Kenneth E. Barden is an investment banking and legal advisor based in the West Bank. He has worked in development finance and building legal frameworks in Kosovo, Palau, Indonesia, Vietnam, Russia, Romania, Mongolia, and other developing regions.

Both a Borrower and Lender Be

Can Islamic Microfinance Bring Peace to Palestine?

Kenneth E. Barden

RAMALLAH, Palestine—Mahmod Ismail Oda is a farmer, raising a variety of leafy vegetables in a small greenhouse in the northern part of the West Bank outside of Jenin, some 25 kilometers from the border with Israel. The land here is rocky and hilly and a great amount of effort is required to turn this land to productive use. Two years ago, Oda needed money to obtain some plastic housing to protect his vegetables from the elements. Unfortunately, the $5,000 he needed was not an amount that commercial banks were particularly interested in servicing, nor did Oda possess the collateral typically required in conventional loan arrangements. Oda, a devout Muslim, is in his mid-40s and still full of energy. But, as the father of a young family, he feared being encumbered by a debt he could not readily repay. Oda found his answer in a new model of financing, one that blends micro-loans with respect for Islamic law, or *shariah*. In stepped Reef Finance, just one of a number of nascent institutions that may play a major role in bringing a level of prosperity, even peace, to the rural communities of the West Bank.

Years of conflict and containment have taken a toll on the Palestinian economy. But, since the end of the Second Intifada in late 2004, the West Bank has experienced a measure of economic growth, assisted in part by donor aid programs and by the over nine million members of the Palestinian *diaspora* who have sent their hard-earned money in remittances to aid relatives back home or fund fledgling business activities. Evidence of this economic growth can be seen in the cars, designer clothing, and other material goods purchased by many young Palestinians. New construction of apartments and hotels are some of the most visible signs of investment. A new luxury Mövenpick hotel recently opened in Ramallah, offering gym and spa services to the local professional class. In downtown Hebron, a center of industry in the West Bank, the storefronts offering Rolex, Versace, and other name brands resemble the shopping centers of a European capital.

Yet despite this growth, wealth has not been evenly dispersed across the West Bank. Much of the new money is concentrated in the urban centers. According to a report issued in February 2010, the International Committee of the Red Cross estimates that 50 percent of the West Bank population lives in poverty. In rural areas, many families still live a Bedouin lifestyle, preferring tents or improvised housing shelters, while their livestock occupy sturdier dwellings built under previous relief programs.

The success of rural families, who have long found themselves outside any formal economy, is critical to the development of an environment where peace and economic growth can be shown as more a product of investment and hard work than armed confrontation. Bringing the rural population into the formal economy can be an important factor in building a stable framework free of conflict. Those with a stake in the system are unlikely to want to destroy it in the streets.

If there is to be an eventual two-state solution with Israel, building the economic foundations of rural Palestine is a prerequisite. The agricultural sector of the West Bank accounts for about 10 percent of the gross domestic product—a sharp decrease from 1970, when it comprised some 36 percent. This is primarily due to increasing urbanization and employment opportunities in Hebron, Nablus, Ramallah, and other cities. While nearly half of the West Bank lives in small- to medium-size rural communities, only 16 percent of the labor force is agriculture-related. This is due in part to limited access to resources caused by the conflict between Israel and Palestine. The harsh climate requires significant inputs of water, machinery, and fertilizers—all of which are often hard to come by. A secondary problem is that the formal banking sector has not considered agriculture a viable place for investment, since most farms are barely a few hectares in size—providing little collateral. This has led to the slow decline in Palestinian farming, which has seen the parallel rise of a robust market for imported foods from Israel and the Arab world.

Many experts, however, say reversing this trend is just what is required if Palestine is to build a functioning and robust economy. Jake Lomax, a researcher at the Birzeit University Center for Development Studies in the West Bank, notes that many donors of aid and technical assistance in the Palestinian territories view economic growth as a necessary component of a lasting peace. Likewise, the Portland Trust, a British foundation that monitors and correlates economic activity with peace and security, has reported that in Bosnia and Herzegovina, as well as in Northern Ireland, the establishment of a lasting peace was directly correlated to growth and sustainability in the economic sector. As such, the critical task remains how to increase the opportunities for prosperity for the 50 percent of Palestinians that live in small, rural communities. However, perhaps the key impediment to developing a working system of personal banking in Palestine is Islam itself.

Out with the Money Changers

For much of its modern history, commercial transactions in Palestine have been predominantly cash-based. Palestine has no currency of its own, using instead the U.S. dollar, the Israeli new shekel, the Jordanian dinar, and more recently, the euro. This multiplicity of currencies in a narrow and largely impoverished area has led to the establishment of a vast network of money changers of all sizes and reliability, who can readily convert currency to suit the needs of local merchants. This constant changing of currency on a day-to-day, indeed hour-to-hour, basis poses many problems in a growing economy, not the least of which is the safety and security of cash couriers in the narrow, crowded passageways of local bazaars, markets, and villages. While the crime rate in the West Bank is relatively low, carrying the amount of cash required for even medium-size transactions is fraught with danger.

One of the reasons for this chaotic state of affairs is that traditional Islam prohibits usury. Though banks and financial institutions exist across the Muslim world, many of those institutions were designed to service the larger international and business sectors—which hew to the more secular gods

©Muhammed Muheisen

Btother, can you spare a dime?

of profit and loss, and generally use Western models of financing, with a touch of Islamic traditions sprinkled in. Indeed, financial institutions in Palestine are experiencing a growing interest in conventional mortgages, savings and loans, and trade financing—at least in the commercial sector—though even here, payment of interest remains antithetical to Islamic practices.

For devout Muslims, their personal finances are guided by the principles of *shariah*, which prohibit charging or receiving exorbitant rates of interest, known as *riba*, and generally prohibit any income based solely on the time value of money. This does not preclude a return on investments—but both the provider of capital, as well as the recipient, must share the risk, as well as the profit (or loss for that matter), in any transaction. Speculative activity, or *gharar*, is likewise prohibited. Islamic financial principles encourage foreseeability and relative certainty as cornerstones to investment and economic growth. (In light of the recent global financial crisis, this principle has found greater attraction among Muslims who see the financial collapse in Dubai as a function of how far the emirate has strayed from this principle.) Moreover, there is an understanding that parties to a transaction should be honest and transparent with each other in all aspects. It is a violation of the principle to take unfair advantage of an unsuspecting party to a transaction.

Furthermore, some investments are prohibited entirely in certain activities, such as pork production, the sale or manufacture of alcoholic beverages, and other activities either specifically prohibited by the Koran or deemed by later interpretations to be harmful to the well-being of the community as a whole. Finally, there's the principle of *zagat*, or charity, which plays a central role in Islamic finance. This principle recognizes the duty of believers to assist those who are in need or less fortunate—wealth creation should not come at the expense of those in the community often forgotten or abandoned. As such, Islamic financing institutions routinely give a share of their revenues to charity.

All this is well and good, but such strictures have impeded the creation of a robust financial sector. Fewer than 10 percent of Muslims in the West Bank (who constitute some 75 percent of the population) have access to the banking, debt, and personal finance taken for granted in so much of the world. Palestinians have traditionally held their wealth closely, either in cash or tangible assets such as real estate or gold. In Palestinian society, a bridegroom is still expected to pay a dowry in gold—usually in the form of large pieces of solid gold jewelry—for the privilege of marrying a suitable partner. Some of the reluctance to participate in the formal financial sector may be attributable to a lack of understanding about how it operates, compounded by concerns that such practices may be prohibited by Islamic law.

This new model of Islamic microfinance could fill the void, and Oda's experience suggests just how effectively this process can work. As part of the application to qualify for the loan, Oda had to provide certain commitments that had little to do with the financing of his enterprise. He prepared the land for installation, obtained seedlings, fertilizer, water, and packaging materials. His family contributed labor: planting and later harvesting the produce. His lender provided the housing as an in-kind loan. Throughout the growing season, Reef staffers would stop by and see how production was progressing, offering assistance and advice on proper irrigation techniques, application of fertilizers, and proper harvesting and packaging, when needed.

When it came time to sell the produce, the revenue obtained was divided according to a pre-arranged agreement. Reef's portion was compensation for the purchase of the greenhouse and equipment. At the end of the growing season, Oda made a nice return for his efforts, had a new greenhouse that he could use in future seasons, received expert input that honed his farming skills, and avoided incurring a lasting debt.

Targeting Small

Several aid and technical assistance programs are currently underway in the West Bank and Gaza regions to provide support for a strong and healthy financial sector on a large scale, including financing for infrastructure projects. But for smaller businesses and individuals, microfinance programs, particularly those based on *shariah* principles, are becoming increasingly widespread.

Reef Finance Company was founded in 2007 by a group of investors at the initiative of the Palestinian Agricultural Development Association. This in turn became part of a broader Palestinian Network for Small and Micro Finance—a dozen organizations ranging from Reef to the YMCA, Microfinance Department of the United Nations Relief and Works Agency, Palestine Development fund, and even the Gaza Women Loan Fund. These provide local *shariah* loans (generally under $10,000, and often way under) at competitively low interest rates of 5 to 10 percent, and require borrowers to attend classes in financial and business management. Funds come from donor agencies, venture capital provided by private investors and the Palestinian *diaspora*, and foundations established abroad to channel resources to these enterprises. At least seven local *shariah* microfinance organizations are wholly Palestinian-owned.

Oda's lender, Reef Finance ("rural" in Arabic), is based in the West Bank town of Ramallah, six miles north of Jerusalem. It is unlike most microfinance institutions which are organized as not-for-profits. Instead, Reef is a private company, owned by a number of shareholder investors. These include two major overseas microfinance networks—Triodos Facet in the Netherlands and PlaNet Finance in France, run by Jacques Attali, who was the first president of the European Bank for Reconstruction and Development. Reef receives its funding from grants, loans, and capital invested by its shareholders. Revenue from its microfinance investments are used to pay off loans, provide dividends to investors (which average 5 percent a year), and are put toward building additional capital.

These microfinance institutions generally offer three lending models. The first is *murabaha,* a cost plus markup sale (or type of contract financing): the bank purchases materials required for the productive activity on behalf of the client, rather than simply providing funds to the individual. For example, it might purchase raw materials to be incorporated into handcrafted items or packaging supplies for the sale of farm produce. The client is then entrusted with what is essentially the bank's property. When sold, the client repays the original purchase price, plus an agreed mark-up—which would be considered interest in conventional financing. This model is ideally suited to short-term trade transactions.

Leasing, or *ijarah-wal-iqtina*, is generally used when the client needs to finance equipment or machinery, such as a farm tractor. This would be bought by the bank and then leased to the client, who would make installment payments, which would include a portion of the principal plus an agreed upon profit for the bank. At the end of the lease period, ownership is transferred to the client. This model was employed in Oda's case, and he obtained title to the greenhouses once Reef had received its portion of the profits.

Finally, *bai'salam* is an arrangement whereby the bank purchases an item to be delivered at a later date, so long as the goods are defined and the date of delivery fixed. Such an arrangement could be used for the purchase of seeds or young plants, where the financier pays money up front. The client would then deliver a portion of the harvested crop to the financier (who would then sell it to recover its capital investment and profit.) While such an arrangement may seem a lot like derivatives in conventional financing, it is fundamentally different. To be compliant with *shariah* principles, the goods must be in existence, not merely on paper. In the case of buying seeds or young plants, the object exists, albeit in a younger form.

> "Fewer than 10 percent of Muslims in the West Bank have checking accounts."

In each case, these financial institutions have established an intricate monitoring system to review prospective transactions and assure that they are appropriate on financial, ethical, and religious terms. This includes a panel of Islamic clerics and scholars who issue advisory opinions as to whether the proposal meets or violates *shariah* law. Another group of advisors maintains regular contact with clients to monitor progress of the activity being financed and offer assistance in case of difficulty, such as the unforeseen effects of drought on crops or veterinary care needed for sick livestock.

In many ways, Islamic financing creates a sort of partnership relationship, rather than one of lender/borrower. Because the financier and client share both the reward and the risk, there is a need for communication and interaction that is not often found in conventional financing arrangements. A thorough review of the applicant is conducted, not only as to the need for financing and the creditworthiness of the investment, but as to the credentials and capabilities of the borrower.

If these are lacking, often the recipient will be offered skills training to raise the likelihood of success—in Oda's case, he was trained in modern irrigation and fertilization techniques. Should a client nonetheless run into problems in the productive activity, the bank provides assistance to look at ways of minimizing the loss, such as finding secondary markets in the case of damaged produce. Additionally, since most of the financing is done through in-kind provisions, even if the productive activity completely fails there is usually a residual value of the hard goods. When the activity reaches an end and the products are finally sold, the revenue is allocated on a mutual basis agreed upon at the outset, ensuring openness, fairness, and trust.

Challenging Times

There is some debate as to whether these *shariah*-compliant micro-transactions significantly advantage the financier. Some have argued that clients would be better off taking an interest-based loan which can be paid off over a longer period of time. It's a fair point, although competition from conventional banks has decreased the rate of return that Islamic financiers can reasonably charge, somewhat leveling potential cost savings for clients. But it's somewhat of a moot point, as well. In the rural areas of Palestine, this matters little to those who are seeking loans—finding the best rate is secondary to the cultural sensitivity and project assistance that these new microfinance institutions offer. As such, institutions such as Reef have a considerable advantage in the provision of financial services in line with the traditional religious sensitivities of Palestinians.

These efforts described here are still quite new, but so far, they seem to be working for both financiers and rural Palestinians. So, while the amount of funds being loaned may be relatively small, the goals are anything but. Building a sustainable economic foundation in the rural West Bank is a powerful inducement to keep young men off the streets, and a big step forward in the march to a lasting peace in the Middle East. If international aid efforts are to be focused on this particular goal, a dramatic expansion in *shariah*-based microfinance is likely to bear enormous dividends, far beyond any immediate economic impact. ●