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RESEARCH MONOGRAPH

SUPPORTING CREDIT UNION DEVELOPMENT IN AFGHANISTAN:

AN OVERVIEW OF ISSUES IMPORTANT TO THE DEVELOPMENT OF SHARI'A-COMPLIANT COOPERATIVE FINANCE

January 2008

This publication is made possible through funding provided by the United States Agency for International Development's Cooperative Development Program.

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ACKNOWLEDGEMENTS

This publication is made possible through funding provided by the United States Agency for International Development's Cooperative Development Program. The name of WOCCU's program is "Cooperative Development Program (2004-2009): Furthering Credit Union Development: A Business-Driven Systemic Approach to Improving Financial Performance and Increasing Outreach."

This publication has been prepared by Robert Wieland, economist at Main Street Economics and consultant to WOCCU.

The research was conducted in partnership with WOCCU project staff in Afghanistan, in particular Randall Spears, Renia Salinas and Edgar Comeros. Editorial and additional contributions from WOCCU staff Curtis Slover and Catherine Ford.

Front cover photo credit: WOCCU MISFA Project Staff photo.

TABLE OF CONTENTS

ACRONYMS ..... **III**

GLOSSARY OF ISLAMIC FINANCE TERMS ..... **1~~1~~**

PREFACE ..... **2~~2~~**

INTRODUCTION **3**

PROJECT PREPARATION AND IMPLEMENTATION ..... **5~~5~~**

STAFFING AND MANAGEMENT ..... 5~~5~~
LOAN PROGRAM ..... 6~~6~~
REGISTRATION OF THE CREDIT UNIONS ..... 8~~8~~
SECURITY CONSTRAINTS IN PROJECT IMPLEMENTATION ..... 9~~9~~
SUMMARY AND BRIDGE ..... 9~~9~~

THE AFGHAN CONTEXT AND SUBSEQUENT IMPLICATIONS OF ISLAMIC FINANCIAL PROHIBITIONS ..... **10~~10~~**

TYPES OF (INFORMAL) FINANCE IN AFGHANISTAN ..... 11~~11~~
ISLAMIC PROHIBITIONS ..... 12~~12~~
PROSPECTS FOR SHARI'A-COMPLIANT CREDIT UNION PRODUCTS AND SERVICES ..... 14~~14~~
SHARI'A COMPLIANT FINANCIAL PRODUCTS AND SERVICES ..... 14~~14~~
Savings ..... *15~~15~~*
Investments ..... *15~~15~~*
Production Loans ..... *16~~16~~*
Equipment Loans ..... *17~~17~~*
Consumption Loans ..... *17~~17~~*
Mortgages ..... *18~~18~~*

SUMMARY AND CONCLUSIONS **19**

REFERENCES ..... **21~~21~~**

ACRONYMS

ARIES	Agriculture, Rural Investment, and Enterprise Strengthening
CIDA	Canadian International Development Agency
DAB	Da Afghanistan Bank
DFID	Department for International Development
IFC	Investment and Finance Cooperative
MISFA	Microfinance Support Facility for Afghanistan
NGO	Non-Governmental Organization
USAID	United States Agency for International Development
WOCCU	World Council of Credit Unions

GLOSSARY OF ISLAMIC FINANCE TERMS

Gharar: risk or uncertainty

Hawala: a money transfer system executed by a person called "Hawaladar" at the two ends of a distant transaction.

> Example: Customer A gives Hawaladar A a sum to be transferred to Hawaladar B. Hawaladar A then calls, e-mails or faxes Hawaladar B at the other end of the transaction who provides an equivalent sum to the beneficiary of the transfer. The two Hawaladars then sort out their liabilities by any number of reverse transactions

'Ijarah: lease-based

Mudaraba: partnership agreement

Mudarib: entrepreneur-borrower

Musharaka: equity participation

Rabbul-mal: owner of capital

Riba: often translated as "interest" or "usury", but it is somewhat different than either of these. It refers to the increase in money (or commodities) lent over time and, in Islamic finance, is not allowed.

Salam: forward purchases

PREFACE

This report is a product of desk research undertaken from March-July 2007. The study's objective is to describe WOCCU's efforts to establish credit unions in Afghanistan and to provide an overview of issues important to the development of Shari'a-compliant cooperative finance.

Under the original plan for this research, a field visit to Afghanistan was envisaged. However, in further considering the risks and benefits of this, both WOCCU and the consultant agreed that it would be possible to generate a useful report without such a visit. Interviews with field staff were arranged through the Internet, e-mail and current policy, and procedure documentation was provided to the consultant.

The absence of site visits is mentioned here because it does place limits on the report's claim of completeness. The author concedes that some important aspects of both the process by which credit unions were supported in Afghanistan and the results of those efforts may have been overlooked because he was not on-site to observe them. But within this limitation, field staff answered questions fully and usefully, program staff provided the information requested and WOCCU/Madison provided useful background materials. In addition to WOCCU-sourced material, the project made use of recent research on finance outside of Kabul that was supported by the Afghan Research and Evaluation Unit. Reports from World Bank and the U.S. Agency for International Development (USAID) were also consulted.

INTRODUCTION

In 2004, with funding provided through the Microfinance Support Facility for Afghanistan (MISFA) project, WOCCU helped to operationalize two savings and credit unions in Afghanistan: Balkh Savings and Credit Union in Mazar-e-Shariff and Jawsjan Savings and Credit Union in Sheberghan. These credit unions are area-based, open-bond institutions with members from specific towns and villages. Their establishment was a result of project effort targeting membership marketing, staff recruitment and training, regulatory backing, and associated business development, as described below. The MISFA project was funded from March 2004 through April 2005.

From the April 2005 end date until the start of the ARIES project in May 2006, WOCCU's Afghanistan credit union activities were maintained primarily through grant funding from First America Credit Union in Utah, at a much lower level than under the MISFA project. Since May of 2006, renewed funding through ARIES has allowed increased project activities, resulting in three new Investment and Finance Cooperatives (IFCs) made ready for operation, additional support for the existing credit unions in Mazur-e-Sharif and Sheberghan provinces and preparations for developing IFC's in Afghanistan's southern region.

Given Afghanistan's security situation, the country's uncertain and unsettled legal/regulatory environment, its human capital constraints and other obstacles to finance and contract enforcement – in addition to the normal difficulties of setting up credit unions where these have not previously existed – the establishment of the original two credit unions and prospective start up of several IFCs is an important achievement. This paper discusses some of the work undertaken to achieve the start-up of the two credit unions and other developments under the project, focusing on efforts up to the start of the ARIES project. It will also identify problems that constrained progress and describe how these were or were not overcome.

The security situation in Afghanistan has not improved since WOCCU first started developing credit unions there and, in some ways, has worsened. The situation continues to constrain project implementation, limiting travel and consequent project participation and intensity of effort. Additionally, it generates an increased potential for exceeding acceptable risk with respect to the safety of project staff. These constraints and hazards must be kept in focus as WOCCU prepares to move its efforts to the south and to areas that have more severe security concerns than existing operating areas.

In addition to the standard review of systems and controls, business planning, attracting members and providing services, a description of credit union development in Afghanistan requires consideration of *Shari'a* law and Islamic injunctions against *riba*[1]. A separate chapter of the report discusses the legal/regulatory environment and the implications of *Shari'a* compliance for services that credit unions can supply in rural Afghanistan. That chapter will discuss, in this context, adjustments that can be made under the project to remain *Shari'a* compliant and to secure sanction from both secular and religious authorities. As noted in

[1] Riba is often translated as "interest" or "usury" but it is somewhat different than either of these. It refers to the increase in money (or commodities) lent over time and, in Islamic finance, it is not allowed.

that discussion, WOCCU's current project effort already entails, among other things, instituting *Shari'a*-compliant savings and other financial instruments.

PROJECT PREPARATION AND IMPLEMENTATION

Early efforts to lay the base for credit union operations involved project staff traveling to locales within potential membership radii to introduce the credit union concept to people. Importantly, credit unions conceived under this project were to be area-based and not trade or employer-based in their bond. Project staff focused on three fundamental points in their extension of the credit union concept. These were:

- Member ownership of the institution
- The institution's focus on financial services
- The sharing of benefits generated by the credit union's operations

While people were receptive, particularly to self-ownership and the promised access to capital, Afghanistan's fractious history has left a legacy of mistrust and skepticism among its people that had to be overcome. The channels used to obtain an audience in villages included the various chambers of industry and commerce, which are burdened with the history of the socialist period, but which retain some base in the towns and villages. Local social relations are also quite complicated in Afghanistan and it is not clear to what extent important local people used their authority to support or to oppose the new credit union idea. In the two areas where focused efforts were made, however, the reception by local people to the credit union idea was sufficient to allow the project to formalize two credit unions with a combined membership of 1,788 at the end of their first quarter of operation.

Staffing and Management

As the project attempted to generate local interest in the credit union idea, it also undertook to develop training programs for local hires to staff the new credit unions. Finding and holding qualified staff was difficult due to the relative scarcity of educated candidates. Although some Afghans have been able to overcome the great obstacles to obtaining an education, the (15+) adult literacy rate in 2004 comprised only 28%[2] of the population. Potential hires with relatively more education can command premium wages, to the extent that there is demand for their services. Because the new credit unions are attempting to adopt policies and pay scales that would be sustainable over time (and other employers seeking workers are not), educated staff[3] have proved difficult for credit unions to find.

The short-term adaptation to this problem has been to hire affordable staff and provide them with the necessary training. In addition, systems and operations have been kept simple and accessible. This has not entirely solved the problem, as staff turn-over has remained an issue to the present. When openings occur, there are often few candidates from which to choose. Additionally, due to travel limitations imposed by the uncertain security situation, the amount of time and frequency with which project staff can actively oversee credit union staff may be limited.

Waiting for the large public investments in education to generate a better-educated workforce is the long-term resolution to this problem. In the meantime, the costs of training

[2] World Bank Statistics: http://devdata.worldbank.org/edstats/SummaryEducationProfiles/CountryData/

[3] Even when candidates have basic numeracy, they typically lack an understanding of double-entry accounting.

and losing staff may outweigh the benefits of providing additional enticements for trained staff to stay, even though this increases the accounted costs of operation. However, higher staff costs will require additional income-earning assets, and assets at the two original credit unions have not yet reached the level projected under the original project business plan. In addition, delinquency and write-offs are both somewhat higher than anticipated under the original business plan. These limitations constrain the credit unions' ability to invest more in staff salaries, even though such investments might offer benefits. This provides a lesson in the challenges of establishing sustainable credit union operations in Afghanistan.

In addition to operational staff, credit unions require boards of directors (boards) to govern them. The project satisfied its need for a board by encouraging attendees at outreach events to nominate representatives for an interim board. Those interim directors (four at each credit union) were provided with training, using materials adapted from other WOCCU credit union programs, specifically those used in Uzbekistan and the Philippines. These materials included, among other things: 1) a general introduction to credit unions, including the allocation of roles, duties and responsibilities; 2) a focused description of board versus management functions; and 3) a detailed checklist describing directors' responsibilities and ways to conduct board meetings. Ultimately, board directors were elected by a voice vote of the general membership, serving along with a fifth member who represents WOCCU.

The narrowly proscribed role of credit union directors and officers has required considerable project attention, since these roles are new to the Afghan context. Along with the high staff turnover, uncertainty with respect to the credit unions' legal/regulatory status and other early challenges, the novelty of directors' roles, relative to cultural expectations, has required on-the-job coaching as follow-up to the training described above. In addition, chairmen and managers of the two credit unions were provided a tour of Uzbek credit unions in the second quarter of 2005. The board's need for continued project support is apparent through the most recent project quarterly report, wherein serious problems at the Mazar-e-Shariff Balkh Savings and Credit Union, described below, are presented to that board. New expatriate staff members were brought into the project at the end of 2006, and they will presumably continue to support training of the board, managers, loan officers and accountants for these credit unions.

Loan Program

Summary information about the loan program provided for this review indicates two different types of loans, similar in all respects except their targeted sectors. These are agricultural loans and business loans. Both carry an interest rate of 2% per month and both are limited to sums that are less than five multiples of the borrowers' savings and share capital. Both are short-term loans with maximum terms of six months or one production cycle. The balance sheet attached to the quarterly report for the period ending December 31, 2006, merges these two loan instruments into a single category, "Loan Type 1".

The loan officer is very involved in the loan application process. He or she visits the borrower's business or home and assesses their debt capacity and their savings and credit history. If there are other signatories to the loan, the loan officer meets and interviews them. They validate the appraisal of any collateral offered on the loan and, finally, gather all available information into a credit scoring tool to establish the credit risk in the loan. At the

end of this process, the loan officer prepares a loan recommendation sheet, which provides a basis for credit committee deliberations.

This heavily documented process requires literacy and numeracy on the part of the loan officers, as well as some degree of discernment. Given the educational constraints discussed above and high staff turn-over, back-up for the loan officer's work is clearly necessary and under the project this back-up has been provided by a review of borrowers' credit and loan information by the manager of the credit union and project staff. More recently, accounting software has been adopted under the project that allows transactions to be booked in real time and provides a more secure record of those transactions.

After a loan is granted, monies disbursed and transaction documented, there is the important matter of loan monitoring to ensure timely repayment. Loan monitoring is managed by the credit union manager, the responsible loan officer and the accountant. The loan officer generates a loan collection sheet daily, accounting for payments due and payments received. Cash received is verified against the collection sheet's record of payments at the end of the day. The manager verifies payments received against payments due and follows up with borrowers who have missed payments. The manual loan monitoring/collection process is transparent as long as the guidelines are followed but, as shown in the case of Mazar-e-Shariff, it is not failsafe.

At the Balkh Savings and Credit Union in Mazar-e-Shariff, a general manager was hired who appeared to have appropriate skills and motivation for the job. Whether due to a change in her social position (she married shortly into her term) or for some other reason, her execution of her responsibilities generated serious problems for her credit union. In particular, she allowed her chairman to influence loan decisions outside the standard loan approval process and she obscured delinquency in the outstanding portfolio. In the absence of an electronic tracking system, she misrepresented repayment information in a way that ultimately led to high arrearages. Because of these problems, the general manager was asked to resign from her position. She has, however, remained a credit union member in good standing, indicating that either "good standing" criteria are not adequately enforced or that she did not behave in a way that contravened credit union safety and soundness. What is important in this instance is that, under the manual system in place at the time, it was possible for one person to obscure information that the loan monitoring system is meant to ensure and to otherwise undermine the loan portfolio.

Loan monitoring is only a first line of defense in ensuring the integrity of the loan portfolio and it is important to have the loan accounts reviewed by a party not directly connected with the credit union's business. Such review can help to identify problems that were missed by local managers and the knowledge that others will be examining the loan portfolio and its various ratios helps to focus staff on the importance of accuracy and timeliness in loan monitoring. The credit policy provided for this review states that a "Supervisory Board" will review each credit union's loan portfolio on a quarterly basis and it specifies a range of issues and items for supervisors to consider. At the present stage of development, project staff members provide this supervisory function. In future, if there is growth in Afghanistan's credit union movement, this function will be vested in a credit union association. The institution of computerized systems for tracking accounts and transactions will be very important.

Registration of the Credit Unions

The legal/regulatory status of the new credit unions has been an issue of concern since their start-up. As a confidence building exercise, the project invited Provincial Governors to their openings. One governor attended and the other governor declined. The project attempted to register the credit unions as Non-Governmental Organizations (NGOs), but this effort did not come to fruition. Registration was also attempted under the Banking Law, but this was also unsuccessful. A more recent attempt to register through the Afghan Investment Support agency is still in play. Additionally, project staff members are seeking registration through the Ministry of Agriculture's department of cooperatives but, since the credit unions work across a number of sectors and only some of their members are farmers, it is not clear that this will be possible.

The Afghan government can be difficult to navigate and, without powerful supporters, can be impossible to get the hearing needed to advance a case. In this respect, it is worrisome that the project funders (DFID, CIDA, USAID or Dutch AID) have not taken the initiative to break bureaucratic logjams. Without the ability to enable regulations and protections, credit unions are very exposed. The fact that they are being developed using external funding to generate economic benefits within Afghanistan should encourage the relevant officials to provide necessary legal registration/sanction. But this message may most effectively be made by the funder.

The lack of formal sanction from government agencies, while a fundamental concern for long-term credit union sustainability and the short-term interests of their board and staff members, appears to have been less worrisome for credit union members. New members have continued to enroll, buy shares and to invest deposits in both credit unions. Given that the credit unions continue to operate and to grow, it is essential that some means of substituting internal guidance for some of the benefits of external regulation be devised.

In addition to protections afforded by legal registration (i.e. wherein rights and responsibilities of the institution and its parties are clearly spelled out), credit unions derive benefit from the supervisory requirements that are typically a part of their regulation. In order to comply with reasonable reporting requirements, the credit union must have adequate internal controls and reporting. Outside review will help make adherence to reporting requirements more likely. To date, in the absence of any type of external auditor or regulator, this review function has been served by the project. This is not a long term solution.

As discussed in the *Loan Program* section, WOCCU's project activities currently target the development of a credit union *Supervisory Board*, to provide the "external review" among other functions. Groundwork is being laid for this through efforts to establish a network of the northern credit unions and to formalize this with a credit union association. The association would be a legal entity owned in part by its members, but separate in its financial and oversight functions. In addition to housing a *Supervisory Board,* the association would serve as a financial channel, receiving and investing credit union funds and lending such resources as it might be able to access. Such an association will doubtless carry additional costs which, as discussed above, are already above those anticipated in the business plan. In the absence of legislative protections, however, there is little alternative but to internalize

those costs. If properly planned and executed, an association might allow some economies of scope and could help to spread risks.

Security Constraints in Project Implementation

The uncertain security situation in Afghanistan has limited project implementation in a number of ways. As noted above, security requirements have limited the intensity of project implementation when scheduled visits and meetings must be canceled because security risks preclude travel. Such limitations increase staff down-time, limiting what can be achieved and raising the possibility of staff morale problems. Moreover, by limiting face-to-face involvement of project staff in the growth and development of nascent credit unions, there is greater opportunity for problems to fester and unsustainable practices to take root in ways they otherwise may not if project staff made more visits more often. It seems very likely to this reviewer that security concerns affect the project in myriad ways by raising the costs of project operations, though the present review does not permit specific understanding of all those costs.

While security issues and the practical responses to them increase the difficulty of achieving project objectives, these limitations are vastly preferable to ignoring the risks and accepting a higher probability of bad outcomes. The project has made a large investment in security and continues to evaluate what constitutes acceptable risk in the changing Afghan context. Evaluating acceptable risk in this changing environment requires comprehensive and timely information and this has been provided to the project from Afghan-based sources and via the security contractor.

Summary and Bridge

The categories of concern remain much the same for credit union development activities in a "conflict environment" except that each area (e.g., membership, management, operations, growth, safety and soundness, etc.) must also be evaluated in light of security concerns. This impact is all the greater given Afghanistan's legacy of conflict and its effects on education levels, public infrastructure, trust and social cohesion, governance and other elements. The implied impact is that costs will be higher and failures more likely.

On the other hand, there are liquid assets in the farthest reaches of Afghanistan that could benefit regional and national economies if mobilized. Such mobilization could benefit both the holders of those assets and people with a viable investment plan. While banks and banking in Afghanistan are increasing at a fast clip, they do so from a very small base and there seems to be considerable scope for intermediating funds in the credit union way, as evidenced by Balkh and Jawsjan Savings and Credit Unions.

In the more recent work with IFCs, WOCCU's program in Afghanistan is beginning to take account of Islamic prohibitions against interest and adaptations to this prohibition by way of Islamic Finance. Efforts to develop Shari'a-compliant financial instruments and commensurate accounting are underway. If credit unions hope to gain members in regions where these Islamic prohibitions are pervasive, such adjustments seem necessary. The following section outlines the issues both in respect to current financial practice in non-urban Afghanistan and current rulings from the Islamic Finance community.

THE AFGHAN CONTEXT AND SUBSEQUENT IMPLICATIONS OF ISLAMIC FINANCIAL PROHIBITIONS

Afghanistan has a very rudimentary formal financial system. In 2001, after the overthrow of the Taliban, there was literally no commercial banking system in the country. In 2003, Central Banking and Commercial Banking Laws were passed and foreign assistance was provided to restore the Central Bank, known as Da Afghanistan Bank (DAB). Under its prior formulation, DAB provided some commercial banking and clearing services across the country. As of August, 2006, 35 of its provincial branches were believed to have received modernization assistance from USAID. In addition, 12 commercial banks are licensed to operate in Afghanistan, and there are 11 microfinance institutions and two credit unions providing limited financial services (World Bank, 2005).

For all of the progress in its strengthening, Afghanistan's formal financial sector operates at a rudimentary level. Most of the commercial banks are concentrated in Kabul and focus on a clientele of international donors and businesses, foreign NGOs and foreign government agencies. According to the World Bank's Investment Climate Survey (2005) the most important sources of finance for local firms in Afghanistan include internal funds (78%) and family and friends (16%). Much, if not most, trade finance is obtained through the informal *hawala* system[4], which is reported to be more efficient and faster than formal bank transfers. It is tax-free, avoids capital controls and its intermediaries (*hawaladars*) typically operate with low overheads.

There are many historical factors driving the deficit in formal commercial finance in Afghanistan. Important and ongoing among these is the strong adherence to Islamic law and, particularly, its prohibitions on explicit money interest. In order to better understand the effect of Islamic prohibitions on *riba* and, thereby, current markets for financial services in the country, we describe below some common financial arrangements practiced outside the nascent commercial banking sector. This discussion of the ways in which Afghans obtain, intermediate, and use finance is based in large part on informal finance research undertaken by the Afghan Research and Evaluation Unit and reported in a series of case studies (Klijn 2006 and 2007) and a summary of those (Klijn and Pain, forthcoming).

Klijn and Pain (forthcoming) provide a useful and informative description of credit survey data including: who within their sample was borrowing and who was lending, the terms, amounts and conditions for loans, all of which is measured by respondent wealth category. In addition to their description of the survey data, Klijn and Pain analyze these results with respect to the social context within which they happen. They also assess their implications for the objectives of microfinance initiatives. For the purpose of this report, their description of loans, lenders and terms and conditions is of greatest interest. These are discussed below with respect to their "Islamic finance" implications.

[4] Hawala is a money transfer system executed by Hawaladar at the two ends of a distant transaction. Customer A gives Hawaladar A a sum to be transferred to Hawaladar B. Hawaladar A then calls, e-mails or faxes Hawaladar B at the other end of the transaction who provides an equivalent sum to the beneficiary of the transfer. The two Hawaladars then sort out their liabilities by any number of reverse transactions.

Types of (Informal) Finance in Afghanistan[5]

A common means of financing transactions when the buyer does not have money to pay is **delayed payment**. Under this arrangement, shopkeepers or itinerant traders provide goods at a marked-up price against a promise to pay in the future. While this can be thought of as a credit purchase (in the sense that an implicit interest rate can be calculated), it is allowed under Islamic finance because it is trade. It is actually different than a western-style credit purchase in that, if the borrower does not repay in the time agreed, no penalty can be assessed on his or her failure to pay. If he or she is able to repay, it's expected that he or she does so.

A second type of finance employed to smooth income in rural Afghanistan is the **advance provision** of foodstuffs or other needed goods against a promise to pay in the future. Under this arrangement, food or some other necessity is provided (by someone holding a surplus) when it is needed and repaid in labor or cash when the borrower is able (or within some agreed time). Although Pain and Klijn distinguish between an advance and an in-kind loan with profit, these are the same with respect to their compliance with Islamic finance. That is, since it is goods that are being traded against future payment of money or labor, a price higher than the cash price is allowed. If repayment were in the same form as the borrowed item, it would need to be in the same quantity (i.e. without increase). But if repayment is in a form different than the borrowed item, there is scope for the lender to earn a return from the delayed payment.

The inverse of the advance provision of goods – forward purchases of a crop, for instance – is also reported in Klijn (2006). Under this arrangement, with respect to agricultural products, the buyer provides money to the farmer in exchange for the promise of future delivery of the crop. In assessing whether such an arrangement is a sanctioned Islamic practice El-Gamal (2006) notes, "[i]n general, the sale of non-existent objects is forbidden due to *Gharar*" (risk or uncertainty). However, in the case of *salam* (forward purchases), this is allowed as long as the term of deferment and the quantities to be delivered are well specified. In Afghanistan, this allowance is extended to the future supply of labor, as well as products.

A third type of finance is the **cost-free loan**. These loans are typically between friends, relatives and other people known to one another. The loans can be small or substantial, they can be short-term or carry durations up to several years. Their common characteristic is that they are repaid in the same units in which they were borrowed. These types of loans are allowed under Islamic finance and they exemplify the aspect of "charity" that runs through Islamic finance. It is clear that the lender loses something of value in granting such a loan and that it provides an unremunerated benefit to the borrower. But the prohibition against *riba* restricts "money-for-money" transfers over time such that the value of the debt cannot be increased over what was borrowed.

[5] This discussion borrows heavily from Pain and Klijn's, Table 4.3 Matix of Criteria for differentiating informal credit types.

A forth type of loan described by Klijn and Pain is the **mortgage** of agricultural land. As practiced in rural Afghanistan, mortgaging land entails transferring the use of productive land in exchange for a payment which the borrower then has some agreed upon period to repay. Until the mortgage is paid, use of the land and its output is under the discretion of the mortgagee. These are often flexible arrangements and there are a variety of terms and conditions that can apply. Although Klijn cites disagreement about whether these types of loans are compliant with Islamic finance under local interpretation, it is not apparent to this reviewer what rule they break. The money repaid is in the same amount as the money borrowed. The agreement regarding the use of the land would appear to qualify as either a trade or a lease. Although the benefit accrued by the mortgagee's use of the land can be described as an "increase" owing to the provision of the loan, it is not immediately clear how this disqualifies the practice any sooner than would the mark-up in a "delayed-payment" transaction.

A fifth type of credit described by Klijn and Pain is **business credit**. This is not a standard loan calculated at a fixed rate of interest over time, but rather an investment partnership under which the lender provides capital which the borrower puts to productive use, sharing the profits, if any, with the investor. Such arrangements are not only allowed, they are to a large extent, standard practice in Islamic banking. In Afghanistan, such loans may be defined for a single project, for a fixed time or timeless.

A sixth and final type of finance described by Klijn and Pain is **credit with interest**. This type of finance is not allowed under Islamic law and, while people were willing to discuss its existence in the credit surveys (Klijn 2006 and 2007), very few admitted to engaging in it. According to Islamic law, participation in such loans is sinful for both the borrower and the lender (and for anyone who witnesses the transaction). It is also, of course, the basis for western finance. But, under Islamic law, it is not allowed.

The ***hawala*** system, referenced in the introduction, is another widespread financial practice. It doubtless facilitates a great deal of the trade that happens within the country, although its reach into small rural communities may be limited. As the exchange is remunerated for costs incurred in providing the service in a way that does not break either the prohibition on *riba* or *gharar*, this arrangement seems compliant with Islamic law.

Islamic Prohibitions

Understanding when financial arrangements comply with Islamic injunctions against usury depends on whether the money loaned is allowed to increase at a rate determined by the deferment of repayment. There are other characteristics that might make a financial agreement sinful by the lights of Islamic jurisprudence, but this is the characteristic that most flies in the face of western-style banking. To those of us who believe that there is a time value of money and that it is fair and fitting to price it, the idea that this may be wrong is jarring.

Beside the cultural shock, the prohibition on repayments in excess of amounts borrowed

seems at first glance to greatly diminish the scope for financial intermediaries to enjoy returns from gathering and redistributing money. The convenient link between time-based returns to savings and time-based costs of borrowing is severed. For the saver, it implies that deposits cannot grow if they grow by virtue of being lent out at some positive temporal spread. The borrower, who might be in the enviable position of having both access to interest-free loans and a present time preference for money, would not have any funds to borrow if savers were not motivated to place (non-interest earning) deposits. Most importantly, the financial institution would be unable to capture a profit margin between the savings and lending interest rates.

That there are Islamic banks belies the idea that it is not possible to intermediate savings and investments and remain consistent with Islamic jurisprudence. Islamic banks generally solve the problem of the injunction on pricing time-based change in value by investing the funds mobilized from depositors and distributing the investment returns in pro-rata shares. This use of investment as opposed to interest accounting is a fundamental characteristic of Islamic banking. The basis for this solution to injunctions against time-based interest on money is straight-forwardly described by Ariff (1988).

> ...Islam does not deny that capital, as a factor of production, deserves to be rewarded. Islam allows the owners of capital a share in a surplus which is uncertain. To put it differently, investors in the Islamic order have no right to demand a fixed rate of return. No one is entitled to any addition to the principal sum if he does not share in the risks involved. The owner of capital (rabbul-mal) may 'invest' by allowing an entrepreneur with ideas and expertise to use the capital for productive purposes and he may share the profits, if any, with the entrepreneur- borrower (mudarib); losses, if any, however, will be borne wholly by the rabbul-mal. This mode of financing, termed mudaraba in the Islamic literature, was in practice even in the pre-Qur'anic days and, according to jurists, it was approved by the Prophet.
>
> Another legitimate mode of financing recognized in Islam is one based on equity participation (musharaka) in which the partners use their capital jointly to generate a surplus. Profits or losses will be shared between the partners according to some agreed formula depending on the equity ratio. Mudaraba and musharaka constitute, at least in principle if not in practice, the twin pillars of Islamic banking. The musharaka principle is invoked in the equity structure of Islamic banks and is similar to the modern concepts of partnership and joint stock ownership. In so far as the depositors are concerned, an Islamic bank acts as a mudarib which manages the funds of the depositors to generate profits subject to the rules of mudaraba as outlined above. The bank may in turn use the depositors' funds on a mudaraba basis in addition to other lawful modes of financing. In other words, the bank operates a two-tier mudaraba system in which it acts both as the mudarib on the saving side of the equation and as the rabbul-mal on the investment portfolio side. The bank may also enter into musharaka contracts with the users of the funds, sharing profits and losses, as mentioned above.

While the foregoing describes some general principals involved in allowable versus prohibited finance under Islamic law, there are numerous finer points that either can or need to be addressed in structuring a "*Shari'a*-compliant" financial agreement. For structuring *Shari'a*-compliant loan instruments, a specialist in Islamic finance should be consulted.

However, equipped with a general understanding of the injunction against *riba* and some understanding of finance, it is possible to identify areas wherein opportunities exist for *Shari'a*-compliant financial intermediation by a credit union. Moreover, by considering the prohibition against *riba* as binding on all lending of money, it is possible to more clearly identify how to ensure that a credit union's policies and products comply with that prohibition.

Prospects for Shari'a-Compliant Credit Union Products and Services

El-Gamal (2006) makes the argument that much of what currently gets passed off as Islamic finance is based on fictions that do not really absolve an institution whose principal purpose is to increase capital through financial intermediation. His recommended solution to this problem is to make Islamic financial intermediaries truly mutual entities, in which returns are distributed as shares and the "charity" implicit in Islamic lending drives the institution's quest for growth. Such an institution would still be precluded from engaging in prohibited forms of finance, but the distribution of any gains made from engaging in *Shari'a*-compliant finance among the members changes the underlying character of the enterprise, in El-Gamal's view.

This reading of Islamic jurisprudence should interest supporters of credit unions, even though it has not yet passed muster among the specialists and arbiters of Islamic finance. It is certain that a sort of equity position for depositors is accepted for accounting returns to savings in Islamic Banks (Ariff, 1988). But El-Gamal seems to argue that only a factually mutualist institution can clear the hurdles to financial intermediation posed by Koranic prohibitions and Islamic jurisprudence. In his view, many nominally mutualist Islamic banks are profit-driven institutions serving the goals of a relatively few large investors and gaining a positive return from what he terms "*Shari'a* arbitrage." A truly mutualist institution would minimize the costs of achieving *Shari'a* compliance for its beneficiaries and, to the extent that profits were generated, these would accrue fully to the member-participants. This reasoning (minus the concern about *Shari'a* prohibitions) parallels early thinking about cooperative savings and finance.

That mutual ownership provides a viable institutional form for Islamic finance does not appear to be an issue of contention in current Islamic finance. However, El-Gamal makes the stronger argument that financial institutions must be mutually owned to avoid prohibitions against *riba* and *gharar*. In either event, it is clear that credit unions qualify as being mutually owned and that this provides the basis for them to supply intermediation services in a *Shari'a*-compliant way. The question is what sorts of financial products should credit unions seek to make available, given Islamic prohibitions on increase in money lending?

Shari'a Compliant Financial Products and Services

The following does not purport to be an exhaustive listing of the potential services or products that could be marketed by credit unions in Afghanistan but rather a sampling of potentially *Shari'a*-compliant financial arrangements both useful and readily familiar to members and potential members there.

Savings

The existence of household savings among non-urban Afghans is tangentially mentioned in both Klijn (2006, 2007) and Klijn and Pain (forthcoming), although savings are not accounted separately in their baseline asset study. Household savings are cited by several informants as a factor in their management of household finances. The historically widespread tradition of saving in Afghanistan is important to the development of credit union products and services. Obviously, this tradition can be accommodated through safe-keeping by the credit union, which may be sufficient to mobilize some deposits. On the other hand, the loss of immediate liquidity implied by making deposits may not be compensated solely by the benefit of knowing that their funds are safe and deposits might not be mobilized in sufficient volumes without the offer of some benefit additional to safe-keeping.

The interest benefit paid to depositors in western banks – and which motivates a large portion of the liability side of banks – is off the table in Islamic finance. A known and expected increase in one's deposit over time is considered a loan with interest and is not allowed. While a minority opinion has been offered in a fatwa by Muhammad Sayyid Tantawi[6] arguing that pre-specified interest payments on bank deposits are allowed, this fatwa has proven unacceptable to most Islamic jurists[7].

The use of share deposits which are compensated at a rate not specified *a priori* and which is based on allowable returns to bank financing is a widely accepted means of remunerating deposits among Islamic financial institutions. Such an instrument is similar to the widespread practice among successful credit unions of periodically paying out retained excess earnings to members, based on their share or other deposits. In the absence of deposit interest costs, such returns should be larger for any given return on assets, though they remain dependent on those returns.

Under WOCCU's current project (ARIES), several *Shari'a*-compliant deposit instruments have been developed to supplement current accounts and savings accounts. The *Al-wadiah* account allows depositors to withdraw their money at any time and permits the credit unions to use the depositors' money. At its discretion, the credit union pays the depositors a positive return periodically, depending on its profitability. The *Mudaraba* investment accounts are term deposits that cannot be withdrawn before maturity.

Investments

As noted in the preceding discussion, it matters to Islamic jurists how the institution's funds are invested. In order to comply with Islamic prohibitions against *riba,* three standard Islamic finance alternatives include employing trade- and lease-based loan formats or share investments. As practiced in Afghan informal finance, trade-based finance can entail either a

[6] Dr. Muhammad Sayyid Tantawi. 2002 "Investing funds with banks that pre-specify profits". Azhar's Islamic Research Institute. Cited from El-Gamal, (undated) "Interest" and the Paradox of Contemporary Islamic Law and Finance.

[7] See Fourteenth Session of *Majlis Majma' Al-Fiqh Al- Islami* in Doha, Qatar, January 11-16, 2003. Cited from El-Gamal, (undated) "Interest" and the Paradox of Contemporary Islamic Law and Finance.

purchase on the promise to pay in future or payment for a good or service to be delivered in the future. In either case, the good or service is the focus of the transaction and a higher (lower) cost for the traded (promised) good is allowed. The difference between the cash price and the future payment or delivery price can be characterized as compensating the person financing the transaction for risk or the time value of money and, typically, standard lending rates are used as a reference value for this difference. Using deposits to invest in such funds[8] would appear to provide a credit union with an acceptable way to remunerate depositors.

With respect to lease-based financing arrangements, the "mortgaging" of land discussed in Klijn and Pain (forthcoming) provides an example of an apparently allowable transaction. The owner of the land exchanges use of the asset for a payment of some amount that is repayable after a period. Assuming competitive markets, the price should be set by the land's productivity and should approach the net present value of a stream of income that can be earned from the land. However, assuming competitive markets for finance and land transfer in rural Afghanistan is risky and the actual pricing of leases can also be set with reference to standard loan interest rates. It is important, in considering lease-based (*'ijarah*) financing, to recognize that the lessor must own the asset and the lessee must make use of the asset in order to justify paying a "rent" for it.

A third solution to the Islamic prohibition on *riba* is the use of partnerships (*mudaraba*), wherein the financer provides capital to an entrepreneur who combines them with other assets to generate a benefit which can then be shared. What is important with respect to this form of finance is that returns are specified as a share of actual profits and, if the investment generates a loss, this loss is born by the owner of the capital. Because of potential asymmetries in knowledge about specific investment returns, there is clear moral hazard associated with such financing.

Production Loans

It would be useful to consider the ramifications of converting a loan of some given type to an alternative form which may, with proper framing, be allowed under contemporary Islamic jurisprudence. If we consider a basic agricultural production loan within the context of the financing possibilities described above, there appear to be three different ways that one could convert an interest-based loan into a *Sharia'*-compliant one. First, the credit union could provide funds at the start of the season against a promise on the part of the borrower to deliver a certain volume of his product to the credit union at the end of the season (*salam*). Under this solution, the credit union would effectively provide price insurance to the borrower (since the value of the output at harvest time is uncertain). Moreover, the credit union would be in the position of selling agricultural produce that it received under this arrangement.

Secondly, the investment could be made as a partnership agreement (*mudaraba*) under which repayment would be made as a share of the proceeds from the investment. Under this arrangement, the borrower effectively receives crop insurance since, if his crop fails, the

[8] El-Gamal (undated) refers to these as *murabah* funds, "which are essentially securitized claims to the stream of fixed payments of principal plus interest (mark-up)". Pg 15

investor bears the loss. Establishing an appropriate share arrangement for such a loan seems fraught with hazards. Just to mention a few: In the enterprise budget under which net returns to a *mudaraba* agricultural investment might be calculated, how does one value the farmer's labor? How does the credit union cover the true risk of loss without giving rise to adverse selection? What sort of accounting is required under such an agreement?

A third solution to the agricultural financing problem is to sell the required inputs to the farmer at a marked-up, credit price. While this might be a viable alternative for providing inputs on credit, it would require credit unions to actually sell those inputs to the borrower, which means that they would need to enter the market for agricultural inputs as suppliers. Moreover, this type of mechanism could not fund those parts of the borrower's costs that are not traded (e.g., labor).

Equipment Loans

Loans for capital equipment might be set up as either a lease (*'ijara*), credit purchase, or as a partnership agreement (*mudaraba*). Under a lease arrangement, the credit union must own the asset and the borrower's payments can be thought of as rent, paid for the right to use it. Unless the loan is priced in such a way that the borrower takes possession at the end of the payment period, however, this type of arrangement might generate some perverse incentives. That is, the borrower would have no incentive to care for the asset if he knows that, at the end of some specified period, the owner will reclaim it.

The credit purchase entails a similar requirement as the lease arrangement, in that the credit union needs to own the asset before it can sell it to the borrower. However, under this arrangement, ownership of the asset could shift to the borrower (with a lien on the title) over the period that the credit-adjusted price is being repaid.

Under the *mudaraba* arrangement, the credit union and the borrower could enter into a partnership, under which the equipment would form the credit union's share investment in the enterprise. As in the case of the agricultural inputs loan discussed above, it does not seem a simple matter to specify or ensure the net returns to the asset. One can envision an engine clock that would record the amount of time that a piece of equipment was used or using the odometer on movable equipment as a proxy for use. With some aspect of use so measured, the contract could specify a payment rate that approximates the return to the asset or that share of those returns that are due to the investor.

Consumption Loans

Consumption loans or, debt consolidation loans under which a borrower is provided funds for current expenditure against a promise to pay in the future is a fourth type of instrument, not discussed in the investment section above. Such loans must be interest free and they are, effectively, charity for the borrower. Under the current review of Islamic jurisprudence, it appears that such loans cannot carry any fee and that, while the money should be repaid, the amount of repayment may not increase over the amount loaned. Such lending will not increase the money value of a credit union's resources, but may provide "good-will" benefits.

To the extent that helping farmers to clear accumulated debt is a goal, lending to pay off such debt merely transfers the farmers' obligation to the credit union. As a money-for-money transfer, the amount to be repaid should not increase.

Mortgages

Mortgages are mentioned here not with respect to housing finance but with regard to the property leasing that seems to already be established in rural Afghanistan. As described above, under such arrangements the lessor gets money up front and the lessee gets the proceeds from production on the land over the life of the loan[9]. As currently practiced in Afghanistan, such mortgages retain scope for the lessor to continue to get some benefit from the land, typically as a share of the crop and particularly if he continues to cultivate it. Such lending would require knowledge of returns to agricultural land in order to establish equitable shares between the lessor and the lessee and to ensure loans that satisfy both the repayment capacity of borrowers and the income requirements of the credit union. Within that set, however, they might be an alternative to non-remunerative consumption or debt consolidation loans.

[9] NB, the credit union, in this transaction, is the lessee.

SUMMARY AND CONCLUSIONS

It needs to be emphasized that this discussion of *Shari'a* compliance is based on an outsider's understanding of Islamic jurisprudence and Koranic prohibitions on *riba* and *gharar*. The basic outlines of the original injunctions and modern interpretations of them are not all that difficult, but as with many cultural practices, there may be details that escape the outsider. Moreover, as El- Gamal (2006) notes, experts in Islamic finance form an essential link in determining *Shari'a* compliance, if only by way of having the *imprimatur* with which to pronounce on a new financial instrument or institution. For these reasons, it is recommended that WOCCU secure technical assistance from experts on Islamic finance in developing its program in Afghanistan.

The second important point to be made about this study is that the mutualist institutional form is a viable, if not necessary, way to structure an Islamic financial institution. To a certain extent this requirement is driven by religious prohibitions, but it might also have practical application in Afghanistan, especially with respect to employing local sanction in a credit union's operations. Credit unions introduced to the country will be foreign phenomena until their members truly accept ownership of them. By complying with local cultural and religious practice the credit union will make its services more recognizable to members, allowing them to more easily accept ownership of the institution.

While mutual ownership is an acceptable institutional form, credit unions are not freed from Islamic prohibitions on *riba*. Members cannot be paid a fixed return on deposits, though they can receive a share of the institution's net gains, annually. Nor can the institution invest its funds in interest-earning accounts, unless these are sanctioned as *Shari'a*-compliant. Over all three of the funds-investment possibilities described above, the basic premise is that for investment capital to increase, it should either involve trade or a sharing of the risks between the borrower and the lender. Both of these alternatives entail some degree of participation that is outside the normal range of credit union activities. In both credit purchases and leases, the credit union needs to become a buyer, seller and owner of goods. In the case of share investments, the information requirements for protection of the credit union's investments seem to this reviewer to be large and onerous. The tax implications are similarly fraught, though unknown.

Reverse lease arrangements, whereby land owners mortgage their land to the credit union may provide a way to provide liquidity to farmers. While leasing agricultural land is, again, outside the normal scope of credit union activities, this arrangement has the benefit of familiarity to borrowers and it provides a way for a credit union to enjoy some positive spread on the "debt-consolidation" side of its portfolio[10].

Adopting any of the investment vehicles discussed in this paper will require drastic re-thinking of the credit union's accounts. Discarding time-based, *a priori* interest returns will make estimating the institution's position at any point in time more difficult. Greater risk sharing will imply greater risk for the institution. While clearly difficult, the fact that other

[10] To the extent that there is a generalized benefit to substituting credit union debt for opium-trafficker debt, some third-party buyer of this debt might be sought, after the desired change in cropping occurred.

Shari'a compliant institutions operate in the region indicates that it is not impossible. Moreover, to the extent that credit unions might gather more local acceptance if their products and operations are more recognizable, it is likely a task worth undertaking.

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