

# Spotlight on Financial Inclusion Leaders



Citi Microfinance



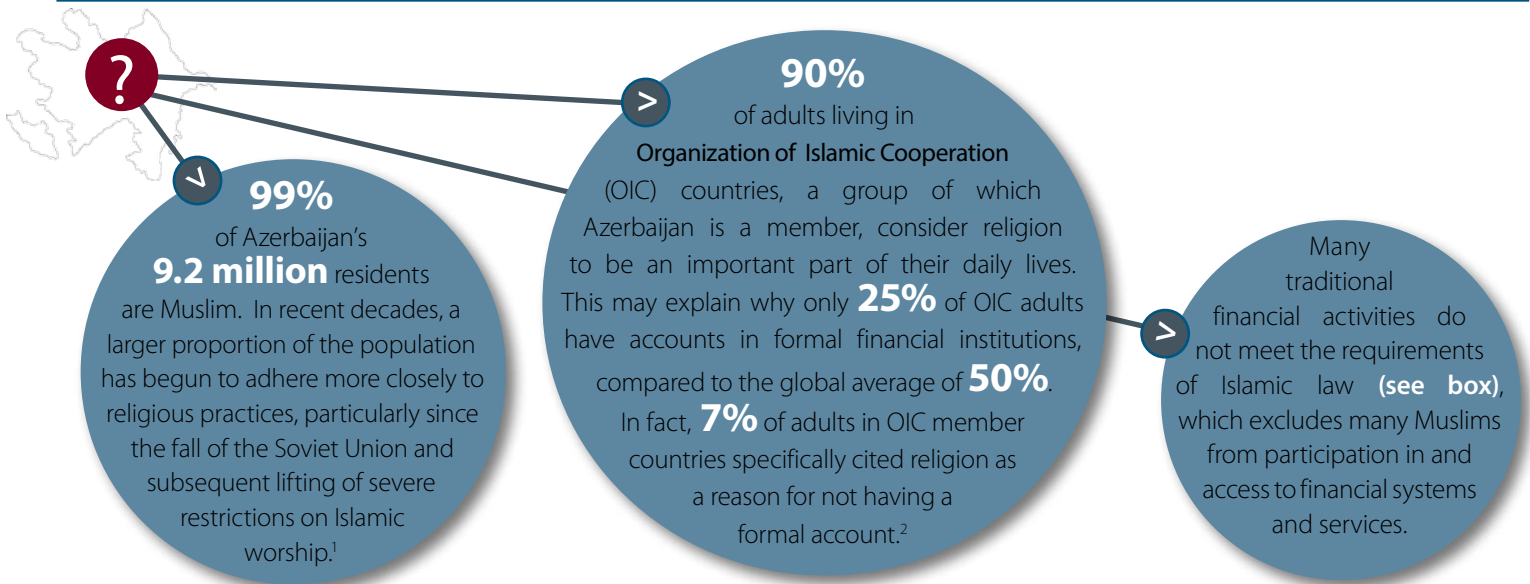
## EXPANDING ISLAMIC MICROFINANCE IN AZERBAIJAN

The case for industry coordination  
to serve new client segments



In an effort to meet increasing client demand for Islamic microfinance products in Azerbaijan, a broad group of diverse stakeholders led by the **Azerbaijan Microfinance Association** is working to enact legislation and build the capacity of financial service providers to deliver these products. By mid-2015, it is expected that both the legal framework and the requisite support services will be in place to enable wide access to Islamic microfinance, thereby enhancing overall financial inclusion in Azerbaijan.

## Rationale and Background: Why Islamic Microfinance in Azerbaijan?



In 2010, members of the Azerbaijan Microfinance Association (AMFA), representing some of the largest Microfinance Institutions (MFIs) in Azerbaijan, began to notice an increase in client drop-outs. The MFIs conducted client exit surveys to determine why the clients had suddenly stopped using their services. The surveys revealed that after a pilgrimage to Mecca, many clients felt that they could not continue taking traditional loans as these were inconsistent with their religious beliefs. Other AMFA members confirmed similar findings across several regions of the country considered to be particularly devout.

To further investigate this issue, one of AMFA's members independently recruited an Islamic microfinance expert from ALHUDA Islamic Microfinance Centre, Pakistan, and carried out a rapid market assessment. They discovered that approximately 17-25% of the Azerbaijan microfinance market would choose Islamic microfinance products if available. In addition, it is expected that given a choice between Sharia-compliant banking services and Western banking services, current and future clients would choose services that abide by Sharia law. Since Islamic finance products are viewed as "equity investment partnerships," expansion of these offerings results in increased client trust of financial service providers, while the Sharia-compliant institutions become equally interested in the success of their clients.

### Islamic Finance at a Glance

Islamic banking and finance refers to an entire system of banking activities that are consistent with Sharia principles. It prohibits:

- » Predefined interest loans
- » Trading in financial risk, which is considered gambling
- » Investing in businesses which are considered *harām* (*forbidden*), such as businesses that sell alcohol, pork, or produce un-Islamic media

Instead, Islamic law requires financial providers to share risks (profit and loss sharing) of business activities, with financial fair play standing as a core value. Profit-and-loss sharing arrangements (PLS) or the purchase and resale of goods and services thus provide the basis for financial contracts. Under PLS, the rate of return is unknown and not fixed prior to the transaction.<sup>3</sup>

The market for microfinance in the Islamic community can be divided into three segments:

1. Individuals who will accept conventional finance products
2. Individuals who state a clear preference for Sharia-compliant finance but—as a result of unavailability or price differentials—accept conventional finance
3. Individuals who only use Sharia-compliant products

Overall, it is estimated that roughly 2/3 of the Muslim microfinance market either prefers or requires Islamic financing.<sup>4</sup>

1. World Bank. (2014). *Azerbaijan* [Data file]. Retrieved from <http://data.worldbank.org/country/azerbaijan>; AlHuda Islamic Microfinance News. (2014). Retrieved from <http://imfn.org/news.php>

2. World Bank. (2014). Global Financial Development Report 2014: Financial Inclusion. doi:10.1596/978-0-8213-9985-9

3. Hesse, H. & Čihák, M. (2008). *Islamic Banks and Financial Stability: An Empirical Analysis* (IMF Working Paper 08/xx). Washington, DC: International Monetary Fund.

4. Karim, N. & Khaled, M. (2011, Feb 23). Taking Islamic Microfinance to Scale [Blog]. Retrieved from <http://www.cgap.org/blog/taking-islamic-microfinance-scale>

## Market Limitations on the Provision of Islamic Microfinance in Azerbaijan



**Lack of regulatory framework.** Islamic microfinance is not just another product. It is an entirely different system that requires a distinct legal framework and licensing processes, and is dependent upon strengthening the capacity of Azerbaijan's Central Bank to ensure adequate supervision and regulation.



**Lack of expertise and infrastructure at the financial provider level.** To be Sharia-compliant, providers will have to create completely independent subsidiaries. This requires significant investment in building the technical capacity of providers, as well as the development of manuals, procedures, management information systems (MIS), new bank accounts in which Islamic microfinance funds can remain separate from the rest of the portfolio, and so on.



**Lack of information at the client level.** Potential clients, and those who have dropped out of traditional MFI offerings, are poorly informed with respect to the availability of Sharia-compliant financing options. At present, they often draw upon family sources, the lottery, and mutual support groups to meet their borrowing needs.



**Lack of specialized investors.** Those investors currently active in the Azerbaijani market don't have the expertise and resources to invest in Islamic microfinance providers.



Typically, users of Islamic microfinance have little or no collateral, as they do not possess significant assets. They would therefore be excluded from other forms of financing, including Islamic bank financing. Thus, Islamic microfinance provides a means of accessing funds for those who are unlikely to qualify for other forms of finance yet are still seeking full compliance with Islamic law and an Islamic way of life.<sup>5</sup>

### Why did AMFA decide to support members in this area?

- » **Member Demand:** The members who requested Islamic microfinance are among AMFA's largest and most supportive. They devoted their own resources and expertise to understanding the situation and developing potential solutions, which was a clear indication of member interest and commitment.
- » **Business Opportunity:** This is a good opportunity for AMFA as it positions the association to offer a new service—technical assistance in Islamic microfinance—that is not presently supplied by other actors in the market. Since this is an area in which demand from both members and external stakeholders alike is increasing, the business case is particularly robust.

### Promoting Islamic Microfinance in Azerbaijan

In an effort to better understand how they could re-engage devout Muslim clients and meet anticipated future demand, the MFIs brought this issue to AMFA and collectively decided that the association would dedicate resources to support the development and expansion of Sharia-compliant financial offerings.

AMFA began actively working to support the introduction of Islamic Microfinance in Azerbaijan in 2010, working across multiple levels to increase awareness, share knowledge, and build partnerships. AMFA is currently funding these efforts from its membership fees, as it believes investment in these services will be crucial to member retention and satisfaction. In addition, workshops organized to date in the area of Islamic microfinance have been fee-based, which has helped to cover costs incurred by the association.

5. (Islamic Microfinance Training for AMFA members, 2012).

## Ecosystem-Level Activities Implemented to Date by Key Stakeholders



### Building Awareness

- ✓ AMFA invited a speaker from Sanabel to their 2010 member meeting to discuss Islamic microfinance and introduce this topic in the market.
- ✓ This attracted government attention and also led to the development of the the Azerbaijan Working Group on Islamic Mcrofinance, which was formally initiated in 2013. This group is led by AMFA and comprised of six members representing banks, MFIs, leasing companies, and credit unions.



### Developing a Legal Framework

- ✓ At the governmental level, a Task Force was convened. Representatives include experts from the Ministries of Economics and Industry, Finance, Taxes, and Justice, along with representatives from the Central Bank of Azerbaijan and the Islamic Development Bank.
- ✓ The task force is in the process of conducting a feasibility study to produce recommendations for an appropriate legal framework. This process could take 2-3 months, and it is expected that by late-2014 the regulatory framework will be drafted.
- ✓ AMFA will facilitate the gathering and incorporation of practitioner feedback on the draft legislation.



### Sharing Knowledge and Expertise

- ✓ With support from the Islamic Development Bank (ISDB) and AlHuda (the Center of Islamic Banking and Economics in Pakistan), AMFA has organized capacity-building seminars for its members and partners.
- ✓ The State Economic University in Azerbaijan began to promote Islamic finance. They are organizing a conference to be held in November 2014, which will provide academic professors and students with advanced technical knowledge.

## Islamic Microfinance: Key Terminology and Products

- » **Murabaha:** Purchasing goods for borrowers and charging a fee or markup
- » **Qard Hassan:** Interest-free/benevolent loans, usually to students or the very poor
- » **Musawama:** The seller and buyer arrive at an agreeable price for a commodity
- » **Mudaraba:** A limited liability partnership (not allowing for direct investor involvement)
- » **Musharaka:** A joint venture with profit and loss sharing
- » **Salam:** An advance purchase of goods delivered on a future date set by the buyer and seller
- » **Ijarah:** Leasing of goods with a second contract to purchase them at the end of a lease period <sup>6</sup>

6. Bradford, B. (2012, May 1). Islamic Microfinance: How is it different? [Blog]. Retrieved from <http://www.kiva.org/updates/kiva/2012/05/01/kivas-approach-to-lending-and-islamic.html>



# AMFA's Next Steps in Facilitating Islamic Microfinance in Azerbaijan

In addition to its current advocacy and facilitation roles, AMFA will:

- 1 Build members' capacity**
  - » Organize a study tour to countries where Islamic microfinance is more advanced
  - » Organize technical workshops on business models, product development, bring in MIS experts specializing in Islamic microfinance
  - » Lead technical workshops on issues such as sustainability of products, client protection, and transparency
- 2 Raise awareness and educate potential borrowers in target regions**
  - » Offer workshops on key features of Islamic microfinance
  - » Develop client educational materials explaining the economics of these products (Types of businesses permitted within the framework, where loans can be obtained, etc.)
- 3 Build in-house expertise**

AMFA will train a certified Islamic microfinance expert. This expert will then be available to assist members in developing these products and/or to become providers of Islamic microfinance products. This strategy will enable AMFA to be prepared and self-sufficient when the legislation comes into effect, and not dependent on external expertise.
- 4 Facilitate funding and sustainability**

AMFA will work to attract investors for its members. The organization has already identified investors who support Islamic microfinance in other markets, and is working to build relationships with these and other potential stakeholders.

Based upon observation and analysis of other countries and markets where Islamic microfinance is more established, AMFA has identified and plans to address the following key issue areas when working with its members to develop Islamic microfinance products:

Issues	
Product	<p><b>Diversification:</b> Though a broad range of Islamic microfinance products exist, the available supply has been largely limited to the cost-plus-markup product known as <i>murabaha</i>, which is geared toward asset purchases. The next most common product is the 'benevolent' loan which is easy to administer, but its pricing rarely covers its costs.<sup>7</sup></p> <p><b>Sustainability:</b> Given that interest and late fees are prohibited by Sharia law, providers will have to carefully analyze the business model for offering these products. In many cases, costs are higher than for traditional microfinance products owing to additional factors such as added staff time to accompany clients to buy products. Product revenue can also be unpredictable; for example, Islamic microfinance clients may be expected to offer a benevolent contribution which can not be guaranteed and/or is unpredictable.</p> <p><b>Credibility:</b> Given that Islamic microfinance offerings are only beginning to assume a more prominent place in Azerbaijan's finance marketplace, some clients and religious leaders familiar only with traditional products have been suspicious as to whether new products actually are Sharia-compliant. It will be important for AMFA to make sure Sharia-compliant offerings are clearly defined as such when introducing them to key stakeholders.</p>
Clients	<p><b>Outreach to Women:</b> To attract female borrowers, providers will most likely have to hire more female loan officers. Labour Fairs are organized by the Ministry of Labour &amp; Occupation in Azerbaijan's different regions and within its universities on annual basis. In addition, advertisements and postings will be targeted near schools, medical clinics, hospitals, and state buildings.</p> <p><b>Risk Assessment:</b> When providing Islamic microfinance products, providers are prohibited to charge late fees, accrued interest, or impose any penalties. Therefore, in addition to pricing the products to account for the risk of delays or default, additional assessment methodologies need to be considered to carefully evaluate the willingness and capacity of clients to repay.</p> <p><b>Client Protection:</b> Responsible pricing and collection practices will have to be carefully considered when developing Islamic microfinance products.</p>

7. El-Zoghbi, M. & Tarzi, M. (2013, March 26). *Trends in Sharia-Compliant Financial Inclusion*. Retrieved from <http://www.cgap.org/publications/trends-sharia-compliant-financial-inclusion>





## Lessons for Microfinance Associations



### Leverage member interest and resources

- ✓ Mature service providers often have resources and connections that can be leveraged by an association for the benefit of its wider membership and the industry at large. In this case, a few of AMFA's members pooled resources and financed an initial market assessment to evaluate actual client demand for Islamic microfinance products. The results of the study confirmed their internal client data, prompting AMFA and other stakeholders to initiate advocacy activities in support of a legal framework.



### Take a seat at the table

- ✓ Associations should strive to attain a reputation as influential and trusted market stakeholders. This sets the stage for their involvement in top-level sector and national initiatives, ensuring their members' interests are represented in decision-making processes and also enabling the association to bring prime opportunities to members. The AMFA-led Working Group on Islamic Microfinance and AMFA's promotional activities in this area created the opportunity to incorporate practitioner voices into the legislation being developed.



### Build or facilitate the building of local expertise

- ✓ Leveraging external expertise, whether international or regional, can be a good strategy, especially in areas where there is limited local knowledge. However, it is important to strengthen and support the development of local sources of expertise in areas where there is high demand and clear opportunity for scale. This can ensure the sustainability of scale-up strategies and the development of a local support infrastructure.



### Keep an eye on client-related trends

- ✓ It is crucial to stay informed on what is happening in the market with respect to client needs, preferences and especially what products might be available to them from other players. This will enable the association to assist members in the development of new products, enter new markets, and be a competitive player. To this end, associations should encourage members to collect and thoroughly analyze client data on a regular basis. Key data tools may include demand studies, client intake surveys, customer satisfaction surveys, or exit surveys. Furthermore, associations should establish a space in which members can discuss observations within their own portfolios to identify common trends. This ability to dialogue and exchange information was what enabled AMFA members to realize that client drop-out due to religious preference was not an isolated occurrence.

## About AMFA

The Azerbaijan Microfinance Association was informally established in 2001 and legally founded in 2004. It is currently comprised of 35 members: 10 commercial banks, 18 non-bank credit organizations, 2 leasing companies, 1 international foundation, and 4 credit unions. Collectively these organizations serve close to 600,000 clients with an outstanding loan portfolio of 1.3 billion USD (April, 2014).<sup>8</sup> AMFA's mission is to strengthen the capacity of microfinance institutions and to promote effective collective action in advancing the interests of the microfinance community and its clients.



"It's time for AMFA to reinvent itself to help members build new products and educate borrowers. The big, established members don't need AMFA to provide the very basic services anymore. They need us to help them enhance scale and outreach, to identify opportunities for new products, and build client capacity to become good borrowers."

-Jhale Hajiyeva,

AMFA Executive Director



## Microfinance in Azerbaijan

Azerbaijan has a strong microfinance sector: Approximately 30 microfinance organizations, along with several credit unions and banks, provide up to US \$3.5 billion in loans to approximately 837,692 borrowers.<sup>9</sup> According to The Economist Intelligence Unit's *Global microscope on the microfinance business environment 2013*, Azerbaijan saw the greatest overall score increase of all countries analyzed in 2013—by 14 points—with improvements in transparent pricing, dispute resolution, use of credit bureaus and agent-based financial transactions. This improved its ranking to 15th globally, up from 33rd in the previous year.<sup>10</sup>

## About this Series

This article is one in a series developed by SEEP with support from Citi Microfinance titled **Spotlight on Financial Inclusion Leaders**. The series profiles selected microfinance associations, showcasing the ways in which they are supporting their members and meeting the challenges of value-added growth in financial inclusion. These associations are leaders in implementing innovative and locally-responsive approaches to financial inclusion. Their work is having a clear and measured impact on the lives of their clients, and their experiences bring valuable new knowledge to the industry at large.

8. AMFA Monthly Matrix Report. (2014). Retrieved from <http://www.amfa.az/index.php?view=Monthly%20Matrix%20Report>

9. MIX Market. (2014). *Azerbaijan Market Profile* [Data file]. Retrieved from <http://www.mixmarket.org/mfi/country/Azerbaijan#ixzz32C64QxUn>

10. The Economist Intelligence Unit. (2013). *Global microscope on the microfinance business environment 2013*. Retrieved from <http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38098109>



## About SEEP

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Founded in 1985, The SEEP Network was a pioneer in the microcredit movement and helped build the foundation of the financial inclusion efforts of today. In the last three decades, SEEP members have continued to serve as a testing ground for innovative strategies that promote inclusion, develop competitive markets, and enhance the livelihood potential of the world's poor.

SEEP members work together and with other stakeholders to mobilize knowledge and foster innovation, creating opportunities for meaningful collaboration and—above all—for scaling impact.

## About Citi Microfinance

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Working across Citi's businesses, product groups and geographies, Citi Microfinance serves more than 150 microfinance institutions (MFIs), networks and investors as clients and partners in nearly 50 countries, with products and services spanning the financial spectrum - from financing, access to capital markets, transaction services and hedging foreign exchange risk, to credit, savings, remittances and insurance products - to expand access to financial services for the underserved. For more, please visit <http://www.citi.com/citi/microfinance/>

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