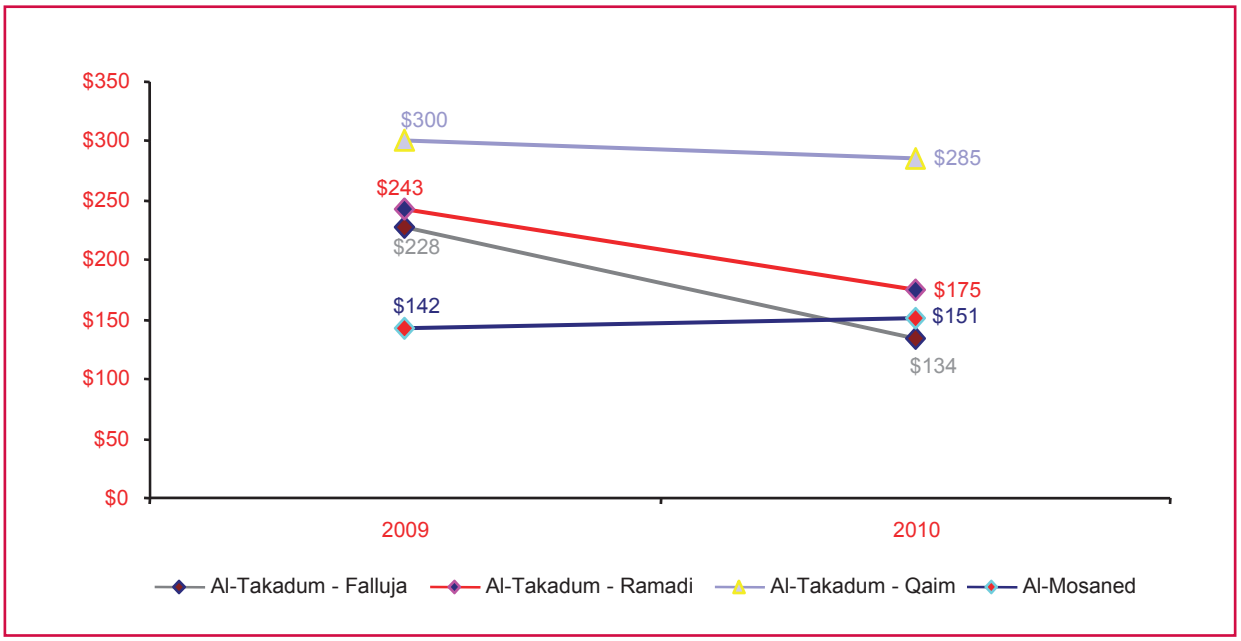


FIGURE 13 – DECREASING COST PER CLIENT OF MURABAHA ACROSS YEARS



Cost per client for Murabaha MFIs decreased on average, with Al Takadum Ramadi recording the greatest decrease from $243 in 2009 to $175 in 2010. Mosaned's cost per client increased slightly from $142 to $152.

2.4. DIVERSITY OF SECTORS FINANCED BY ISLAMIC MICROFINANCE MURABAHA

Islamic MFIs provide Murabaha financing to a range of sectors, with 69% for business financing such as start-up asset purchase and trade. In addition, home improvement and housing loans form an important segment for the clients accessing Shari'a-compliant Murabaha financing at 29% compared to 10% for mainstream MFIs.

TABLE 11 – SECTORS FINANCED BY ISLAMIC AND MAINSTREAM MFIS

	Islamic MFIs	Mainstream MFIs
Business Loans	69%	85%
Agriculture Loans	2%	5%
Home Improvement/Housing Loans	29%	10%

The aim of the housing loans is to provide financing for the repair and reconstruction of housing, often damaged from conflict, as well as new housing construction. Although MFIs target poor clients in general, it also particularly targets minority returnees, internally displaced persons as well as women headed households who are unable to return to their pre-war homes. Figure 12 below portrays the importance of housing and home improvement loans during the initial years of Iraq's recovery from conflict that continue to threaten economic recovery in various provinces such as Salah-ad-Din, Anbar, Ninewa and Kirkuk where MFIs offer Islamic microfinance operate.

Both Al Takadum and Al Mosaned play a pivotal role in helping to promote community stabilization through their focus on economic development. A large proportion of Al Mosaned's clients in the Salah ad Din Province represent former soldiers from the pre-2003 regime. Al-Mosaned is helping re-integrate them back into economic activities through provision of start-up business Islamic microfinance. Al Takadum works in one of the most security challenged provinces, Anbar. In a predominantly tribal-based society, Al Takadum since 2007 has been working closely with local tribal and religious sheikhs to help re-integrate the province to where local youth and their families can rebuild their lives and contribute to the development of their local communities. Al Takadum is lauded as an Islamic microfinance institution by all tribal leaders and is recognized as an integral part of the socio-economic fabric of the province.

FIGURE 12 – AL TAKADUM SECTORS FINANCED

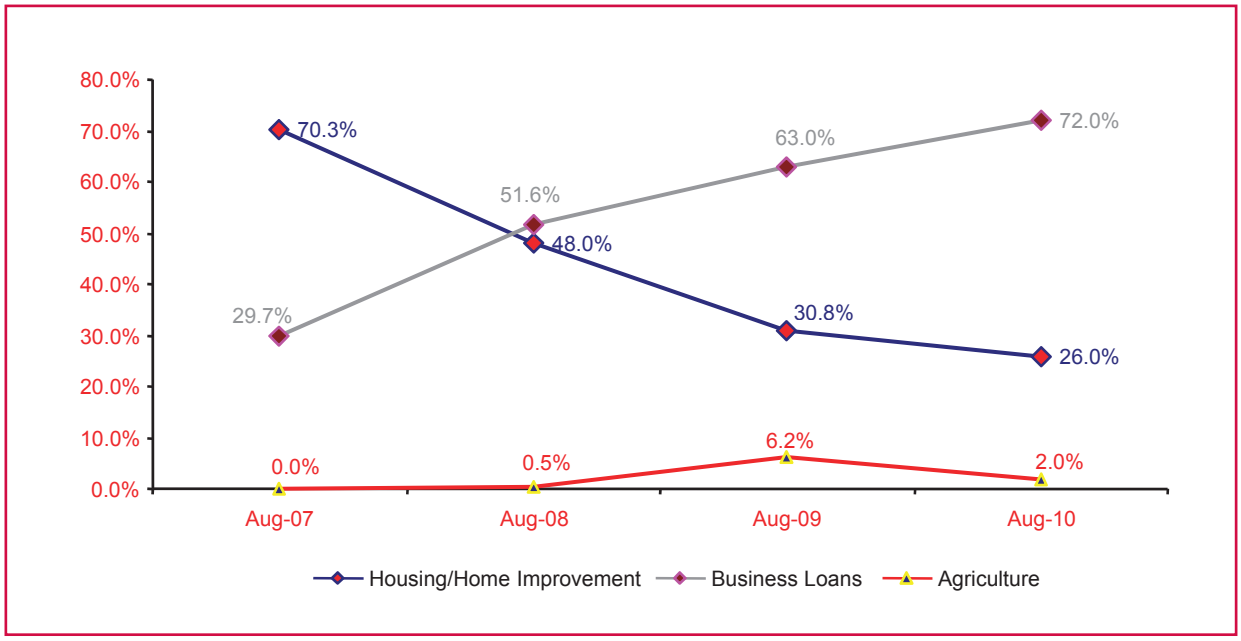
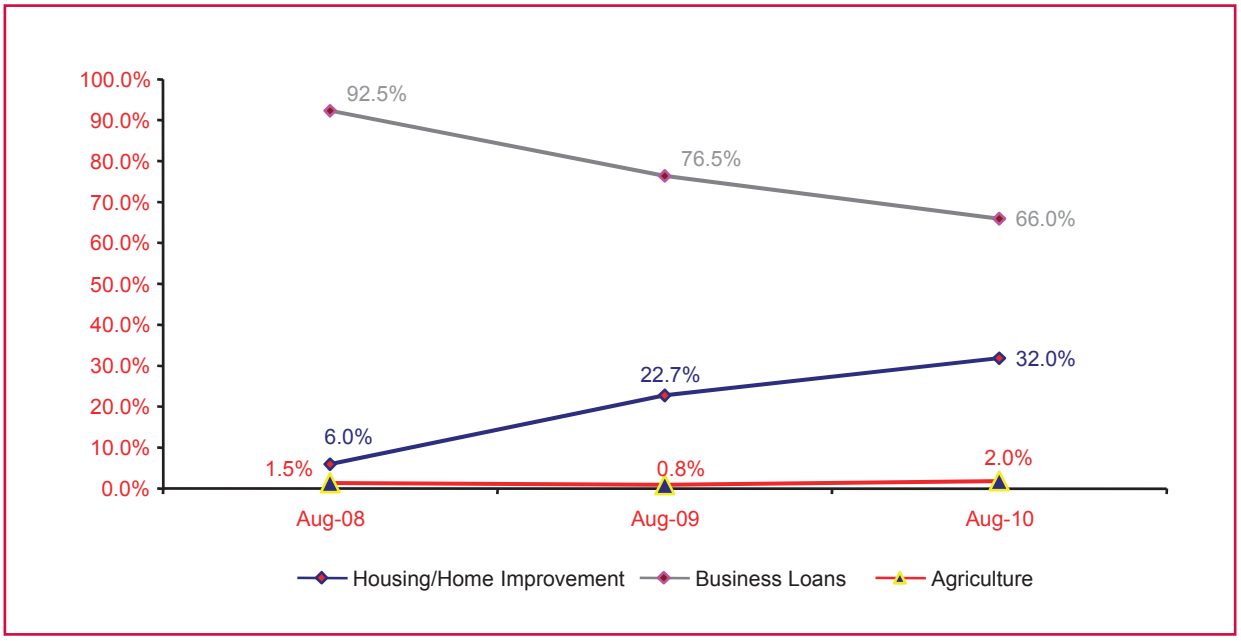


FIGURE 15 – AL MOSANED SECTORS FINANCED



The district of Beiji in Salah ad Din, where Al Mosaned has a branch, remains highly insecure with weekly explosions and a rumored insurgency stronghold. Al Mosaned met with the religious sheikh of Beiji to get support for its Islamic microlending intervention. The Executive Manager was invited to speak at Friday prayer services to promote Shari'a- compliant entrepreneurship. In early August 2010, Al Mosaned started dialogue with the Salah ad Din Agriculture Association, a government-facilitated union of farmers, to provide much needed capital to small-scale farmers to cultivate and grow on lands that once used to be green, to look at the future with hope. The portfolio of agriculture financing is projected to increase substantially, in particular due to business support and technical skills training that the Agriculture Association will facilitate for the small-scale farmers in the province.

2.5. ACHIEVING OPERATIONAL EFFICIENCY THROUGH THE BUSINESS APPROACH TO MURABAHA LENDING – INNOVATION & FUTURE DIRECTIONS

Islamic MFIs have prospered due to increased demand for Shari'a compliant products in Iraq. The demand for such products, however, exceeds the current supply. Together, the six MFIs providing Islamic microfinance Murabaha serve 0.84% of total market of 820,000 households[28]. These MFIs have scaled-up lending as per Shari'a principles over the last year: Islamic microfinance Murabaha outreach grew at a rate of 68% compared to the average industry growth rate of 36%. Despite high growth rate, at only 10% of total industry portfolio, scale is vital to driving down cost-income ratios for Islamic MFIs. They face the unique challenge of Shari'a compliance in their operations and accounting/MIS practices, with the added complexity from the breadth of a Murabaha transaction.

The increased competition will force Islamic MFIs to pay more attention to performance and costs. This is as more and more conventional MFIs start Islamic lending within a potentially improved regulatory environment for Iraq's Islamic finance industry and future availability of regional funds focused on Islamic lending. Designing affordable products, building sound institutions, improving efficiency and managing risk are all critical components of a sustainable business model.

TABLE 12 – GROWTH RATE OF INDUSTRY ACROSS YEARS

	2008-2009	2009-2010
Growth in Islamic Microfinance Clients	79%	68%
Growth in Conventional Microfinance Clients	42%	32%
Growth of Overall Industry MF Clients	45%	36%

28 Refer to footnote (1) and (2)

Operational Efficiency

The Murabaha financing instrument requires MFIs to maintain relationships with commodity brokers, take title of goods temporarily, and directly supervise each purchase and sale. The formal documentation is longer and more complex than it is for conventional cash loans. Murabaha operations face expansion problems and high administrative costs due to the additional efforts required from loan officers in locating, purchasing and re-selling goods to borrowers–especially when there are hundreds of loans to be disbursed and with increasing diversity of borrowers. MFIs Al Takadum and Al Mosaned have introduced innovation in their business model through formalized relationship with a network of wholesale distributors for trade financing that forms up to 72% and 62% respectively, of their outstanding portfolio. Although overall transaction costs are higher, the extra cost to the customer is generally offset by wholesale prices and the related saving of time otherwise spent selecting suppliers and negotiating contract terms.

For MFIs offering Murabaha to improve their sustainability margins, they must further standardize the process of goods procurement in order to create volumes to lower operational costs. With the operationg cost ratio of Islamic MFIs decreasing to 16%, their overall efficiency is improving, although it is above the average industry ratio of 14%. Murabaha financiers incur $186 per borrower compared to the industry average of $166, with 165 clients per loan officer compared to 201 clients for the overall industry. The performance of Islamic MFIs is below the industry average, although improving annually.

Islamic microfinance Murabaha could potentially expand access to finance to unprecedented levels. To take advantage of this opportunity, access to finance should be expanded throughout the country and ease financial exclusion exacerbated by the abhorrence to interest-based products. Iraqi Islamic MFIs need to improve efficiency of their business models and impact at the client level. USAID-*Tijara* recommends Islamic MFIs to further refine their operating model in order to lower costs and improve loan officer efficiency.

Governance & Management

Islamic MFIs have strong governance structures as demonstrated through their diverse boards of directors and frequent meetings. In order to further strengthen their foothold in the local communities they serve, USAID-*Tijara* recommends the creation of institutional Shari'a boards in addition to their governing board. Ensuring an appropriate mix of religious scholars, however, who are also well versed in financial aspects of the MFI is a challenge. USAID-Tijara is facilitating and supporting the discussion of creating a national Shari'a board exclusively for the Iraqi microfinance sector in order to standardize Murabaha product for the Iraqi microfinance industry.

Accounting and Financial Issues

MFIs offering Murabaha lending have two elements of accounting/finance which differ from conventional microfinance. Both have implications for content of financial statements. The first is capitalization of the service charge expected upon disbursement, which affects the balance sheet. The second is the absence of the 'principle of interest' on outstanding loan balances affecting yield on the portfolio and thus income earned. Installment amounts are calculated in advance and include both the initial amount extended as well as a service charge. The service charge is nominally based on the amount loaned as well as the term in which installments are to be paid back, primarily on a monthly basis. The 'mark-up' or agreed cost of the buy-and-sell transaction is a fixed amount based on the expected term of the loan and frequency of installments.

A major tenet of the Murabaha methodology is the existence of a fixed contract for the service. This contrasts with conventional microfinance. The client enters into a contract where the cost for the service could change depending on repayment performance. When a Murabaha loan is issued, the service charge is based on a fixed loan term and installment schedule. When these parameters are violated, there is no recourse in terms of penalty to compensate for the fact that the loan is outstanding longer than expected or that the loan installment is late. In a conventional MFI, late fees and penalty interest is a critical motivation for repayment. However, in addition to the operational implications this has in terms of the importance of effecting prompt repayment, it also has implications for the income statement.

USAID-*Tijara* recommends Islamic MFIs to standardize accounting practices as per global guidelines of Shari'a law. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)[29], is an international autonomous non-for-profit Islamic corporate body that prepares accounting, auditing, governance, ethics and Shari'a standards for Islamic financial institutions.

29 AAOIFI also offers professional qualification programs (notably CIPA, the Certified Shariah Adviser and Auditor «CSAA», and the corporate compliance program).

Monitoring & Risk Management

Managing credit risks is more complex because Islamic MFIs need to estimate not only the expected losses from defaults on the loans. They also need to estimate the real cost to the MFI of delayed payments. Consequently, the fixed mark-up on Murabaha limits an Islamic MFI's ability to adapt to changing inflation and costs of funds.

Although the creation of debt does not require the client to maintain written records and reduce the opportunity for abuse through inaccurate recordkeeping, the implementation of Murabaha is costly. The checks and balances of adequate documentation showing ownership and constructive possession are extremely difficult, as microfinance involves the disbursement of small amounts in large frequencies. Another problem associated with debt-financing involves the possibility of moral hazard where clients default because Islamic principles do not admit the possibility to sanction against this behavior with payments in excess of the original debt amount . Incidence of delinquency among the current Islamic microfinance Murabaha clients has been as low as 3% notwithstanding the moral hazard potential.

Portfolio quality and the eventual recovery of the loan are determined by the credit process ranging from promotion, screening, application, analysis, approval (pre-loan), through post-disbursement management such as collection, delinquency follow-up, and qualification for additional loans. These elements are as integrated into the Murabaha product as they are in "standard" microfinance products. However, the borrower or Murabaha client incurs no penalty for late payment (except for fees and transportation costs charged for legal follow up)—one of the principal motives for on-time repayment. Nonetheless, other incentives for repayment remain in place:

- Attraction of the possibility of additional, larger loan
- Program rigorously goes after delinquent borrowers
- Regular equal installments enforce discipline among borrowers

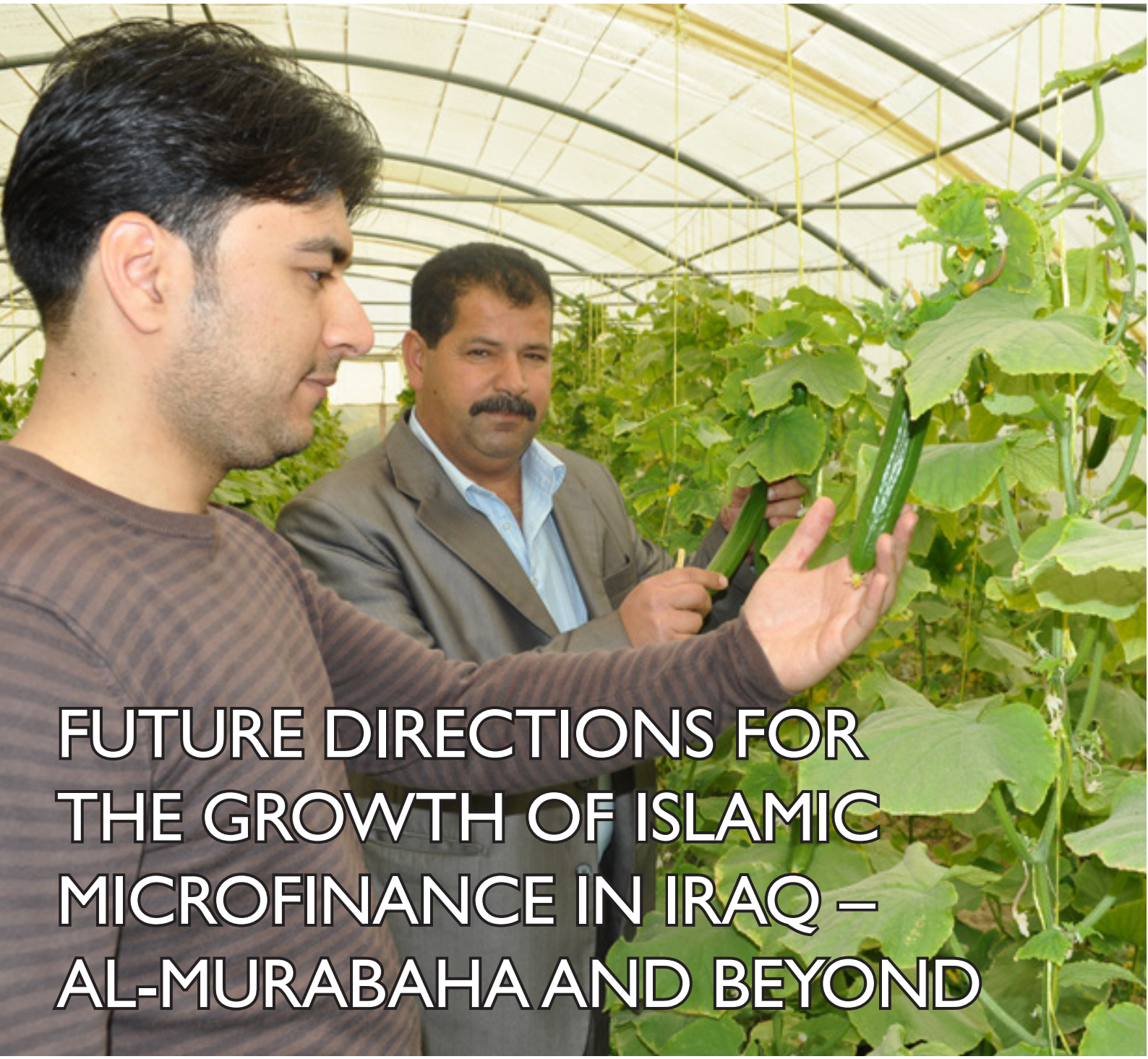
Control

A significant operational difference separating the Murabaha system from the conventional microfinance system is the disbursement transaction. Effectively the client does not handle cash at disbursement. Rather, the transaction is between the institution (represented by the loan officer) and the vendor/supplier of the commodity or fixed asset. As such, the institution bears the risk of this transaction. The transaction is normally done on a cash basis. Consequently the loan officer may carry large amounts of cash to suppliers or markets. The MFI is then highly susceptible to risk of theft by an outside party or even staff fraud.

To minimize the impact of these concerns, certain levels of cash disbursement require more than one loan officer present or they restrict their disbursement to a small number of clients, thereby carrying cash for only three to four transactions. Each of these restrictions/controls imply additional costs, not generally incurred in many MFIs where the clients come directly to the institution to obtain their disbursement and are thus the ones to take the risk.

IRAQI MICROFINANCE MURABAHA PROVIDERS

CHAPTER 3



FUTURE DIRECTIONS FOR THE GROWTH OF ISLAMIC MICROFINANCE IN IRAQ – AL-MURABAHA AND BEYOND

In 2009, Hamdi Faraj Faiz, a 45-year old secondary school headmaster in Ramadi, built a greenhouse next to his residence. He needed additional funds for seed and fertilizer and applied to Al-Takadum for a $2,000 loan. His application was approved by 26-year old loan officer Emad Shakir Mahmoud, an agricultural loan specialist with a B.Sc. in Agricultural Science. Today, Hamdi's greenhouse produces cucumber, eggplant and tomatoes.

There are tremendous opportunities as well as significant challenges that donors and industry stakeholders can jointly address to support the development of Islamic microfinance in Iraq. This chapter provides recommendations to the Iraqi industry stakeholders on their role in developing the Islamic microfinance segment of the country's microfinance industry.

3.1. OPPORTUNITIES FOR GAIN

- **Underserved Customer Base**
  The demand for Shari'a-compliant Islamic microfinance products in Iraq varies across 18 provinces. The total demand is estimated at 820,000 poor households of the total 1.03 million Iraqi households living below the poverty line. Within this population segment, many prefer Islamic microfinance products but may access mainstream microfinance products based on the non-availability of Islamic loans.

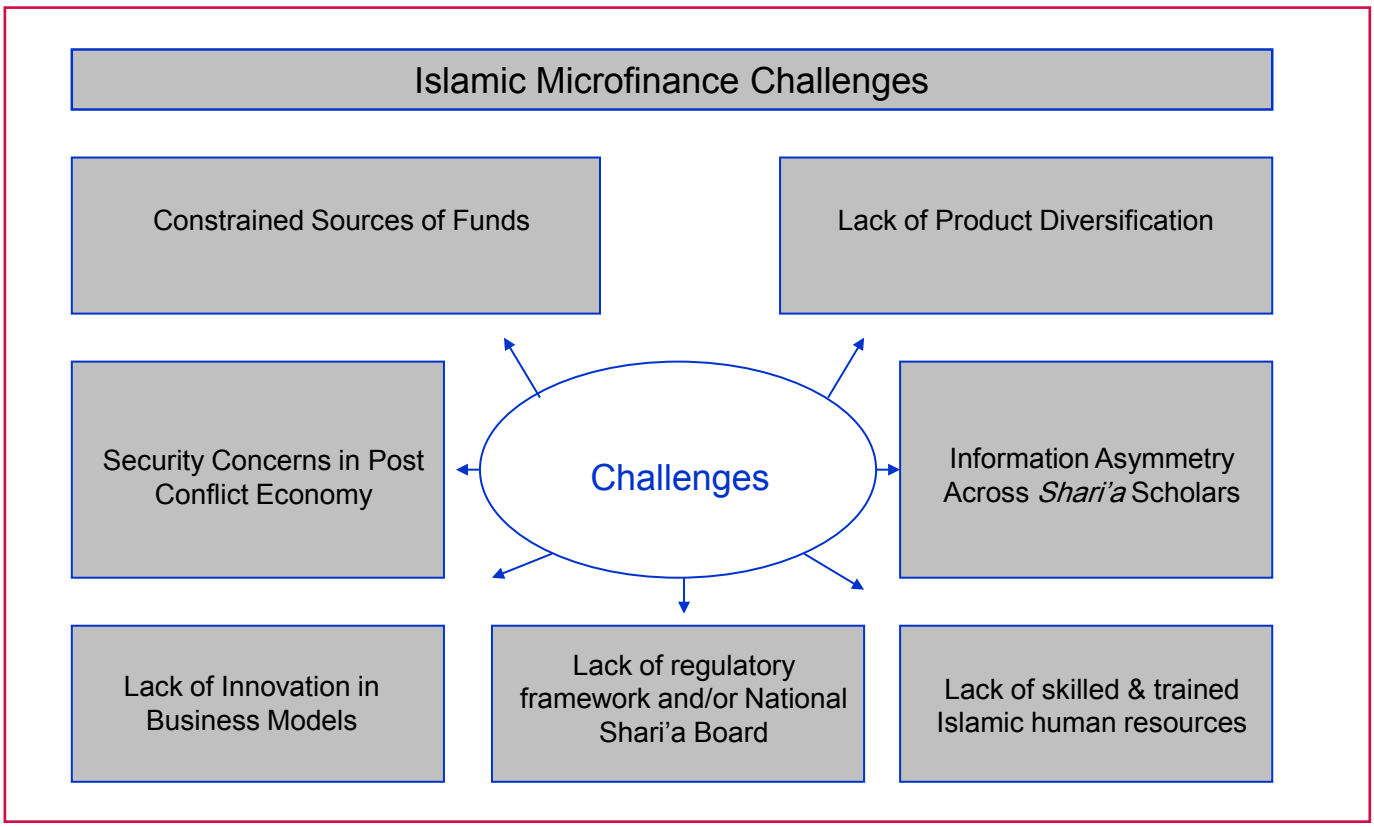
- **Product Considered as Ethical by Local Community**
  With a general abhorrence against interest-bearing loan products, Islamic microfinance Murabaha has gained wide acceptance across the provinces it currently serves. Local religious sheikhs often praise the work of these institutions and have actively supported them as community development interventions. This has contributed to strong MFI-client relationships, and repayment of Murabaha financing as a religious obligation by clients.

- **Diversification and New Business Opportunities**
  As Iraqi MFIs scale up outreach as well as their engagement with the global Islamic microfinance and banking sectors, they are poised to develop unique interventions aimed at diversifying the portfolio of Islamic microfinance products in order to develop the local economies of the communities served. With the upcoming legal and regulatory framework for Islamic finance by CBI, Islamic banks and new regional Islamic players will enter the Iraqi market, providing the required impetus for the MFIs to forge partnerships for growth and impact.

- **Direct Livelihood Intervention**
  As non-cash based financing, where the MFI directly purchases or invests in the assets identified by the client, Islamic microfinance Murabaha is well placed to promote social development. This promotion exist through supporting holistic industries at a large scale. Economies of scale are also promoted through bringing together producers to create volume within a supply chain.

- **Potential to Tap Diversified Sources of Funds**
  In the context of Islamic microfinance, there is a growing tendency to view Zakat (funds donated pursuant to the Muslim obligation to pay alms) as a source of funding. Besides conventional donor and on-lending funds available to MFIs providing Islamic microfinance, they can also access funds reserved for Islamic finance to develop pilots and test new business models.

FIGURE 16 – OPPORTUNITIES OF ISLAMIC MICROFINANCE IN IRAQ



3.2. CHALLENGES TO GROWTH

- **Lack of Coordination Among Shari'a Scholars in the Country:**
  As demonstrated in the differences highlighted between the Murabaha product across provinces, MFIs face the challenges of reconciling the product during expansion. As such, there is a need to establish a national Shari'a board to provide concerted advice on Shari'a compliance. In addition, the current cadres of local religious sheikhs often lack financial knowledge, thereby constraining their role in promoting innovation within the Islamic microfinance domain.

- **Challenges internal to the institution**
  Operational risk, which arises due to the failure of systems, processes, and procedures, is an area of concern. Weak internal control processes may present operational risks and expose an Islamic microlending to potential losses.

  - Excessive documentation: Islamic microfinance Murabaha is document-intensive. Each transaction has multiple phases – contract, procurement, sale, financing and servicing requiring extensive documentation. Documents are required to be completed during the various stages of the deal. At the same time, adoption of e-documentation can obviate the need for multiple physical meetings, track the time elapsed and also alleviate the need to maintain paper and related storage and retrieval costs.
  - The different nature of contracts will require new practices: The use of non-conventional contracts to offer products for financial services can create a whole range of issues concerning corporate governance standards, sources of new risks and how to manage them.

- **Operational efficiency**
  Operational efficiency is key to providing affordable financial services to the poor. Managing small transactions is expensive. MFIs must innovate to reduce transactions costs. In Murabaha, the provider of funds purchases a commodity and resells it to the user with a mark-up. Islamic MFIs may benefit from cheaper prices on the wholesale market, but the costs associated with purchasing, maintaining, selling a commodity are expensive, and the added costs are often passed on to clients.

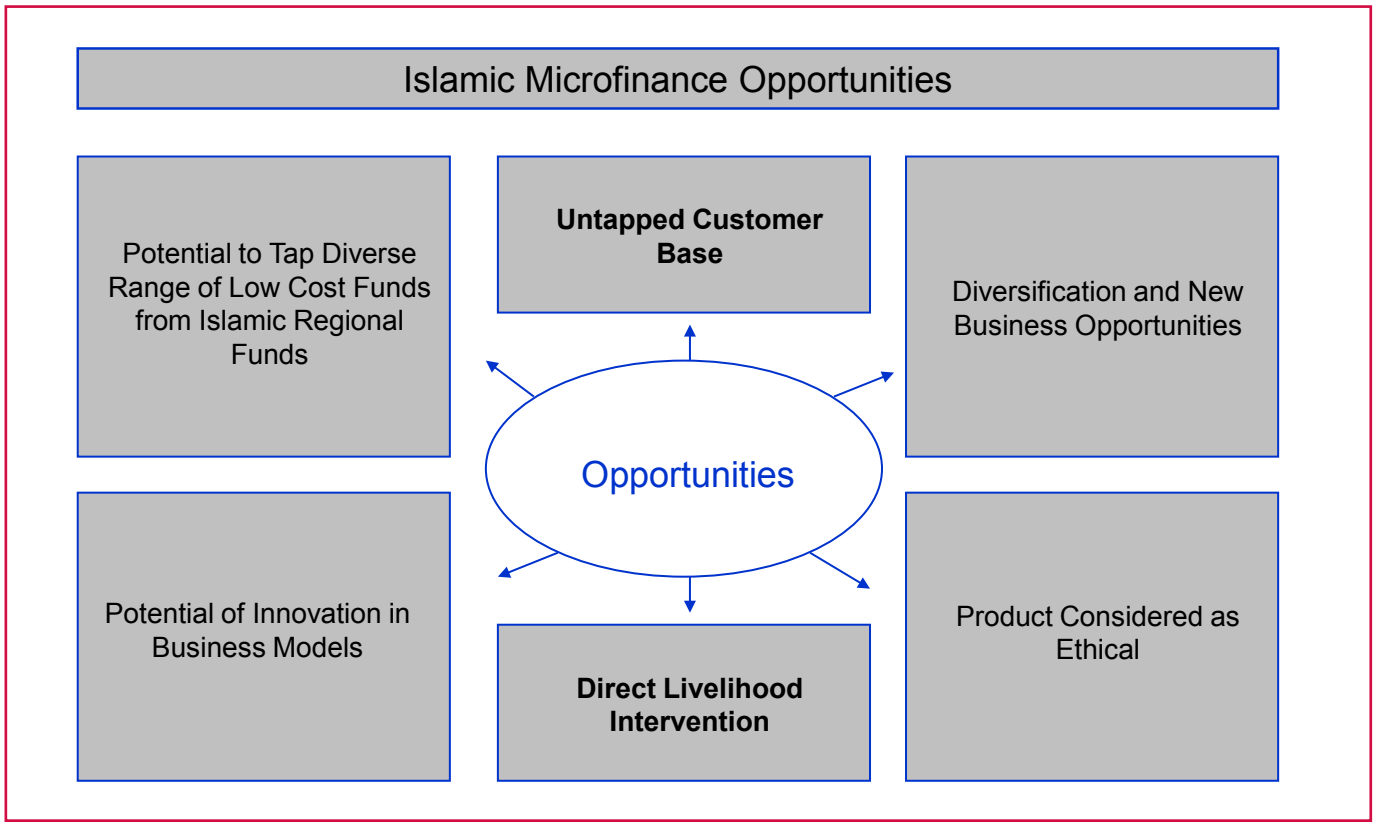
- **Risk management**
  Risk management is another important factor to building sustainable institutions. The conventional

microfinance industry has developed a set of good practices to manage credit risks, and MFIs boost excellent portfolio quality.

- **Building Capacity**
  Capacity building is needed at all levels to realize the full potential of Islamic microfinance. Al the macro level, the Islamic Development Bank and Islamic financial standard setters (such as AAOIFI) should consider developing global financial reporting standards adapted to microfinance to build the infrastructure for transparency in the global Islamic microfinance sector. This infrastructure would entail comprehensive disclosure guidelines on Islamic microfinance accounting principles, pricing methodologies, financial audits, and eventually rating services.

- **Product Diversification**
  Concentrating primarily on asset financing, the Islamic microfinance industry still lacks product diversification to serve the various needs of the poor.

FIGURE 17 – CHALLENGES FACING THE IRAQI ISLAMIC MICROFINANCE INDUSTRY



3.3. RECOMMENDATIONS FOR DONORS AND MICROFINANCE STAKEHOLDERS

Donors can play an important role in expanding access to finance in Muslim communities by helping MFIs scale-up provision of Murabaha and other products discussed in Chapter 1. Through funding pilot projects to test business models and new Shari'a compliant products, donors can facilitate and unleash innovation. In addition, more efforts can be made to train Islamic MFI managers and staff through, for example, the development of operational tools and manuals. Together, the donor community can invest in the development of common Shari'a committees and boards for the Iraqi microfinance industry, in order to promote product standardization as well as meaningful dialogue with religious leaders for socio-economic development of the target population: the poor.

Client Segmentation

The market for Islamic microfinance consists of diverse segments of the poor, with a key focus on the enterprising poor. In addition, there are also those poor people who lack any practical experience and therefore there are linkages that these MFIs can form to these clients direct livelihoods through trainings, relevant technical inputs, as

well as the provision of Qard Hassan (financing with no additional charge beyond the cost of commodity) to the 'very' poor clients until they graduate to micro-loans such as Murabaha.

Advocating for Regulatory Frameworks for Islamic Microfinance through CBI and National Shari'a Board

The Islamic microfinance industry needs to adapt its product set and operating models - not fundamentally, since the basic structures are already there - to meet the needs of the poor, the target clients of microfinance. There is a strong need to build formal bridges between the religious establishment and the microfinance industry. A common misconception is that the aims of the two are incompatible. Al Takadum and other MFIs, however, are providing Murabaha that demonstrate the contrary. Dialogue must be continuous with the common ground of human development. Donors and other sector stakeholders can facilitate working meetings and conversations within the framework of creating a national Shari'a board in order to establish information symmetry within this nascent focus area.

Building Linkages between Islamic Banks & MFIs for Islamic Microfinance Murabaha

Microfinance is an excellent opportunity for Islamic finance to reflect its core values and mission. At the same time, Shari'a compliance can help microfinance institutions reach a large number of Muslims who prefer Shari'a compliant forms of financial activity. One possibility is to coordinate as donors, since Islamic financial institutions see poverty alleviation as central to corporate social responsibility. Collaborative partnerships in which Islamic bankers provide product structuring expertise and advice to MFIs through their Shari'a boards is another means of collaboration.

Funding Pilots & Research

Donors can support the Iraqi MFIs to test new business models and other Islamic microfinance products. Through sharing such risks, donors can create incentives for MFIs to innovate. Simultaneously, through capacity development of Iraqi microfinance staff members in Islamic microfinance, the capability to innovate can also be strengthened further.

GLOSSARY

Fatwa: A religious opinion concerning Islamic law issued by an Islamic Scholar, also referred to as Mufti (an issuer of Fatwa). According to Islam, anyone trained in Islamic law may issue a Fatwa. A Fatwa generally contains the details of the scholar's reasoning, typically in response to a particular case, and are considered binding precedent for by those Muslims who have bound themselves to that scholar.

Murabaha: Referred to as 'mark-up' financing, Murabaha involves a finance party purchasing tangible assets from a seller and selling them to a buyer at a predetermined mark-up/margin.

Musharaka: Referred to as 'partnership' financing, Musharaka involves investors interjecting equity into a business venture and sharing any profits and losses from that venture according to predetermined ratios. Each partner retains management rights in the venture, must receive accounting and other information on business activity, must authorize the raising of capital from any new partners and may receive a salary in return for participating.

Mudaraba: Referred to as 'trust financing', Mudaraba involves an investor or investors providing funding for a business venture and a manager with fiduciary responsibilities providing managerial or market specific expertise (and sometimes additional funding). The investor(s) and the manager share any profits according to predetermined ratios. The investor(s) share any losses according to their respective funding contributions.

Jouala: Referred to as 'service charge' financing, Jouala involves a finance party charging a client fees for providing the finance.[30]

Shari'a Law: Shari'a, also referred to as Islamic, law is meant to regulate all aspects of a Muslim's way of life. It is broadly divided into two sets of rules: one relates to the obligatory worship of God and the other related to daily life outside the context of obligatory worship, including commercial and financial dealings. Shari'a is not a codified body of law. It consists of general rules and principles derived from the Qur'an (the Muslim holy book), the practices (Sunnah) and sayings (ahadith) of the Prophet Mohammed. These general principles are capable of interpretation and development to address new issues and circumstances that arise from time to time.

Qard Hasan: Referred to as 'free' loans, Qard Hasan is a benevolent loan which is returned at the end of the agreed upon period without any interest or share in the profit or loss of the business.

Riba: Referred to as 'interest'. Under the Shari'a, it is not permissible to charge, pay or receive any interest. The Shari'a does not recognize the time value of money and it is therefore not permissible to make money by lending it. Money must be used to create real economic value and it is not only permissible to earn to a return from investing money in commercial activities which involve the financier or investor taking some commercial risks.

Sheikh: Is an honorary word in Arabic language that literally means 'elder'. It is commonly used to designate an elder of a tribe, a revered wise man, or an Islamic scholar.

Zakat: Zakat or 'alms giving', one of the five pillars of Islam, is the giving of a small percentage of one's possessions to charity, generally to the poor. As a mandatory requirement of Islamic faith, every year 2.5% of one's wealth is given away to the poor.

30 There is very little literature available on this product, with one of its major shortcomings being that it mirrors a conventional microfinance loan.

The USAID-*Tijara* Provincial Economic Growth Program
www.tijara-iraq.com

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