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Building a Successful Business Model for Islamic Microfinance

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Building a Successful Business Model for Islamic Microfinance

I. Introduction[1]:

Today, microfinance and Islamic finance are professionalized industries with diverse products, growing client bases, and widening geographical coverage. Both have developed innovative solutions to cater to populations that are outside the fold of conventional financial access. They share objectives of providing inclusive banking through financing productive, asset-backed activity and lay special emphasis on economic empowerment through entrepreneurship. These complimentary objectives create a framework ready for the confluence of both sectors—into a special niche industry referred to as "Islamic microfinance," which is just taking off.

High unemployment, poverty, and low levels of financial access in Muslim countries continue to create high demand for microfinance. While conventional microfinance has successfully reached large numbers of the poor in Muslim countries (most notably, Bangladesh and Indonesia), there is evidence to suggest that there are many potential clients of microfinance that categorically reject products that do not comply with Islamic principles.

IFC-commissioned market studies[2] reveal that in Algeria and Jordan, approximately 20 percent of the poor cite religious reasons for not seeking conventional microfinance, while, in Yemen and Syria, this percentage rises to 40 percent. In a 2008 CGAP survey[3], local practitioners and key informants suggested similar demand trends in Indonesia, Afghanistan, Pakistan, and the Palestinian territories as well as in Muslim majority areas of India, Sri Lanka, Brunei, Cambodia, and the Philippines.

Broadly speaking, the market for microfinance in the Muslim world can be divided into three segments: 1) individuals who only use Sharia-compliant products; 2) individuals who state a clear preference for Sharia-compliant finance but, due to unavailability or price differentials, accept conventional finance, and finally; 3) individuals who will accept conventional finance products. The ratios of these groups fluctuate by region. For example, individuals who would

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[1] This introduction is adapted from a blog post called, "Taking Islamic Microfinance to Scale," which was posted by Nimra Karim and Mohammed Khaled on CGAP Microfinance Blog on the 23rd of February 2011.

2 A number of IFC-commissioned market studies suggest a strong demand for Islamic microfinance products. For example:

- More than 60 percent of low-income survey respondents in the West Bank and Gaza claim a preference for Islamic products over conventional products. More than half of such respondents prefer such products even if they come at a higher price (PlaNet Finance, 2007).
- In Jordan, studies by USAID (2002) and IFC/FINCA (2006) show that 24.9 percent and 32 percent of those interviewed, respectively, cite religious reasons for not seeking conventional loans. The IFC/FINCA study also showed that 18.6 percent of those interviewed rank religious reasons as the single most important factor in their decision on obtaining a loan.
- In Algeria, a 2006 study revealed that 20.7 percent of microenterprise owners do not apply for loans primarily because of religious reasons (Frankfurt School of Finance and Management, 2006).
- In Yemen, an estimated 40 percent of the poor demand Islamic financial services, regardless of price.
- In Syria, a survey revealed that 43 percent of respondents considered religious reasons to be the largest obstacle to obtaining microcredit. In addition, 46 percent of respondents who had never applied for a loan stated that religious reasons were the primary reason they had never applied. Nearly 5 percent of current borrowers said they would not apply for another loan for religious reasons (IFC, 2007b).

[3] The survey results were published in CGAP Focus Note # 49: Islamic Microfinance: An Emerging Market Niche

insist on Islamic financing (category 1) constitute far more than one-third of the market in Yemen but less than a third of the market in Bangladesh. *Overall*, it is estimated that roughly two-thirds of the microfinance market in the Muslim world either *insists on*, or *prefers* Islamic financing.

The 2008 CGAP survey[4] revealed that global Islamic microfinance supply is very limited and concentrated in only a few countries (80 percent of the 380,000 clients of Islamic microfinance worldwide are in Bangladesh, Indonesia, and Afghanistan). Moreover, Islamic microfinance does not exceed more than 0.5 percent of total microfinance outreach.

Stemming from the conviction that Islamic microfinance can offer an alternative paradigm for millions of poor people who are currently not served by conventional microfinance, this paper will look at why microfinance has not succeeded in reaching as many clients as conventional microfinance and will recommend elements for a viable business model. It will also suggest pre-requisites for laying the groundwork for successful implementation.

II. Background:

A. Islamic Finance and Microfinance[5]:

Islamic financial practices are founded on the core belief that money is not an earning asset in and of itself. The economic aspects of the Islamic banking system can be fully understood only in the context of Islamic attitudes toward ethics, wealth distribution, social and economic justice, and the role of the state. Principles encouraging risk sharing, individual's rights and duties, property rights, and the sanctity of contracts are all part of the Islamic code underlying the banking system.

In this light, many elements of microfinance could be considered consistent with the broader goals of Islamic banking. Both systems advocate entrepreneurship and risk sharing and believe that all socio-economic classes, including the poor, should participate in such activities. Thus Islamic banking and microcredit programs may complement one another in both ideological and practical terms. This close relationship would not only provide obvious benefits for poor entrepreneurs who would otherwise be left out of credit markets, but investing in microenterprises would also give investors in Islamic banks an opportunity to diversify and earn solid returns.

B. Basic Principles of the Islamic Finance System

"Islamic finance, more precisely termed "*Sharia*[6]-compliant" finance, refers to financial services conducted in accordance with Islamic legal principles" (Iqbal, 1997). As [Iqbal] explains in his

[4] CGAP collected information on over 125 institutions and contacted experts from 19 Muslim countries. "Islamic Microfinance: An Emerging Market Niche", August, 2008 Nimrah Karim, Michael Tarazi, and Xavier Reille

[5] This section is adapted from "Islamic Financing Systems", Zamir Iqbal, Finance and Development, June 1997;and from "Towards Islamic Microfinance: A Primer, an interview with Aamir A. Rehman, formerly of HSBC Amanah, with the Microfinance Gateway (11 Jun 2007)".

article: Islamic Financing Systems, the basic principles for an Islamic financial system can be summarized as follows:

1) Prohibition of interest (*riba*[7]): Conventional interest on loans or savings, as a fixed return without sharing any risk, is considered unjust and, accordingly, is not allowed.
2) Risk sharing: Because interest is prohibited, suppliers of funds become investors instead of creditors. The provider of financial capital and the entrepreneur share business risks in return for shares of the profit.
3) Money as "potential" capital: Money is treated as "potential" capital, which means that it becomes actual capital only when it joins hands with other resources to undertake a productive activity. Islam recognizes the time value of money only when it acts as capital, not when it is "potential" capital.
4) Prohibition of speculative behavior: An Islamic financial system discourages hoarding and prohibits transactions featuring extreme uncertainties, gambling, and risks.
5) Sanctity of contracts: Islam upholds contractual obligations and the disclosure of information. In sales contracts, the product or service that is bought or sold must be clear to both parties. This feature is intended to reduce the risk of asymmetric information and moral hazard.
6) *Sharia*-approved activities: Muslims cannot profit from activities considered immoral. Only those business activities that do not violate the rules of the *Sharia* qualify for investment. For example, investing in businesses dealing with alcohol, gambling, casinos, pornography, or weapons of mass destruction is not allowed.
7) "Short selling" is not permissible: Muslims are not allowed to sell what they do not own, therefore, "short selling" is not allowed.

"Islamic finance, like the *Sharia* generally, emphasizes the process and structure of human interaction as well as the moral impact on society. It shares a great deal with the fields of "ethical investment" and "corporate social responsibility," both of which are growing in popularity worldwide. People increasingly realize how important it is to be mindful of how their wealth is used and the sources of their returns.

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[6] *Sharia* is the body of Islamic religious law governing economic, social, political, and cultural aspects of Islamic societies. It frames the value system of Islam, which emphasizes ethical, moral, social, and religious factors to promote equality and fairness for the good of society as a whole. *Sharia* originates from the rules dictated by the *Quran* and its practices, and explanations rendered (more commonly known as *Sunnah*) by the Prophet Muhammad. Further elaboration of the rules is provided by scholars in Islamic jurisprudence within the framework of the *Quran* and the *Sunnah*. The *Sharia* is interpreted by trained scholars, though Islam does not have a formal clergy or ordainment process.

[7] *Reba* is a term that literally meaning "an excess" and is interpreted as "any unjustifiable increase of capital whether in loans or sales." Any positive, fixed, predetermined rate tied to the maturity and the amount of principal (i.e., guaranteed regardless of the performance of the investment) is considered *riba* and is prohibited. The general consensus among Islamic scholars is that *riba* covers not only usury but also the charging of "interest" as widely practiced. This prohibition is based on arguments of social injustice, equality, and property rights. Islam encourages the earning of profits but forbids the charging of interest because profits, determined *ex post*, symbolize successful entrepreneurship and creation of additional wealth whereas interest, determined *ex ante*, is a cost that is accrued irrespective of the outcome of the business operations and may not create wealth if there are businesses losses. Social injustice demands that borrowers and lenders share rewards as well as losses in an equitable fashion and that the process of wealth accumulation and distribution in the economy be fair and representative of true productivity.

More fundamentally, Islam seeks to alleviate poverty and circulate wealth in the economy. One of the faith's "five pillars" is *Zakah*, or almsgiving. Unlike a simple income tax, *Zakah* is calculated based on assets and therefore re-distributes wealth within the community. As Islamic scholars point out, even the rules of *Zakah* promote more active forms of investment and business activity – wealth from passive activities is subject to greater *Zakah*. Muslims are taught to have sympathy with the poor and recognize that the poor have rights over them" (Aamir A. Rehman, 2007).

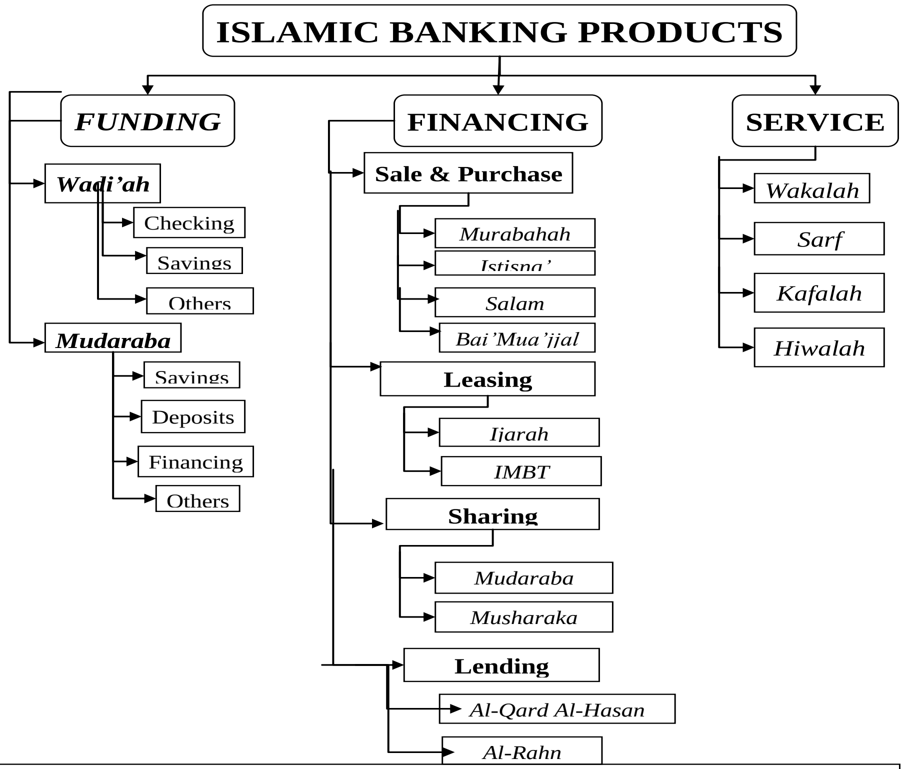
C. Islamic Banking Activities and Products[8]

Literature separates Islamic banking into three main activities: funding, financing and service **(Figure 1).** It also separates financing into four main categories: sale and purchase/trade financing (*Murabaha, Istisna'*, *Salam and Bai' Mu'ajjal*), leasing (*Ijarah*, *IMBT*), concessional lending (*Al-Qard Hasan*[9], *Rahn*), and sharing/participatory mechanisms. Within the participatory category are various contractual forms that conform fully to the tenets of profit and loss sharing. The more commonly used profit-and-loss-sharing transactions are *mudaraba* (trustee financing), *musharaka* (equity participation), and *musaqat* and *muzar'ah* (specific counterparts in *mudaraba* contracts). All of these financing products appear to include a degree of uncertainty regarding the eventual returns due to the entrepreneur and to the Islamic bank. **Annex I** provides a brief description about each one of the above mentioned financial contracts.

Figure 1. Types of Islamic Banking Products/Contracts

[8] Adapted from Rahul Dhumale and Amela Sapcanin, "An Application of Islamic Banking Principles to Microfinance-Technical Note," A study by the Regional Bureau of Arab States, United Nations Development Program in cooperation with the Middle East and North Africa Region, World Bank, 1998. and from the Islamic Banking Training course developed by Janis Sabita in 2007 for GTZ and Micra in Indonesia.

[9] benevolent loan



Source: Adapted from a Islamic Banking Training Course developed by Janis Sabita in 2007 for GTZ and Micra in Indonesia

III. <u>Why Hasn't Islamic Microfinance Reached Scale Yet?</u>

If there are so many poor Muslims in the world if the overwhelming majority of those Muslims do not have access to financial services if two-thirds of them either prefer or insist on having financial products that comply with *Sharia* and if there are MFIs that are providing Islamic microfinance services, then what went wrong? How is it that out of the more than 200 million active borrowers in the world, fewer than 1 million use finance that follows the Islamic *Sharia*? Why is it that in a country such as Bangladesh, the largest MFI or bank providing products complying with *Sharia* reaches only 100,000 active borrowers when more than 20 million active borrowers are reached by Grameen Bank, BRAC, and ASA, all of which are providing conventional products? The Arab world is no different. While we have conventional MFIs reaching tens and hundreds of thousands of active borrowers, Islamic MFIs have stagnated at fewer than 10,000 active borrowers and typically plateau at 3,000 to 5,000 active borrowers. Why hasn't Islamic microfinance succeeded[10] in reaching as many clients as conventional microfinance?

[10] In this context, success implies programs which reach tens of thousands, or hundreds of thousands, of clients in a sustainable and profitable manner while maintaining focus on the poor and very poor. A handful of microfinance programs in the Arab world, such as Azal in Yemen, Jabal Al-Hos in Syria, and Port Sudan in Sudan apply Islamic principles. While these programs/MFIs have been operating for about 10 years, none of them has managed to grow beyond 10,000 active clients to date. Many of these programs have not achieved financial sustainability and are targeting better-off segments of the poor, if the average loan balance is taken as a proxy in this regard. At the same time, there are several conventional microfinance programs in

A. A Primary Focus on Murabaha, So Far

So far, Islamic microfinance MFIs/programs have focused on exchange/debt financing instruments, which closely resemble conventional microfinance. The most widely offered *Sharia*-compliant contract is *Murabaha* (cost-plus-markup sale contract), an asset-based sale transaction used to finance goods needed as working capital. Typically, the client requests a specific commodity for purchase, which the financier procures directly from the market and subsequently resells it to the client, after adding a fixed "mark-up" for the service provided.

According to CGAP Focus Note # 49: "Islamic Microfinance: An Emerging Market Niche" which was published in 2008, "Although there is ample evidence of demand for Islamic microfinance products, this demand can only be met if low-income clients are convinced that the products offered are authentically Islamic. Critics of Islamic finance products suggest that the pricing of some products offered as *Sharia*-compliant too closely parallels (or even exceeds) the pricing of conventional products. For example, some institutions offering *Murabaha* seem to disguise interest as a cost markup or administration fee."

The cost of *Murabaha* involves more than simply giving the money to a borrower so s/he can go and buy the items needed for their enterprise. Costs are elevated by the additional staffing costs incurred when staff members accompany clients to buy the goods, materials, or equipment covered by the loan—on top of all of the transactions completed in conventional lending. To reduce this cost, in most cases, MFIs revert to issuing fewer, larger loans. As a result, they either serve fewer clients, clients who were not impoverished, or a poor client with a loan larger than his/her capacity to repay.

In addition, in most cases, *Murabaha* does not allow a late payment fee, and MFIs seem to take that into consideration when they price their product. *Murabaha* also tends to be less flexible, and does not allow borrowers to access cash they need to pay other expenses, such as utilities.

To lower costs, some MFIs have asked the borrower to deal directly with the seller of the commodities that s/he wants and then bring the invoice for the MFI to pay. Others have used what is called *Alwakala Alnaqdeyyah*, a process where the cash is issued to the borrower's guarantor, who then purchases the commodities on behalf of the borrower. Both of these approaches can attract unwanted criticism, because they too closely parallel the conventional loan processes, raising borrower concerns that the loan does not comply with Islamic principles.

In brief, MFIs seem to have limited the wide range of Islamic financing schemes to one contract: *Murabaha*. This loan process is complicated by additional costs and criticism regarding compliance with Islamic principles, both of which contribute to the limited outreach of MFIs offering *Murabaha* as compared to MFIs using conventional microfinance.

B. **Very Limited Experience with Profit and Loss Sharing (PLS) Schemes**:

Morocco, Tunisia, Egypt, Yemen, and Jordan that have run for the same time period or less but have managed to reach tens of thousands, or hundreds of thousands, of poor and very poor families while achieving financial sustainability.

There has been very limited experimentation with profit and loss sharing (PLS) schemes. MFIs tend to believe that PLS schemes require particularly vigilant reporting and a high level of transparency in order for profits and losses to be distributed justly. Consequently, though promoted strongly by *Sharia*, they result in substantial operating costs, particularly for micro and small enterprises that are not accustomed to formal accounting. This may be a primary factor in the lack of success of these instruments thus far on the micro level and a reason for MFIs to avoid use of such financing instruments. PLS schemes require far greater intervention from the MFI to study the feasibility of the project or enterprise and, in some cases, to guarantee the marketing of the products in order to make it a profitable enterprise. Furthermore, the MFI needs to ensure that it can get back its investment and its share of the profit. These issues may have discouraged MFIs from promoting Islamic microfinance and from using the PLS schemes.

MFIs seem to fall in one of two traps when exploring Islamic microfinance products. The first trap is when MFIs look at these products through the lens of mid- and large-size Islamic banking. In this instance, the enterprise has to be big enough to have sufficient bookkeeping capability in order to guarantee transparency on its profit data. Instead of searching for solutions (e.g., designing business models that would allow the microenterprise, without the need for serious bookkeeping, to inform the MFI how much profit was made), MFIs essentially disqualify microenterprises for the product. The second trap is where MFIs look at those products through the lens of conventional microfinance. In this instance, the MFIs issue the loan and subsequently collect that money with a percentage of the profit. Providing little support to the enterprise, and not analyzing enough its situation, MFIs choose the cost-plus approach.

Industry players need to think outside the box of conventional microfinance and its business models. They have to develop new models combining all the Islamic financial contracts, especially PLS schemes which are, most often encouraged by Sharia scholars. The new models should guarantee data transparency and maintain reasonable management costs. This new approach could reach scale and sustainably serve many poor Muslims with financial services.

C. The Result was a Very Limited Outreach

If we look at the Arab world, we see that some conventional MFIs are reaching more than 100 thousand active borrowers (such as ABA, Lead, DBACD, Enda, the Popular Bank Foundation, Fondep etc), and some even over 300 thousand active borrowers (the case of Alamana). However, MFIs that provide Islamic products[11] (such as Jabal Alhos in Syria, Port Sudan in Sudan etc.), even though they have the same institutional age, are not reaching more than 10 thousand active borrowers.

[11] The only exception for this is Al-Amal bank in Yemen. Though the bank has been in the market for less than 3 years, it has managed to reach 15,000 active borrowers, about 30,000 active savers, and to become the largest player in Yemen.

Table 1[12]: Outreach of Conventional Vs Islamic MFIs in the Arab World						
		Year Established	# of Active borrowers	Amount of Portfolio in $	Average Loan Balance	Year of Data
Conventional						
Morocco	Alamana	1997	339,408	292,738,781	862	2010
	Fondep	1996	132,419	80,763,280	610	2010
	Popular Bank	2000	146,566	154,048,265	1051	2010
Egypt	Lead	2003	194,392	27,769,830	143	2010
	ABA				275	2010
	DBACD	**1998**			245	2010
Tunis	Enda	1995	156,854	56,227,039	358	2010
Jordan	MFW	1999	62,408	20,184,855	323	2010
Islamic						
Syria	Jabal Alhus		3,328	1,143,547	344	2010
Sudan	PASED	2001	3,947	883,639	224	2010
Yemen	Azal		3,462	699,268	202	2010
	Al-Amal Bank		14,730	2,610,799	177	2010

The table below shows similar findings in Pakistan.

Table 2[13]: Outreach of Conventional Vs Islamic MFIs in Pakistan					
	Year Established	# of Active borrowers	Amount of Portfolio	Average Loan Balance	Date of Data
Conventional					
Kashf Foundation	1996	313,512	44,230,466	141	2008
FMFB-Pakistan	2002	167,193	29,846,110	179	2010
Khushhali Bank	2000	409,177	50,463,122	123	2010
ASA Pakistan	2008	170,116	20,270,687	119	2010
Islamic					
Akhuwat	2001	25,880	2,290,517	89	2010
Farz Foundation	2008	84	8,221	98	2009

D. Very Limited Financing Resources Compared to Conventional MFIs.

In the early days, there was a lot of donor money for conventional microfinance to build and finance MFI portfolios. This has enabled MFIs to become sustainable and use their historical performance to gradually convince commercial banks that they were credit worthy. MFIs could then take a loan from the bank, lend it to the clients, and pay it back with interest. Clearly, this

[12] This table was developed using data from the MIX market and from the annual sector survey of Sanabel, the Microfinance Network of Arab Countries
[13] This table was developed using data from the MIX market

has not been the case for Islamic microfinance, given the number of existing Islamic MFIs. These MFIs have not yet developed a successful model to reach a large number of clients on a profitable basis and to show their potential, So far, they have failed to convince Islamic Banks to invest in their portfolio, as they are still considered a very risky business, and the only loan they can get from them is an interest free loan. This lack of financing was raised by some managers of Islamic MFIs as a factor which limited the scale of their outreach. If we take the example of Pakistan, out of almost 30 MFIs or banks reporting to the MIX, only 2 or 3 are using Islamic contracts. This means that we need a larger pool of MFIs applying Islamic *Sharia* law in order to increase the chances of having successful ones.

E. A Business Model, Not Another Loan Product

When the conventional microfinance movement began in the late 70s, pioneers at the time questioned conventional banking and its business models and came up with new models which, over the years, proved that the poor are creditworthy. These new models showed that the poor can pay interest rates that not only cover the cost of operations but also allow the MFI/bank to make a profit. Collaterals were replaced by group guarantees, and later by character checks. While it is important to keep in mind the knowledge and experience acquired from both Islamic finance and conventional microfinance, we need to go beyond. We need to innovate and come up with new business models, models that comply with *Sharia* and that provide financial services to millions of poor Muslims, on a sustainable and profitable basis.

Basically, MFIs have been limiting themselves to Islamic contracts, which could be implemented in a similar way to conventional microfinance's loan products. There are MFIs focusing on either *Al Qard Hassan* products with no interest rate or fees, or products with a small fee, such as *Akhuwa*t in Pakistan. These MFIs have been unable to cover operational and financial costs and they remain dependent on subsidies, which prevent wide outreach. Also, there are MFIs using only, or mainly, *Murabaha.* Apparently they are adapting a more expensive form of conventional microcredit, which has numerous limitations and has raised suspicions[14] about their compliance with *Sharia* law. Moreover, to be sustainable, the cost mark-up that these MFIs charge on the *Murabaha* is equal or higher than the rates of conventional loans, making clients wary due to high service costs.

Practitioners need to develop new business models, instead of merely adopting an Islamic product which closely resembles a conventional loan product. As an alternative, business models should combine the various and well diversified financing instruments and contracts promoted by Islam.

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[14] "Low-income populations, often rely on local religious leaders to address religious issues. These leaders seem to perceive the *Murabaha* as if it is simply a "rebranding" of conventional finance and not truly reflective of Islamic principles. More efforts should be invested in convincing those local leaders and the poor clients, with the authenticity of the Islamic financial products if Islamic microfinance is to reach its full potential" (Karim, Tarazi and Reille, 2008).

IV: Islamic Microfinance Challenge 2010[15]

Responding to the limitations of Islamic microfinance products offered so far and to the absence of a successful business model, CGAP, Deutsche Bank, Islamic Development Bank, and Grameen-Jameel launched the Islamic Microfinance Challenge 2010. The objective of this challenge was to canvas the industry for ideas for sustainable, scalable, and authentic Islamic microfinance business models to meet the financial needs of the Muslim poor. The competition was open to the general public. Institutions as well as independent individuals, consultants, academics were invited to apply, with the stipulation that applicants have the capacity to roll out a pilot project using the prize funds.

The competition generated a lot of interest and received over 130 applications from 43 countries, with the highest number from Indonesia, Pakistan, and India. "Applicants included Islamic and conventional microfinance institutions (MFIs), multi-sectoral NGOs, apex institutions, consultants, and academics"[16]. A review board with expertise in microfinance practice, microfinance investment and Islamic finance judged submissions against the criteria of profitability scalability and Sharia-compliance [17],

Five applications were shortlisted by the judges, namely, Al Amal Microfinance Bank (Yemen), Bina Insan Sejahtera Mandiri (Indonesia), Centre for Women's Cooperative Development (Pakistan) Tameer Bank (Pakistan), and Tanzania ecoVolunteerism (Tanzania). These five applicants were asked to apply to the second phase with more detailed plans on implementation. On February 16, 2011, the sponsors named Al-Amal Microfinance Bank from Yemen as the finalist and recipient of US$ 104,000 in prize funds. Annex II summarizes the five finalists' proposals.

V. A Draft Framework for a Potential Business Model:

A. Prerequisites to build such a model

Based on my participation/moderating for different sessions about the topic whether in Sanabel 8th Annual conference (7-9 June 2011) or in the Speakers Corner # 44 (28-30 June, 2011)[18], I think there is a group of prerequisites which the players who are trying to build a successful business model for Islamic Microfinance have to agree upon early in the process. These prerequisites are:

[15] The views in this article reflect those of the author and not necessarily those of the Judges and/or sponsors of the Islamic Microfinance Challenge 2010.
[16] http://www.cgap.org/p/site/c/template.rc/1.26.15722/
[17] http://www.cgap.org/p/site/c/template.rc/1.26.12645/
[18] http://microlinks.kdid.org/groups/speakers-corner/speakers-corner-44-islamic-banking-and-microfinance

1. Defining Success: The sector has to agree on the definition of success as a first step. In my opinion, to consider the business model successful, it has to achieve the depth, breadth and length of outreach. In other words, such a model has to reach so many poor people on a sustainable basis and have a serious impact accordingly on their lives. i) We can do the best work ever but if we do not reach scale, the impact will be limited. ii) We can reach so many people but if the model is not sustainable and if it is relying on an external source of subsidy, it will collapse when that source dries or changes its priorities iii) There is no point of reaching so many people on a sustainable basis without making a positive change in their lives, and this is part of the trap in which some conventional MFIs/lenders are falling recently. If we agree on this definition of success, then we can move forward.

2. Recognizing that there is a problem: I would like to assume that this would be a natural result of defining success, as so far Islamic microfinance had not reached scale. I saw and heard many practitioners who do not even recognize that there is a problem, which is why the second prerequisite has to be for those who are interested in building such a model, to recognize that there is one. They also have to admit that we have failed so far. The session of Sanabel's 8th conference about Islamic microfinance attracted many people who showed interest in the subject. But I was very surprised to see that many of the attendants do not realize that there is a problem and that we had failed so far. Some MFIs, which have been in the market for a decade serving only 4 to5 thousands active borrowers, think that they are doing great and there is nothing that needs to be solved, but if they could have more money they could serve more people. Some people keep talking about how good *Al-Qard Al-Hassan* is and how it is good for the poor because it does not charge them any interest rates or any type of fees, as if that would be a solution by itself. Others seem to believe that by using the word "Islamic", everything will turn to be fine. They think that all the clients pay back their loans and that they are honest about how much profit their projects made, and therefore, there is no need to do anything or to try to come up with new business models. If we do not accept that we are sick, we will not go to the doctor. If we do not recognize that we have not succeeded yet, we will not do anything to change the course of our actions.

3. How should we look at Conventional Microfinance: We also need to admit and to accept that conventional microfinance has been successful and that we can learn from its errors and its achievements. It will not be able to solve the problems of the majority of the poor Muslims in the world, because it does not comply with their religious belief, but it still serves millions of the poor people in the world. We can learn from MFIs' specialization in financial services and from the fact that they have to rely on their own revenues in order to continue providing their services and products to more poor people. Also, we can learn from the mission drift we began to notice recently in some countries like India where the profitability of some MFIs became a goal for itself and not a mean to help reaching more poor people, because even if the Islamic model succeeds and grows it will not be immune. Being a Muslim is not enough. Pioneers in the conventional microfinance field and many of those who started conventional MFIs were socially motivated and their main goal was to improve the lives of poor people, both in their countries and in the world, but that was not enough over time. We can also learn from how the conventional microfinance sector reacted to such problems with more focus on and campaigns for client protection. Attacking conventional microfinance and claiming that after 25 years it has not accomplished anything would not take us anywhere. We need to

build bridges with that field and we must start a dialogue from which we can first learn and then teach.

4. Sustainability: We need to think about the sustainability of the model. From the beginning, MFIs will have to cover all of their costs and making a margin of profit from their own operations and not from donations, *Sadaqat* or *Zakah*. Those donations should be used to sustain the organization and they should not be channeled to the clients. Only sustainable MFIs or banks are able to reach so many poor people. Islam allows that type of money investment for the creation of profits, so if we can encourage rich people to invest in poor people's projects, and both of them receive profits, we might get to a point where there are no more poor people, except for those who do not have any human capital and need relief.

5. Thinking outside the Box: In order to start thinking outside the box of conventional microfinance and the box of Islamic finance, we need to stop the copy and paste game. Islamic microfinance has been limited so far to mainly *Murabaha*, which has been tailored to resemble a conventional loan, interest has been called *Murabaha* fee, and so on. What has been the result? A more expensive suspicious product. Instead of facing the need for a new business model, some are trying to run away from the issue by recommending the movement to a small and a medium scale, hoping that this will create jobs for the poor. That is fine of course but, in my opinion, is not the solution for the question we are trying to answer. We are talking about an Islamic microfinance model and not about small and medium Islamic finance models, which could change if we conclude that we cannot succeed. Imagine if Yunus kept thinking within the walls of the conventional banks business models, would we have what is known today as conventional microfinance movement and all the outreach it have achieved?

6. Defining the Target Group: In conventional microfinance, there was a huge debate about whether microcredit is something which could serve all the poor and poorest people of the world or not. Though there are still some differences, most people agree that: i) the destitute poor will always need charity. ii) BRAC, CGAP, and Ford Foundation are working on an approach to deal with the ultra-poor and to help them to develop a livelihood activity in order to generate income. This approach includes: assets transfer, stipends, training, self-confidence building and a savings component. The goal is to help the ultra-poor families to rely on themselves, to stop needing stipends and to link them later with MFIs from where they can borrow to expand their enterprises[19]. iii) microfinance targets economically active poor. I think that we need to have a similar definition for the target group for Islamic microfinance. Until this is clear and well defined, there will be confusions. *Sadaqat* and *Zakah* can go to the first and second group and can go to build organisations which would serve the third group but should not go directly to subsidize the cost of financing the third group. This subsidy cannot go on forever and there is no point on building an enterprise which will collapse when the subsidy disappear.

7. Changing Terminology: One of the obstacles that we need to overcome, when trying to build an Islamic Microfinance business model, is to change some of terminology that we have been

[19] for more info about this please visit: www.cgap.org/graduation

using. In the old days it took people a while to move from the word beneficiary to the world client orcustomer. This change had a huge impact on many of the aspects of our work not only regarding the issue of sustainability, but also regarding customer services and the fact that these people are our clients who pay our salaries at the end of the day and are not beneficiaries to whom we give a free hand or a charity. I think if we talk about Islamic microfinance, one of the words we need to forget about is the word "loan". There is only one allowable loan in Islam which is *Al-Qard Al-Hasan,* an interest free loan that is not for business and would not build a sustainable scalable microfinance sector. So, there is no reason to keep talking about loans if we are not offering them. This would not only create confusion but also will keep the practitioners looking thru the lenses of conventional microfinance, which is not helpful. I think that only whenever MFIs start being perceived as investors and not as creditors, we will begin to see many of the challenges of PLS schemes resolved. We should not underestimate the effect of terminology in this regard.

B. Some Elements of the Proposed Business Model:

Examination of the business models of finalists of the Islamic Microfinance Challenge, and other Islamic microfinance businesses, reveals important elements of a potential business model which fulfill the three conditions of outreach (breadth, depth and length). These elements are:

1. Market Segmentation from Day One: In conventional microfinance, an MFI usually begins with one product which fits the needs of many clients who are running different kinds of enterprises (one size for all). Over time, it begins to segment its market and to diversify its products. This has to change in Islamic microfinance where an MFI would have to begin by segmenting its market into subsectors, and then designing special products and/or using different instruments or contracts for each subsector of the market. The way that an MFI would invest in those who raise cows for milk or for meat is different from the way it would in those who have sewing machines or those who make honey. A careful market study will come up with tons of such segments in each market.

2. An Investor, Not Only a Creditor: In order to implement a *Musharaka* and/or a *Mudaraba* contract in the animal raising subsectors, for example, the institution not only must get involved in buying the cows or the baby cows, but also, it must get involved in more careful monitoring of the project and in the provision of some vet services and counseling. Otherwise, the animals might die or the quality and quantity of the outcomes may not reach their potential, causing the institution either to lose its investment, or to have less revenue and hence, less profit. In addition, the institution needs to get involved in marketing, and, might have to do the marketing on its own, not only to benefit from the economy of scale and the power of negotiations, but also in order to overcome one of the major challenges, which is how to track how much revenue there is for each client, business partner, or/and entrepreneur. The involvement in marketing[20] of the outputs could actually be a crucial element of the new business model if we want to overcome the challenge of tracking those

[20] Marketing also has been identified in many studies by microentrepreneurs as one of the main obstacles in front of their attempts to expand their businesses.

revenues at relatively low cost. In other words, the institution's role would be different than what it would be in conventional microfinance. It cannot just lend money, retrieve it, and make a profit. In most cases, we are talking about a partnership, not simply a lending operation. The MFI or bank should think as an investor, not only as a creditor.

3. Business Development Services (BDS) are back on the Table: While many practitioners believe that BDS is important for the development of the capacity of the borrowers, most MFIs do not get involved in it, and consider it somebody else's role. MFIs which intend to offer Islamic microfinance financing instruments might want to revisit this issue. Making sure that clients are business partners and have the best skills needed for their work, will decrease the risks/increase the profit of the enterprise and will accordingly increase revenues and decrease the chance of failure which would cause the MFI to lose its investment in this case.

4. Takaful/Microinsurance: Microinsuring the enterprise's assets against theft and death, in the case of animals and livestock, is also part of the model. There is a bigger incentive for the MFI to do that under such a model. In the case of TeV, the beehives were insured and the insurance cost was added to the price. In the case of Farz Foundation (Halal Livestock product) each animal was insured against theft and death. Alamal bank[21] said that they will insure all of the leased items under their new leasing product.

5. Savings: Savings should be a core element of an Islamic microfinance business model. As in conventional microfinance, it is believed that more Muslims would benefit from savings than from loans[22.] In fact, I think that while there are many Muslims who would accept a conventional loan in the absence of a Sharia-compliant financing option, many would not do the same when it comes to savings products. Since the majority of savings accounts Muslims have access to earn interest, there is a disincentive for Muslims to hold bank accounts. Also, having Sharia-compliant savings accounts will help mobilize deposits, install a culture of savings, and contribute to economic development.

6. Use of the different Islamic financing instruments/contracts. The new business model should include the use of the different Islamic financing instruments or contracts in a more innovative way. Good examples found in the proposals submitted to the Islamic Microfinance Challenge included:

    - A better version of Murabaha, where the MFI really owns the goods before they sell them to the client: In one proposal, CWCD develops a retail outlet model which targets the rural and semi-urban areas of Pakistan, and sells **grocery** items to clients either on *Musawama* (cash/spot payment) or *Murabaha* (deferred/installment) basis. Similarly, the retail outlet will also establish a dairy farm in which the organization

[21] All of Al-Amal bank clients are insured against death and total disability. The insurance includes covering the balance of the loan and paying the family of the client an amount of 20,000 YER which is equivalent to almost 100 USD.

[22] In most of the cases you give one loan to a household or you make one investment with them while each member of the household can have a savings account. Also, many poor families who do not need a loan will be happy to have the opportunity to have a savings account.

will maintain fifty cows, and clients who are interested in buying cows can select any for purchase. In this way, clients will be able to choose the cow first-hand, according to their requirements. At the same time, clients will not be burdened by on-the-spot payment, and can opt for a deferred payment plan.

- Leasing and Lease to Own Products: The same CWCD retail outlet will have a special counter where clients can submit their requisition for the purchase of vehicles (mostly motorbikes and rickshaws). The request will be directed to the procurement department, which will purchase and deliver the requested vehicle at the retail outlet. The outlet will subsequently enter into a *Musharaka* (joint partnership) agreement with the client, whereby the client will purchase units of the vehicle, and pay rental for usage of the units of the vehicle owned by the organization. Alamal Bank's proposal will also introduce a leasing product for vehicles and equipment. The bank plans to have two contracts with the client, a leasing contract and a purchase and sales one, where the latter is activated when the client leases the equipment for certain number of months/years and pays the rent on time.
- Combination of the loan with savings and insurance, as in the case of Tanzania ecoVolunteerism: In this case, each family will harvest honey and will benefit from a revenue stream, based on fair-market-value sales to TeV. TeV will then export the raw honey to wholesalers at a profit, capitalizing on market opportunities. Each family will have two years to pay back the qard hasan to TeV. The revenue stream that each family will produce from selling their harvested honey will be partitioned into three segments: 25 percent will translate into loan repayments to TeV, 25 percent will contribute to the cooperative farming savings fund (wadiah) called Asali Saccos[23], and 50 percent will be new cash at the disposal of the participant families. Earnings per family will further increase if they decide to invest their savings into more Langstroth Hives[24] to produce more honey. All the beehives are insured and their insurance was added to the price from the beginning
- Farz Foundation[25] in Pakistan just finished developing two livestock products using *Mudaraba*, the first will provide each poor family with five females and one male goat for breeding and the second will give the poor family 10 male goats (3 months old) to cater for meat. They will also provide a vet service. The profit or gain will be 50/50 after excluding the principal amount, as the client nourishes the young goats and Farz Foundation provides the animals. After these goats mature, they can be sold for profit, or distributed as per the formula agreed among the two partners.
- Al-Amal bank, to overcome the issue of financing, developed some investment funds and marketed them among Yemeni Businessmen inside and outside Yemen. Al-Amal bank will use one of those funds to finance the proposed new leasing product.

C. Can such a model be implemented while keeping the focus on the Poor?

How can we implement such a model with poor families and with small transactions? Here we need to learn from the continuous efforts of conventional microfinance, to find ways to cut down

[23] Asali Saccos is a cooperative farming program that encourages a culture of savings amongst beekeeper families.
[24] Each year participants will be able to invest their savings to purchase more Langstroth Hives.
[25] This MFI is relatively new and was not one of the finalists of the Islamic Microfinance Challenge 2010.

the cost of transactions. It is too expensive to track these very small investments if only one or two individuals are working in the same field across a wide geographical area. It is best to focus on economical activities where many people are implementing the same type of activity. In other words, it would not be ideal for an MFI to develop a product to invest with people to raise cows for milk, if those people are scattered over several sites, and only 1 or 2 clients are in each location. However, if the MFI first selected villages or locations which have experience and resources like *Mara'ee* (grazing fields) where if 50-100 families there each needed financing for one or two cows, this would facilitate the tracking process, the provision of vet services, etc. It would also make it easier to gather the milk and to transport it to the dairy factory.

Such a model can also allow the MFI or bank to focus on more poor people, than those targeted by conventional microfinance. The model can target many of those who are too poor to accept to be indebted, or those who would be excluded by the group (in the case of a group lending methodology) or by the MFI because they could not provide a guarantor, for example. These people would qualify to benefit under such model, since they would have the human power, the will, and the determination to learn and work hard.

D. What about the Cost of Such a Model[26]?

If the institution must be very closely involved in the microenterprise's development, in buying the inputs, marketing and providing BDS services, veterinary services in the case of animals and livestock projects, providing insurance, and controlling the quality of the products, wouldn't all of the above increase the cost of operations in general? Wouldn't such a model be very expensive? Would the poor be able to afford it?

Again, practitioners must stop thinking within the limited scope of conventional lending. In the case of *Mudaraba*, the MFI is not a lender but a business partner who, on one hand, takes far more risks and a greater role in the business, and on the other hand, takes a pre-agreed percentage of the profit. In order for the MFI to make more money, the enterprise must make more profit. Therefore, it is in the interest of both parties to develop a profitable enterprise. In most cases, such a percentage of the profit, when converted into an interest rate calculation accounts for far higher interest rates than those charged by MFIs on conventional loans.

Annex III shows the prototype for two *Mudaraba* products which were advertised recently by Farz Foundation in Pakistan. From the financial features of the product, we can see that the expected return from investing US$ 500 is US$ 447 for the family and another US$ 447 for the foundation. It also shows that for the second product the profits are US $147 for the family and another US$ 147 for the foundation over a period of 3 months only. In the language of conventional finance, that is approximately a 90 percent effective interest or yield on gross portfolio over a period of 12-14 months, for the first product, and about 36 percent over a period of 3 months (144 percent per year) for the second product.

[26] Assumptions in this section like the cost of such a model are still to be tested over time when such a model is tested and we have real data.

So, though the cost is higher, the return is expected to be higher, and this would not be necessarily at the expense of the customer or client; on one hand, the bank or MFI will be paying for expenses that the borrower would pay for in the case of conventional finance (such as BDS and vet services) and also, the bank or MFI would be taking risks the borrower usually takes in the case of conventional microfinance, especially the risk of losing the investment if the project fails. The bank also would do more than just lend the money and in some cases they might get involved in buying inputs and in marketing outputs. Though this level of involvement might cost time and money, it can also save money, assuming that the MFI or bank will be able to get better quality for lower prices when buying large quantities, and will get better prices as they will have a better negotiating power compared to individual clients. Most importantly, as they are faced with the risk of losing their investment, they will make every possible effort to make sure that the project is successful and profitable. This will definitely make the client happy and appreciative for the service, even if the bank or MFI ended up taking a higher percentage of the profits.

E. Potential Social Benefits/Impact:

When such a business model, especially the PLS sharing instrument, is implemented on a wide scale, it is expected to have the following potential social benefits/impact:

1) The Ability to Target People Who Are More Impoverished: Such a model will enable the MFI or bank to focus on people who are poorer than those targeted by conventional microfinance. Many will qualify to benefit under such a model, including those who are too poor to accept being indebted, those who would be excluded by a group (in the case of a group lending methodology) or by the MFI because they could not provide a guarantor etc. They would have the human resources, the will and determination to learn and to work hard.

2) Less Likelihood of Over Indebtedness: Such a model will require a more thorough investigation of the client, because Sharia compliant models do not use any kinds of guarantee, except against negligent behaviors, and because if the wrong client or business partner is selected and things go wrong, the MFI will lose its investment. Motivation to implement a thorough investigation will definitely lead to a higher likelihood of success among clients. Moreover, the MFI will have to make sure that its funds are going towards economic activity and enterprise development. In fact, the MFI will be the one who will buy those assets in most cases. Under such a set-up, it is not possible for an MFI to make a profit and flourish while its clients are suffering, as in the case of Andhra Pradesh in India.

3) More focus on productive economic activities \Contributing to the GNI. It is also expected that such a model will focus more on productive economic activities, which contribute more to the country's GNI, instead of commerce activities.

4) More Job Creation: There is a near consensus that conventional microcredit is not a good job creation tool as risk-averse lenders tend to focus more on those who already have an enterprise and are looking to expand. Implementing this model might change this equation, and the focus could be more on those who have human capital and have the skills, or can acquire the skills, which might lead to the creation of jobs for them.

5) Less Problem Attracting Financing Resources: though it took the conventional microfinance sector years to attract commercial sources of financing, it is expected that this will not be the case under a successful business model of Islamic microfinance, not only because conventional microfinance already paved the way and demonstrated success, but more fundamentally because Islam seeks to alleviate poverty and circulate wealth in the economy. Muslims are taught to have sympathy for the poor, and recognize that the poor have rights over them[27]. So far, it is believed MFIs have failed to show a promising successful and profitable model which could convince banks to take a risk and to finance an MFI portfolio on the basis of *Mosharaka* or *Mudaraba*. However, should such a model be developed and become operational, Islamic banks and even Islamic business people are not expected to be reluctant to provide the needed financing. The collection of $6-7 million in investment funds for Alamal Bank, when their portfolio was still near $US 2.5 million, creates such expectations.

VI. What Else is Needed to Develop Such a Business Model?

1) In order to provide access to sustainable services on scale, it is imperative for the industry to adopt innovative and sound practices, and to prove that these models work. Development of such models is expected to follow a track similar to that which was used to develop conventional microfinance models, while advancing more quickly, benefitting from over 30 years of experience. To this end, the industry requires deeper market research and a comprehensive initiative to build the capacity of players at the micro, meso and macro levels, to help develop and implement appropriate business models. Specifically, Deeper Market Research: to better understand the size and segments of demand, on one hand, and to try to come up with a group of products responding to this demand, on a large scale.

2) Capacity Building Activities should be provided at all levels to realize the full potential of Islamic microfinance. More efforts should be made to train Islamic MFI managers and staff. This includes the development of training courses, training of trainers, and development of a group of consultants who can train and advise MFIs[28].

3) Financing Pilots: At the micro and institutional levels, international donor agencies can play a major role in expanding access to finance among poor Muslims by funding pilot projects which provide the opportunity to test various Islamic microfinance business models.

4) Global Financial Reporting Standards: the Islamic Development Bank and Islamic financial standard setters ,such as IFSB or AAOIFI, should consider developing global financial reporting standards, adapted to microfinance, to build the infrastructure for transparency in the global Islamic microfinance sector. This infrastructure would entail comprehensive

[27] One of the faith's "five pillars" is *Zakah*, or almsgiving. Unlike a simple income tax, Zakah is calculated based on assets and therefore re-distributes wealth within the community. As Islamic scholars point out, even the rules of Zakah promote more active forms of investment and business activity – wealth from passive activities is subject to greater Zakah.

28 In this regard, the operational tools and manuals which were developed by Deutsche Gesellschaft fürTechnische Zusammenarbeit (GTZ) for use in Indonesia in 2007 can be something to build on instead of beginning from scratch.

disclosure guidelines on Islamic microfinance accounting principles, pricing methodologies, financial audits, and eventually, rating services.

5) Benchmarks: The MIX should also consider creating a new group in its reports and begin tracking products which are offered according to Islamic Sharia law, their outreach, average loan and investment size, etc. to get good idea about these products over time, and to compare them with conventional products.

In brief, we have to remember how much was invested in the development of conventional microcredit and microfinance in the 80's and 90's, to recognize how minimal investment in the development of the Islamic microfinance has been to date.

Annex I: Islamic Banking Products[29]

This Annex summarizes primary Islamic banking financial products (service, financing and funding) and the types of instruments/contracts which can be used under each.

ISLAMIC BANKING PRODUCTS

SERVICE	FINANCING	FUNDING
Wakalah (Procurement)	**Trade/Exchange** -*Murabaha* (cost plus mark-up) -*Istisna'* -*Bai' Salam and Bai' Salaf* (forward sales contract) - *Bai' mua'jjal* (differed payment)	***Wadi'ah*** -Current/checking account -Savings Account -Others
Sarf (Money Exchange)	**Leasing** -*Ijarah* (Leasing) -*IMBT*(Leasing to Own)	***Mudaraba*** -Deposits Account, -Savings Account -Other funding Account
Kafalah (Insurance)	**Profit Sharing** -*Mudaraba* -*Musharaka*	
Hiwalah (money transfer)	***Qardul Hasan*** (Benevelent Loan)	

I) Funding Products

In Islamic banking, funding products can be in the form of demand deposits, savings and time deposits. The prescribed Sharia operational principles in the pooling of public funds are the principles of *Wadi'ah* and *Mudaraba*

1. The principle of *Wadi'ah*
In banking practices, *Wadi'ah* is applied in the form of demand deposit.

"*Wadi'ah* is an agreement for placement of funds or goods made between a holder of funds or owner of goods and a custodian of the funds or goods, with an obligation that the party accepting the placement return the entrusted funds or goods at any time"[30].

The general conditions for *Wadi'ah* funding products are as follows:

[29] This annex was adapted from the Islamic Banking training course developed by Janis Sabita for GTZ and MICRA in Indonesia in 2007 and from "An Application of Islamic Banking Principles to Microfinance" -Technical Note- A study by the Regional Bureau of Arab States, United Nations Development Program in cooperation with the Middle East and North Africa Region, World Bank. Rahul Dhumale and Amela Sapcanin, 1998.
[30] This definition is according to the PBI regulation No. PBI/46/2005 (Sabita, 2007) –

a. The profit or losses arising from the funds channeled are under the responsibility of the bank. The bank is only committed to ensure that the fund owner bears no losses, but not to provide any rewards
b. Once the fund owner opens the *Wadi'ah* account, the contract that gives the bank a permission from the fund owner to channel the deposited fund as well as other requirements that do not contradict the *Sharia* principles, especially to holders of a demand deposit, the bank can provide checkbooks, a gyro slip, and debit cards.
c. The bank can place administrative charges to cover the cost that is really incurred, on the account opening.
d. Other stipulation related to demand deposits and savings accounts should apply, as long as they are *Sharia* compliant.

2. The principle of *Mudaraba*

"*Mudaraba*" is placement of funds by a holder of funds/fund owner (*sahibul maal*) with a manager or bank (*mudarib*), to conduct a specified business with sharing, applying the method of profit and loss sharing or revenue sharing between the two parties, at a ratio agreed in advance.

Usually the bank uses the funds to finance the *Murabaha* and *Ijarah* financing products.

The *rukun Mudaraba* must be perfectly fulfilled (i.e. existence of fund owner -*sahibul maal*-, bank (*mudarib*), a venture on profit sharing basis, a ratio on the profit sharing and a contract"(Sabita 2007).

As per Amir Rahman, there are two main types of *Sharia*-compliant savings accounts:

- *Mudaraba*-based accounts, wherein the customer deposits money in the bank and shares the profits and risks of the bank's use of that money. This type of account is the most liquid, but it is not insured.
- *Murabaha*-based term deposit accounts, wherein the customer deposits money in the bank and the bank conducts *Murabaha* transactions with the money, often on 30-day or 90-day terms. This type of account is much safer, but it is not as liquid as *Mudaraba*-based accounts. However, being less liquid could also be conceived as an advantage, encouraging clients to hold on to their assets. This may be the most appropriate tool to use to mobilize savings with microfinance clients.

II) Islamic Financing contracts/instruments

<u>Profit-and loss-sharing schemes (Investment/Venture)</u>

1. *"<u>Mudaraba</u>* is a contract between two parties -where one party acts as the fund owner, entrusting a specified amount of capital to be managed by the other party, who manages a profit-seeking venture. *Mudaraba* denotes trustee financing" (Sabita, 2007). "Under a *Mudaraba* contract the bank/MFI provides the capital needed for a project while the entrepreneur offers labor and expertise. The profits (or losses) from the project are shared between the bank and the entrepreneur, according to a predetermined fixed ratio. Financial losses are entirely assumed by the bank/ financier; the liability of entrepreneurs is limited to their time and effort. In cases of proven negligence or mismanagement by entrepreneurs however, they may be held responsible for the financial losses. These types of contracts are most common in investment projects in trade and commerce, which are capable of achieving full operational status in a short period. The

contract between the bank and the entrepreneur is known as restricted *Mudaraba,* because the bank agrees to finance specific investments by specific entrepreneurs and to share relative profits according to an agreed percentage. To engage in Mudaraba transactions, a bank must meet the following legal obligations:

- The bank should not request collateral to reduce its credit risk on these transactions, and thus bears the entire financial risk. Collateral may, however, be requested to reduce moral hazard.
- Profit sharing rates must be determined only as a percentage of the profit, not a lump sum payment. In some cases the bank may receive part of the principal from the borrower at the end of the period, if a surplus exists. In cases of loss, the entrepreneur will not be liable unless found guilty of negligence of mismanagement.
- The entrepreneur exercises full control over the business; however supervision by the bank is permitted" (Dhumale and Sapcanin, 1998).

Essential factors in *Mudaraba*

a. Parties (fund owner and fund manager)
b. Objects I (capital and labor or service)
c. An agreement between both parties (a'qd)
d. A profit sharing ratio

2. *"Muzar'ah* is essentially a mudaraba contract in farming, where the bank can provide land or funds in return for a share of the harvest"(Dhumale and Sapcanin, 1998).

3. *"Musharaka* is an equity participation (in a business venture) contract in which the bank is not always the only provider of funds. The distinguishing features of this type of contract are the nature of the business activity and the duration of the gestation period for the business. Two or more partners contribute to the capital and expertise of an investment. Profits and losses are shared according to the amount of capital invested. This type of transaction has traditionally been used to finance medium- and long- term investments"(Dhumale and Sapcanin, 1998). Musharaka can be used for assets or for working capital.

   "Under the Musharaka financing products, the bank and the customer act as partners by jointly providing funds and/or goods to finance a specified business venture. The client acts as business manager, and the bank acts as business partner. The bank may participate in management of the business, according to agreed powers and assignment of tasks. Each investor's rights correspond to their amount of equity capital in the enterprise. The bank may appoint the client to manage the business, based on the terms agreed with the customer. Direct investments are similar to transactions in Western banking and thus require the greatest discretion. Islamic banks cannot invest in the production of any goods or service that might even *appear* contrary to the ethical and moral values of Islam" (Sabita, 2007).

4. "Musaqat is a specific type of musharaka contract for orchards. In this case, the harvest is shared among all the equity partners, according to their contributions"(Dhumale and Sapcanin, 1998).

Non-profit- and loss- sharing scheme (Trade/Exchange)

1. "*Murabaha* is a sale and purchase of goods at cost price plus an agreed profit margin" (Sabita, 2007). "*Murabaha* is a common instrument used for short-term financing, based on the conventional concept of purchase finance or cost plus markup sales. The seller reports the cost of acquiring or producing a good to the buyer, then a profit margin is negotiated between the two parties. Payment is usually made in installments"(Dhumale and Sapcanin, 1998).

2. "*Salam* is the sale and purchase of goods by means of order, placed with certain requirements and full cash payment in advance"(Sabita 2007). "*Bai'Salam* and *bai'salaf* are similar to forward contracts, with the buyer paying the seller negotiated price for the product, which the seller promises to deliver at a future date. The quality and quantity of the products involved in this type of transaction must be capable of being specified at the time of the contract"(Dhumale and Sapcanin, 1998).

3. "*Bai' mua'jjal* is deferred payment or spot sales in which the seller of a product accepts deferred payments in installments or in a lump sum. The price is agreed on between the buyer and seller, and the seller is not allowed to include any charge for deferring payments"(Dhumale and Sapcanin, 1998)..

4. "*Istisna* is the sale and purchase of goods, and comprises an order for production of goods according to certain agreed criteria and requirements, with payment on agreed terms"(Sabita 2007).

5. "*Ijarah* is a transaction for leasing of goods and/or hire of labor over a specified period, through lease payments or remuneration for service rendered" (Sabita 2007).

6. "*Ijarah Muntahiya Bittamlik (IMBT):* represents two contracts, Al-Bai s (a buy and sale contract); and Ijarah contracts. At the end of Ijarah it follows with sale and purchase of the IMBT object" (Sabita 2007). "Ijara wa iqtina' involves lease purchase/lease to own (ijara wa iqtina') transactions, in which a party leases a specific product, for a specific sum, for a given period. In lease purchase arrangements, a portion of each payment is applied to the final purchase of the product, at which time ownership is transferred to the leaseholder" (Dhumale and Sapcanin, 1998).

7. *"Al-Qard al-Hasan* is a loan with zero return that the *Quran* encourages Muslims to make to "those who need them." Banks are allowed to charge a service fee to cover the administrative and transaction costs of these loans, so long as such costs are not related to the maturity or amount of the loan "(Dhumale and Sapcanin, 1998).

III: "*Jo'alah (Service)* is a service charge that usually occur during transactions of various services. They often occur when the buyer of a service agrees to pay the provider a specified fee according to a contract"(Dhumale and Sapcanin, 1998). *Wakala* (procurement), *Sarf* (money exchange), *Kafala* (Insurance) *and Hiwala* (money transfer*) are different kinds of services/Jo'alah.*

"The main difference between transactions that do not involve profit and loss sharing and those that do is that returns for the former may be calculated at the final stage, as a fixed percentage of the total investment. However, none of these contracts can be legally negotiated to provide a fixed rate of return. Islamic banks may occasionally add an extra fee to compensate themselves for costs incurred by the additional transactions they must undertake. Thus, these instruments appear similar to those in conventional banks, where risk aversion and risk pooling are important factors. All of the above instruments, however, conform to the Islamic code, because their rates of return are related more to the transaction than to time.

The application of religious principles to banking practices may affect the continued development of Islamic banking. At present, most banks seek approval from their religious boards and *Sharia* advisors before marketing new financial instruments. A standardized regulatory and legal framework could help assimilate Islamic institutions into international markets. As it stands, Islamic banks occasionally experience difficulties when attempting to explain their practices in countries or systems that are not based on Islamic principles"(Dhumale and Sapcanin, 1998).

Annex II[31]: The Project Ideas of the Five Finalists of the Islamic Microfinance Challenge 2010

A. Bina Insan Sejahtera Mandiri (BISMA):

BISMA, an apex fund founded in 2003, is designed to balance social and commercial impact in microfinance sector development through contributing to the financial and technical capacity building of MFIs. BISMA has served 25,000 micro-entrepreneurs through 126 MFI partners. BISMA's proposal is to mobilize savings using a Recycled Waste Savings Product. The idea is that MFIs pay community members for recyclable waste that they collect. However, instead of paying for it with cash, MFIs will open a savings account for each student or community member who has collected the waste. The collected waste will then be sold to either a waste power plant or the city's waste recycling company. Through this initiative, three parties benefit directly. The community finds a solution to the waste problem, volunteers gain access to a unique savings mechanism, and the waste recycling company improves efficiency by collecting waste directly from the MFIs, instead of having to go door to door. MFIs "need to promote this program by providing waste management and environment education and awareness to students or community members, so that they understand the importance of keeping the city waste-free"[32].

B. Centre for Women's Cooperative Development (CWCD)

CWCD, a micro-enterprise development NGO, has converted its previously conventional operations into a Sharia-compliant business. Since 1992, CWCD has helped develop 21,000 micro-enterprises. CWCD's proposal is to develop a retail outlet model based on Islamic trade principles, target the rural and semi-urban areas of Pakistan, and sell grocery items to clients. Under this model, the items are sold on *Musawama* (cash/spot payment) or *Murabaha* (deferred/installment) basis. The clients are offered a selection of items that they may want to purchase and then will be given the option to settle their payment for the selected items either by cash or a deferred payment plan. . If clients wish to opt for the deferred payment plan, they are offered the deferred tenure ranging from 8 hours up to a maximum of 15 months. The client is informed of profit charged, which is in accordance with the respective time duration of the payment plan. At the retail outlet, there will be a special counter where clients can submit their requisition for the purchase of vehicles (mostly motorbikes and rickshaws). The request will be directed to the procurement department, which will purchase and deliver the requested vehicle at the retail outlet. The outlet will subsequently enter into a *Musharaka* (joint partnership) agreement with the client, whereby the client will purchase units of the vehicle, and pay rental for usage of the units of the vehicle owned by the organization. Similarly, the retail outlet will also establish a dairy farm in which the organization will maintain fifty cows, and clients who are interested in buying cows can select any for purchase. In this way, clients will be able to choose the cow first-hand, according to their requirements. At the same time, clients will not be burdened by spot payment, and can opt for a deferred payment plan.

C. Tanzania eco-Volunteerism

Tanzania eco-Volunteerism's (TeV) honey project is a community development program providing rural poor communities of Tanzania with an innovative microfinance model that is in complete compliance with Islamic guidelines for business and finance. TeV's microfinance activities are sustainable, scalable, and market-driven and include interest-free loans (qard hasan), savings (wadiah), and insurance (takaful).

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[31] This whole Annex was adapted from the 5 posts written on CGAP blog about the finalists of the Islamic Microfinance Challenge 2010. Some parts of this are basically copy and paste from those blogs.

[32] http://microfinance.cgap.org/2011/05/03/recycle-waste-savings-product-from-indonesia/

TeV's mission is to invest in communities by introducing sustainable beekeeping. TeV empowers communities by offering each family two Langstroth Hives (beehives) on an agro-based, qard hasan loan. Each loan is interest free and does not require any form of physical collateral or al-rahn. Each family will harvest honey and will benefit from a revenue stream based on fair-market-value sales to TeV. TeV will then export the raw honey to wholesalers at a profit, capitalizing on market opportunities. Each family will have two years to pay back the qard hasan to TeV. The revenue stream that each family will produce from selling their harvested honey will be partitioned into three segments: 25 percent will translate into loan repayments to TeV, 25 percent will contribute to the cooperative farming savings fund (wadiah) called Asali Saccos[33], and 50 percent will be new cash at the disposal of participant families. Earnings per family will further increase if they decide to invest their savings into more Langstroth Hives to produce more honey. Furthermore, TeV will insure (micro-takaful) families' hives to mitigate potential financial harm impacting the participants. The cost of insurance is included in the cost of the initial purchase.

TeV focuses on capacity building of farmer communities, in addition to offering products. The principles of self-help and trust within the communities are key to economic and socio-cultural freedom for Tanzania's millions of poor Muslims.

D. Tameer Bank

Tameer Bank is a conventional microfinance bank which started its operations in Pakistan back in 2005, and has already reached about 80,000 active borrowers. The bank's proposal is to create a separate Islamic Banking division to serve as the business managing unit for Islamic banking. Once this experiment is successful, the next step would be to create Islamic counters at different branches already existing throughout the country. In a period of three years a total of 19 Islamic banking desks will be opened in 19 conventional branches. This will help Tameer in assessing customer needs and preferences, product specifics and operational requirements. Areas where customer feedback is more positive could be converted to completely Islamic products. Tameer expects to launch eight Islamic banking products; four on the asset side (Murabaha, Bai' al 'inah, Ijarah, Musharaka), three on the liability front (current/checking account, Mudarba, Mudarba certificates), and one Takaful product (health microinsurance).

E. Al Amal Microfinance Bank (the Winner)

Al Amal Microfinance Bank is the first microfinance bank in the Arab world to offer only Sharia-compliant products. Operating for just over two years, the bank has 15,000 active borrowers and 20,000 savers, and has captured over 25 percent of the Yemeni microfinance market. Al-Amal Bank established the first microfinance investment fund, which provides investment bonds the bank utilizes to finance people with low income and small businesses. The bank is planning to have 100,000 active borrowers and 250,000 active savings accounts in 2013. The bank's proposal is to introduce Ijarah (Islamic leasing). The bank will offer the leasing option, by which it will purchase equipment and vehicles needed by various professionals and lease to them. In order to honor Islamic law, the contract will stipulate that the bank retains ownership and maintenance responsibilities and that at the end of the lease, ownership is transferred to the client. The bank plans to self-fund its leasing product by relying on an Islamic investment funds product. It expects to reach operational and financial sustainability by 2012. The bank's menu of Islamic microfinance products include group and individual financing, project, corporate, and investment financing, savings, investment funds, and insurance.

[33] Asali Saccos is a cooperative farming program that encourages a culture of savings amongst beekeeper families.

Annex III

Farz Foundation Livestock Products

Livestock Product I	
Objective	Breading
Size	Set of 6 goats for one poor family (5 Female Goats + 1 Male Goat)
Age of Animal	6 month
Kind	Taidy ((
Size of Investment	500 USD
Period	12 to 14 month
Modality of partnership with poor Family	50 percent/50 percent at reproduced Goats
Modality of partnership with the Investor	Investor gain 60 percent of the net profit exclusive of client's profit
The parent animals remain as owned by Farz Foundation, and the Foundation can hold them back after 12-14 months, and can transfer the animals to another poor family for the same purpose.	

Livestock Product II	
Objective	To cater the meat market
Size	Set of goats for one poor family (10 young male goats)
Age of Animal	3 month
Kind	Taidy ((
Size of Investment	412 USD
Period	3month
Modality of partnership with poor Family	The profit or gain will be 50/50 after excluding the principal amount, as the client nourishes the young goats and Farz Foundation provides the animals. After the maturity of these goats, they may be sold for profit or distributed according to a formula agreed by the two partners.
Modality of partnership with the Investor	Investor gain 60 percent of the net profit, exclusive of client's profit

Financial Features		
Five Female Goats & One Male Goat		
Features	PKR	USD
Total Investment	42,500	500
Total Expected Income	76,000	894
Client Gain (50 percent)	38,000	447
Organization Gain (50 percent)	38,000	447
Operational Cost	12,000	141
Net Profit	26,000	306
Investor Gain from Net Profit (60 percent)	15,600	184
Farz Gain from Profit for re-investment (40 percent)	10,400	122

Financial Features		
Ten Male Goats for Meat		
Features	PKR	USD
Total Investment for 3 Month	35,000	412
Total Sale After 3 Month	60,000	706
Total Expected Income	25,000	294
Client Gain after 3 Month (50 percent)	12,500	147
Organization Gain after 3 Month (50 percent)	12,500	147
Operational Cost in 3 Month	2,000	24
Net profit after 3 Month	10,500	124
Investor Gain from Net-Profit (60 percent)	6,300	74
Farz Gain from Profit for re-investment (40 percent)	4,200	49

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