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Islamic Microfinance

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For my parents, Inge and Helmut,
my sister Friederike,
my brother Christian,
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this thesis would not exist in
this form, if not for you.
Thank you

Contents

List of abbreviations

AIM	– Amanah Ikhtiar Malaysia
A. o.	– And other
Approx.	– Approximately
ASBISINDO	– Asosiasi Bank Syariah Indonesia
BIS	– Bank for International Settlements
BKRS	– Bank Perkreditian Rakyat Shayrah
CGAP	– Consultative Group to Assist the Poorest; www.cgap.com
CAR	– Capital Adequacy Ratio
DAC	– Development Assistance Committee
DB	– Delinquent Borrowers
Dipl.-Vw.	– Diplom Volkswirt
Dr.	– Title, comparable with a PhD
Esp.	– Especially
E.g.	– For example
EU	– European Union
FDI	– Financial Direct Investments
Fig	– Figure
GNP	– Gross Net Product
GTZ	– German Agency for technical Co-operation (Gesellschaft für Technische Zusammenarbeit); www.gtz.de
HIC	– High Income Countries
ICT	– Information and Communication Technology
IDB	– The Islamic Development Bank
I.e.	– Id est (that is)
ICMI	– Ikatan Cendiakiawan Muslim Indonesia
IMF	– International Monetary Fund
JV	– Joint Venture
Km	– Kilometre – 1000 meter
LDC	– Low Income Development Countries
Max.	– Maximum
MFA	– Microfinance Association
MFI	– Microfinance Institut
Mr.	– Mister
NGO	– Non-Government Organizations
ODA	– Official Development Assistance

OECD	– Organisation for Economical Co-operation and Development
OtRR	– On time repayment rate
PAR	– Portfolio at risk
PLS	– Profit and Loss Sharing
Prof.	– Professor
RM	– Malaysian Ringid
RWTH	– Rhein-Westfälische Technische Hochschule
UN	– United Nations
US	– United States
VCC	– Venture Capital Company
YDBP	– Yayasan Dharma Bhakti Parasahabat
YSK	– Yayasan Siti Khadijah

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Introduction

Microfinance is not a panacea against poverty.

Talking about Microfinance as being a so-called panacea – a pill against poverty – would be as arrogant as declaring the existence of a pill against sickness in general. Every single sickness, however, has different causes, is influenced by different ascendancies and consequently can only be treated by adjusted ways of healing.

Nevertheless, in the past, similar approaches were introduced to help people without or with very limited access to financial services (e.g. in effect of the European wars (1619-1648)[1]). Since the idea of microfinance was reborn 1976 as 'developmental aid' by Professor Yunus in Bangladesh, a revolution has begun that has had an enormous success. It has even been thought that they had found the solution to delete poverty completely. However, in recent years, this revolution has slowed down again probably due to multifaceted reasons (see below). Most of these reasons are not new since they have been identified as typical problems arising in the 'development aid theory'. Nowadays, however, Microfinance is or should be seen as an industry. It is settled within the financial sector and the target group is either below or along the poverty line.

Microfinance industry – like every other industry – has to be competitive in order to be sustainable and successful. No company or organisation can rely (only) on funds for surviving in the long run. For example, government-owned companies are seldom effective or professional enough to survive in an open market. In the branch of microfinance, in which many organisations are usually very young, lacking both experience and especially educated human resources, to be competitive and thus professional would mean to adopt a business-like approach. Thus, without loosing their core philosophy of targeting the poor and enabling them to improve their living standards they need to predict risks, cover their costs, introduce new technologies, build up networks for co-operation, and adjust their products according to demand. Moreover, they need to be aware of problems that can arise while working in different cultural, social, religious, political and juridical circumstances, and cannot simply transfer and use tools or procedures from one environment in another. Basically, they need to develop a framework in which free competition is possible. Only if microfinance institutes change their traditional approach of relying mainly on funds towards a timely economical competitive approach, they will achieve their goal of effectively increasing their outreach to the poor.

[1] See Steinwand (2001) for further reading.

The problems of microfinance institutes are common knowledge in the development field both for practitioners and scientists. The literature discussing microfinance topics like sustainability, outreach and improvement of methods as well as the role of the governments in terms of interference, supervision and regulation is getting more differentiated and substantiated. Despite this increasing interest, one aspect of microfinance has been largely neglected both scientifically and in its application: Islamic Microfinance.

This paper attempts to adjust the financial products microfinance institutes are using to be able to meet the demand of the not yet regarded group of poor devout Muslims. This group of devout Muslims below and at the poverty line is enormous in number and spread all over the world. They are not just excluded from convenient banks due to their lack of collateral, but also from convenient microfinance institutes because they produce only a limited number of products. The prohibition of *Riba* (interests) by the Islam is binding for devout Muslims and many poor Muslims would rather remain poor than taking the chance to escape poverty by compromising their faith. In almost every case study regarding Muslim dominant countries, this issue is remarked upon and the demand for Islamic Microfinance is described. The fact that this important issue has not received much attention yet and that, despite the obvious demand for financial opportunities of devout poor Muslims, no solutions have been found or even proposed is beyond understanding. Some of the problems causing this neglect might be seen in the higher efforts and risks Islamic products cause and which the MFIs will have to face when implementing them, as well as the higher complexity of the products.

In this paper I will discuss, if the principles of the *Shari'ah* (the Islamic law) are not somewhat compatible with the needs and obstacles of microfinance, where stewardship is to be shared and trust crucial. Further, I will discuss in detail if the prohibition of *Riba* is a serious, insolvable obstacle and if it is really more expensive for microfinance institutes to provide Muslims with financial services. By comparing traditional instruments of microfinance with new, transferred instruments borrowed from Islamic banking, I will try to explain – on the bases of the Islamic culture – why people are surprised about the neglect of Islamic Microfinance.

Chapter one will outline the development of microfinance and explain why microfinance can and is successful in so many countries. The aim of this chapter is to help the reader to comprehend the difficulties of development aid as well as to understand microfinance as a tool to stimulate a decentralized economical growth in many developing countries.

In the second chapter, I will try to explain the basic principles of the Islam. The subject is not religion itself, but rather the Islamic guidelines, which govern a Muslim's day-to-day life. Focused on banking and financial activities within these guidelines this chapter determines the "model of man" we will use in the analysis following in chapter four based on the assumption taken by the stewardship theory.

In chapter three, I will describe the rise of Islamic banking as a success story and with this will proof that Islamic banking can work and be very profitable. Finally, before a projection of Islamic banking principles on microfinance is possible, differences between commercial banks and Islamic banks will be explained.

In chapter four, an analysis based on literature and on a survey conducted in Malaysia and Indonesia in co-operation with ASBISINDO, AIM and several NGOs as well as an internal survey of the Bank Indonesia is presented. By comparing the Islamic culture, Islamic banking and convenient microfinance practices with each other, I will test three hypotheses based on the 'principal agent' and 'stewardship theory' that could explain the obstacle to implement Islamic microfinance:

The hypotheses are as follows

- The implementation of Islamic financial products causes too high risks for microfinance institutes. The restriction of involving 'risk' in financial contracts for both parties by the Islam is binding. Therefore, market risks and moral hazards, make a save and steady return for the MFI not possible.
- The higher efforts of Islamic Microfinance are too much for the already weak organisation structures of MFIs. MFIs have to avoid or at least decrease market risks and moral hazards. Thus, higher efforts need to be invested by the MFIs due to the increased dependency on the success of the pre-financed projects.
- The complexity of Islamic financial products compared to convenient credit contracts leads to difficulties in both their explanation as well as their promotion in less educated areas.

"The poor stay poor, not because
they're lazy but because
they have no access to capital."
Milton Friedman

Chapter 1 Microfinance … an explanatory approach

The fact, that ´Microfinance´ did not turn out to be the 'panacea' most people believed it to be, does not imply that the so-called "revolution of microfinance"[2] has come to an end. Actually, the revolution has just taken its first step and now it has to proceed to the next one.

1.1 Microfinance

One of the clearest frameworks of microfinance has been put forward by Prof. Dr. H. D. Seibel who defines microfinance as follows: "A sector of formal and non-formal financial institutions providing microsaving[3], microcredit[4] and microinsurance[5] services to the microeconomy, thereby allocating scarce resources to microinvestments with the highest rates of return. In a narrow sense, microfinance institutions are small local financial institutions. In a wider sense, they may also comprise national or regional banks with microfinance services for small savers and borrowers."[6]

The recurrence of the preface "micro" is abusive, however, emphasising the focus that some interpretations and projects are loosing. Microfinance should provide financial services to people, both rural and urban, who farm, fish, herd, provide services, operate small enterprises, where goods are produced, recycled, repaired, or sold or to people who gain income from renting out small amounts of land, vehicles, draft animals, machinery or tools.[7]

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[2] Robinson, M.S., "The Microfinance Revolution, Vol. 1, Sustainable Finance for the Poor", Washington,DC, 2001,
and Robinson, M.S., "The Microfinance Revolution, Vol. 2, Lessons from Indonesia", Washington, DC, 2003,
and Robinson, M.S., "The Microfinance Revolution, Vol. 3, The Emerging Industry", Washington, DC, 2003.

[3] Microsavings deposits facilities for: Safekeeping of savings, consumption-smoothing, emergencies, accumulation of resources.

[4] Microcredit, with access to loans of various sizes and maturities for external financing of investments, consumption-smoothing and / or emergencies.

[5] Microinsurance, including specialized services (life, health, accident or cattle insurance) and non-specialized services (providing social protection through access to one's savings or to credit in cases of emergency) for risk management, social security and / or loan protection.

[6] Seibel, H.D., Kumar, B.K.C., 1998, Page 5.

[7] Robinson, M.S., 2001, Page. 9.

Thus, in general Microfinance should reach all people who were once addressed with the term “non bankable”[8].

The aim of microfinance has been reached in many examples, but still the success remains behind the potential demand of mircofinance. To maximise the reach towards people with a potential demand for financial services, the discussion about better methods have increased and new approaches are invented. I mentioned in my introduction that the microfinance revolution has to advance to the next step. Microfinance institutes have to start perceiving their services in the light of current economical situations and adjust accordingly. Providing credit to the poor is not a developmental theory anymore, or rather to be most effective it shouldn’t be one anymore.

1.2 The evolution of “Microfinance”

Since the 1960s, the major multilateral and bilateral donor organizations have concentrated their activities on a whole range of different approaches to alleviate poverty. Within this discussion the definition and causes of poverty seem to change almost every decade. The famous sentence of Karl Marx “The developed countries showing the less developed countries a vision of their own future” turned out to be an illusion. The ‘Trickle – Down effect (1960s) assumed that the economic growth expansion, through the transfer of capital (FDIs, financial development aid, etc.), outside values, technology and organisations would leak out to the poor, failed. In these days, when development co-operation was focused on a ‘growth centred’ approach, it was considered to be a process of predefined and universal stages of economic growth.[9] A change came with the launching of the “World Food Program”[10] by the United Nations in 1963, which is still operating today. This program was one of the first steps towards the participation of the poor and constitutes the critical break in the development aid. It is known as the ‘participatory approach’.

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[8] See Page 2 above.

[9] Holloh, D., “Microfinance in Indonesia, Between State, Market and Self-Organization”, Hamburg, 1998, Pages 5 -11.

[10] Set-up in 1963, the WFP is the UN frontline agency in the fight against global hunger. In 2003, WFP fed 104 million people in 81 countries.
“In the first case, food aid is essential for social and humanitarian protection. […] In the second case, food aid is a pre-investment in human resources. In the third, it uses poor people's most abundant resource, their own labour, to create employment and income and to build the infrastructure necessary for sustained development.”
Mission statement taken from: www.wfp.org.

Introduced in 1968, the "Green Revolution"[11] finally made the first approach to establish the bottom-up theory as the new paradigm. However, the "Green Revolution" required high investments of the poor and as a consequence the demand for credit in rural areas increased. The credits were usually given by multilateral donors e.g. the World Bank, who offered subsidized targeted credit lines. The drawback of this approach became obvious quite soon in that the "Green Revolution" was designed to reach the better-offs rather than the landless and the poorest of the poor. Furthermore, in the mid-1980s, the approach was heavily criticized since most programs had accumulated large loan losses and could not survive without continuous funding. It became evident that market-oriented loans would be more appropriate for rural development. In their book *"Undermining rural development with cheap credit"* by Adams, Graham, and von Pischke, the authors considered credit as a "financial intermediation" rather than an "input" [12].

This shortcoming – the repeated exclusion of the poor by the 'Green Revolution' – was discovered by Prof. Muhammed Yunus in the 1970s, who pioneered the world of development theory. Employing a special credit delivery mechanism he provided small collateral-free, affordable loans based on group-lending to the poor in Bangladesh and showed the world the possibility of providing the very poor with credit. This disproved the widespread assumption that the poor were "non bankable" due to their small loan requirements, small amounts of assets and lack of collateral. Effectively, the "Microcredit" was born. The success story of the so-called "Grameen Bank model"[13] has made microcredit very popular and it has gained worldwide attention as an integral part of the development process.

"Microcredit" promotes the productive use of poor people's most abundant asset – their labour – and gives them a chance to establish or expand their businesses. Moreover, it generates resources of income. An increase in income decreases general risks, enables consumption and provides a chance to escape hunger, disease and exploitation. Regarding Abraham Maslow's assertion in his theory of "hierarchy of needs"[14] this effect can lead from

[11] Further reading: Robinson, M.S., "The Microfinance Revolution, Vol. 2, Lessons from Indonesia", Washington, DC, 2003, Pages 90 - 93.
The Green Revolution by Boilang, N.E. (Rockefeller Foundation): The introduction of HYV (High Yielding Varieties), a new sort of seed which promised to increase the farmer output by new technology of irrigation, pesticides and fertiliser.

[12] Compare: Adams, D.W., Graham, D., von Pischke, J.D., "Undermining rural development with cheap credit", Boulder, 1982.

[13] Founded in 1976, by 1994 the Grameen Bank had mobilized more than 2 million members, 94% of them are women. The Grameen Bank reached a loan recovery rate of more than 95%.

[14] Maslow, A., "Motivation and Personality", 2nd edition, New York, 1970, - Human beings are motivated by unsatisfied needs, seeing physiological needs as the most basic one it is followed by safety, love, esteem and self -actualization. In this hierarchy lower needs need to be satisfied before higher needs can be achieved or even satisfied.

self-esteem to self-confidence and eventually to self-actualization. This process is thought to be the key of the microcredit idea. To be able to rise out of poverty on one's own account, will form one's personality more in the sense of Maslow's theory than if poverty is reduced by subventions and presents[15]. Further, Prof. M. Yunus holds the opinion that "Credit is of fundamental importance if we are to build a just society where all human beings can live with dignity; I am convinced that credit is a basic human right."[16] Nevertheless, the reality has another face. The Women's World Banking (1995) estimated that in most developing countries, only the top 25 percent of the economically active people have been reached by the formal financial system.[17] The rest is without any access to financial services except those provided by moneylenders and family.

Is microcredit therefore just another path of the development aid, emerged from the mistakes made in the "Green Revolution" and doomed to failure? Or is the number of people with a demand for a financial services a sign for the enormous economical potential in developing countries?

1.3 Why was the development of microfinance so successful?

Worldwide microfinance has been recognized as a powerful tool for alleviating poverty, raising living standards and creating jobs. However, is the general opinion not that traditional agricultural societies, caught in a "Schultzian equilibrium"[18] had little demand for formal or even semi-formal financial services?

The widespread application and success of microfinance is based on various reasons or changes. Within the changes of the policy environment[19] in many countries, one of the main driving forces of microfinance was the rising awareness of the importance of an efficient financial system for economic development that reaches every level of society. This resulted in financial liberalization in many developing countries often forced by the IMF and the World

[15] Brüntrup, M., „Kleinkredite: Bänker statt Entwicklungshelfer", Published on: www.der-ueberblick.de, 2002.

[16] Yunus, M., "The Grameen Bank Story: Rural Credit in Bangladesh" in: Krishna A. "Reasons for Hope, Instructive Experiences in Rural Development", Connecticut, 1997), Page 12.

[17] McGuire, P., Conroy, J., "The Role of Central Banks in Microfinance in Asia and the Pacific", Metro Manila, 2000, Page 7.

[18] Low marginal rate of return on investment provide little incentives to savers and for capital accumulation. Occasional demand for emergency loans can be met by informal sources of loans.

[19] This includes: Macroeconomic stability; Emphasizing on "good governance"; Ease of setting up banks or branches; Low minimum requirements for MFIs.
Still, property rights, confidential judicial procedures and an appropriate legal framework are still lacking in many developing countries.

Bank, which were again heavily criticized[20]. The still ongoing financial liberalization has pushed above the liberalization of the interest rate regulation, which has given MFIs a chance to cover their costs. Moreover, the strengthening and deregulation of the banking sector has given them more opportunities. Dr. Dirk Steinwand summed it up as follows "the new financial sector policies created some important prerequisites for the growth of the microfinance sector."[21]

The 2nd force promoting microfinance are the main players in developing business (e.g. UN, EU) emphasizing more and more the co-operation with non-governmental organizations (NGOs). This increasing cooperation supported the emergence and widespread of the participatory approach[22]. The advantages of cooperation with NGOs are similar to the advantages of joint ventures. Using the close-to-the field experiences of the NGOs as well as their local networks saves a lot of time and money and sometimes it is the critical factor that enables market entry at all.

However, these two mentioned forces would not have been sufficient to establish a new approach in the development aid. Its success attracted also an exponentially increasing number and scale of funding companies / organizations. Moreover, the market was not perfect[23]. The inability of development banks and the inability or unwillingness of commercial banks to provide financial products in acceptable conditions to the microeconomy led to a missing rivalry among competitors. Thus, the MFIs faced only shopkeepers and pawn lenders as competitors, who took much higher interest rates[24]. Consequently, the achievement is stunning. OECD (Organisation for Economic Co-operation and Development) data indicate that the amount of aid given to the NGOs between 1975 and 1993/94 rose from 0.7% to 5%. According to the World Bank estimates, these figures are highly underestimated due to the exclusion of funds of approx. three billion US$ provided by the US, World Bank, EU and UN.[25]. The success of microfinance programs in reaching the poor unfiltered compared to other approaches forced donors and governments to push and contribute money to them. Seen as "a critical element of an effective poverty reduction strategy […] microfinance helps to promote economic growth and development."[26]

[20] See almost all publications of Joseph E. Stiglitz, and www.attac.org or www.weed.org.
[21] Steinwand, D., "The Alchemy of Microfinance", Berlin, 2001, Page 27.
[22] Suratman, S., "Poverty Alleviation in Rural Malaysia. A case study of the Credit Scheme of Amanah Ikhtiar Malaysia", Bielefeld, 1995, Page 24.
[23] A "not perfect market" in business terms means less competition, uneven power of competitors, no or less power of buyers and sellers, restrictions.
[24] Seibel, H.D., Kumar, B.K.C., Working Paper No. 1998-3, "Microfinance in Nepal: Institutional viability & sustainability and their compatibility with outreach to the poor", Köln, 1998, Page 6.
[25] Hulme, D., Edwards, M., "NGOs, States and Donors", New York, 1997, Page 6.
[26] Asian Development Bank, "Finance for the Poor: Microfinance Development Strategy", Manila, 2000, Page1.

Unfortunately, there are two sides of the story. A higher degree of funding (see above) consequently implies a higher dependence on the donors. Nowadays, many MFIs are established by governments (e.g. BancoSol in Bolivia and Bank Perkreditian Rakyat (BPR) in Indonesia) or under governmental supervision (e. g. Amanah Ikhtiar Malaysia (AIM)). It has been argued that active governmental support, including direct financial support, is critical for a viable microfinance sector[27]. Moreover, NGOs are often supported by several donors. While in 1970, NGOs relied on donor funds only in 1.5%; in developed countries the number increased to 30% in the mid-1990s. In developing countries these percentages of official funds are even higher and can reach up to 80 to 90% in Asian countries[28]. This development of relying heavily on funds is claiming decision power from the MFIs, limiting their abilities to act. It confines the incentives and efforts of employees, slows down the process of providing loans and thus limits the effect. Again, microfinance should be business not financial aid.

Overall, a successful development of a large number of MFIs since the 1980s has helped many poor people to cross the poverty line. The establishment of the Consultative Group to Assist the Poorest (CGAP)[29] in 1995, to which all major multilateral and bilateral donors have subscribed and which was initiated to assist the development of microfinance internationally, reflects the increasing acceptance of microfinance as a suitable tool for poverty alleviation. Book publications about microfinance are getting more differentiated and substantiated and are based on more experience and surveys (Hulme & Mosley 1996; Seibel 1996; Ledgerwood 1999; Robinson 1999, 2001, 2003). Discussion forums emerge on the internet (i.e. yahoo.groups) and several conferences and campaigns have discussed the role of microfinance in poverty reduction (e.g. the Bank Poor`96 in Kuala Lumpur, the US-based movement Microcredit Summit Campaign (1997)). Furthermore, the proclamation of the year "2005 as the year of microfinance" by Kofi Anan has stressed its importance.

In spite of the great success of the microfinance model, there is still scepticism about the efficiency of microcredit for poverty reduction in the long run. Khandker argues that "The appropriateness of microcredit as a tool for reducing poverty depends on local circumstances"[30]. He claims that only if poverty is the result of unemployment, low productivity and low income, credit will be a powerful human and physical capital investment instrument designed to enhance the productivity of the poor. And moreover, the success of microfinance, in the way it is practised today, seems to be limited. According to the

[27] See the discussion in: McGuire, P.B., Conroy, J.D., Thapa, G.B., "Getting the Framework Right: Policy and Regulation for Microfinance in Asia", Brisbane, 1998.
[28] Hulme, D., Edwards, M., 1997, Page 7.
[29] http://www.cgap.org/.
[30] Khandker, S.R., "Fighting Poverty with Microcredit; Experience in Bangladesh", New York, 1998, Page 1.

investigations of the German Agency for Technical Co-operation (GTZ) microfinance has not been as successful in providing financial services to the agriculture related enterprises as it has been in urban areas. This is caused by a demand for medium- and long-term loans in agro industries in contrast to the short-term loans mainly offered by MFIs.[31] To aggravate the situation, the transaction costs in rural areas are higher than in urban areas. The CGAP even suggests that MFIs actually reach fewer than 2 percent of microentrepreneurs worldwide.[32]

However, although the hardliners of microfinance promote the objective to adopt a holistic solution, Hulme argues that “MFIs virtually never work with the poorest - the mentally and physically disabled, the elderly, street children […]”. He even proclaims that the “MFI and donor hype has created the impression that microfinance is a cure for poverty.”[33] His arguments are probably based on the hot debate, which inflamed in the 1990s between two leading theories/approaches the financial systems approach and the poverty lending approach.[34]

- The financial system approach, also known as the minimalist approach, sees in institutional self-sufficiency the only way to meet the widespread client demand for convenient, suitable financial services. It is based on the assumption that there is a “single missing piece” for the enterprise growth – the access to capital. And this access to capital can be offered by a MFI. Additionally, the MFI tries to focus on a one core competitive advantage and with this to build up a comparative advantage.

- The poverty lending approach or integrated approach focuses also on the background and the circumstances of their mission. It includes a combination of financial and social services. The choice of emphasis on either one depends “on its objectives and the circumstances (demand and supply) in which it is operating”[35]. Moreover, it concentrates on reducing poverty by providing subsidized credit typically at below-market interest rates often along with complementary services such as impartment of training skills or the delivery of literacy and numeracy, health, nutrition, family planning, etc. The goal is to reach the poor, especially the extremely poor to empower themselves.

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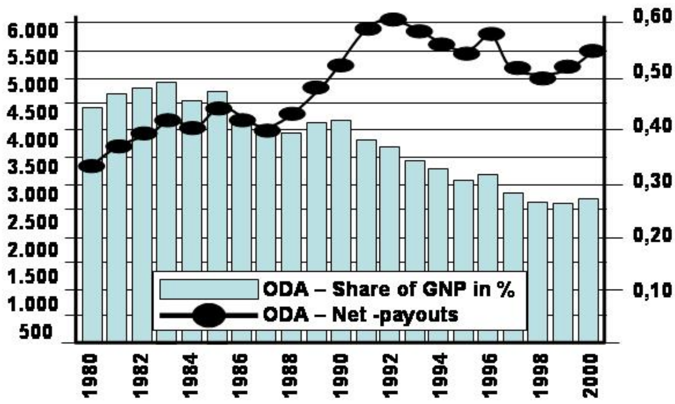
[31] Internal Newsletter of the GTZ, “Prepared for the 21st Century – Financial Systems Development and Banking Services”, “Rural and Agricultural Finance”, Eschborn, 2003.
[32] McGuire, P., Conroy, J., 2000, Page 10.
[33] Hulme, D., “Is microdept good for poor people? A note on the dark side of microfinance” in: Harper, M., “Microfinance Evolution, Achievements and Challenges“, London, 2003, Page 156.
[34] See as well: Rhyne, E., “The Yin and Yang of Microfinance: Reaching the poor and Sustainability”, MicroBanking Bulletin, 1998, Pages 6 - 8. http://www.microfinancegateway.org/download/yym.pdf, 16.07.2004.
[35] Ledgerwood, J., “Microfinance Handbook, An institutional and financial perspective”, Washington, DC, 1999, Pages 65 - 66.

"We could not separate it [humanitarian and social service] *with financial service. We work with marginal people. Empowering them does not mean to give just financial services. Financial service is only the enter point to develop their capacities and their capabilities"*[36]

On the other side, it might be irritating for the customers and difficult to differentiate between free services, aid and business.

Although there is a large number of supported NGOs (esp. Grameen Bank Replications with high repayment rates by using the poverty lending approach), the fact of the impossibility of an idealistic global solution, financed by donors and governments, is demonstrated by the latest numbers. Figure 1.1 shows the trend of a decreasing Official Development Assistance (ODA)[37] (share of Growth Net Product (GNP)) in Germany between 1980 and 2000. And Germany is slightly above the average of all Development Assistance Committee (DAC)[38] member countries (0,25 % of GNP in 2000). However, nowhere else is the decrease of bi- and multilateral financial development payouts as glaring as in the context of LDC (Low Income Development Countries), which can be seen in Figure 1.2. demonstrated on the example of Germany (1980 and 2002). The funding from donor agencies is limited and if it is the only

Figure 1.1: ODA Germany 1980 to 2000
Net payouts in million Euro and share of GNP in %



Source: German Ministry of Economic Co-operation and Development, Werkstatt e.V., in Heidel, K., "Deutschland: Immer weniger Geld für die Ärmsten – Direktinvestitionen und Handel können öffentliche Entwicklungszusammenarbeit nicht ersetzen", Page 6, edited.

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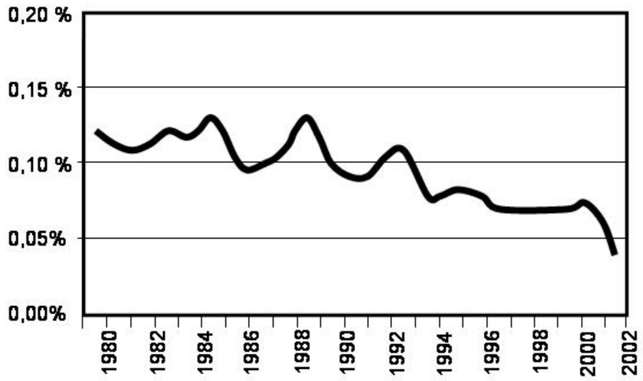
[36] Compare own survey. Questionnaire: Yayasan Siti Khadijah, Jakarta, Mai 2004.
[37] Official Development Assistance.
[38] The list of developing countries issued by the Development Assistance Committee (DAC) of the OECD was initially drawn up in 1962 to create a comprehensive systematic overview of ODA and other inputs provided by DAC members to the developing countries.
Since 1993 the DAC List has been divided into two parts:
Part I includes all recipients of ODA. The DAC designates all countries in Part I of the list as developing countries.
Pursuant to a United Nations agreement, funds equivalent to at least 0.7% of the gross national product of the respective DAC member state should be spent on ODA.
Part II of the DAC List includes all recipients of Official Aid, which is distinguished from ODA and is not counted in reaching the target of a 0.7% share of GNP as expenditure on development assistance. These include the more advanced transition countries and former developing countries which, due to their increase in per capita GNP, have been classed as HICs (High Income countries) for three consecutive years. These countries are termed "more advanced countries".

source for financial flow, the outreach and thus the effect of microfinance will be limited. Self-sufficiency and commercial sources of finance are needed.

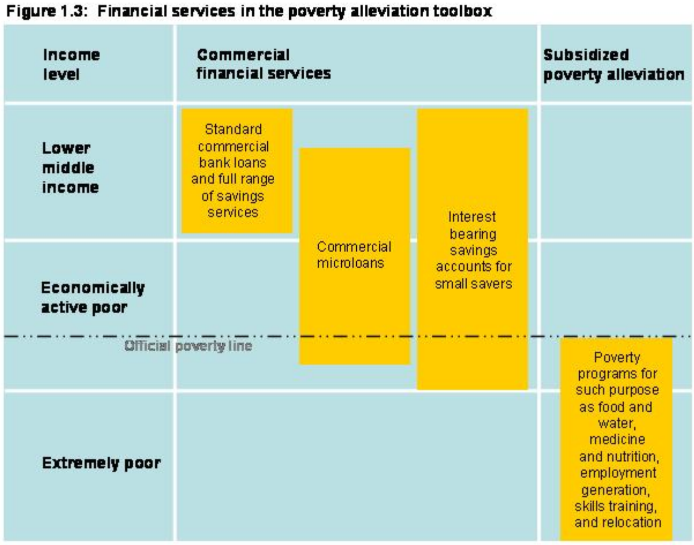
Figure 1.2: Share of the bi- and multilateral ODA – Net payouts to LDC of GNP



Source: German Ministry of Economic Co-operation and Development, Werkstatt e.V., on http://www.bmz.de/infothek/hintergrundmaterial/statistiken/stat_03h.pdf edited

Though the discussion about pros and cons is still continuing, I agree with Robinson and others about drawing a clear dividing line between Microfinance and Development Aid (Figure 1.3). Commercial microfinance is not designed for ill, malnourished and / or unskilled poor people. Starving customers would use the loans to fill their bellies or those of their children instead of establishing a business. These people need development aid and charitable contribution. "For these people, microfinance is the next step – after they are able to work."[39]

Figure 1.3: Financial services in the poverty alleviation toolbox



Source: Robinson, M.S., "The Microfinance Revolution, Vol. 1, Sustainable Finance for the Poor", Washington, DC, 2001,Page 2, edited

A further discussion of this subject can be found under the topic of microfinance as supporting economical growth or just as a reallocation of money[40]. However, I could not find any analysis regarding this issue.

[39] Robinson, M.S, 2001, Page 8.
[40] Reallocation in this context means, exampled: The habitants of one village, who would spend their money on the market in the next village, are now spending it at the neighbours' supermarket,

Summing up, microfinance seems to be a powerful tool to give poor people a chance for development especially within the participatory approach, which is being supported by many NGOs, donors and governments. Changes of the banking sector by strengthening and deregulation, the awareness of the importance of the co-operation of main players in the developing business with NGOs and its success itself were crucial driving forces that led to this success. But success always has a counterpart and being aware of the youth of this development, it is understandable that even fundamental discussions are still proceeding. But can Microfinance be profitable? Can it be sustainable?

1.4 Can microfinance be profitable?

This question is one of the most analyzed issues in microfinance and still not solved.[41] But why should it be unprofitable in the first place? As long as the supply meets a demand and risk is adequate to the possible return, there is no logical reason to doubt its success. Delivering financial services is a business that has worked in every culture and country since centuries. The differences are the methods, which are marked by trial and error, cultural influences and legal restriction. And by comparing MFIs and commercial banks it becomes obvious that the key success factors or the presupposition are the same: financial sustainability and focus on institutional viability. Sustainability refers to the extent, to which an institution, besides being viable, mobilizes its own financial resources (by equity, savings and/or reserves from profit) instead of depending on government or donor resources. Viability, on the other hand, refers in this context to covering the costs, e.g. having the loans repaid. Fact is, however, that most MFIs are operating since less than a decade[42] and are lacking experience as well as training opportunities for their staff. Still, survey reports exist that name 63 of the world's top MFIs with average return rates of 2,5 %[43] after adjusting for inflation and excluding subsidies programs. This is very impressive and can be compared to the commercial banking sector. Success depends largely on market circumstances and social norms, thus on tailored solutions as will be discussed in the following chapters. Avoiding the term “best practices[44]”, “sound practices” are ensembled in various books disregarding “that successful microfinance institutions can become successful financial

without any effect on other neighbours. Another possibility would be an economic growth: This would occur for instance when this supermarket would empower another family of this village to open a dough cake production and sell them through the supermarket. Through this production in turn, a third family could start a flour production.

[41] www.cgap.org; www.gtz.de; www.microfinancegateway.org/; www.uni-koeln.de/ew-fak/aef/; etc.

[42] Compare as well: Lianto G.M., Chua, R.T., “Transaction Costs of Lending to the Poor: A Case Study of Two Philippine Non-Governmental Organisations“, India,1996.
They determine an inverse relationship between an organisation’s transaction costs and the number of years in existence. This results, like the authors argue, from an organization’s capacity to learn and develop.
http://www.bwtp.org/publications/main.htm, 05.06.2004.

[43] http://www.microfinancegateway.org/.

[44] It is difficult to state “best practices” in such a young industry.

institutions by diversifying their services and targeting specific groups"[45]. The aim of microfinance should be to 1) realize the diversification of products and target groups and 2) the change to commercialization.

Christen (2000) mentioned competition to be the "key feature of the commercialization of microfinance"[46]. Commercialization is further defined by Poyo and Young (1999) as "the application of market-based principles to microfinance"[47] to survive in a competitive market. According to Charitonenko, Campion, and Fernando (2004), who proclaim the third critical core issue apart of viability and self sustainability in microfinance, outreach, commercialization (competition and market-based principles) would allow MFIs a "greater opportunity to fulfil their social objectives of [exposing the poor to the access] to an array of demand-driven microfinance products and services (…)"[48]

1.5 External approach

The need for regulation of economic activities is often justified as a policy instrument to minimize the effects of market failures. It has gained substantial attention recently, particularly in the course of reform measures in developing countries[49]. But are these effective means in the market of microfinance?

The financial crises in various countries in the '90s have indeed brought the issue of regulation to the forefront of financial sector reforms. But these processes are mostly very unpredictable and the success is not guaranteed e.g. the relapse of Thailand due to the effect of the bird flue. Thailand followed most advises of the IMF regarding the financial crisis in 1998, but missed some. Kieser and Woywode argue accordingly

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[45] Brandsma, J., Chauali, R., "Making Microfinance Work in the middle East and North Africa", Washington, DC, executive summary. http://www.mafhoum.com/press/54E18.pdf, 02.02.2004.
[46] Christen, R.P., "Commercialization and Mission Drift: The Transformation of Microfinance in Latin America. Consultative", Group to Assist the Poorest (CGAP), Occasional Paper, Washington, DC, No. 5, 2000, Page 21. http://www.microfinancegateway.org/content/article/detail/2589, 03.02. 2004.
[47] Poyo, J., Young, R., "Commercialization of Microfinance: A Framework for Latin America", United States Agency for International Development, Microenterprise Best Practices Project. Washington, DC, 1999, Page 47. http://www.mip.org/PDFS/MBP/Commercialization_of_Microfinance.pdf, 22.01.2004
[48] Charitonenko, S., Campion, A., Fernando, N.A., "Commercialization of Microfinance. Perspectives from the South and Southeast Asia", Page 4. http://www.adb.org/Documents/Reports/Commercialization_Microfinance/South_SE_Asia/default.asp, 03.02.2004.
[49] See: Armstrong, Cowan and Vickers, 1994 as well as Majone, 1996.

„Gestalter setzen folglich häufig Änderungsprozesse in Gang, die sie nur z. T. kontrollieren können: ihre Pläne enthalten unrealistische Annahmen, ihre Maßnahme zeitigen Konsequenzen, die sie nicht vorausahnen, ihre Maßnahmen lösen u. U. andere Probleme als diejenige, die sie ursprünglich lösen sollten usw.“.[50]

These problems are even more evident when trying to work across different nations and especially if the same principles are supposed to be used in more than one country or culture.

1.5.1 The government's role in supporting microfinance

The role of governments in intervening in the evolution of microfinance is still uncertain and heavily discussed. Even if the question whether the so called "invisible hand"[51] needs to support or regulate, is a discussion with a long history, the trend to a consensus in the literature is more obvious in developing countries than in developed economies. While statements like "government failure as a pendant to market failure" of the so-called New Political Economy or "governments may be the problem, rather than the solution"[52] are still present, the inclusion of the state authority in developing countries is necessary and successful. Basing his arguments on the experience of East Asian regulations before 1998, Stiglitz emphasises "the active role of governments in the creation and regulation of financial institutions"[53] as an example (a showcase) for successful development.

In terms of microfinance, however, the role of governments is more complicated. Feeling responsible for developing activities such as 'development finance', governments failed in their approaches over the last three to four decades. Nowadays, as microfinance is gaining in popularity, governments are tempted to use savings banks, development banks, postal savings banks, and agricultural banks to mobilize micro financial service. This motivation or promotion, which leads to the opening of possibilities in the first place, is not compatible with the regulatory goal of a sound financial system[54]. Governments see a tool in microfinance, which seems to be successful, but the questions are if they should intervene and if yes, for what are they responsible?

[50] In Kieser, A. , Woywode, M., „Evolutionstheoretische Ansätze“, in Kieser, A. „Organisations-theorien“, Stuttgart, 1999, Pages 253 - 285.
Own translation: "Consequently, formers stimulate often changing process, of which only parts are controllable: their plans include unrealistic assumptions, their suggested arrangements have unpredictable consequences and perhaps even solute other problems, which were not aimed in first place, etc…".
[51] A metaphor brought up by Adam Smith, assuming that the forces of market act in same matters like the evolutionary approach.
[52] Steinwand, D., 2001, Page 41.
[53] same.
[54] Meagher, P., "Microfinance Regulation in Developing Countries: A Comparative Review of Current Practice", Maryland, 2002, Page 11.

A review of literature on the development of microfinance enabled Fernando[55] to differ between three schools of thought on the role of the government:

- **Laissez-faire school:**
  Supporter of this school (mostly South America) assign governments to be only responsible for macroeconomic stability and leave microfinance development to non-government organizations (NGOs) and the private sector.

- **Moderate interventionist school:**
  Governments should, additionally to macroeconomic stability, provide an enabling policy environment and an essential financial infrastructure. But that does not mean this school supports direct interventions by the government in the provision of services.

- **Interventionist school:**
  Based on the postulation of failing markets and non-regarding of the microfinance market by traditional commercial banks for various reasons, this school recommends governments to play a major role in expanding the outreach to "non bankable" people including provision of services by different type of government-owned organizations. The bulk of supporters of this school are found in South Asia.

It can jauntily be agreed upon that "there appears to be a consensus among the three schools that there is a role for the government in microfinance development. However, there is no such consensus on what exactly that role should be."[56]

Providing the best practices, sound practices or standard lists, is in this literature as common as in other fields and most people who discuss the role of governments in the context of microfinance are doing so as well. The (most frequent named) schemes include improvement of policy environments and development of a legal, regulatory and supervisory framework – commonly branded as "financial infrastructure development". Regarding the frequency that these two schemes are implemented in modern microfinance compared to other schemes, the "moderate interventionist school" seems to be the most accepted one However, most of the practice lists are not transferable from country to country, and sometimes not even within countries. Several factors make adjustments unquestionable

[55] Compare: Fernando, N.A., "Do governments in Asia have a role in development of sustainable microfinance services? Some views", Manila, 2003, Page 2, http://www.adb.org/Documents/Slideshows/Microfinance/Fernando_paper.pdf, 05.04.2004.

[56] Fernando, N.A., 2003, Page 3.

critical and refer to 1) the level of macroeconomic stability, 2) the different stages of infrastructure, 3) the stage of development of the banking system, 4) the size of the potential microfinance market, 5) the stage of development of the microfinance sector itself, 6) the geographical diversity of the country, and 7) the population density, as well as 8) the ethnic and cultural mix of a country.

Moreover, it is necessary to name two more possible tasks of governments, which are not as country-dependant as the above mentioned factors and should be considered:

- **Curtail the emerging trend for re-introduction of directed credit programs**
  In recent years, these occurred again esp. in Asian countries like Indonesia and the Philippines. Although they are adjusted and improved, the consensus of the damage of those practices is still unchallenged.

- **Support ICT development in rural areas**
  Government interventions are needed to support the use of new information and communication technology in rural areas. They are crucial for sustainable institutions and the future of any possible regulations.

Prima-facie, the biggest and most successful MFIs have been and still are heavily supported by the government.[57] Examples include the Grameen Bank (since 1983) in Bangladesh with currently two million borrowers and the BRI (since the mid-80ies) in Indonesia with nowadays 22 million customers. Nevertheless, most examples are flagships of this development and can hardly been taken as a typical institution involved in providing financial services to the poor.

But, it is also true that governments "have little or no experience with implementing microfinance programs".[58] They hardly have a competitive advantage in running MFIs and when programs are set up, they are often perceived as social welfare as opposed to economic efforts. Not realizing what they are doing, some programs even grow too large. They often disburse too hastily and thoughtlessly; they collect repayments too sporadically and/or often are unwilling to be tough on defaulters[59]. Undoubtfully, political and ethnic

[57] Zeller, M., Lapenu, C., „Institutionelle Diversität im Mikrofinanz-Bereich ist gefragt. Unterschiedliche Ansätze für Arme und nicht ganz so Arme“ in „E+Z - Entwicklung und Zusammenarbeit“, No.11, Frankfurt/Main, 2000, Page 311.

[58] Ledgerwood, J., 1999 Page 14.

[59] Internal Newsletter of the GTZ, "Prepared for the 21st Century – Financial Systems Development and Banking Services", "Microfinance", Eschborn, 2003.

turmoils, short-term goals and external requirements of bilateral and multilateral co-operation do not make it easier.

Taking Malaysia as an example, this becomes obvious even though Malaysia is a relatively stable environment. The Amanah Ikthiar Malaysia[60] (AIM), a Grameen Bank replication starting as a result of the “Project Ikhtiar”, literally “Project Attempt”, was very successful in reaching out to the poorest of the poor. AIM was soon regarded as a powerful tool of poverty alleviation by the government, which has led to the integration of AIM into the national development policy, not at last because it fitted perfectly into national priorities for poverty reduction. In the Sixth Malaysian Plan (1991-1995) the government placed emphasis on poverty reduction through the “creation of the right environment for the poor to utilize their own economic potential in order to develop a self-reliant community.”[61] Therefore, AIM got an allocation of RM 20 million during the plan period. In the second half of the 1990s, the Seventh Malaysian Plan provided AIM with an allocation of RM 200 million with an additional RM 100 million in response to the economic crisis. But AIM experienced some painful detrimental consequences out of this special relationship in the mid-1990s. Like one employer stated in one of our interviews:

“If you get money from them, you have to do what they want“[62]

In return for providing assistance the government asked AIM to take their objectives into consideration as well. Yet, as soon as AIM accepted the funds, it became subject to certain expectations from the government and in the end a hostile take-over came along. The management was changed and the positions were filled with government people. This was the most threatening influence imaginable on each single part of the organization with major detrimental implication for the outcome of the work and therefore for the life of the poorest of the poor. The focus shifted from the poor, to the better-offs or “not-so-poor” with a blatant disregard of the Grameen Principles. The goals of the government stated target lines for the outreach; reputation and special target groups were heavily followed by new methods and products. Nowadays, the portfolio at risk (PAR – an indicator for repayment quota) of the new introduced products like SKIT and SPIN[63] is around 81% and 91%. Moreover, these

[60] Nowadays AIM is one of the oldest and one of the largest Grameen Bank replications in Asia.
[61] Government of Malaysia, “Sixth Malaysia Plan 1991-1995”, Kuala Lumpur, 1991, Page 44.
[62] Compare own survey. Interview: Amanah Ikhtiar Malaysia, Kuala Lumpur, 10.02.2004.
[63] SKIT is a single-mother scheme. SPIN a fishermen loan program. Both were targeted financial supports, sponsored by the government channelled through AIM, which did not put the usual requirements or restrictions on the behalf of the borrowers. Sometimes it was even “free” money. The programme particularly aimed to help fishermen and single mothers with bigger amounts of loans than usual, (worth up to RM 10,000 in comparison to the much smaller sum of RM 1,000 for the usual “first loan”) with a fairly high interest rate of 19%. Simultaneously, the

repayment problems (a high PAR) affected most of the other products as well, since borrowers did not understand why they should pay back their loans, if other defaulters did not without experiencing any consequences. Today AIM is back in the hands of its founder and relatively independent of the Malaysian government in terms of decision-making. But still, they are not allowed to take deposits, are full financed by the government and have to follow a credit ceiling of 4% annual, with which sustainability is almost impossible. Even though, their success is impressive.

Anyhow, to improve the enabling policy environment, to develop a legal, regulatory and supervisory framework and to eliminate provision of directed credit at subsidized interest rates, new methods have to be found. In some countries, first steps are made in terms of policy environments, legal frameworks and subsidized interest rates. However, the main factor remains mostly unanswered: Regulation and Supervision.

1.5.2 Regulation and supervision

The nature of a contract between two parties always provides windows for opportunistic behaviour for at least one actor. This issue is based on an asymmetric distribution of information[64] between a principal (p) and an agent (a). In the case of a contract between a financial organisation (a) and a depositor (p) the opportunistic behaviour would probably be found on the side of the financial institution. The organisation, which acts in order of the depositor, has different goals, which can lead to action that is suboptimal for the depositor. Furthermore, by working with the capital of their clients, the financial organisation has another attitude to risk and even moral hazards[65] are possible. Financial institutions are responsible for maximizing "the mobilization and intermediation of funds, ensure appropriate risk management and to enhance efficiency in the allocation of capital"[66] and thus protecting the savings of clients and shifting the cost structure in the direction of the institutions. Hellmann, Murdock and Stiglitz stated accordingly that

repayment was not so important, as the government had enough money to spend on these programmes.

[64] This problem is analyzed in the Principal Agent Theory. The Principal Agent Theory postulates that a risk-neutral principal gives an incline-risk taking agent certain orders and rights to act in his interest. By that the principal improves his results by using the specialised manpower and the information advantage of the agent. But on the other side he increases the risk by less knowledge about the incentives of the agent – there can be a large clash between the interest of the principal and the agent. It will be further discussed in Chapter 4.

[65] The moral hazard argument is often used to argue against the forgiveness of legally contracted debt; it has also been used to criticize IMF rescue packages, which bail out reckless bankers and private investors.

[66] Meagher, P., 2002, Page 2.

"Financial market liberalization increases competition; competition erodes profits; lower profits imply lower franchise values (i.e. the capitalized value of expected future profits); and lower franchise values lower incentives for making good loans – increasing the moral hazard problem. With sufficient competition banks will find it desirable to gamble. There is thus an inconsistency of interest rate liberalization and prudential bank behavior."[67]

Furthermore, especially in a liberalized, competitive market scenario, other institutions would be forced to adapt the inappropriate actions of one institution, like, for example, extremely high interest rates[68] or gambling[69], which eventually leads to an excessive risk of market failure. In the same way the failure of one institution can lead to panic within the system and could affect even the most prudent institution. Thus regulation and supervision seems justified. The financial system as a whole could be in danger through the consequences[70] of the opportunistic behaviour of a single institution. Nevertheless, one has to relativise the problematic according to its importance. The fact of the unimportance of the microfinance sector for the financial system of a country, which is often stated in the literature as argumentation against regulation, is not the core of the matter. As long as the development of microfinance is still in fledging stages, the importance is limited to the financial system of the microfinance market itself – the financial markets will stay untouched. In the microfinance market, however, it is critical! Moreover, the attraction of equity investment and the long-term implementation in the general financial system with access to financial markets is still the overall goal. Besides, microfinance institutions operate in very limited local areas and bankruptcy of an institution will likely threaten other local markets.

Nevertheless, one can take a comparative point of view between both – the financial and the microfinance – markets. In the last decade, a couple of changes in prudential regulation in the banking system in general became obvious:

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[67] Hellmann, T.F., Murdock, K.C., Stiglitz, J.E., "Liberalization, Moral Hazard in Banking, and Prudential Regulation: Are Capital Requirements Enough?", American Economic Review, Page 2,
http://faculty-gsb.stanford.edu/hellmann/pdfs/aerpaper.pdf, 15.06.2004.

[68] A typical example for this are the habits of pawnbroker and money lenders.

[69] The head of AIM in the 1990ies gambled with the money of AIM on financial markets and lost everything in the South-East Asian Financial market crises. When they uncovered the truth, the government made him fully responsible for his action. But this is in many countries not possible, caused be the weakness of police and court. For instance in Indonesia it happens not very seldom that a director of an institutions vanishes with the money and moves just to another island.

[70] So-called "spill over effects".

- Greater emphasis has been placed on monitoring banks' risk management systems;[71]
- Interest rates have been deregulated;
- Restrictions on the asset choices of banks have been lifted;
- Greater emphasis is put on capital requirements, typically using the BIS standards of the Basle Accord.

These trends will probably be projected on the regulation of the microfinance market, even if in the context of developing countries some obstacles occur, which have to be considered. Some of these issues are the high unit costs of lending, the need for alternative collaterals, the necessity of local branch locations, the relatively undiversified and sometimes unpredictable nature of MFI credit portfolios, the fact that most MFIs began as unregulated credit NGOs with a focus on social goals rather than financial accountability and sustainability, the market risks with the especially high potential for moral hazards and not at least the ethnic or religious particularities in many countries.

Besides, one has to consider that statutory regulation of MFIs involves substantial efforts and costs for both the regulators and the regulated MFIs (e.g. heavy investment in improved data collection and reporting). The limitations on the part of the supervisory agencies are marked by the lack of infrastructure and qualification of staff up to the inadequate resources of the agencies. On the part of the MFIs the most critical grievances are the lack of information systems, the low level of communication between MFIs, and again the lack of qualifications of staff. After finding, based on an international survey conducted by the 'Sustainable Banking with the poor' (1996) that most MFIs have no accurate accounting system, the authors asked:

> *"If some managers of microfinance institutions are unable to answer questions about their own costs and arrears without the help of outside experts, how can they be expected to run sustainable financial institutions"?*[72]

The Asian Development Bank underlined that it is critical to find a way to improve the "standards of the large numbers of MFIs that are not currently operating on a sound basis, while at the same time avoiding restrictions that impair their efficiency or effectiveness and meanwhile encourage them to be innovative"[73] The message is clear. Many believe it is more important to strengthen the capacity rather than to try to regulate what you hardly can

[71] The monitoring of every single transaction is too difficult, caused by the increasing complexity.
[72] McGuire, P., Conroy, J., 2000, Page 49.
[73] Same.

supervise. Anyway, putting capacity in the foreground does not imply neglecting the regulation and many countries have already started to review their legal and regulatory framework.

1.5.2.1 Prudential regulation and supervision

One differs between prudential or the non-prudential regulations. Prudential regulation and supervision is a set of general principles that cover accounting policies and standards of financial structure. They aim mostly at the protection of the general security of the financial sector as well as the savings of mainly small depositors. The idea is to “create an alternative institutional type that allows sound financial NGOs, credit unions, and other community-based intermediaries to obtain a license to offer deposit services to the general public and obtain funds through apex organizations”.[74] Most authors in the literature suggest that prudential regulations should only target MFIs that hold savings of a certain threshold. Compulsory savings, which are often used as a an alternative for collateral, do not count here. MFIs that do not reach the threshold should not be permitted to mobilize public deposits. This is seen as an acceptable compromise between cons and pros.

1.5.2.2 Non-prudential regulation and supervision

Non-prudential regulations include: Tax treatments or the protection of borrowers, business practices, codes of behaviour and performance monitoring, ownership and control and publication of financial statements in MFIs. It is generally acknowledged that this should not be disclosed to the state and with this to the central bank. Many countries set up apex facilities or second tier organisations to monitor the regulations, but most are not very successful[75]. The discussion is still continuing. The GTZ, for example, stated in one of their latest drafts about microfinance, that “successful apex organizations in microfinance tend to be built on the backs of successful MFIs, not the other way around“[76].

Another approach becomes obvious in the establishment of independent credit rating agency like Microfinance Association[77] (MFAs). They rate MFIs according to pre-established performance standards. By publishing these ratings for clients, competitors and even donors and second tier agencies, they provide a powerful tool for MFI compliance. They can take the

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[74] Schliwa, R., “GTZ Microfinance Operations”, An Update (Draft), Division 41, Economic Development and Employment Promotion, Eschborn, 2003, Pages 7.

[75] McGuire, P., Conroy, J., 2000, Page 61.

[76] GTZ Microfinance Operations, An Update (Draft), Division 41, Economic Development and Employment Promotion, Eschborn, 2003, 6.

[77] A whole series of studies by the GTZ on eight microfinance associations in Africa shows that these still young institutions make important contributions to the development of the national microfinance sector.
GTZ Microfinance Operations, An Update (Draft), 2003, 7.

ratings as indicators for a possible co-operation or partnership. This would be enough to regulate and supervise the rating organisations and the second tier organisations, where they may channel government financial resources.

A last approach that accrues in some theories is the possibility of special laws under a special regulatory framework or perhaps a regulatory “stamp of approval”, but most authors dissuade this approach.

It is not within the scope of this work to discuss and compare sound practices in regulation and supervision of MFIs[78]. All in all, I want to emphasize that the appropriate and consistent frameworks and practices tend to be country specific, and institutional arrangements developed for one country may not be directly or effectively applicable to others. In this context, I want to refer to further literature such as the book “Getting the framework right” by Paul B. McGuire, John D. Conroy and Ganesh B. Thapa (1998) and the already twice adduced paper “Microfinance Regulation in Developing Countries: A Comparative Review of Current Practice” by Patrick Meagher (2002), which both include a couple of case studies.

In the context of regulation and supervision a new field of consultancy emerged concerning the development and implementation of national and sectorial strategies for microfinance systems. Here, of course the legal authorities and especially the central bank plays an important coordinating role.

1.6 Prospect and outlook

The success of the co-operation between the MFI and the client depends on many forces as outlined above. Chapter one has illustrated the development of microfinance and why microfinance can and is actually working in so many countries. The aim was to build up a comprehension of the difficulties in the developing aid and to show that microfinance can be used as a tool to stimulate a decentralized economical growth from the grass-roots level throughout many developing countries. However, by discussing microfinance it becomes obvious, that neither the initiative of the clients that fight against their own poverty, nor the advantage of “being at the point of sale” nor the use of typical instruments by the MFI is enough for the success. MFIs have also to be sustainable. They have to diversify their products and to promote With more experience and success, businesses and products will attract more imitators, which increase the competition. And rivalry is already intense in many

[78] For readers looking for in-depth information I want to refer to Christen and Rosenberg (1999), Gonzalez-Vega (1998), Rhyne, (2001), Van Greuning et al (1999) and Cracknell (2000).

urban areas[79]. Thus, like convenient products, financial products have to be assimilated to local needs and customs. Consequently MFIs have to diversify. The developing aid has always tried to project the principles that worked successfully in one country to another one, but that usually failed. [80] This fact is even more obvious when regarding the role of governments within this discussion. Part of the first chapter emphasises the importance of governments as well as the regulation and supervision by governments. Solutions have to be found to give microfinance a chance to develop effectively. Attitudes of certain people concerning the role of the government are based on the different experience and surveys that were conducted in certain country and culture groups. Social norms in developing countries are much more determined by the day-to-day life and influence all sides – clients, institutes and governments – in many ways, especially in regard to religion.

Religion influences cultures stronger than anything else and makes it necessary to adjust products, development aid and even political approaches. The development of microfinance seems to have ignored this influence so far and makes this typical ”one for all” mistake as well. It is just concerned about regional cultures, and takes no notice that religion influences cultures within and across geographical borders and thus is not limited to regional boarders. Religion sets norms, values, habits and traditions. It is the back up for many poor people to handle the poverty and to infringe against their religion, is in many cases unimaginable. In my analysis in chapter four I focus on religion in the light of microfinance and adjust the products to the social norms of the Islam. The Islam is the world's fastest growing religion and will soon be the largest in the world. The Islam is widespread; much represented in developing countries and thus represents a big group of potential borrowers, which are not yet able to take part in the development of microfinance. Taking into account their number it is beyond comprehension that this demand has not yet found supply[81]. In fact it is not only the diversity, which could be a way to be profitable and sustainable, that should encourage practitioners to provide Islamic financial products. If microfinance is seen as a tool for developing aid, it is also the right for equality which is included in the constitutions of almost every country, that should force the provision of Islamic Microfinance. “Why should Muslims be excluded from this revolution?” The answer is that MFIs are working with interests and those are forbidden in the Islam.

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[79] Compare own survey: in esp. BKRS.
[80] There are e.g. still structural paper programs which are trying to interfere with the same basic ideologies in all countries.
[81] Compare various author’s like:
Timberg, T.A., “Islamic Banking in Indonesia”, Jakarta, 1999,
and, “Risk Management: Islamic Financial Policies”, Arlington, 2003,
Association for Creation of Employment, Conference and workshop report on “Islamic modes of financing”, Peshawar, 2000.

But before I can provide a solution, a basic understanding of microfinance and the Islam needs to be achieved. So far, I explained the principles of microfinance and took a closer look at the problems and lacks, which it is facing. In the second and third chapter, I describe the Islam to elucidate the basic principles of a Muslim's day-to-day life. I will especially point out the aspects that determine the "model of man". The "model of man" one faces when working with devout Muslims in the banking sector, is different compared to standard "models of man", which are usual in western theories. Furthermore, I will explain products that conform to their philosophy and compare them with western financial products for a better understanding. In chapter four, I will implement these products in the field of microfinance in order to provide the access of financial services to a broader target group, including Muslims along the poverty line.

"I do support the partners and hold together
their business so long as they are God-fearing
and faithful to one another.
I would, however, pull out as soon
as they start to deceive one another,
and their business collapses."[82]

Chapter 2 The basic principles of the Islam

To be a Muslim in our century means to choose between two different worlds. A Muslim has to decide either to rely on inherited values, manners, habits and instruments or to take part in innovations of the industrialized world. It has become a quest of authenticity to be a Muslim. In this quest, the Islam forms a new language, even if the intellectuals will still debate for years how a Muslim society in the 20th or 21st century should look like.[83]

2.1 A new language?

Islam is the world's fastest growing religion and will soon be the largest of the world, with a current figure of more than one billion believers. These 1.2 billion Muslims make up almost one quarter of the world's population, and are not just concentrated in Egypt, Iraq, Iran, Syria and Saudi Arabia, the traditional heartlands of the Islam, anymore. With 178 million Muslims, there are already more Muslims in Indonesia than in the traditional heartland. But also in America the adherents of Islam are more numerous than the Episcopalians. Given the large number of adherents in every corner of the world, it is no surprise that Muslims embody a broad and diverse spectrum of positions with respect to liberalism and democracy. Some reformers reinterpret Islamic traditions in support of elective forms of government. Others are secularists, who fight for a clear separation of religion and politics. Still there are others that reject democracy entirely. Heavy media coverage on TV and discussions in magazines and newspapers about the Islamic dispute and irregularity, means to always be confronted with the same questions:

- Why does the Middle East have so many issues with undemocratic forms of government that emphasize little on pluralism and human rights? Especially, since such concepts have always been supported more in the Islam than in other religions.

[82] Abod, S.G.S., Agil, S.O.S., Ghazali, H.A., "An introduction to Islamic Finance", Kuala Lumpur, 1992, Page 1.
[83] Compare: Wissenschaftlicher Bereit, BMZ, „Handbuch für Internationale Zusammenarbeit", Lieferung 328, Baden-Baden, 1994, II A 12 58, Pages 1 - 8.

- Should one overturn centuries of wisdom because a few Western Muslims publish/ believe in new interpretations of Islam?
- Are some of the ideas in the Islam simply outdated today, such as the draconian punishments, *Riba* or the legal position of women?

These questions provide a clear picture of the attitude towards the Islam and general misunderstandings. They demonstrate how the Islam is perceived by the outside world based on practices, subjective interpretations and above all the abuse of Islamic principals.

> *"O people, listen to me in earnest, worship Allah, say your five daily prayers, fast during the month of Ramadhan, and give your wealth in Zakat. Perform Hajj if you can afford to. All mankind is from Adam and Eve, an Arab has no superiority over a non-Arab, nor a non-Arab has any superiority over an Arab; also a white has no superiority over a black, nor a black has any superiority over a white except by piety and good action. Learn that every Muslim is the brother of another Muslim, and that Muslims constitute one brotherhood. Nothing shall be legitimate to a Muslim that belongs to a fellow Muslim unless it was given freely and willingly. Do not, therefore, do injustice to yourselves. Remember, one day you will appear before Allah and answer for your deeds. So beware, do not stray from the path of righteous-ness after I am gone."*[84]

A historical analysis shows the importance of an individual, reasonable and practical interpretation of the Qu'ran and the Sunnah by Muslim scholars (predominantly male). The Sunnah is the second most important root of Islamic jurisprudence after the Qu'ran. The *Shari'ah*, based on the Qu'ran and the Sunnah, is an extensive system of justice and values. It should help to build clarity and stability in a situation of increasing complexity for Muslims. Closing the gap between morality and justice, the combination of legality and legitimacy is possible in her. The *Shari'ah* is thought to be the only way to disengage the alienation, the colonialism and the neo-colonialism and thus find authenticity and identity for Muslims. To make it short: the *Shari'ah* determines the relationship between Allah and human beings as well as the inter-human relationships. She features unity and uniqueness. She is identical with "system"[85]. The subjective interpretations of *Shari'ah*, which are renewed almost every couple of decades, and the gap between the ways she was practiced in the past compared to today, raises problems and misunderstandings. Consequently, this issue discourages hope and expectations of many coeval Muslims, male and female, to build one conjunct

[84] Prophet Muhammad's (SAWS) Last Sermon, this sermon was delivered on the ninth Day of *Dhul-Hijjah* 10 A. H, (632 A.D.) in the 'Uranah Valley of Mount Arafat' in Mecca.

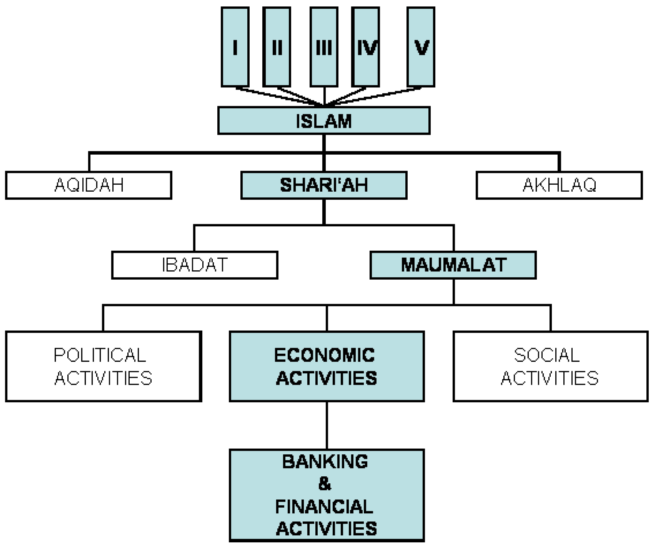
[85] Compare: Wissenschaftlicher Bereit, BMZ, „Handbuch für Internationale Zusammenarbeit", Lieferung 328, Baden-Baden, 1994, II 72, Page 3.

Muslim society based on the *Shari'ah*. But if modernity is not found within the own traditional culture, development must take place at the expense of one's own identity.

2.2 Al-islam din wa-daula[86]

The Islam does not only determine the relationship between humans and Allah – the so-called *IBADAT* – but the Islam is society, values and order[87]. According to figure 2.1 the Islam defines three spheres: the *AQIDAH* (the belief, a statement of faith, a creed), the *AKHLAQ* (a concept of ethics – a combination between pre-Islamic virtues and later Islamic development) and the *SHARI'AH* (the Islamic law). Living as a devout Muslim can be summed up in five simple rules, the so-called Five Pillars of Islam: Belief (affirmation of the God's oneness and the central role of the Prophet), worship (Muslims believe that the five times per day repeated call to prayer by the human voice distinguishes Islam from Judaism, which uses the *shofar*, or ram's horn, and Christianity, which uses the bell), fasting (during the month of Ramadan; in the ninth month of the Islamic calendar, a Muslim has to abstain from drink, food, smoking as well as sex between sunrise and sunset), almsgiving (the *Zakat;* Muslims are supposed to donate a fixed amount of their property to charity every year), and pilgrimage (a pilgrimage to Mecca that has to be conducted at least once in a Muslim's lifetime; with the completed pilgrimage a Muslim earns the title known as *hajj* in Arabic, which is a title of great respect).

Figure 2.1: The relationship between the banking system and religion within Islam



Source: Haron, S., Shanmugam, B., Islamic Banking System Concepts & Applications, Petaling, 1997, page 69.

The presence of Allah is omnipresent. Being Muslim demands to follow the epiphany of Allah in all affairs, which also includes the rules and regulations that govern the day-to-day life. Within the *Shari'ah* the *MUAMALAT* covers man-to-man relationships. It is separated in political, economical and social activities. Consequently, the compliance with the *Shari'ah* is

[86] In Arabic: "The Islam is religion and state",
further readings: Khan, M S., Islamic interest-free banking: A Theoretical Analysis, IMF Staff Papers, Vol. 33, No. 1, Washington, DC,1986. Pages. 1-25. The forbids esp. Pages. 4 - 6.

[87] Haron, S., Shanmugam, B., Islamic Banking System Concepts & Applications, Petaling, 1997, pages 69 - 71.

a criterion of devoutness. Moreover, it establishes the social and political system. This conclusion has consequences for all Muslims, even if they are farmers in Indonesia, bankers in the UK or members of the Hizballah, the AMAL, or of the Jamaat-I Islami. For all Muslims, a state is only a constitutional state when it is based on the principals of *Shari'ah*.

If a nation, however, invokes the Islam to the state religion and the *Shari'ah* to the only or main source of legislation, it does not necessarily mean that all traditional norms are implemented. Almost everywhere, a mix of new and old methods can be found. Still, many international development agencies and authors of western literature are concerned with the interdependency of the *Shari'ah* and the development, especially in regard to economic development.

Nonetheless, this appraisal might be overhasty. Contemporary concepts of an Islamic economy are not at all obstructive. They just work differently as we will see in the following chapters.

2.3 The Islam and economy

The economic values of the *Shari'ah* can be separated into a micro and a macro perspective. The macro perspective emphasizes a "real contribution to social welfare through the implementation of several norms"[88]. These norms are:

- **Al-Zakat** (the 4th pillar of Islam),
- the prohibition of taking interests (**Al-Riba**)
- the prohibition of unproductive speculation[89] or unearned income (**Al-Maysir**) as well as gambling (**Al-Qimar)**.
- Freedom from excessive uncertainty **(Al-Gharar)**

The micro perspective emphasizes integrity and prudentially of trade with the following norms

- **Al-Shiddiq** - be aware of high morality
- **Al-Amanah** - trust, honesty

[88] Bank Indonesia, "The Blueprint of Islamic banking development in Indonesia", Jakarta, 2003, Page 9.

[89] It should be noted that the term "speculation" has different association. Speculation means an attempt to predict the future. The process may or may not be based on collection, analysis and interpretation of relevant information. The former case is very much in conformity with Islamic rationality. Under the principles of *Shari'ah*, it is required to assume risk after making a proper estimation of risk using information. In this sense all business decisions involve speculation. "It is only the gross absence of value-relevant information or conditions of excessive uncertainty that makes speculation akin to a game of chance and hence, forbidden."

- **Al-Fathana** - provide service always with manners (***Ru'ayah***) and sincerity (***Mas'uliyah***)
- **Al-Tabligh** - socialize and educate the public about *Shari'ah* principles, products, services and also the benefits to be gained)
- **Being free of Al-Gharar** - all contracts and transactions must be free from excessive uncertainty

If one takes a closer look at these rules, only the prohibition of *Riba* may hamper trade and with this economic growth:

> *"Allah has forbidden you to take interest, therefore, all interest obligation shall henceforth be waived"*[90]

The Islamic restriction against taking interests is as old and similar to the former prohibition of taking interests for Christians before the Renaissance. Usury laws that prohibited the collection of interests were strongly enforced in medieval Europe by the Roman Catholic Church.[91] Led by bankers such as the Medici, methods were invented to circumvent these laws (e.g. the "bills of exchange"[92]). Similarly, in latter years many Muslims, especially traders have "simply ignored the strictures against interests or argued that they did not apply to commercial as distinguished from personal transactions."[93] On the other hand, especially in Islam orientated countries, many traditional Muslims refused to engage in transactions involving interests. But like everyone else, Muslims still like to save money and to protect themselves from external and unprecedented shocks. They need to keep up with inflation and invest in ways that will offer them a steady return and/or meet other financial needs. Moreover, Muslims also like to expand their companies, build new plants and accommodate working capital needs. In fact, most Muslims living in Western civilisations had no other choice than ignoring the prohibition of Riba if they wanted to hold up with others. In many developing countries many devout Muslim traders and manufacturers tried to raise their own money to avoid transactions with banks[94]. Generally, families and friends help each other out

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[90] Association for Creation of Employment, Peshawar, 2000, Page 1.
[91] Knowledge Wharton, "Islamic Banking Comes of Age - But What's Next?", Philadelphia, 2004. http://knowledge.wharton.upenn.edu/index.cfm?fa=viewArticle&id=944, 18.03.2004.
[92] (,which allowed money to be received with credit for travel time to destinations around Europe.)
[93] Timberg, T.A., Jakarta, 1999", Page 2.
[94] Gallardo, F., "Credit lack ails Mindanao's small traders" in "MindaNews", Davao City, 6.11.2003, Page 3, www.mindanews.com.

by being informal moneylenders. The access to financial funds stayed limited, however, especially in developing countries. Anyhow, history seems to repeat itself and the Islamic bank development is thus immersed in its own Renaissance. Over the last 30 years, a development of Islamic financial institutions emerged using financial instruments that are accepted by the Islamic religious authorities.

2.4. The emergence of Islamic banking

In the middle of the 1960s, the German Dr. Achmaed Elnagger developed a new finance system in Egypt. The motto was "Saving without interest" and the idea tailored to reach middle and low-income people. Instead of taking interests, the bank gave them access to free loans. In the cases of social emergency, people could get loans of a so-called "*Zakat*[95] fund". Unfortunately, his experiment was so successful with 200.000 farmers participating relatively fast that a couple of years later the government Nasser took over and transformed the initiative into a state owned bank. The effect was the breakdown of the movement. Anyway, Elnagger's idea was reintroduced with slightly adjusted goals towards a more business like approach and a wealthier target group by Muslims in Iran, Iraq and Saudi-Arabia in the 70ties. In 1973, seven Arabian nations even installed the Islamic Development Bank to promote economic development, regional trade and Islamic financial markets. The 1975 established copy of the World Bank provides short and long term loans as well as equity financing for productive loans and equity financing for productive projects. It also offers trade deals, which are usually co-financed by commercial banks or other lenders. Today, the institution has 55 member states. "It was part of a development strategy for financial markets"[96] explained Wharton finance Professor N. Bulent Gultekin, the quondam head of Turkey's Privatization and Housing department and later a governor of Turkey's central bank. Further he explained that there "was concern that many people didn't use banks or financial services because interest was prohibited"[97]. Subsequently, after an initial rush of people depositing money in Saudi Arabia and the Gulf States, Dr. Sami Homoud, a pioneer of modern Islamic banking and former Jordan Islamic Bank General Manager of the Bahrain-based Al Baraka Islamic Investment bank, stated in an interview that "60 % of the deposits came from people who did not use the banking system before" [98]. The main difference of the convenient and Islamic banking system is the replacement of *Riba* through the Profit-and-Loss Sharing (PLS) system. As mentioned earlier, the *Shari'ah* prohibits the payment (or receipt) of a fixed, predetermined return of money if no risks are involved. On

[95] the 4th pillar – see page 28.
[96] Knowledge Wharton, 2004., 18.03.2004.
[97] same.
[98] Khouri, R.G., "Islamic Banking: Knotting a New Network" in "ARAMCO WORLD MAGAZIN, Vol 38, No. 3, Houston, 1987 Page 20.

the other side, the *Shari'ah* does allow and even encourages an uncertain rate of return, because this might be positive (profit) or negative (loss). The Qu'ran does not allow that one can increase his stock without any risk or work.[99] Thus, in the PLS system, the bank and the defaulter or the depositor agree on a partnership, which is mostly very similar to joint ventures or venture capital. The success of financial institutions, which are based on a free-interest system, is very impressive. Not only that the Iran, Sudan and Pakistan have legally required their entire banking system to introduce Islamic financial practices, six of the top 30 world banks are now based on *Shari'ah* principles. One example is the Faisal Islamic Bank of Egypt, which nowadays boast total assets of more the US$ 2, 27 billion. Most of the 1,200,000 customers are small savers with a few hundred or thousand dollars that they previously had kept at home. There are also two US stock funds, the Amana Growth Fund (AMAGX) and the Amana Income Fund (AMANX), with a very good performance. Both avoid investments in the financial sector or in companies whose primary business involves pork, prostitution, alcohol and gambling[100]. Moreover, the international *Shari'ah* banking community is presently working on two projects: first on the establishment of an international financial market and second on the establishment of the Islamic Financial Services Organization, an international institution whose main objective it will be to issue prudential regulations for *Shari'ah* banks.[101]The latter is in preparation by 18 member countries of the International Monetary Fund (IMF).

2.5. Islamic banking to microfinance

Regarding this enormous development, especially in reaching so many people that had never seen a bank from the inside, many facts point to a possible projection of Islamic banking principles onto the development of microfinance. However, this should not be seen as the only reason to encourage Islamic Microfinance. Nor would it be enough to justify an implementation by explaining that the root of Islamic banking is basically the same as the root of microfinance and thus the step to Islamic Microfinance is very small. There are other facts, I want to point out again:

Development is all about giving choices and alternatives[102]:

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[99] Darrat, A.F, "Islamic Banking: an outline of some conceptual and empirical aspects" in "Savings and development", No. 2, Orambling, 1990, Page 187.

[100] Boss, S.J., "Overcoming The Cost of Being Muslim", New York, 2000, http://www.forbes.com/2000/09/21/0921pfinance.html, 26.03.2004.

[101] Asian Development Bank, "Commercialisation of Microfinance. Conduciveness of the operating environment", 2003, Page 27, www.adb.org/Documents/Reports/Commercialization_Microfinance/PHI/chapter_03.pdf, 22.03.2004.

[102] Association for Creation of Employment, 2000, Page 9.

1) Although one can find MFIs in almost all parts of the world, they cannot work on the same principles. They have to be adjusted to cultures, norms and ethics. "[…] some areas/regions work especially hard to adapt certain basic microfinance tenets to their own unique circumstances"[103]
2) The potential demand for "microfinancial service" in developing countries is according to international sources, covered only to a maximum of 3%.
3) A large percentage of all humans living below the poverty line are Muslims.
4) Traditions, habits and values in developing countries are more important for the day-to-day life than in developed countries. Religion in poor areas, esp. in rural areas is more fundamental and orthodox than in those areas that are richer. This is not only limited to the Islam, but also to Hinduism and Christianity.
5) It could be more profitable to work on the PLS basis than working according to the traditional system, if one could reduce the accompanying risk.
6) The surveys that analysed this issue (e.g. a survey of the Bank Indonesia), underline the high demand for Islamic banking esp. in low and middle-income societies[104].

Social, economic and religious restrictions have often led to creative ways, and indeed, Islamic banking is one of those.

Providing financial services, which conforms to the Islam, would enable millions of poor people to take part in the revolution of microfinance, to exploits its benefits and to escape poverty. I will discuss next if the principles of *Shari'ah* cannot be tailored somehow to the needs and obstacles of microfinance, where stewardship is to be shared and trust is critical.

[103] Al-ZamZami, Grace, L., "Islamic Banking Principles Applied to Microfinance. Case Study: Hodeidah Microfinance Programme, Yemen", UNCDF, http://www.uncdf.org/english/microfinance/reports/thematic_papers/islamic_banking/main_text.html, 01.05.2004.
[104] Ibrahim, M., 2004, Page 13 - 14.

Chapter 3 Islamic Banking

Before a projection of Islamic banking principles on microfinance can take place, differences between commercial banks and Islamic banks should be explained. According to the outline presented above, Islamic banking needs to achieve a balance between maximization of profit, serving the community, fostering economic welfare of people, and the development of human resources based on Islamic values. Suleiman wrote that “any person approaching an Islamic bank should be given the impression that he is entering a sacred place to perform a religious ritual, that is the use and employment of capital for what is acceptable and satisfactory to God, the Almighty.”[105] Realistically speaking, the differences between a commercial bank and an Islamic bank are not that big. The fact that Islamic Banks need to avoid interest rates does not mean they revolutionize the principles under which banks operate. Both types of institutions have to keep the same three guidelines in mind:

1) Profitability – to provide more loans
2) Safety – to provide quality loans
3) Liquidity – to provide short term loans

Nevertheless, the Islamic bank is based more on certain economic and above all philosophical principles than commercial banks. The aim is not profit alone as we will see in the following chapter.

3.1 Wealth is just material

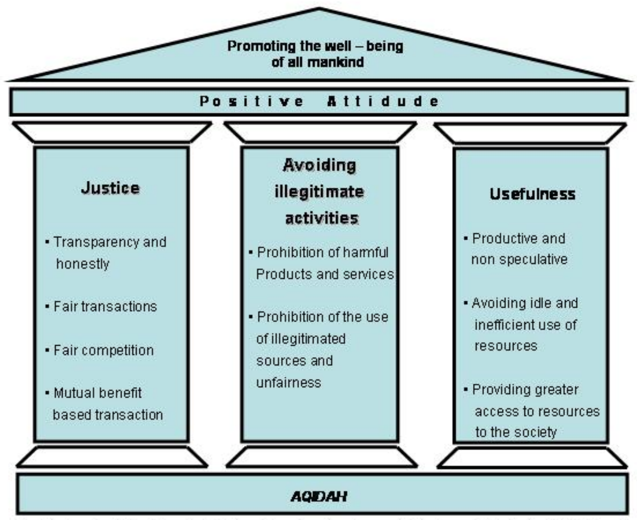
Figure 3.1 illustrates the principal goal of the Muslim economy: *Falah*. *Falah* – “promoting the well-being of all mankind” – is based on all macro and micro perspectives of the *Shari’ah* represented in the principals ‘justice’, ‘avoiding illegitimate activities’ and, ‘usefulness’. Moreover, *Falah* shows the importance of all macro and micro perspectives for the intense commitment of the Islam to brotherhood and justice.

This is understandable in the light of the philosophical principle that claims God to be “the Creator and Ultimate Owner of the Universe and man, on earth, is His vicegerent”[106] and on which Islamic banking is build. It is their creed and faith. *AQIDAH.* Wealth belongs to Allah and mankind is only, individually and/or collectively, the custodian. The importance of the *Amanah* (or trust/responsibility) concept in the Islam is just one indicator that money and property are social tools to achieve social goals. Thus, the economic system has to eliminate

[105] Suleiman, N.M., „Corporate governance in Islamic banks“, Manama, 1990, Page 42.
[106] Al-Harran, S.,”Time for Long-Term Islamic Financing”, in Islamic-Microfinance.com, http://www.islamic-finance.net/islamic%2Dmicrofinance/harran1.html, 03.04.2004.

Exploitation. In particular, injustice is to be eliminated. Otherwise it would be able for a financier to be assured of a positive return and materialising profit without the investment of real work or at least the potential of losing something, while the entrepreneur who invests management skills and work, is not assured of such a positive return.[107] Therefore, the Islamic principals demand justice between the financier and entrepreneur.

Figure 3.1: Perspective of Shari'ah principles on economies



Source: Bank Indonesia, "The Blueprint of Islamic banking development in Indonesia", Jakarta, 2003, Page 8., edited

This philosophical principle is the bases for three columns: 1) the principle of justice, 2) avoiding illegitimate activities and 3) usefulness. Together these include all micro and macro perspectives of the *Shari'ah*. With an emphasis on a "positive attitude", it makes it imperative for a bank to be active. It is a principle that should not be underrated. For an Islamic bank it is not possible to "sit and wait" until their customers enter the bank. They have to go out and seek new opportunities to invest funds instead of relying on the money for short-term gains.

All in all, in spite of the ban of *Riba,* one can see an Islamic economical ethic, which can be categorized as an Islamic socialism or as an Islamic market economy. Currently, most of coeval Islamic theoreticians lean towards several variants of a social market economy, which is based on a social obligation towards property and the idealism of justice in terms of distribution of property[108]. *Riba* is, however, a prominent source of an unjustified advantage. Money is not seen as a commodity and therefore cannot have a price for its use. Thus, the historical supported orthodox and dominant[109] principles of the Islam in Muslim countries make Islamic financial products differ, although they seem to be familiar...

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[107] Sarker, A.A., "Islamic Business Contracts, Agency problem and the theory of the Islamic firm", in "International Journal of Islamic Financial Services", Vol. 1, No. 2, Bhubaneswar, 1999, Pages 1 - 2.
and Yusoff, N.Z., "An Islamic perspective of Stock Market", Kota Bharu Kelantan, 1992, Page 154.

[108] Compare: BMZ; „Handbuch für Internationale Zusammenarbeit", Lieferung 328, Baden-Baden, 1994, II A 72, Page 12.

[109] See more in: Khan, W.M., "Towards an Interest-Free Islamic Economic System – A Theoretical Analysis of Prohibiting Debt Financing", Islamabad, Pages 1 - 25, esp. Pages 1 - 2.

O you who believe! Have fear of Allah
and give up what remains of which
is due to you of usury.
If you do not then take notice
of war from Allah and
His Messanger[110]*.*

3.2 Of Arbaibou'l mal and Mudarribouna[111]

Financial instruments conforming to the *Shari'ah* principles are simply a small group of convenient financing tools. Considering interest as "usury and thus prohibited"[112], their financial contracts combine features of mutual funds, conventional bank intermediation and limited partnerships. Their properties are comparable to shares of enterprises or of mutual funds. In this context, the financial institution due to their intermediary or partner-like role adopts characteristics of a broker, a venture capital provider, a financial leasing company or a mutual fund investment. These financial instruments contain higher risks but in return also higher dividends[113].

Abdul Awwal Sarker defines three broad categories of Islamic business contracts[114]:

- **Uqud al-Ishtirak (Direct Financial Accommodation)**
  Products included in this category are non-debt creating modes of finance and based on the Profit Sharing Principle, the Profit Loss Sharing Principle, and the Output Sharing Principle.
  (here I present and analyse the following: Mudarabah, Musaqat, Musharakah, Mazar'ah)

- **Uqud al-Muawadhat (Indirect Financial Accommodation)**
  Products in this second category are debt-creating modes of finance. They are developed on the bases of Mark-up Based Principle, Lease Based Principle, and Advance Purchase Principle
  (here I present and analyse: Murabaha, Istishna, Bai al Salam, Ijarah, Qardh ul Hasan)

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[110] Qur'an, Chapter 2, Verse 278.
[111] The owner of the capital is called "Arbaibou'l mal" (Arbaibou'l is the plural of reb'l, human) and the worker "mudarab" (Mudarribouna is the plural of mudarab).
[112] Darrat, A.F., 1990, Page 186.
[113] Iqbal, Z., Mirakhor, A, "Islamic Banking" in Appendix 2, International Monetary Fund, 1987, Page 125.
[114] Sarker, A.A., 1999, Page 4.

- **Other forms:**

  In the last category, Abdul Awwal Sarker includes a lot of new Islamic products. Direct investment, finance on development charge, bonds (like Mudarabah bonds of Islamic insurance companies, Muqaradah bonds, solidarity bonds), certificates (White Loan Certificates, Index-linked Green Loan Certificates, Human Capital Certificates), rent - sharing on the basis of construction / purchase of houses / flats, sheds etc. on co-ownership basis, investment auctioning and godowns.

This categorisation is certainly not perfect yet and is too superficial for the conventional banking system. Anyhow, in regard to microfinance, where tools from the third category are not implementable, this clustering is adequate. In fact, this paper will deal only with instruments applicable to Microlending. Some of those were used in the institutions I worked with and some others, which should be implemented because of their benefits, easy application and risk minimising effect. Saving products are not the main concern of this thesis and just will only be named. This decision is not supposed to undermine the importance of savings, quite the opposite (as discussed in chapter one, donor dependency is very critical and savings are very important to achieve sustainability). My decision is instead based on two aspects: 1) the fact that the differences between conventional saving products and Islamic saving products are very small except of mudarabah savings, which will be explained. 2) Most products were developed by individual banks and only very few are commonly used. In general, they substituted interests with rewards.

3.2.1. Uqud al-Ishtirak

3.2.1.1. Mudarabah / Muqayyadah / Qirad / Muqaradah / Commenda …[115]

Mudarabah is one of the most well known Islamic products with as many translations as Arabic names[116]. Profit Sharing, Joint-Venture Trust, Trust Financing, Trustee Profit-Sharing are just a few. Interestingly, some of them are wrong, whereas others are very close to its actual meaning. In this thesis, I will use the translation, which is closest in terms of a general inclusion of all features: a ‘Silent Venture Capital’.

A convenient venture capital company (VCC) normally invests in private companies that require capital to open their business, to develop and market their products or simply to

[115] Ibrahim, M., 2004, Page 10,
and Sarker, A.A., 1999, Pages 4 - 5,
and Lewis, M.K., Algaoud, M.L., “Islamic Banking”, Cheltenham, 2001, Pages 5 - 7.

[116] See title.
Remark: These terminologies reflect geographical identification of this contract rather than any other essential difference.

expand. In this context, most of the receiving enterprises are start-ups or very young companies, mostly operating less than 2-3 years. However, these companies often have a very high growing potential, but are not yet credit-worthy and thus are not eligible for traditional bank debt financing. In these private equity investments, the VVC participates in profit and loss and possibly the sharing of risk. In general, VVCs raise money from other investors either institutional or high net worth individuals.

Basically Mudarabah has a similar concept as a VVC. The bank provides the entrepreneur with capital, who in turn makes the bank a partner and gives him a pre-agreed percentage of the yield. The share of the profits provides the repayment of the principal plus "interest" for the bank. The money is then passed on to its depositors. The decreasing status of the capital provider is set in Mudarabah contracts. The final goal is that the entrepreneur – over an agreed period of time – will buy back the part that the bank owns and thus own the company by himself. A continuous status for the bank as a partner is not the intention; the deferred repayment is set contractually and usually starts very soon after the capital was provided. Mudarabah is distinguished into several forms and types: First of all it is divided into <u>restricted</u> and <u>unrestricted</u>. Restricted means that the capital provider sets up restrictions "related to the type of commodity that is to be traded, the time of trade, the place of trading or the person with whom the working partner should trade"[117]. Only the Hanbali and Hanafi Schools[118] accept these restrictions, esp. restrictions related to time or people. Comparing

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[117] Sarker, A.A., 1999, Pages 4.

[118] The Islam is separated into two major branches: the Sunnites and the Shiiten.

The Sunnites distinguishing them as the ahl al - sunna wal - jamaa ("the people of the Sunnah and the community") from the Shiites. Sunnites are, by this definition, Muslims who strictly follow the Sunnah of the Prophet Muhammad and preserve the unity and integrity of the community. Anyone who stands within the mainstream of the Islamic tradition and acts in accordance with generally accepted practices of the community is, therefore, a Sunni. Most Muslims see the Sunnah as complementary to the Qu'ran insofar as it explains certain points and elaborates some Qu'ranic principles by offering details necessary for the practice of Islamic law. The Sunnites present the great majority of the world's Muslims and are therefore in the focus of this paper.

Sunni Islam includes the followers of four legal schools (the Malikis, Hanafis, Shafi'is, and Hanbalis). In contrast to the Shiiten, the Sunnis believed that leadership was in the hands of the Muslim community at large. The consensus of historical communities, not the decisions of political authorities, led to the establishment of the four legal schools. In theory a Muslim could choose whichever school of Islamic thought he or she wished to follow and could change this choice at will. The respect and popularity that the religious scholars enjoyed made them the effective brokers of social power and pitched them against the political authorities.

After the first four caliphs, the religious and political authorities in Islam were never again united under one institution. Their usual coexistence was underscored by a mutual recognition of their separate spheres of influence and their respective duties and responsibilities. Often, however, the two powers collided, and invariably any social opposition to the elite political order had religious undertones.

these features with normal venture capital contracts, the decision rights of VVCs are similar, even though they are not the same. Receive a say in the company's management in normal venture capital contracts, in Mudarabah the capital provider has only rights concerning basic decision e.g. changes in the existing lines of business, the disposition of profits and the ones mentioned above. These rights can be compared with the rights of silent business partners, who normally have very less and if, very basic or limited rights in a contract. So, a comparison is even more obvious in regard to the unrestricted form of Mudarabah as long the trading commodity is legitimate. In contrast to the restricted form, the unrestricted one is approved by all schools including the Shafi and Maliki Schools. Within both forms, one can further classify between:

- Single Mudarabah:
  Only one financier and one client take part in the contract.
    - Ú Compound Mudarabah:
      More than one fund provider and borrower at least on one side take part in the contract.
- Limited Term Mudarabah:
  Profits are accounted for at the end of the contract.
    - Ú Continuous Mudarabah:
      Profits are accounted for on a periodical basis during the contract period.
- Commingled Mudarabah:
  Mudarabah funds are invested by both parties, while the work is carried out by the client alone.
    - Ú Non-commingled Mudarabah:
      Mudarabah funds are invested by the fund provider only.

Mudarabah is the riskiest of all the financial products, since the capital (fund) provider has no “real” control over the management, while fully responsible for any financial losses arising from the business.

In terms of adherents, the Hanafi-school is the biggest in count. The Sunni and esp. the Hanafi are followed by the majority of the Muslim population Of Turkey, Albania, the Balkans, Central Asia, Afghanistan, Pakistan, China, India and Iraq.

Shiism, a name derived from the Arabic shiat Ali, "the party of Ali") which adherents are by far the minority but more orthodox, emphasizes the spiritual function of the Prophet's successor, the imam, in whom the Prophetic Light is ever present in this world. He is believed to be divinely protected against sin and error and to have an infallible understanding of the Qu’ran, a supernatural knowledge of future events, and intercessory powers.

(Collocated from the website: http://mb-soft.com/believe)

3.2.1.2 Mazar'ah

Mazar'ah is similar to Mudarabah, but specifically designed for farming. The bank provides land or funds to buy land. What is interesting in this particular product, is that the harvest itself is seen as profit instead of the money earned through the sale. Consequently, the efforts (selling the harvest) that the bank has to put into the business are even higher than Mudarabah contracts. The shared risk refers only to the entrepreneur's skills in farming and to natural disasters. Market interferences are not in issue of the contract, but stays as additional risk for the bank.

3.2.1.3 Musharakah[119]

Musharakah is in terms of risk an attenuation of Mudarabah. Again known by many different names such as *Shirkah, Sharikah*[120] and *Musyarakah*, it is commonly translated as a Joint Venture Profit Sharing, a Partnership Financing or a Participation Financing. A "Joint Venture" (JV) is the correct counterpart in the western economy. A Musharakah features all characters of a JV. A JV is the most complete form of strategic alliances in terms of the level of interaction and cooperation and is an equity alliance. It involves the creation of a separate organization, "in which each firm [or party] has an equity investment"[121]. The partnership may be managed by the bank and/or the customer or by a third party. The investment may be capital, knowledge, access, technology, business contacts, reputation, etc. The different purposes of combining one's resources determine the ilk and the names of JVs. Names like Market Entry JV, Downstream Vertical JV, Equity JV or Technology JV, Scale JV, Link JV, International JV, and Trinational International JV are widespread. A Musharakah belongs to the group of "Link Joint Ventures" in which two parties contribute different resources. Depending on which resource is contributed the Musharakah is categorized as *INAN* partnerships[122], *AMWAL* partnerships, *ABDAN* partnerships or *WUJUH* partnerships:[123]

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[119] Al-Harran, S.A.S., "Islamic Finance Partnership Finance", Selangor Darul Ehsan, 1993, Pages 72 - 95.
and Abod, S.G.S., Agil, S.O.S., Ghazali, H.A., 1992, Pages 212 - 215.

[120] The term is mostly used for joint-stock companies and corporations, but is qualified with an adjective to indicate its nature. Nevertheless it is often used similar to Shirkah, which is close in meaning to a partnership.

[121] Delios, A., "International Business in the Asia Pacific", Singapore, 2003, Page 131.

[122] Hanafi scholars define partnership as "a contract between partners on both capital and profit." Shafi'i scholars define partnership as "a contract giving the right in something to two or more people, making it common." According to Hanbali scholars, it is "the coming together of two or more people in disposal or acting".

[123] Actually there might be more than 4 groups of Musharakah (5-6), but it was not possible to find a unique categorization. These 4 here mentioned categories are the only which are repeated in almost every publication. Ammah-, Khassah-, Mafalis-, and Zimam partnerships are not really own categories, but more subcategories of the already named. Further discussion would be outside the scope of this thesis.

- *INAN* partnerships are unequal partnership where any party can participate with any proportion and therefore they are the most open contracts,
- *AMWAL* partnerships (or *mufawadah*) are based on the contribution of wealth by all partners. Two or more parties contribute equal shares of money, goods, equipment and work. An emphasis of *AMWAL* partnerships is the amplification of "equal shares". It is also possible that one partner contributes all the equipment and the other contributes all the goods, as long as the rental value of the equipment and the profit-potential of the goods is approximately the same,
- An *ABDAN* partnership refers more to the labour and service rather than to finance issues. Different to *AMWAL,* in an *ABDAN* one party is only contributing its skills and efforts to the management of the business without contributing any capital, while the other party contributes the capital. Moreover, it can also describe a scale JV, in which both partners contribute only their skills and who are therefore liable for the delivery of orders taken by the other[124],
- *WUJUH* partnership. *WUJUH* is the plural form of *wajh* (face) and means reputation, name and goodwill. Those partnerships are therefore based on credit worthiness of one partner in which the ratio of profit and loss is based on the liability borne. It is a partnership with eminent people.

In general, the main differences of a Musharakah contract compared to a Mudarabah contract are the sharing of the management decision. Thus, the efforts the capital provider has to put into the business increase, but he also can decrease his risk by interfering and contributing to the success of the business. Furthermore, the investment is not required to be paid back at a predetermined date and the bank remains a partner in the operation. Although a decreasing Musharakah is in general possible, where the bank encourages the partner and provides the option to gradually buy the bank's shares.

3.2.1.4 Musaqat

Musaqat is the traditional counterpart of Mazar'ah (see.3.2.1.2) in the context of Musharakah contracts.

[124] In some publications this second kind of ABDAN partnerships is explicit in a category called "Shirkat-as-Sanai " – company of workmanship and arts.

3.2.2 Uqud al-Muawadhat

3.2.2.1 Murabaha[125]

Murabaha is a cost plus financing contract and the other best known product next to Mudarabah. Against theoretical approaches it is also the most frequently used tool in Islamic banking due to the risk aversion of banks[126]. One party (the borrower) wishes to purchase equipment or goods, which the other party (the investor) purchases on behalf of the borrower. For this service, in which the product has to be defined in all issues, the investor demands a service- or management fee (his profit margin), when selling the item to the borrower. The mark-up, which has to be negotiable, is not related to time and won't increase in case of a delay. The repayment is conducted by instalments within a specified period[127]. The possibility of delayed repayment without the chance to penalise "as long as it is not an event of wilful default"[128] increases the costs for banks.

In general, this technique is used for financing trade especially to purchase existing or at least readily available goods or commodities. By engaging just in buying and selling, the banks' profit originates from a real service that necessitates certain, but also minimal risk and thus is seen as legitimate.

3.2.2.2 Istishna[129]

Istishna means purchase with specification and is a tool of pre-shipment financing to encourage and facilitate production, which otherwise would not be possible due to a lack of capital. Like Murabaha the product has to be defined in all issues, like in quality, quantity, and prize. Furthermore, the delivery date has to be set in advance. In contrast to the general opinion, Istishna is the total opposite of Murabaha. The client – or others under his control and responsibility – produces the not yet existing item that is pre-financed by the bank according to the stage of work completed. The bank in turn inspects the pre-agreed arrangements either in advance if they are alienable or afterwards if the client complied. After the item is finalized, there are two possibilities. First, the bank adopts a merchandise role and sells, for example through a murabaha deal, the item, or secondly, the producer himself sells the item and pays the bank back within a specified time period. These contracts open the

125 Banaga, A., Ray, G., Tomkins, C., "External Audit and Corporate in Islamic Banks", Aaldershot, 1994, Pages 75 and 137 - 141.
and Al-Harran, S.A.S., 1993, Page 98,
and others.

126 Haron, S., Shanmugam, B., "Islamic Banking System", Petaling, 1997, Page 111.

127 e.g.: Cost of product + service fee + service for purchase and delivery; payable in 12 months in rates of 1/6 every month starting after the 5th month.

128 Haron, S., Shanmugam, B., 1997, Page 122.

129 http://www.isdb.org/english_docs/idb_home/MFIstMod_Home.htm, 04.05.2004,
and Sarker, A.A., 1999, Page 7.

way to a number of new possibilities including for example the trading of processed commodities. Derivatives may also be possible.

3.2.2.3 Bai al Salam[130]

Bai al Salam is a purchase with deferred delivery or “Forward Buying” and is the closest form of a future contract. It is equivalent to an advance payment. Like Istishna, the contract is based on a preferred mode of payment (money or anything else agreed upon) for goods which are to be delivered to an agreed later date. As a consequence of paying in advance, the bank receives a more favourable price. Although, the price has been fixed at the beginning of the deal, there is still uncertainty in regard to the future price of the goods involved in the contract. Consequently, the capital provider has to be able to predict the future price of the goods.

The difference between Bai al Salam and Istishna is the higher risks involved in the former tool, because the goods are not specified as much as they are in Istishna. Even though the date of delivery is set in advance, the product itself is just described in quantity, quality and/or workmanship (e.g. a sword or a cow), but not more. Because of this restriction, Bai al Salam is mostly used in an agricultural context, where the bank advances money for various purchases to receive a share in the crop that can be sold on the market. The only exception in terms of a Bai al Salam is a *nasia'a* contract. Here, the money is allowed to be repaid later after the contract is already closed. However, payment as to occur on the present date and no delay in payment or delivery is allowed. The ownership would be transferred immediately. The option of revoking the contract on account of a defect in the subject matter is allowed.

3.2.2.4 Ijarah[131]

Ijarah is a contract form known in conventional banks as “leasing”. The customer (or lessee) pays for the use of an asset (may it be capital goods or equipment) in regular instalments as the asset produces revenues. One can distinguish between “operational“- and “financial” leasing. In an operating lease (Ijarah Mutahia Bittamlik), the lessee can acquire the use of an asset for a fraction of its functional life. This leasing contract is short term (max. 1 year and normally less than 40% of the life time of the asses) and usually subject to denunciation at any time. Thus, the leased asset is usually used by several lessees until the end of its functional life. Sometimes the lessee has the option to purchase the asset at residual value

[130] http://www.geocities.com/Athens/Delphi/6588/fairtrade.html, 17.05.2004,
and Timberg, T.A., 1999, Page 3.

[131] Al-Harran, S.A.S., 1993, Pages 95 - 97,
and Timberg, T.A., 1999, Page 3,
and Iqbal, Z., and Mirakhor A, 1987, Page 126,
and Sarker, A.A., 1999, Pages 7.

upon termination of the lease term. The risk carrier is the owner of the leased asset, who is responsible for maintenance, insurance, etc.

The financial lease (Ijara Wa Iktina) on the other hand enables the lessee to acquire use of an asset for most, if not all of its functional life (40 - 90%). Consequently, this contract is on a long-term basis. The length of the contract depends mainly on the basic life time of the asset and reciprocal termination is not possible. The contract may be offered in half (with residual value) and full amortization. At the end of the lease period, the customer normally buys the equipment at an agreed price from the bank. The already paid rental fees are acknowledged as part of the price. Another option is an additional leasing contract with lower rates. Because of the higher risk in operational compared to financial leasing (e.g. more responsibilities, more users, and no agreed sale afterwards), and the preference of banks to avoid a large asset pool, financial institutions normally prefer financial leasing contracts. The existing risks of asset failure, the active part of the bank in pre-purchasing and providing extra service like inland transportation, erection and installation of the asset as well as the long term nature of the contract make this tool also acceptable in terms of the *Shari'ah*.

New western bank enhancements like Revolving Leasing[132], Special Leasing [133] or Sale-and-lease-back[134] contracts have not been incorporated by convenient Islamic banks.

3.2.2.5 Qardh ul Hasan[135]

This loan functions without collecting interests and without profit sharing. The exact loan has to be paid back on a pre-agreed date. Qardh ul Hasan is deeply connected to *Zakat* and has a charitable motivation and a social purpose.

3.2.3 Al Motddakharat[136]

Saving deposits like Arafah Savings, Fulinves Deposits, Wadi'ah Current Account, Muamalat Financial Institution Pension Fund or Mudarabah Accounts are comparable with commercial saving accounts in most features even though they are mainly set up in order to finance the pilgrimage to Mecca. The prohibition of interests is bypassed by a whole range of alternatives, starting from physical presents to mudarabah profit – sharing. The "mudarabah profit sharing saving account" can best be explained by comparing it with a venture capital

[132] At the end of the contract period a new contract is <u>always</u> following, e.g. exchange for a technical further development.
[133] Same as "Revolving Leasing", for extra produced assets and changed conditions.
[134] Lessee sells product to the bank and leases it back à Liquidity procurement.
[135] Al-Harran, S.A.S., 1993, Pages 98 - 99.
[136] In Arabic: Saving Deposits.

contract. The saver adopts the role of an investor and finances mudarabah deals through the bank. In effect, even the saver faces a risk. Thus, it is questionable whether “saving account” would be a suitable name.

According to the outline above, the presented products are very similar to convenient contracts. Even not established in convenient western banks, but which are popular in terms of business contracts. A basic understanding is sufficient to see the differences between Islamic and convenient banking products, which include increased efforts and increased risk taking by the financier as well as the potential of a higher rate of return for the financier compared to a fixed interest rate. In the next chapter, I will analyze those differences with special regard to risks and efforts in a microfinance context. I will show that, when working with devout Muslims along the poverty line, Islamic products are almost tailored for the use in microfinance.

Chapter 4 Islamic Microfinance

The main aim of this paper is the projection of Islamic financial products into a microfinance context.

During my literature and field research, I found neither a single microfinance institution offering financial products that conform 100% to the norms of the *Shari'ah* nor any financial institute which provides Islamic financial products to the poorest of the poor, with one exception. The four-year old NGO Yayasan Siti Khadijah (YSK) offers Musharakah, Mudarabah and four different saving accounts. The seven employees served 500 Muslims in 2003 with a repayment rate of 85%, and the potential demand is more than 10.000 clients. According to Islamic standards, the NGO is under external supervision of the Ikatan Cendiakiawan Muslim Indonesia (ICMI) to assure that the *Shari'ah* is kept.[137] The (almost) complete non-existence of Islamic microfinance institutions has also been noted by other people. For example, stated Dr. T.A. Timberg that "there has been some discussion of Islamic banking for microcredit, but most documented experience that I know of is in Pakistan, where institutions charge a service fee to cover their costs"[138]. However, there are also some success stories for institutions that try to adapt to new methods. The Bank Perkreditan Rakyat Syariah (BKRS)[139] network in Indonesia, organised and somewhat supervised by ASBISINDO, is often seen to be the only institution that can be considered a real pioneer for Islamic microfinance. Providing only Islamic products (e.g. Murabaha, Musharakah, Mudarabah and Qardh Hassan Loans as well as Al Wadiah[140] and Mudarabah Savings), the network encompasses 83 branches. They are mainly clustered on Java with only a few exceptions on Bali, Sumatra and Kalimantan. However, the branches of the BKRS are not 'pure' microfinance institutions yet. Their main target group is the business community (sailors, fishermen and medium enterprises) and they do emphasize restrictions such as that potential contractors have to provide "proven transaction reports over two years" before getting a loan"[141]. It resembles more closely a commercial bank than a microfinance institution. Anyhow, the 11-year history of BKRS is quite presentable according to a recent internal report of the Bank Indonesia. With an average capital adequacy of 30% they are far above the standard and thus have a good back up in case of losses.[142] Their productivity and

[137] Compare own survey: Questionnaire: Yayasan Siti Khadijah, Jakarta, May, 2004.
[138] Timberg, T.A., Arlington, 2003, Page 3.
[139] For further information see Steinwand 2001.
[140] A current account providing checking and allowing some profit sharing.
[141] Compare own survey: Interview with Surachman, ASBISINDO, Jakarta, 01.04 2004.
[142] The Capital Adequacy Ratio (CAR= Capital / Disbursed Financing + Fixed Assets and Inventory) reflects the level of capital that is sufficient to absorb potential losses in addition to building financial sustainability.

efficiency meet international standards for microfinance institutions[143]. However, their PAR[144] of nationwide 20.11% (in urban- and traditional Muslim areas between 12 – 15%) is far above the microfinance standard of 5% and the repayment rate is only good in traditional Muslim communities and not compared to international standards.

Moreover, there are several microfinance institutions that are serving poor people that like to <u>open</u> a business and not just <u>expand</u> it for example in Malaysia and Indonesia. But unfortunately, they fail to offer correct Islamic products. Examples include the Amanah Ikhtiar Malaysia (AIM), a governmental supported organisation, which renamed interest into management fee (a 4% percentage based on the loan amount) and the Yayasan Dharma Bhakti Parasahabat (YDBP), an example for a Grameen Bank Replication[145], which provides in principle also for Muslims but does not take the prohibition of *Riba* into account.

Why has a mixture between the fields of Islamic banking and Microfinance not found an application yet? Avoiding the question of why Islamic commercial banks do not have more interest in microfinance activities – a question that has been discussed in regard to convenient banks in other papers [146] – this thesis focuses on questions concerning MFIs. I will try to test the following hypotheses:

- The implementation of Islamic financial products causes too high risks for microfinance institutes. The restriction of involving 'risk' in financial contracts for both parties by the Islam is binding. Therefore, market risks and moral hazards, make a save and steady return for the MFI not possible.
- The higher efforts of Islamic Microfinance are too much for the already weak organisation structures of MFIs. MFIs have to avoid or at least decrease market risks and moral hazards. Thus, higher efforts need to be invested by the MFIs due to the increased dependency on the success of the pre-financed projects.
- The complexity of Islamic financial products compared to convenient credit contracts leads to difficulties in both their explanation as well as their promotion in less educated areas.

[143] Bank Indonesia, Research Paper: "Assessment on performance of Sharia Rural Bank Industry in Indonesia", Jakarta, 2002, Page 109.

[144] The Portfolio at Risk ratio (PAR = Non-performing financing / Total disbursed financing), in conventional banking terminology more commonly known as Non-Perfroming Loans (NPLs), in *Shari'ah* banking context as Non-Performing Financing (NPF). It is a very common performance indicator for microfinance institutions.

[145] See chapter 1.3 "the birth of the Grameen bank".

[146] In general the lack is explained by the high transactions costs, particular seen in human resources, the importance of a "being at the point of sale" and the small loan amounts.

- Clients do not really care about the prohibition of *Riba*. To use the financial service of convenient MFIs or Islamic MFIs makes no difference for them. A specific development of Islamic MFIs is not necessary.

4.1 "People would much rather remain poor than compromise in their faith."[147]

This sentence was found in an internal report of a conference and workshop held in 2000 by the Association for Creation of Employment for the "Swiss NGO Programme Office" (SNPO). During the conference it was emphasized how little attention Islamic microfinance gets and that the donors are responsible for this lack. It was also argued that there would be less support for Islamic lending causing the large NGOs to lose interest in its development. The general consensus of the conference somehow represents the status of Islamic Microfinance and is closely related to the first three hypotheses. The question whether clients care or not is not answerable in this thesis – one would need to conduct a large representative survey like the GTZ ran in co-operation with Bank Indonesia. This survey (15 Regions, 1503 people) for example states clearly that "the profiles and characteristics of the customer preferred to *shari'ah* bank" but also that factors influence "customer to choose *shari'ah* and conventional bank"[148]. This influence of factors esp. a geographically limitation might be understandable due to the hundreds of different Islamic movements. I found a couple of excerpts in the literature regarding microfinance development in Islam dominated countries reporting the same perceptions: Muslims would not act against their religion and are therefore not or less willing to participate in convenient microfinance. These comments support the experiences I had when discussing Islamic financial products with clients and Muslims during my fieldwork. Furthermore, the large success of conventional Islamic banks over the last years, especially by attracting people who never used banking services before as well as non-Muslims that use the Islamic financial institutions as possible alternatives. That supports that the demand for Islamic microfinance is present and growing.

4.2 The Principal Agent and the Stewardship Theory

Before we can analyse the financial products explained above in regard to the first three hypotheses, it is important to understand the difficulties, which generally occur in the application of more complex contracts and partnerships. The main problems of almost all mentioned financial products can be categorized as typical principal agent problems.

[147] Association for Creation of Employment, 2000, Page 6.
[148] Bank of Indonesia, Jakarta and Research Center on Development Studies, Diponegoro University, "Research on Potency, Preference and society Behavior toward Syariah Banking System in Central Java and Yogyakarta Provinces", Executive Summary, Semarang, Page 2.

The Principal Agent Problem was first investigated by Berle and Means in 1932[149] and is a standard theory in the field of business administration preparing and analyzing the nexus of contracts[150]. The Principal Agent Theory postulates that a risk-neutral principal gives a risk avers agent certain orders and rights to act in his interest. Thus, the principal improves his results by using the specialised manpower and the information advantage of the agent. On the other side, he increases his risk by possessing little knowledge about the incentives of the agent – there may be a large clash between the interests of the principal and the agent[151]. This problem of an unevenly or “asymmetric” distribution of information and the awareness of incomplete contracting create costs on both sides. The principal has to cover control and leading costs (costs of the contract conclusion, incentives components, risk premium, supervision) and the agent has to cover residual costs (loss of welfare). He has to deal with guarantee costs such as self-control, actions of accountability, a. o.

The two main problems are “hidden information/characteristics” and “hidden action/intention”, which both causes costs for the principal. Hidden information occurs as a problem before the contract is closed or before the fulfilment starts. The agent might dispose incomplete or illusive self-portrayed information, which are not or not freely available for the principal. That means the principal has to get further information from an external source to proof the correctness of the data the agent provided. This causes costs for the principal. The second problem occurs during the fulfilment of the contract and the conclusion. Caused by the impossibility of a 100% supervision of the agent, there is no transparency of how the benefits of the agents’ work are achieved. This means that the principal has no or little information about the courses of action and the actual performance of the agent. This could tempt the agent to adopt opportunistic behaviour for example reducing his efforts (shirking responsibilities) and/or using resources for his self-interest.

The products of Islamic banks have the same kind of problems. High risk is involved in investments due to 1) the lack of transparency and inability to monitor the investments, 2) the lack of competency of the *Shari’ah* bank employees (problems in a micro environment) and 3) in the unavailability of information about business performance of each targeted industrial sector (the macro environment). The bank can be seen as the principal, who has very little chance to supervise the pre-financed businesses and the entrepreneur (or the bank for the depositors) as an agent. Especially problematic is the fact that the bank is usually solely

[149] Berle, A.A., Means, G.C., The Modern Corporation and Private Property, New Brunswick,1932.
[150] Organisations and their relationships to their environment are seen as a network of implicit and explicit contracts. Those contracts regard binding rights, duties, cognizances and the distribution of profits. In other words: the rules of the game.
[151] A typical example: Principal, a CEO of a company, who wants profit maximization by his agent, the worker, who wants a big salary, a job-satisfaction, some vacations, etc.

responsible for losses, which increases the so-called moral hazard problem[152]. This term is based "on the principle that if actors are allowed to escape the consequences of their risky actions, they are more likely to engage in reckless behaviour in future"[153]. But this so-called "model of man" is the bases of the Principal Agent Theory (see below) and important for the further analysis. In the Principal Agent Theory the two players act on the basic assumption of an utilaristic and hedonistic individual maximizing personal economic gains on each side. The agent is self-interested, rational and risk avers, while the principal only differs from the agent by being risk neutral. The Principal Agent theory, which belongs to the "Theory X" in organizational psychology, is based on the postulation of an inherent conflict of interests between owner and manager - the 'model of man".

Regarding the rules of the Islam (chapter two and three), it cannot be assumed that the same "model of man" can be used when working with devout Muslims. The obligation to follow *MUAMALAT* and with this the Islamic codes of conducts, namely *Al-Shiddiq* (morality), *Al-Amanah* (trust and honestly), *Al-Fathana* (manners and sincerity) and *Al-Tabligh* (to socialize and to educate the public about the Islamic social community) and by understanding the Islamic social community itself, Muslims should behave quite differently than non-Muslims. In developing countries, the chance to take part in innovations of the industrialized world is not as pronounced as in developed or transformation countries. Traditions, inherited values, manners and habits are more present. For poor people and esp. for the poorest of the poor, religion and beliefs are a fundamental backup; to handle poverty, to handle their situation, to handle their lives. This of course is not just linked to the Islam, but also to Hinduism and Christianity. There are also other "models of man" developed by organisational psychology and organisational sociology[154]. It is also possible to find role-holders, esp. agents, who are motivated to achieve intrinsic satisfaction through successfully solving inherently challenging tasks and not only gain recognition from one's peers, colleagues and bosses, but also from neighbours and family members. Thus, people who are immune (more or less) to their self-interests. It all depends on the one's situation when entering the contract. In fact, there are a lot more non-financial than financial motivators. After all, it is not all about profit, like the *Shari'ah*.

In a relatively new approach within the field of business administration, an identification of managers and workers with their corporation is induced, especially with those people who have a long history of working for the company and thus have already a close relationship

[152] See 1.4.1.
[153] http://www.currencytax.org/glossary.php, 03.08.2004.
[154] Donaldson, L., James, H.D., "Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns" in the "Australian Journal of Management", Vol. 16, No. 1, Sydney, 1991, Page 51.

with it[155]. The goal is to promote an emerging of a ‘company’ ego, thus melding individual self-esteem with corporate prestige. When the agent is the founder of the business himself, it may imply that the business is his life, and in this case it might be even easier to get the “company ego” to emerge. When the business is the chance to improve living standards, to rise out of poverty or even just to provide a future for his children, personally unbeneficial actions will eventually be carried out from a sense of duty. This difference is obviously contrary to the agency theory, which claims a gap between the interests of both parties. Here, instead, the motivation that inspires individual calculated actions lies in their personal and subjective perception. “To a degree that an executive feels their future fortunes are bound to their current corporate employers through an expectation of future employment or pension rights, then the individual executive may perceive their interests as aligned with that of the corporation and its owners, even in the absence of any shareholding by that executive.”[156] No doubt the entrepreneurs would resist to such a chance if the MFI provides it. This core idea is part of the stewardship theory[157]. In contrast to the agency theory, the agent is considered to want to do a good job and to want to be a good steward to the assets. One of the strands of the ‘stewardship theory’ concerns the role of corporate culture in eliciting appropriate responses through structures that promote cooperation rather than coercion and control. Those, who identify with the organisation’s mission, vision and objectives, are more likely to act as stewards and custodians. That is why the main question is not how to supervise or how to reward the agent with momentary incentives, but how the organisational structures will enable the agent’s actions.

In the following argumentation I do not want to concentrate on one of the theories, but on combining them. I do not want to take the realism of the Principal Agent Theory, which includes opportunistic behaviour, asymmetric information distribution and costs on both sides, but the limitation of the “role of man”, explained above. This role is disintegrated by the stewardship theory, which itself goes too far in strategic structural decisions regarding MFIs. The question is, with which “role of man” are we dealing when working with devout Muslims? Which behaviour can we anticipate?

[155] Compare recent publications of Donaldson, L., James, H.D (1990 - 2003).
[156] Same place.
[157] Donaldson, L., 1990a, “The ethereal hand: organizational economics and management theory”, in the “Academy of Management Review”, No. 15, Briarcliff Manor, 1990, Pages 369 - 381.
and Donaldson, L., 1990b, “A rational basis for criticisms of organizational economics” in the “Academy of Management Review”, No. 15, Briarcliff Manor, 1990, Pages 394 - 401.
and Davis, J.H., F.D. Schoorman, L. Donaldson, “Toward a Stewardship Theory of Management” in the “Academy of Management Journal”, No. 31, Briarcliff Manor, 1997, Pages 488 - 511.

According to the prior discussion we can define the aim of Islamic Microfinance as providing Qu'ran conforming financial products to poor people and especially to enable poor Muslims along the poverty line to open a business and thus improve their living standards. This thesis deals only with financial products, but a wider definition including an integrated approach and insurance, is in principal possible. Based on the assimilated background knowledge, it can be argued that devout Muslims will not act against the rules of the Islam. As all poor people though, they want to escape poverty, provide a better life for their children, and are very sensible about their social status or reputation in the community. However, the allure of opportunistic behaviour is always high, in particular when opportunities are openly presented. So I will use the Islamic 'model of man', and implement it into the Principal Agent theory, to be as realistic as possible.

In order to start my analysis of investigating whether Islamic products are too complex for microfinance I have to establish certain presumptions:

4.3 Risk and Effort in Islamic microfinance …

1. The financial instruments should be used to finance only "ONE specific project, whether this project is undertaken by the issuer of the financial instruments, or is undertaken by others on behalf" [158] of him. This is a very realistic presumption, since otherwise the contract would be exceeding its potential in terms of coverage, success and risk;
2. The bank is faithful. Otherwise, it could eventually lead to a double moral hazard problem, "in which principal and agent in a single dyad are both involved in production and thus may both exhibit shirking behaviour" [159]. Unfortunately, it has happened before as apparent by the following report: "It happened that the manager of the branch took all the money from the bank and simply vanished to another island"[160].

   Nevertheless, I assume that this scenario is the exception and the presumption that the bank is faithful rather describes reality.
3. The employees of the bank are faithful and satisfied with their job having responsibilities and receiving wage above minimum. Thus, I exclude the possibility of defalcation by the management or deception by field workers who keep a certain amount of the repayments for themselves. Otherwise, this "Dual moral hazard [would] create(s) a utility function for the service provider

[158] Yusoff, N.Z., "An Islamic perspective of Stock Market", Kota Bharu Kelantan, 1992, Page 159.
[159] Ellis, R.S., Gudergan, S.P., Johnson, L.W., "The Satisfaction Mirror as a Principal-Agent Problem", http://130.195.95.71:8081/www/ANZMAC2000/CDsite/papers/e/Ellis1.PDF, 01.02.2004.
[160] Compare own survey: Interview with Surachman, ASBISINDO, Jakarta, 01.04 2004.

that includes variables relating both to the service provider's relationship with the customer and his / her relationship with the employing organisation";

4. The entrepreneur is a devout Muslim;
5. Both, the agent and the principal are self-interested and remain rational actors.

4.3.1. … projected on direct financial accommodation

According to the explanations given in chapter three, an application of financial products of the first group is accompanied with the highest risks for a bank. The capital provider is fully (Murabaha) or to the invested percentage (Musharakah) responsible for any loss. This increases the risk for a moral hazard enormously.

Problems may already occur before the contract is established. The bank might have little experience in the certain industry sector the entrepreneur wants to open his business in. To decide, whether to pre-finance the project the capital provider has to estimate the risks and potential return. When starting a business it is critical to know the strengths and weaknesses of the potential business itself and the opportunities and threats the market presents (SWOT-Analysis) in order to guarantee a successful venture. Moreover, to try to estimate the attractiveness of an industry and the industrial profit potential in a branch can be useful as well (however, this estimation is only possible with high efforts). Michael E. Porter summarizes the profit potential to a function of five driving forces: the threat of new entrants, the bargaining power of suppliers and buyers, product substitutes and the rivalry among competitors.[161] This analysis of "Porter's Five Forces" is included in every strategic business decision regarding a set up of new departments, new products or co-operations. For a bank or for a MFI, however, it might be difficult to have an overview of every market segment, to know the situation of industry competition in every region or the demand for every product their customers want to invest in. In effect, the phase of pre-monitoring can be very expansive for the MFI and an application of the named classical business tools too complex.

Moreover, in addition to this lack of information on the macro level, the micro level is hazardous as well. The lenders have inside information about their investments. They have information about the demand and perhaps even about the likelihood of the project's success, but regardless of that knowledge, they will probably claim the project to be of the highest quality even if it is not the case. In a competitive situation for debt sources this leads eventually to various forms and problems of adverse selection[162]. In the worst scenario, a

[161] Porter, M.E. „Competition Shapes Strategy", in „Harvard Business Review", Boston, 1979.
[162] Definition: In a market where buyers can not accurately gauge the quality of the product that they are buying, it is likely that the marketplace will contain generally poor quality products. Adverse selection was first noted by Nobel Laureate George Akerlof in 1970.

MFI would just attract borrowers who expect high risk, more non-monetary benefits or very high total returns at an artificially low cost of capital.

An advantage of MFIs is that they work on site, may it be urban or rural. Even in rural areas, where it is normally not feasible for commercial banks to be at the "point of sale", MFIs are usually available and easily accessible. In my survey the average distance to the customers was less than 25 km (a maximum one-hour-drive by motorcycle). Additional to the close contact to the clients, the field workers are locals and thus can build up trust between the organisation and their clients as well as use advantages of "intra-group-relations"[163]. Even though this raises big problems in hiring educated staff, especially regarding knowledge about the Qu'ran and computer skills, their micro knowledge is increased. Field workers are usually born in the area, know the inhabitants, the families and the social structures in the individual social networks, which are more significant in rural areas than in urban areas. Besides the fact that speculation and highly risky projects are prohibited for Muslims (*Al Maysir* and *Al Gharar*), a disclosure of those illegal activities to the local society would probably be worse than a confrontation in a court. In fact, to put social pressure on their clients some MFIs promulgate the list of delayed defaulters in the local newspaper or openly address them in village meetings. In Islamic communities this has probably a greater effect than in Christian or Hindi societies.

In addition, the group lending approach can also be used to minimize risks of hidden characteristics. Many MFIs, at least those working on the Grameen bank principles, issue loans to groups and not to a single person. That means that a person who wants to apply for a credit has to present a group of 5 - 20 people[164], with each of them wanting to have a credit. With these methods, MFIs force everyone of the "peer"- group to take responsibility for each other. In fact, with this approach they shift a lot of effort and risk back to the clients. If one fails, the others will not be able to get another loan. This self-selection tool obligates the borrowers to search for trustful partners in order to avoid personal consequences. Moreover, another side effect emerges. By forming a group the clients learn already how to explain their products. People that get interested will start to collect information (e.g. of neighbours who

[163] Compared to inter-group-relationships (the relationship of members from two different groups) it is easier to build trust in intra-group-relations (between members of the same group), because of the assumption that the likelihood of exploiting is smaller in the latter.
„In Intergruppenbeziehungen besteht ein geringeres Maß an Vertrauen als in der Intragruppenbeziehung, bedingt durch die Furcht, von anderen Gruppen ausgenutzt zu werden" and „Innerhalb der eigenen Gruppe gibt es ein höheres Niveau wechselseitiger Unterstützung, wenn die Eigengruppe auf Kosten der Fremdgruppe gestärkt werden soll".
Thomas, A., Kinast, E.-U., Schroll-Mach, S., „Handbuch der Interkulturellen Kommunikation und Kooperation", Bd 1, Göttingen, 2003, Page 111.

[164] Remark: Caused by the trend to increase efficiency of field workers a smaller group is to prefer.

are clients, flyers, mosques) and they will ask questions until the benefits of the products are understood.

Compulsory (group) savings can be used to clear sporadic failures in addition to their use as a guarantee and a demonstration of the ability of clients to manage cash flows and make periodic contributions[165]. But those savings are often perceived by clients as a fee and can also be problematic when the profit margins of the businesses are small. Still it is used as a common tool as an alternative for collateral and if no information on the clients is available (e.g. by a MIS[166]).

Anyway, many credits issued for the first time are small, short term and mostly just provide borrowers with an opportunity to show their "bankability". Repeating loans and increasing the amount are incentives that can also be used for all Islamic financial products. For direct accommodations, in which a relationship based on trust is more important than in every other microfinance product, this would provide a perfect base for long-term co-operation. Indeed, in my survey[167] (interview and questionnaire[168]) in Indonesia and Malaysia, "trust" and "a relationship based on trust" was the most frequent answer to the question "What do you think is most important to make the people pay their money back?" Thus, the role of the field workers becomes even more important and their role as a critical copula between customer and organisation is underlined. The expression "Trust Agent" would therefore be a more adequate name for their position.

Within the principal agent theory, the efficiency of trust in promoting exchange, reducing uncertainty, improving co-operation and contributing positive outcomes has been discussed in many papers and books. [169]. Trust is very important in reducing agency and transactions costs as an invisible institution of ethics and morality.

Although a closer look would exceed the scope of this paper, the effort in building trust should be emphasized. There is a difference between seeing the solution and solving the problem. Many MFIs, although they determine trust as crucial, regard the weekly collecting meetings and the monitoring of the projects from time to time as enough[170]. But instead of defining trust as a subjective conviction to be able to rely upon a person, institution or even upon oneself (self-confidence), trust is in general based on positive experience and mutuality.

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[165] Ledgerwood, J., 1999, Pages 72.
[166] See below, Page 58.
[167] See appendix I.
[168] See appendix II.
[169] See as well: Bromiley and Cummings (1995); Mayer et al (1995) Dahlstrom & Nygaard, (1995); Tyler & Degoey (1996); Gilbert (1998); Gilson (2003).
[170] Own survey.

In this context, the YDBP, for example, makes a difference. The NGO organises “lessons, parades and prize presentations” [171] . The field workers are trained on interpersonal communication skills and to rapport with customers. Another example is given by a branch of the AIM on the Malaysian Peninsula, where the women tailored themselves voluntarily a robe to identify themselves with the organisation. The goal should be to establish a “sense of family” between the field workers and the customers, to develop a socialized concept involving the borrowers. Barcelon suggests to “[…] develop a club of borrowers. Be with them in their time of need and happiness. Be one with them”[172]. He argues that this is the “reason why small storeowners and vendors patronize the “Bombay lenders” even though they charge exorbitant interest rates that run as high as 240 percent per annum.” [173] Moneylenders have often a very close relationship to their customers.

The decision if clients will become customers, is in most MFIs I worked with a very long-winded process. The trust agent (TA) is seldom authorised to give the final “o.k.” for a loan. In most cases, the branch manager or – if existing – the regional manager[174] has to come and justify the potential a business has. In convenient microfinance this issue is often heavily criticized, because of the long information trails and the time gap between application and realization of loans. But in regard to the actual practical application, the average gap between application and fulfilment is rarely more than 4 weeks in all branches of my survey[175] and thus acceptable. Also, taking this responsibility away from the TA strengthens the relationship between customer and TA. Otherwise, the clients could have the impression that the TA is too powerful, which would make it difficult to build a personal relationship. Moreover, the client could be confused if he could raise the loan with the TA instead at the MFI. It is necessary that it is clarified all the time that the TA is just working for the organisation; taking orders from them. By avoiding the conflict the TA is “always on the side of the client” and if the contract is refused the TA can claim that he tried his best but that his hands are bound. Most importantly, he can explain what has to be improved in the application to be accepted without being directly involved. Besides, concerning Islamic direct financial accommodations and its importance of due diligence, this decision should not be in the hands of the TA himself. The responsibility would be a heavy burden and would be only justifiable when the TA is accordingly trained. Otherwise, it increases the risk of opportunistic actions on the side of the TA, disregarding the third presumption. TAs should concentrate on efficiency and productivity.

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171 Compare own survey: Questionnaire: Yayasan Siti Khadijah, Jakarta, Mai 2004.
172 Gallardo, F., 2003, Page 2.
173 Same place.
174 Compare own survey: example: AIM - branch in Sabah, East-Malaysia.
175 Own survey.

In general, the productivity of a MFI is measured by three criteria: 1) the number of TAs, 2) the number of financing customers, and 3) disbursed financing. The productivity of *Shari'ah* banking is probably determined by even more factors, especially the availability of incentives in the form of competitive salaries / wages / bonuses, efficiency by operating cost ratios and salaries as well as benefits to portfolio outstanding. These additional criteria might be important due to two facts: First, that in microfinance the wages are in general higher than the regional minimum wage and second, that a TA probably could not supervise as many customers as he would be able to supervise in convenient microfinance. But here improvements are possible with the right economies, scope and learning. In the already mentioned survey of the Bank Indonesia, it was obvious that traditional Islamic regions have the best productivity improvements with 21% and the best numbers of active loans per field workers in rural areas[176]. In other words, it seems that the Islamic culture is supporting these improvements and indeed this is what this manuscript will prove. Moreover, productivity is usually followed by declining non-performing financing and improving the loan size. [177]

This discussion leads to two assumptions, which eventually strengthen the success of co-operations. First, the decision about consent or refusal of loans should be made by a third, objective and trained person and second, exclusion criteria have to be accessible and understandable by the clients. Consequently, the products have to be clarified. With games, pictures and small flyers direct products can be explained very fast, especially the conditions for the PLS are simple and direct. Properly more effort would be necessary to make the exclusive criteria understandable, transparent and, if possible, standardized. In most "best practice lists" for microfinance, simply application is emphasised, but efficiency has to be economical. Clients have to understand at least the very basic principles of economics – how to calculate their input and how to set the price for their output, and thus be able to decide when a business has potential or not[178]. It is in the favour of the institution that the clients understand the importance of profit and efficiency, esp. if the institution relies on their success. And success is important. Without the steady return through interests, Islamic MFIs are forced to distinguish between business with and without potential as opposed to convenient banks that allow credit only by collateral and not by potential. One could even claim that the bank needs to identify viable projects with a quick break-even point. This increases the efforts enormously.

[176] Bank Indonesia, Research Paper, 2002, Page 36.
[177] Regarding this survey: Sumatra is leading in this category with a plus of 120%.
[178] Remark: It is always very interesting to see, that the 50 souvenir vendors at tourist sights always offer the exact same product lines, without any diversity, always pretending their products are special. "Same same, but different".

In this context, I would like to explain the importance of the Management Information System (MIS). This system would simplify many processes in a MFI, such as keeping record over clients. They would make MFI-networks possible. For example, the mentioned records of clients could be updated to avoid moral hazards and thus would encourage co-operation between different MFIs and certain businesses.[179]

Regarding the little experience banks usually have in all business fields, the microfinance field shows similarities to venture capital companies. Like venture capital companies, Islamic MFIs would be highly specialised in the businesses they invest in (similar as convenient MFIs). Most of the businesses opened by the targeted groups are not limited to a certain field. but usually are very similar (e.g. farmers, vendors, hawkers) or regional specific (e.g. fisher, handcrafts). Regarding this the learning curves of MFIs should be relatively steep. MFIs should be able to estimate demand, potential and rivalry and with this risks and the likelihood of loss or success. However, whereas “risk” can be calculated from experience, “uncertainty” cannot. Moreover, with improved knowledge MFIs would be able to give technical support to their clients.

Technical support already begins with the teaching of basic economic principles. The technical support can also be provided for preparing a loan application or a business plan. In the latter, the idea of the relevant business, its potential success and risk is estimated, the intermediation of business partners[180] is discussed or support for an optimization of business processes is suggested. This kind of technical support is often not provided in convenient microfinance, which is theoretically not understandable. Practically, it might be quite a different issue though since it may exceed the structures of small MFIs. However, in Islamic microfinance the organisations – even small ones – have to provide technical support in order to have a guarantee to receive higher profits. [181]

This issue is not part of the discussion about the minimalist or the integrated approach, which was elucidated in chapter one[182]. It does not mean that the integrated approach has to be implemented in all Islamic MFIs. Social services, which are charitable and mostly additional development aid, can indeed be implemented in Islamic MFIs, but because of the higher necessary efforts that have to be invested before setting a contract, an integrated approach is more unlikely for an Islamic MFI compared to a convenient MFI.

[179] Remark: This paper is limited and by this can not analyze the eventually usefulness and importance of networks, esp. in Islamic banking. Those networks are probably a very good opportunity to decreases risks by combining businesses like e.g. Bai al Salam and Murabaha.
[180] Like e.g. for a supermarket contacts to a wholesale dealer from the city.
[181] During my survey the most often argument in declining technical support was “that the business are too small and therefore technical support is seen as not necessary”.
[182] See above: Chapter 1.3.

4.3.1.1 Specifics in Mudarabah

In Mudarabah contracts, the main problem lies in the little control or authority the MFI has in business decisions. Regarding the case of unrestricted contracts, it is almost impossible to influence the success apart from technical support, which obviously is here more crucial than ever. Thus, the biggest chance of manipulation without risking social consequences for the clients lies in the overvaluation of the opening inventory and final assets[183]. This could be a sufficient means even though the Islam attaches great importance to the role of information in the market and consequently strictly forbids the release of inaccurate information. Furthermore, the concealment of vital information (*ghish*) would also violate the norms of Islamic ethics. According to the traditions of the holy prophet, the informational disadvantaged party has the option to annul the contract even though it is theoretically bound to the contract. Hence, Islamic ethics requires that all information relevant to expected cash flow and asset valuation should be equally accessible to all.

The opening inventory would influence the negotiation of the profit participation of the MFIs. Although this negotiation should be flexible according to the situation, standardisation should be aimed for. This is particularly very difficult in the case of repeating loans, since in the end one depends on the same criteria as in a situation of a start-up company. In mudarabah contract[184], those criteria may be the loan amount (rising participation with increasing loans), in the repayment schedule (depending on the business, e.g. farmers vs. vendors[185]), and in the opening inventory (clients' assets, which will be used in the business), as well as in the risk anticipation (SWOT-analysis and Porter's five forces; besides: long-term financing involves higher risks[186]). Another issue that would certainly influence the negotiation between

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183 Al-Harran, S.A.S., 1993, Pages 138.

184 Remark: Other as in normal principal agent theory situations, in which a principal can offer the agent more than one contract (with different incentive structures) to use self selection, in microfinance it is not the agent who is choosing between contract forms, it is more the business which determine the type of contract.

185 "The loan term is very important and affects the repayment schedule, the revenue to the MFI, the financing cost for the client, and the ultimate suitability of the use of the loan. The closer an organisation matches loan terms to its client's need, the easier it is for the client to "carry" the loan and the more likely that payments will be made on time and in full." (Ledgerwood, 1999, Page 134).
Remark: But this only counts for very small businesses, esp. when the entrepreneur does not save. If they have equity periods of lower income and periods of higher income are clearing each other.

186 This conclusion is based on hypothesis of J. Ledgerwood in her book "Microfinance handbook", which is actually disproved by a survey about the BPRS by the Bank of Indonesia. Ledgerwood stated that if the ratio of Delinquent Borrowers (DB) is lower than Portfolio at Risk (PaR), then "it is likely that larger loans are more problematic than smaller ones".
This "is not applicable in Indonesia" regarding the survey. (Page 30-31). A test of the correlation between the on time repayment rate (OtRR) and DB produces a result of 0,33 with 90% certainty. Even a positive correlation exists between both, it is not a particular strong one.
I still stay to Ledgerwood and doubt the significance of the survey. Besides the fact that BPRS emphasis on small and medium enterprises, they just include the 25 biggest customers of each branch in their regarded test.

both actors is the question, whether the business is within a favourite sector of the MFI or not and, moreover, whether the effort and skills of the entrepreneur are sufficient.

Overvaluation of assets is a typical hidden action problem to inflate deprecation in order to cut or eliminate the element of yield and thus would influence directly the profit of the MFI. The clients can deflate profits by taking excessive perquisites, extra leisure or resorting to accounting subterfuges. To avoid both problems, a minimum of a first and a final project visit as well as the restraint of account keeping would probably belong to “sound practices” in Islamic microfinance in addition to promotion, screening, application, analysis, approval (pre-loan) and post-disbursement management (e.g. collection, delinquency follow-up, and qualification for additional loans). Due to the fact that weekly meetings with the target groups are convenient in microfinance, they provide the chance to improve relationships, to keep up connections with the organisation, to collect repayments (esp. in ‘continuous’ Mudarabah contracts), to report the ongoing of the business and to discuss emerging external and internal shocks. They can also be linked to an on-site visit, with book checking and evaluation of the business situation. Thus, a business could be evaluated at least 4 - 5 times a year – a standard in many MFIs – and thus would make deception more difficult.

A last incentive of Mudarabah to avoid risky behaviour is the decreasing status of the bank. This feature changes the role of the agent more and more to the role of the principal and the principal more into the role of an agent. Thus, the opportunistic behaviour of the entrepreneur would create actually more costs to his own account than to the bank’s and would be illogical assuming a rational behaviour.

4.3.1.2 … in Mazar’ah and in Musaqat[187]

Like explained in 3.2.1.2 and 3.2.1.4 Mazar’ah is similar to Mudarabah and Musaqat similar to Musharakah. However, through the additional risk caused by the variability of market prices and the long-term trend, the MFI will be forced to claim a higher percentage of profit in both products. Besides, the difficulty of short-term lending in agricultural business – for agricultural issues repayments are in general not possible under 6-9 months (excluding certain rice, which has a more frequent circulation) – should be emphasized and regarded. However, these huge problems have all MFIs, convenient or Islamic, as well as informal moneylenders. It underlines the importance of both products for agriculture businesses. Furthermore, both products would enable the MFI to combine businesses, which would

[187] Agricultural direct financial products.

increase profitability with non-monetary Mudarabah, Musharakah as well as Murabaha contracts[188].

4.3.1.3 … in Musharakah

In Chapter three it was already said that "Musharakah is in terms of risk an attenuation of Mudarabah"[189]. With the larger influence that the MFI has on the management of the project, the MFI can actually avoid a lot of risk. Furthermore, losses are not solely burdened on the MFI. Even though the sharing profit ratio is left to be mutually agreed upon and may be different depending on the ratio the two parties have invested, all the jurist are, unanimously, of the view that the loss shall be borne by the partners according to their capitals. In all forms of Musharakah (i.e. limited companies, co-operative societies and partnership) the loss is borne on the basis of capital"[190].

This is understandable in the light of the following two arguments. First, in the case of loss the agent has suffered a loss of his effort and labour, so he cannot additionally be asked to share any loss of capital. Since the principal, on the other hand, provides capital, his loss would be the capital lost in the business. Second, losses constitute erosion in equity and must be charged to the capital. Therefore, a loss that was incurred in one period must be offset against profits in the following periods until the entire loss has been written off and the capital sum returned to its original level. Accordingly, it would be attractive to build reserves from profits to offset any losses that may be incurred in the future. But this cannot be taken into account until the client has to contribute "capital" (the client does not have capital before). The first two to three loans will probably be carried on the financial responsibility of the bank. Based on this assumption and taking into account that businesses are dropping out of the target group of MFIs when they exceed a certain size, it can be seen as a sophism that losses can be carried on both parties.

A differentiation between *INAN*, *AMWAL* and *ABDAN* is not necessary, because the risk and efforts are almost equal. Their application is founded on the situation of the client as well as the business. *WUJUH* partnerships, in contrast, are not risky at all. The only possible risk is the loss of a reputation of the MFI. This could occur if the entrepreneur should fail a business contact or if the entrepreneur using the MFIs' face would offend the norms of the society, which is unlikely when working with Muslims.

[188] Example: A clients wants to open a pancake production based on a Murabaha contract. This business can be combined with another client, a farmer, who has a Mazar'ah contract with the bank and who is repaying with corn.
[189] See chapter above: Chapter: 3.2.1.3.
[190] Al-Harran, S., "Musharaka Financing Model", http://www.islamic-finance.net/islamic%2Dmicrofinance/harran7.html, 03.04.2004.

Again, the main difference of Musharakah contracts compared to Mudarabah contracts is the sharing of the management decision. Thus, the efforts the capital provider has to put into the business increase, but he also decrease his risk by interfering and contributing to the success of the business. The means of the engagement were demonstrated in the analysis of Mudarabah contracts where the contact between TAs and clients include at least weekly visits on site. Effectively, the increasing effort would be minimal, especially compared to the increasing control over the business.

A decreasing status of the bank should be used in Musharakah as well in order to minimize the incentive against opportunistic behaviour as mentioned in 4.3.1.1.

4.3.2 … projected on indirect financial accommodation

The situation changes when regarding indirect financial accommodations. Here, the bank is no partner of the entrepreneur anymore and is not relying on the profit of the business but instead is offering direct financial accommodations. This issue simplifies the financial transaction enormously. The effort of the side of the bank is limited to the time before and after the contract is realized and on top decreasing. The superiority[191] of these product groups in application of convenient Islamic banks proves that Islamic banks are risk-avers as well.

4.3.2.1 Specifics in Murabaha

In Murabaha the bank is adopting a trailer role in buying and selling the demanded products, for financing commodity trade and acquisition of long-term assets. A major tenet of the murabaha methodology is the fixed contract for a certain service. This contrasts with conventional microfinance, in which the clients engage in a contract, whose cost could change depending on repayment performance. If repayment is not defined in regard to a specific time, problems can occur. According to the definition of Murabaha there is no possibility to penalise delayed payments, and apart of these costs, a long-term problem may emerge as well. “How should an entrepreneur understand why he has to pay back the loan at all, when his neighbour sees almost no personal consequences in not doing so?”[192] And experience has shown that many borrowers take advantage of this[193]. This issue has received much attention e.g. “In some countries, like Bangladesh and Pakistan, a penalty provision is introduced on mark-up based contracts if the stipulated instalments are not paid by the clients to the bank in due time-period, which also acts as a risk minimiser. This type of

[191] Dr Al-Harran, Saad, Time for Long-Term Islamic Financing, http://www.islamic-finance.net/islamic%2Dmicrofinance/harran1.htm, 03.04.2004.
[192] Interview with Radif (trust agent) at the 27.02. in Beaufort, Sabah, East Malaysia.
[193] Haron, S., Shanmugam, B., 1997, Page 122.

mark-up on mark-up is called “compensation charge” in Bangladesh and “kheyanat charge” in Pakistan respectively.”[194] In general, before the different schools can take position, a solution acceptable for clients has to be found for this problem.

Another risk may emerge, if the borrower does not accept the quality or price of the purchased items. Even though the conditions of the product are in general agreed upon before the contract is closed, sometimes not all criteria can be met (sometimes it just not possible to find a perfect 5`11 feet, hazel, 4 month old cow for 200.000 rupiah within 2 weeks). The problem is increasing, especially when this process is being repeated constantly – i.e. a Mudarabah[195] contract stating several sales over a certain time span. In this case, risk would be fully avoidable when the MFI would make a separate murabaha contract for each consignment. However, if there is a long time gap between contract closing and delivery, this is not an option. Still in both situations – one time or repeating transactions –, the problems often occur with commodities that have volatile prices – where the price declines after the first purchase by the bank. In this case, the MFI could retain an option for itself at the time of purchase from the original supplier. Subsequently, if the client buys the product like promised, the option would automatically expire and the former contract would become binding. However, if the client fails to honour his commitment – this is prohibited by *Al Qimar* – the Islamic bank would be in a position to exercise its option and rescind the purchased contract. This is ethically justifiable since the MFI is just decreasing its own risk, not abolishing it. The original supplier, on the other side, is now exposed to greater risk and as long as he has calculated his contractual price (*thaman*) including the compensation for risk, it is islamically valid. Thus, the MFI would face a higher risk, which would probably affect the entrepreneur.

Nonetheless, other incentives for repayment remain in place. Tools such as the attraction of the possibility for renewing loans and/or taking larger loans, using peer groups as well as regular equal instalments – compulsory savings – to enforce discipline among borrowers, and social pressure on delinquent borrowers can reduce the risk.

However, the risk for the bank is very limited on this product, especially since the items are still in the possession of the bank and thus can be taken back in the case that a contract fails. On the other side, this ownership makes the bank bear the risks of breakage, theft and fire as long as the debt is not fully paid.

[194] Sarker, A.A., 1999, Page 8.

[195] This does not conflict with presumption one, because this contract covers one project. Examples: A farmer wants to purchase fertiliser over 2 years. A pancake-productions wants to purchase flour over 6 months.

Even though Murabaha is preferable in regard to many products, it is still not applicable for all products and businesses. And although the application for a Murabaha loan is not linked to the investment of training the entrepreneur and monitoring the business, both should be provided with the same coverage.

4.3.2.2 … in Istishna

The additional problems compared to the other financial products lie in pricing the risk itself. As explained above, the MFI finances a production by buying the produced items in advanced. This leads to two risks. First, the market price is to be determined long before the product is delivered. If the market price of the commodity decreases subsequently, the Islamic bank would clearly be at a disadvantage. While its cash inflow due to sales from the client's business would remain fixed, the outflows in the form of payments to the final buyer would increase – if this transaction were not already closed as well. This is actually a realistic assumption, since the MFI would prefer a safe distribution channel as soon as possible and not to get stuck with the assets. The second possibility – a price increase – would only reduce the cash inflow of the final buyer and thus would not affect the MFI and client. The second risk includes the product characteristics. Besides that the product has to be defined in quality, quantity, and price, the delivery date has to be set, idiosyncrasies are not to be excluded.

4.3.2.3 … in Bai al Salam

Both of the problems occurring in Istishna are magnified in regard to Bai al Salam. The price also has to be estimated but with little specification of the product it is even more difficult and uncertain.

In order for the MFI to avoid the risk of poor product quality and to gain benefits from subsequent favourable price movements, another basic derivative product that facilitates risk management could be invented: an option. Already named as one possibility in Mudarabah contracts, an option contract provides the right to buy or to sell the product eventually. The price of such a put/call is a clear loss and makes an option islamically legitimate. If the product does not correspond to the agreed quality standards, e.g. the entrepreneur did not take care well enough of the calf (seen as the debt) and consequently the calf is weak and sick, the client would be forced to sell the products (the calf) on his own. Another possibility occurs when the price falls and no following sale is closed. In that case, the MFI would have the same possibility as the client himself when the price is increasing and abdicating from the contract would pay the agreed call price.

For some businesses, however, Bai al Salam is not comparable to Istishna. Exemplified on pre-financed corn whose quality is hard to pre-determine and thus excluded from Istishna contracts, the business type determines the type of contract. Clients have just a small chance to choose between contracts and thus singal their intentions.

4.3.2.4 … in Ijarah

Whether Ijarah in Microfinance will be as popular as leasing is in the industrialized world (1999 it constitutes 15% of the world's macroeconomic investments; in the USA even 20%)[196], remains to be seen.

For sure it has to be adjusted to microfinance first before it can be implemented. Especially critical are the time spans of the leasing contracts. Ijarah Mutahia Bittamlik (operating lease) with a general time span of 1 year and especially Ijara Wa Iktina (financial lease) with a time span of normally a couple of years would both probably exceed the puissance of MFIs. A MFI is not able to hold a large asset pool and should aim at a fast amortization. Even more, the already mentioned efforts of MFIs (to search, to buy, to transport, to erect and to install the demanded product) and the involved risks in those efforts will be increased. The responsibility for maintenance, insurance and drop-outs when providing operational leases leads to the recommendation of financial leases.

The complexity of the products itself and the problems of explaining the products increasing in the here seen order of appearance in indirect financial accommodations. This issue has to be regarded in regard to educating both stuff and clients. But taken the idea into account that the mark-up principle will probably be the first loan type a client will be offered by a bank, due to the short term character and the minimal risks, to prove his bankability, the bank has enough time to discuss and to explain the product availability for the future. And with visualisation, games and role plays the most difficult things can be made easy to understand.

4.3.2.5 … in Benevolent Loan—Qardh ul Hasan

Since there is no monetary benefit in this product, there is no risk. Qardh ul Hasan is linked to *Zakat* and can be seen as a development aid and should be used for a social purpose.

4.3.3 Saving Deposits

Saving accounts do not bear the risk for the MFI either but are critical for sustainability, as long as the rewards taken as a substitute for interest are not exceeding the cash inflow.

[196] http://www.bankstudent.de/downloads4/bbl11.htm, 13.07.2004.

Chapter 5 Conclusion

If regarding the revolution of microfinance as an evolution of a new industry, one can hardly say “this revolution is over”. So far, many questions have not been clarified including if and how this industry may be profitable, how much regulation is necessary and which practices are sound and the best. And most importantly, the potential demand is still unbroken.

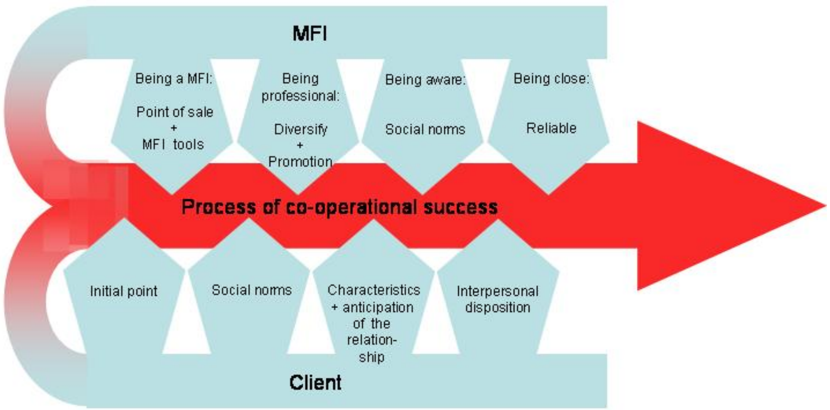
This paper aimed to analyse the possibility of opening the access to financial services to a new, not yet regarded group of devout Muslims under and along the poverty line. The comparison of Islamic banking with convenient microfinance practices in the light of the Islamic culture shows that the prohibition of *Riba* (interests) is not an obstacle at all; it has perhaps even more potential in terms of sustainability. The very high rate of return as compared to a fixed rate of interest, the way of supporting businesses and productive activity (in contrast to the only criteria which counts in convenient banks: collateral), the more effective mobilisation of excess resources, the less frustrated and exploited society and perhaps, the positive macro-economical effect with more demands for loans and less collateral will probably cross out all the negative effects. The negative effects include the negative appraisal of a participation of banks due to an increased time and risk investment as well as a potential withdrawal to avoid voting rights by the clients. Perhaps Islamic Microfinance may even be a start for a change into a capitalist approach based on Islamic principles.

Moreover, the Islamic culture supports microfinance in many ways. With its micro and macro perspectives and their omnipresence in the day-to-day life, especially in rural developing areas many risks seen in the products of Islamic microfinance can be overcome. The implementation of direct and indirect financial accommodations is very compatible with sound microfinance practices.

Figure 5.1. illustrates that the advantage of “being at the point of sale” and the use of typical instruments by the MFIs is not enough to be successful. MFIs have also to be sustainable; they have to diversify their products and they will have to promote these products. They have to be aware of the social norms and to adjust their products to the demand and consequently to the social norms. To minimise risks, especially in direct financial accommodation with high potential profit, but where profit and loss are shared and the potential of a moral hazard is very high, MFIs have to build up a trustworthy relationship. They have to form a sense of family and trust among their borrowers. According to the typical problems of principal agent relations, the anticipation and perception of the clients in terms of trust and honesty, pre-information, verbal communication, the willingness of reciprocal liabilities and not at least the

interpersonal disposition between client and trust agent itself, are very important for a positive outcome of the co-operation. Those characteristics enable a renunciation of self-interest for an orientation towards positive results from their actions for their partner. The Islamic culture is supporting this process by determines the Islamic 'role of man', which one have to anticipate when working with devout Muslims. Here, the stewardship theory offers the theoretical background: a set of pre-existing shared values, beliefs, concepts, traditions and moral attitudes, which provide a common bond between those involved similar to bonds derived from religious precepts. Still, a MFI has to be professional and should adopt many business-like approaches to minimise risks, for example to be able to predict the potential of a suggested business and provide technical support to increase the likelihood of success. Efforts, which may be occurred by these additional practices, are simple to implement by using typical microfinance tools (e.g. "group lending" and "weekly meetings"). Furthermore, the decreasing status of the MFI in the businesses is a safeguard against excessive opportunistic behaviour on part of the client.

Figure 5.1: – Driving forces in the co-operation process of Islamic MFIs



Regarding indirect financial accommodations the perspective is just slightly changed. Even though most of the risks are decreasing and limited to the time before and after the contract (thus not really affecting their relationship anymore) the main success bringing factors still remains with the same in direct accommodations. Scilicet, without the success of the client's business there is no chance to get repaid. Nevertheless, by comparing the predominant use of indirect financial accommodations in convenient Islamic banking to direct accommodations, the risk-avers behaviour of institutions is surfacing. However, that does not have to be in a microfinance context. MFIs have an advantage compared to convenient banks: Even though the loan amounts are relatively small, the close cooperation and good relationship between client and MFI based on Islamic principles make the efforts less risky. Thus, the higher rate of return of direct products is more preferable. However, indirect products are not really adjusted yet to fit into microfinance e.g. in Murabaha. Moreover, other products (e.g. options) that conform with the Islamic rules could be invented to reduce risks especially market risks for the MFIs.

On the other hand, in most cases it is not the client that can choose between the products at all; it is the business determining the contract. Consequently, a large number of diversified financial products can be provided in microfinance to open the access to millions of Muslims. It would increase the number of microfinance institutes, thus increasing the market competition and the outreach. The evolution of microfinance would take the next step - the revolution would move on.

During the literature research, my survey (see Appendix I + II) with the help of MFIs in Malaysia and Indonesia, and in discussions during writing this paper, I came across many people in the development co-operation field that were very open and interested in this topic. But not enough that they are interested, they even rank Islamic microfinance as a connotative in the development of Islamic dominated developing areas – and of microfinance itself.

In this context, further surveys are necessary. Apart from the general discussion whether microfinance is supporting economical growth or whether it is just reallocating money (see chapter one), other questions came to surface. One question addresses whether Islamic and convenient microfinance differ in their individual effects, esp. regarding sustainability, outreach and success of the supported projects. Other questions, which should be regarded in further surveys and papers, concern the role of governments, networks between institutes and rankings carried out by MFAs. The role of governments in Islamic microfinance will probably be more intense than in convenient microfinance. A similar discussion is whether Islamic Banks need additionally a Shari'ah supervision, which would have to be arranged by the government or the state bank since MFIs only have limited financial and human resources. The idea of networks for microfinance institutes would be eventually even more effective for Islamic than for convenient microfinance institutes. Like discussed, is the potential for co-operation not limited to the exchange of client records, but even to combine businesses.

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Appendix I

The survey

The field research took place in Malaysia and Indonesia.

The field research in Malaysia was limited to two weeks in which Sonia Reinhardt and I were visiting a couple of branches of AIM in West- and East Malaysia. In the first week, we experienced microfinance for the first time in practise and got an own impression about the direct work with the poor by visiting their projects and discussing with the trust agents and clients. This impression was quite different, and even more positive than the one we had in the first place after reading most of our literature. During our second week in Sabah, East Malaysia, we had the opportunity to take structured interviews with clients and trust agents. We participated at group meetings, project evaluations and work shops.

In Indonesia, where the second part of my field research took place, the survey was limited by external political shocks, the unwillingness of some organisations in forwarding information or contacts. Additionally, I was not allowed to participate at a conference about Islamic Banking in Nusa Dua, Bali. Still, the interview with ASBISINDO in Jakarta, especially with Mr. Surachman, opened the access to the network of BKRS for two more interviews in Yogyakarta and Kuta, as well as for six further questionnaires. By coincident, I came in contact with three NGOs, which increased the number of answered questionnaires up to nine.

Taking in count that the structured interviews and the questionnaires were just slightly different and the answers, which were used in this analysis, were asked in the same way, one could say 14 “questionnaires” were answered.

All in all one has to relativise the survey:

At first Islamic Microfinance, how we defined it in this thesis, was just provided by one of the NGOs. The question, *“if they know any other NGOs providing Islam conforming financial products to the poor”* was always answered with *“no”*. If this shows a true picture of whole Indonesia or not, it made a quantitative comparison between Islamic microfinance institutes and convenient microfinance institutes not possible within this survey. Therefore the emphasis of the survey was on qualitative questions.

Furthermore 14 questionnaires, answered by different organisations using different instruments and ways of implementation, can just give an impression, rather than a general, scientific conclusion.

Appendix II

The questionnaire:

The questionnaire was sent to the NGOs in English and Bahsa Indonesia. Here the English version:

To whom it may concern,

Salamaleikum,

I want to thank you for your cooperation in name of the organisations (Human Behavior, RWTH Aachen, Germany, and the German Institute for technical cooperation) I work for and for sure, myself. Filling out this questionnaire will help me to bring more light into the field of Islamic banking applied in the microfinance environment.

If you want to have a copy of the final report, please feel free to mention that in your response. It will be due in September this year.

If you know other microfinance institutes using Islamic products which might be interested in participation this survey, fell free to forward this questionnaire.

If you might be able to answer the question in English, I would be very pleased. If not, answering in Bahsa Indonesia won't be a problem neither.

If you need more space two answer the questions, please do so on an extra page

Please send the answered questionnaire back until the **25. May 2004** to:

Human-Behavior@email.de

or to

Matthias Range
Prince George's Park Residence
Prince Geoge's Park 6
Block 28, Level 2, Room H
118420 Singapore

Thanks again for you effort and participation

Sincerely

Matthias Range

RWTH AACHEN
RHEINISCH-WESTFÄLISCHE TECHNISCHE HOCHSCHULE AACHEN

gtz
Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH

1. Facts about the organization

1. Since when is your branch operating? ________

2. How many employees working in your branch

    a. Manager : ________

    b. Field staff : ________

    c. Other : ________

3. What products are you offering

    a. How standardised are the products. Is there space for modifications?

    b. Do you offer saving or insurance products?

4. Do you give technical support?

    a. If no, why not?

    b. If yes, which?

5. How important is humanitarian and social service?

a. What are you doing?

6. Is it difficult to explain the products to the clients?

7. How do you collect the money?

2. Identification with the poor

1. Are you giving credit to everybody?
2. Are you having a poverty line
   a. Where do set this

   b. Did you set this by your own, or are you following guidelines?

3. Outreach

1. What's the average distance to your clients? ____________
2. How many people did you serve with credit last year? ____________
3. Could you increase the number of clients compared to last year.?
   If not, why?

____
____
____

4. What exactly are you doing to increase the number of clients?

____
____
____

5. How long does it take from the point somebody is applying for a loan until he finally gets the money?

____
____
____

6. Who is giving the final o.k. for a loan?

____
____
____

7. How big is the potential of new clients in your area? ____________

4. Staff

1. Is it hard to recruit new staff? ____________
   a. Where does it come form?

2. Do they get training?
    a. How often per year?
    b. Who is giving the training?

3. Is there any motivation (money, awards, carreer) for the staff?
    a. Which?

4. How do you try to build up trust with the clients?
    a. Please explain the process

5. Do you have any activities together with your clients? For example?

6. How big is name recognition?

a. How many people know you in this region out of 100? ______

7. Do you think your clients identify themselves with your organisation? Are they proud to work with you? ______

8. Do you have a manual?
   a. Job description ______
   b. Performance degreements ______
   c. Product catalog ______
   d. Other, be specific:

5.. Management

1. Did you have any managerial change in the last years. New Focus? New targets?

______

______

2. How strong is the competition?

______

______

______

3. Do you do marketing?
   a. If yes, what strategies, products, etc do you have?

______

______

______

   b. If not, why?

______

______

6. Risk

1. How do you estimate risk?

______

2. Do you have a risk ranking for the clients? Explain:

3. Do you use criteria for this ranking?
   a. Which are those?

4. What do the clients have to prepare to get the loans?

5. Do you take collateral?
   a. If not, why?

6. Do you work with equity? ____________
7. Do you work with peer groups? ____________
   a. Which size is average? ____________people
8. Do you work with group lending? ____________
   Why?

9. Do you offer saving or insurance?
   a. How many people have you been reaching with these products? ____________
10. Are you monitoring the projects?
   a. Who evaluates? ______________________________
   b. How often per year? ____________

11. How often do the clients have to report about their projects? ____________

12. What do you do when somebody´s business fails?

____

____

7. Your opinion

What do you think is most important in your job?

____

____

____

____

What do you think is most important to make the people pay back?

____

____

____

____

8. Numbers 2003

Total outstanding balance of late loans	____________%
Amount of loans outstanding	____________RP
Costs per loan	____________RP
Financial income + other operating income	____________RP
Loan loss reserve	____________RP
Operating costs	____________RP
Adminstrative expenses	____________RP
Repayment rate	____________%
Portfolio at risk Costs per loan	____________%

Affirmation

With this I affirm, that this thesis is written by myself without any extra help or instruments, which are not mentioned. All excerpts are indicated and as well listed in the bibliography.

This thesis does not exists in any similar form.

Aachen, 15.10.2004 ______________________________