SME's & Islamic Micro Financing in America

Faheem Hameed

Al-Huda University
1902 Baker Rd, Houston, TX 77094

Abstract

This research work explores the purpose and importance of microfinance in the Small and Medium Sized Enterprises (SME) sector of the United States. Highlighted are various Islamic micro financing options available for SME's in the United States. In addition, the potential of Islamic micro finance and its benefits to SME's sector are analyzed.

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Introduction

Micro finance programs have proven to be effective tools for the elimination of poverty and for stabilizing incomes and consumption in both developed and developing economies across the globe. Due to stringent underwriting and the high costs of debt financing that borrowers must meet, large segments of the United States population have limited access to capital for starting and operating small businesses.

An alternative model to this dilemma is Islamic micro finance. Though still in its formative stage, Islamic micro finance offers an alternative model for financing small and middle markets with terms that are less onerous and more empowering for borrowers. For those at the low end of the socio-economic scale, the ability to obtain these loans provide a reentry into the economic stream. The end result is increased equity and a more just distribution of wealth.

Although the Islamic micro finance industry has philosophical, structural, and operational challenges that must be addressed, the marriage of Islamic financing and micro lending promises a new dynamic strategy which Muslim-based entities can adapt to provide a different tranche of financing to a broadening constitute base of Muslim and non-Muslim banking customers.

Purpose of Micro Financing

For those with limited income and resources, the ability to secure loans from conventional or Islamic banks and institutions is not possible. Thus, understandably there is perception among many small businesses that big banks only give to people "who don't need money." While technically untrue, conventional banks who underwrite loans manage their risks by requiring that borrowers have business stability, adequate cash flows, adequate reserves, healthy income projections, and collateral—prior to allocating loans. Therefore, the alternative for micro-business owners who cannot meets these requirements is micro financing.

In addition to providing loans, microfinancing, as a strategy, often includes banking services, educational programs, and training regarding business operations and investing. The focus of micro finance organizations is assisting client entrepreneurs through phases of growth toward stability. The target population, for the US microfinance industry is the poor and working class. Microfinancing provides the working poor opportunities to become self-sufficient business owners. Micro loans, when coupled with business counseling and networking enables recipients to increase profits and trade and to add employees **[1]**. This, in turn helps to improve the overall economy. Although micro loans were conceived as a way to assist small businesses, they are also part of the social safety net used by poor and low-income communities to deal with emergencies like sickness and disasters; to pay for large expenses such as education, funerals, and weddings; thereby allowing for predictable consumption. **[2]**

History of Micro Loan Programs

The late twentieth century saw a growth in the micro loan industry. The microfinance industry in the US began in 1973, in the urban community of Chicago when the Shorebank Corporation launched a fund to provide investment capital to small, local, mostly minority-owned businesses that could not get financing from conventional lenders. **[5]** In 1991, the US Small Business

Administration (SBA) began its own Microloan program which provided loan guarantees to banks and other micro- loan providers who made micro-loans available to "targeted populations." **[6].** This program was enhanced with the passage of the Community Reinvestment Act in 1977, which encouraged banks to serve the credit needs of poorer communities and traditionally un-banked groups **[7]**. Globally there was also growth in the micro fiancé field.

For example, in 1976, the Grameen Bank in Bangladesh organized the first modern micro loan program to assist its poor bank customers. The SKS Microfinance [now Bharat Financial Inclusion Limited] was started in India in 1998, with a similar mission. **[3]** Microfinancing has also been used successfully in Uganda, Malaysia, Indonesia, Serbia, and Honduras. **[4]**

Working Mechanism of Micro Lending in SME Sector

Micro loan clients represent a niche population among small US businesses. However, the structure and process of providing microfinancing is the same as with large conventional banks. Loans are provided to borrowers who are charged interests for their use of borrowed capital. Personal and business assets are required to provide as collateral for the loan repayment. If the loans are delinquent or in default, refinancing at an additional cost is often added as part of a workout. There are no discounts for early pre-payment of loans. Some micro loan funds will pool common-interest borrowers who, after receiving their loans, agree to repay the debts together. This approach has proven a viable alternative to the lack of adequate collateral, which is common. Microfinancing refers to financing and funding targeted for small to medium-sized enterprises (SMEs).

The definition of a SME enterprise can vary depending on the geographical location. The US Small Business Administration (SBA) defines an SME enterprise "generally" as having no more that 250 to 1,500 employees –depending upon the industry type. **[8].** A "small business" is defined by non-government experts as an enterprise with less than $7 Million in annual sales and less than 500 employees. The government's numbers are higher. Micro loans are typically much smaller amounts, ranging anywhere from $100 to $25,000, or more depending upon the use of funds, and criteria of the fund provider. **[9]**

Management Training for Businesses

Non-profit micro-lenders discovered early on that business management training and technical support for its loan recipients was key to the success of the business, and ultimately repayment of the loan. Typically, this includes entrepreneurial training, one-on-one consultations, executive business services, and even location in a business incubator facility. There is an indisputable uptick in the success rates of small businesses, including start-ups, who participate in training and who utilize ancillary support services.

In 2016, Accion, USA reported that the average size of micro loans in its portfolio was $10,049. **[10]** Accion-USA is the largest micro-lender in the US, having provided more than 60,000 loans totaling more than $500 Million to small businesses since 1991. **[11]** In comparing loan recipients who receive training, ACCION's research reveals that "entrepreneurs who use Accion and Opportunity Fund's non- financial services (such as financial counseling, mentorship programs, online resources and workshops) see great benefit to them. Business planning emerged as a concept that business owners generally value. Financial coaching and/or mentoring services that are bite-sized and convenient, such as those using digital channels might be more accessible." **[12]**

Micro Loan Providers

Over the last two decades a host of new micro loan providers have emerged along with third-party organizations who provide ancillary services to micro loan borrowers. This was in response to a national mandate to eradicate poverty and build up the middle class through the creation and growth of small businesses in America. Microfinancing providers now include stand-alone micro-lenders, community development banks, federal and state governmental agencies, credit unions and mutual fund associations, Certified Community Development Financial Institutions (CDFIs), conventional banks who for competitive and regulatory reasons have developed micro-loans products, and for-profit wholesalers and consultants who work directly with financial institutions in providing micro-funds to their clients. **[13].** Nonprofits make up the largest share of these providers.

Islamic Financial Institutions and Contribution towards SME's

Today there are more than 550 Islamic banks and mutual funds operating worldwide. The size of the global Islamic finance industry is projected to reach $3.4 Trillion dollars by the end of 2018. **[14]** Compared to other countries and regions, the size of retail Islamic financial transactions in the US is small; only grossing approximately $4 Billion a year. **[15]** The US has over 25 Islamic financing institutions today including national banks, several community banks, banks with Islamic windows, investment banks, brokerage firms, credit unions, and several nonprofits which feature Islamic products. Each of them offers shariah compliant products that are based on the principles of limited risk and profit sharing. Less than 20% of these institutions provide some form of microfinancing for small business owners. **[16]** Shariah compliant micro loan funds can be structured in any one of three product formats: *Murabahas* which is a profit and loss sharing partnership that separates the management and obligations for capital investment; *Musharaka* which is a profit-sharing joint venture partnership agreement; or *Ijarah* which is a lease-to-own agreement. While not designed exclusively for micro loans, these products can be used for small business acquisitions and working capital.

Muslims remain among the fastest growing population groups in America **[17].** Therefore, Muslim-based institutions and organizations need to join the ranks of micro-lenders in the US with a platform of shariah-compliant and socially responsible banking, business and investment products that are marketed to the public at large. Only a small percentage of the Islamic institutions and a mere fraction of their assets are dedicated to providing funds for middle and low-income persons. Most of the current clients of Islamic banks and banks with Islamic windows are high net-worth individuals; mostly professionals with advanced degrees and significant disposable incomes.

In addition to indigenous and immigrant Muslims, this population now includes 3rd and 4th generation American-born Muslims. Future economic and demographic profiles will include more of these individuals among the middle and low-class than before. These Muslim consumers will need and demand access to shariah-compliant products and services that are more accessible, more affordable, and consistent with their faith requirements. Micro finance institutions could meet many of these demands more efficiently than larger Islamic banks. This is essential because Islamic banking is not just financing, it's funding. One study drew inferences from mosque participation that among Muslims in America some currently use and would continue to use Islamic financing if available. Other Muslims currently use conventional financing, but would switch to Islamic financing if more readily available; and others who use conventional financing and would likely continue, even if Islamic financing were available. **[18]**

The development of Islamic micro financing could simultaneously address a number of economic, social, and religious concerns for Muslims and others in the US today. As noted, "Islamic microfinance represents the confluence of two rapidly growing industries: microfinance and Islamic finance. It has the potential to not only respond to unmet demand but also to combine the Islamic social principle of care for the less fortunate with microfinance's power to provide financial access to the poor." **[19]**

Another compelling reason for promoting Islamic micro financing is its inherent programmatic ability to empower it users. At an Islamic Development bank-sponsored conference, participants discussed innovative approaches utilizing Islamic finance as tools for economic development. Dr. Amjad Saqib, of the Akhuwat Foundation in Pakistan talked about Islamic micro finance and "the need to view Islamic finance as an empowering tool, not just for Muslim, but for all people irrespective of religion." **[20].** Islamic finance can and should be a tool for empowering all income sectors of society who are burdened by debt, the rising costs of inflation, and the trappings of Riba. As an alternative, Islamic finance can provide a new paradigm for social economics for Muslims and non-Muslims in America.

It should be noted that somewhere just below the radar are a small number of Christian and Jewish-based organizations which have revolving loan funds, micro-lending programs, and mutual loan associations which provide riba-free loan products to its members. **[21]** Identical models have been used by faith-based groups, nonprofits, community development corporations, and other community economic development practitioners in the US for over 40 years. The overlay of Islamic legal, religious, and financial principles is new, but not the micro lending industry is still in its infancy.

Muslim-based non-profits who provide Islamic micro funding already exist in California, Texas, Pennsylvania, and Minnesota. Other similar programs are in development. Also, Muslim-sponsored federal and state credit unions have opened their doors and now provide a limited range of services including micro-lending to its equity share members. **[22].** For example, in response to religious concerns from its Somali immigrant clients regarding the use of interest, the Neighborhood Development Center (NDC), a nonprofit in the Minneapolis-St. Paul, established an interest-free revolving loan fund capitalized with grants from state and local governments, and local foundations. The NDC contracted with a separately-formed, for-profit (Reba-Free, LLC) to develop a Murabaha product, that would provide consulting and investment services for the interest-free financing program and its immigrant Muslim investors. Using the Murabaha model, the group raised $317,000 and purchased several vans for a food delivery business, taxi vehicles, and a bus to transport children to a private Muslim school. **[23]**

Another example, Somali Family Services of San Diego, is a non-profit which partnered with Bank of America and the United Way of San Diego to provide a grant and investments to establish an Islamic micro loan fund for the local Somali community. Individual community members will invest equity in several transportation micro-businesses which provide non-emergency medical transportation and taxi service businesses. The program design is based upon risk-sharing and is otherwise Shariah compliant with no interest or Gharar.

Muslim community members and business shareholders were elated at the prospect of having access to commercial financing that aligned with their faith beliefs. According to Ahmed Sahid, President and CEO of Somali Family Services of San Diego, "we embraced the challenge of finding a solution that would align with the needs of Somali Family Service, our investors, and our own organizational goals. The investment would need to fit in our portfolio thesis-both socially and financially-and comply with our partners' faith." **[24]**

Debates and Challenges

The role, use, and effectiveness of micro loan programs continue to be debated around the globe. Arguments have focused on the effectiveness of micro loans in reducing poverty, and job creation. The success or failure of micro loans as a tool for economic development and the appropriateness of for-profit micro-loan funds, which are boastfully claiming attractive profit margins, greater operational efficiencies, and growing demands for services continue to fuel the discussion.

As an industry, Islamic micro lending faces several challenges that must be addressed. Some of these include: Heavy subsidy requirements to capitalize loan funds and business management assistance programs; potential high demands for services and shortages in number of loan fund providers; competition from for-profit micro loan fund providers; the need for standardization of banking products, agreements, operating procedures, legal **[25]** and regulatory requirements; and community education and marketing.

Recommendations for Islamic Micro Loan Institutions

i. Increase the number of Islamic Microfinance institutions.

ii. Refine/engineer Shariah-compliant Islamic banking products and services as competitive options to conventional banking products.

iii. Establish a dedicated Waqf that will provide funds for equity investments to microloan providers for their clients/partners.

iv. Establish a dedicated Waqf that will provide funds for operations, training, and advocacy.

v. Develop a permanent community education and industry-wide marketing campaign regarding the benefits of Islamic financing in America Establish institutional partner agreements with non-profits, SBDCs, merchants & suppliers, executive suites & small business incubators.

vi. Create platforms for Operational training for fund managers, board members, SSBs, and staff "Subject-matter expertise" training for micro loan fund "business analyst" and retained consultants business management assistance training for micro loan fund clients (borrowers)

Conclusion

Early models of micro finance loan programs were designed specifically for lower income and disadvantaged communities. Micro financing is no longer exclusively for the poor. Micro financing has shown to be effective in providing services in the small and middle markets. This base includes lower and middle-class Muslims (and others) who could benefit from the availability of smaller amounts of micro loan funds for businesses which they may borrow as individuals or as a group of partners. Successful models of micro fund lending and management all include some form of business management training. Islamic micro finance must also incorporate subject matter expertise training for loan fund business analyst. Micro financing and Islamic financing can be a timely and useful marriage for addressing new challenges of rising costs and increasing debt. Islamic finance in America with its principles of equity sharing, limited risk, and no Riba will be established on the heels of the micro finance industry that increasingly will speak louder to the needs of middle America.

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