ISLAMIC MICROFINANCE: FROM A MARKET NICHES TO A GROWING INDUSTRY

Islamic microfinance has become a rapidly growing market, providing access to financial services to millions of poor people who are at the moment not served by conventional microfinance. Taken in this context, Islamic microfinance is an important instrument for poverty alleviation and an effective strategy to achieving financial inclusion. Over the past decade, Islamic microfinance has emerged from a market niche to a rapidly growing industry worldwide.

An estimated 255 financial services providers are offering Shari’a-compliant microfinance products, serving about 1.28 million customers of which about 82% are living in Bangladesh, Indonesia, and Sudan. Despite its importance, this niche sector of Islamic finance has yet to reach scale as Islamic microfinance industry accounts for less than 1% of the global microfinance outreach. With 1.2 billion of global population living below the poverty line (i.e. living on less than US$2 per day) and of which 44% of them are concentrated in Muslim countries, Islamic microfinance is set to record double-digit growth rate of 20% over the period 2015-2018.

Microfinance – The Silver Bullet for Poverty Alleviation and Financial Inclusion

Since the first microcredits were issued some 40 years ago, the microfinance sector has significantly expanded. There are some 106 million microfinance borrowers with about 1,391 microfinance institutions (MFIs) reporting data to the Microfinance Information Exchange (Figure 1). According to the Microfinance Barometer 2015, the average micro loan by client was US$1,576 for banks, US$334 for NGOs and US$766 for non-bank financial institutions. Based on estimates for 2014; East Asia and the Pacific, Africa and South Asia experienced the strongest growth, both in terms of borrower numbers and loan portfolio. The Barometer also reported that South Asia is home to more borrowers than the rest of the world combined, even though the region only possesses one tenth of assets.

Although not spared from crises, which had led to huge pressure for the implementation of more responsible economic models to ensure the viability of the sector and its mission, microfinance has remained a resilient sector. This is demonstrated by its continued success and

Figure 1:
MICROFINANCE LANDSCAPE

World Total 2013

- Top 160 MFIs: 78%
- Other MFIs: 22%
- World Portfolio of Loans: $95.1 billion
- Number of Borrowers: 105.9 M
  - +10.3% (2013)
  - +9.2% (2014)

Eastern Europe & Central Asia

- Portfolio Size: $14.1 billion
- Number of MFIs Reporting: 226
- Number of Borrowers: 3.1 M
  - +14.4% (2013)
  - +12.5% (2014)

Middle East & North Africa

- Portfolio Size: $1.8 billion
- Number of MFIs Reporting: 44
- Number of Borrowers: 2 M
  - +4.7% (2013)
  - +9.0% (2014)

South Asia

- Portfolio Size: $10.7 billion
- Number of MFIs Reporting: 203
- Number of Borrowers: 56.7 M
  - +11.9% (2013)
  - +11.2% (2014)

Latin America & Caribbean

- Portfolio Size: $38.1 billion
- Number of MFIs Reporting: 330
- Number of Borrowers: 21.9 M
  - +10.4% (2013)
  - +2.3% (2014)

Africa

- Portfolio Size: $8.3 billion
- Number of MFIs Reporting: 368
- Number of Borrowers: 8.7 M
  - +6.5% (2013)
  - +9.3% (2014)

East Asia and Pacific

- Portfolio Size: $22.5 billion
- Number of MFIs Reporting: 157
- Number of Borrowers: 13.4 M
  - +5.0% (2013)
  - +16.6% (2014)

World Portfolio of Loans and Number of Borrowers in 2013

- Number of Borrowers: +10.3% (2013) Annual Growth
- Proportion of Rural Borrowers
- Portfolio Size
- Number of MFIs Reporting to the Mix

Source: Mix Market
Microfinance remains an important tool in tackling poverty, reducing financial exclusion and promoting social inclusion. The key role of microfinance in these 3 areas was recognised in the United Nations Millennium Development Goals (MDGs) where 89 nations pledged to halve hunger and extreme poverty by 2015, promote gender equality and achieve universal primary education (See Box 9.1). Much progress have been achieved over the last 15 years with microfinance playing a substantial role as a crucial vehicle to driving the achievements of MDGs, especially among the most vulnerable populations in rural areas and least advanced countries.

Despite success in reaching most of MDGs targets, many obstacles are still in line and much more effort is needed. Although the goal of halving poverty was met (the number of
people living in extreme poverty reduced by 56% from 1.9 billion in 1990 to 836 million in 2015); income inequality is higher and various disparities (gender, ethnic and regional) persist.

Based on 2014 figures, Oxfam reported that the world’s 80 richest individuals now own as much wealth as the poorest 3.5 billion people. According to the latest data available based on the World Bank Word Development Indicators (WDI), the percentage of the population living on less than US$1.25 a day at 2005 international prices is highest in OIC member countries located in sub Saharan Africa (Figure 2).

Following the MDGs, the United Nations General Assembly in September 2015 adopted new 17 Sustainable Development Goals (SDGs) intended to eradicate poverty by the year 2030 (Figure 3). The SDGs, which build on MDGs, take into account the two key challenges to be addressed in reducing poverty and ensuring everyone can access their full human rights – growing inequality and increased impact of climate change. The first of the SDGs is to “end poverty in all its forms everywhere,” and one target within this goal is to “ensure that all men

2. The Millennium Development Goals Report 2015 Fact Sheet. UN Department of Public Information.
and women, in particular the poor and the vulnerable, have equal rights to economic resources, as well as access to financial services, including microfinance.”

This means that, despite the recent change in donor priorities, financial inclusion through microfinance is still seen as key to the elimination of poverty. However, financial inclusion in many Muslim majority countries remains low. Particularly in Sub-Saharan Africa and South Asia – home to many Muslim majority countries and also the majority of global poverty – poor people cannot meet their basic needs and have no access to basic services, including financial products that could ease their suffering. Strikingly, bankability and account penetration is lowest in the Muslim majority countries in Sub-Saharan Africa, Central, South and South-East Asia (see Figure 1).

Poverty is the primary reason for the introduction of microfinance in the first place. Therefore, poverty studies should provide some explanation to the resilience and importance of microfinance. It is argued that poverty should be defined within minimally acceptable level of basic capabilities, not just based on income.  

Hence, poverty is a result of combination of entitlement failure (loss of command over resources) and capability failure, or loss of ability to convert resources into useful functioning. Likewise, the World Bank in its World Development Report 2001 defines poverty as a situation where the poor are facing lack of opportunity, insecurity and vulnerability, and powerlessness. It is in the first category that finance has been identified as a source of problem, as well as solution to poverty. The Multidimensional Poverty Index (MPI), on the other hand, assesses poverty from three dimensions: education, health and living standards.

This realisation triggers institution such as the World Bank, Islamic Development Bank and other multilaterals to introduce poverty alleviation programmes with microfinance or access to finance as the main component. These interventions by the multilaterals rest on the assumption that the key opportunity not available to the poor is their lack of access to credit or financial services as a result of market failures. As such, access to finance is an important narrative in the international development financing and economics literature on development and poverty studies. In fact, in recent years the narrative has been broadened to include financial inclusion as the main objective of creating access to financial services for the poor.

However, microfinance in silo is not a miracle solution in eradicating extreme poverty. Experiences in countries where microfinance is firmly established demonstrate that microfinance can deliver positive effects only when it is combined holistically and integrated effectively with other economic and social programmes to meet the diverse needs of the poor and help lift them from poverty. Many development experts agree that microfinance can economically empower individuals as having access to formal financial services help improve their lives and work their way out of poverty. Nonetheless, this positive impact can only be achieved if microfinance is properly harnessed and supported.

Evidence has shown that microfinance programmes can be financially and operationally sustainable and in most cases are claimed to have significant positive impact on poor people’s social and economic empowerment. But more recent impact studies have cast a shadow of doubt over negative consequences such as over-indebtedness, lack of responsible lending and interest rates sometimes exceeding 100% APR. Many critiques say microfinance has not only failed to improve the lives of the poorest groups in society but has led many borrowers into a debt trap.

Microfinance crisis in India following a string of suicides by micro borrowers due to the inability to repay loans is a prime example of how microfinance can be a double-edge sword: it can either reduce the financial vulnerability of households or push them further into debt. These critiques opined that microcredit does not reduce poverty. They argued that microfinance usually ends up making poverty worse due to the following reasons:

- **High interest rates** of between 30% and 40% charged by microcredit institutions often sink consumers further into debt and poverty. Borrowers who failed to earn at least 35% return on investment actually end up poorer as a result of taking a micro loan.

- **Most borrowers are not entrepreneurs and they lack skills to run a business.** Only a few MFIs provide any type of formal business training to the borrowers as they assume these borrowers are entrepreneurs and that they understand how to succeed. When business fails, this leads to vicious cycles of over-indebtedness that drive borrowers even further into poverty.

- **Loans are used to fund consumption rather than for income-generating activities.** As a result,

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5. Banerjee and Duflo, 2006; Tripathi, 2006; Karnani, 2011
BOX 7.1: MILLENNIUM DEVELOPMENT GOALS

The Millennium Development Goals were adopted in the Millennium Declaration by the heads of 189 states at the United Nations Organisation’s summit in the year 2000. The eight Millennium Development Goals constitute the international community’s commitment to reduce poverty and hunger worldwide, to achieve equal status of women and men, improve the state of health, improve the educational conditions, combat AIDS, protect the natural environment, and develop a global partnership for development. The deadline for the achievement of these Goals was fixed for the year 2015.

Some of the key achievements include:

- Extreme poverty has declined significantly over the last two decades. In 1990, nearly half of the population in the developing world lived on less than US$1.25 a day; that proportion declined to 14% in 2015.

- Globally, the number of people living in extreme poverty has declined by more than half, falling from 1.9 billion in 1990 to 836 million in 2015.

- The number of out-of-school children of primary school age worldwide has fallen by almost half, to an estimated 57 million in 2015, down from 100 million in 2000.

- 90% of countries have more women in parliament since 1995.
Global number of deaths of children under five declined from 12.7 million in 1990 to almost 6 million in 2015.

Global maternal mortality ratio declined by 45% from 380 deaths per 100,000 live births in 1990 to 210 in 2015.

Global malaria incidence rate has fallen by 37% and the mortality rate by 58%.

1.9 billion people have gained access to piped drinking water since 1990.

Globally, 147 countries have met the drinking water target, 95 countries have met the sanitation target and 77 countries have met both.

Global internet penetration has increased from 6% in 2000 to 43% in 2015. As a result some 3.2 billion people are linked to a global network of content and applications.

Notwithstanding the many successes, inequalities persist and progress has been uneven as the poorest and most vulnerable people are being left behind. Where progress have been achieved, it tends to bypass women and those who are lowest on the economic ladder or are disadvantaged because of their age, disability or ethnicity. The world’s poor remain overwhelmingly concentrated in some parts of the world and big gaps exist between the poorest and richest households, as well as between rural and urban areas. Climate change and environmental degradation such as water scarcity, rise in greenhouse gas emissions, overexploitation of marine fish stock and massive deforestation had significantly affected the poor as their livelihoods are more directly tied to natural resources.


borrowers end up taking out new loans to repay the old ones as they were unable to generate any new income to repay the earlier loans and hence, wrapping themselves in layers of debt. In South Africa, for example, consumption accounts for 94% of microfinance use.

Lack of economies of scale and low productivity of the businesses, leading to low earning to rise out of poverty. As entrepreneurs, micro borrowers also tend to encounter lack of consumer demand as their potential customers are poor and low on cash, which has the effect of higher business failure risks. This raises some concerns about the viability of Islamic microfinance where economies of scale are required for operational efficiency due to the high transaction cost and the credit risk associated with service delivery to the poor, often in rural areas.

6. Jason Hickel 2015
Similar critics have been addressed to Islamic microfinance, especially to Islamic banks and other prominent Islamic financial institutions (IFIs) for their ‘failure’ to serve the 650 million poor in the Muslim countries. However, the emergence of Islamic microfinance institutions (IMFIs) in early 1980s, and their continued expansion, did rescue the reputation of IFIs, and this momentum continues to develop today as the Islamic microfinance sector is currently serving the poor in more than 18 countries globally.

For microfinance to be an effective poverty alleviation tool and more importantly be sustainable, it should have a positive impact on the financial vulnerability of its clients. However, this depends largely upon how microfinance clients articulate and coordinate microfinance with the other financial tools to which they have access and the whole range of strategies deployed to cope with vulnerability and to build assets, both tangible and intangible. To ensure a high success rate, micro clients should be given basic services that improve the employability

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7. Guerin et al, 2009
Broadly speaking, the market for microfinance in the Muslim world can be divided into three segments: 1) individuals who only use Shari’a-compliant products; 2) individuals who state a clear preference for Shari’a-compliant finance but, due to unavailability or price differentials, accept conventional finance, and finally; 3) individuals who will accept conventional finance products. The ratios of these groups fluctuate by region.” (Mohammed Khaled, CGAP 2011)

Technological innovation, product innovation, wider outreach, and increased stakeholder responsibility are crucial for the sector’s continued growth and sustainability. In recent years, we have witnessed greater willingness by authorities to provide better regulation for this sector. In parallel to this development is the emerging number of regulated initiatives aimed at promoting a healthier and more robust microfinance industry. All these development are geared toward ensuring the sector remains an alternative for more than 2 billion people currently excluded from the traditional banking system across the globe (Figure 4).

Islamic Microfinance – Providing Financial Services for the Poor

The worth of worldwide Islamic financial assets have leapt from half a million dollars in the 1970s to an estimated US$1.5 trillion today (GIFR 2015). Ernst & Young estimates that global Islamic assets will top US$3.4 trillion by 2018. While Islamic banking and finance has long been dominated by the liquidity rich, advanced economies in the GCC, the fastest growing markets are now more evenly spread across the world to include countries like Indonesia, Malaysia, Turkey and Iran with growth rates well above 15% per annum. But this growth is centred on investment banking rather than on the retail sector, let alone bringing Islamic finance to the impoverished masses.

Islamic microfinance is often held up by industry practitioners and policy-makers as the shining example of the social and participatory nature of Islamic finance. It is also said to be at the heart of Islamic finance as it addresses one of the fundamental roles of financial intermediaries demanded by Shari’a - income growth, functional distribution of income and promoting equal opportunities for all members of society as positive measures to improve the life of the poor.8 Moreover it could be argued that Islamic microfinance has the potential to increase the overall market share of Islamic banking and finance by bringing untapped populations

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8. Mansori et. al. 2015
into the formal financial services sector. For example, Islamic microfinance holds tremendous potential to tap into and productively channel scattered Islamic donor streams (namely zakat, sadaqat, and waqf) toward strategic, impact-oriented goals.\(^9\)

As a component of Islamic finance, Islamic microfinance when fully utilised can be of great value in fighting poverty and achieving SDGs. For example, re-distributive instruments such as zakat, waqf (endowment) and sadaqat (charity) can play a vital role of social protection and alleviating poverty in a dignified manner and can lead to wider social and financial inclusion.\(^10\)

Hence as part of the wider Islamic financial system, Islamic microfinance helps stimulate economic activity and entrepreneurship towards addressing poverty and inequality, ensures financial and social stability, and promotes comprehensive human development and fairness. All these are relevant to SDGs. Since Islamic microfinance is said to emphasize more on ethical, moral and social factors to promote equality and fairness for the prosperity of the society, one can view it as offering a better financing tool compared to the conventional microfinance system.

With an estimated 650 million Muslims living on less than US$2 a day, the need to bring together faith and finance is clear. Islamic microfinance fits into the asset-based economic paradigm and equity objective of Islamic moral economy as well as fulfilling all other social expectations. Thus, there is compatibility and complementarity between the objectives and operational mechanism of microfinance and of Islamic finance. However, other than a few exceptions, Islamic banks have shunned away from microfinance.

Islamic microfinance, although still in its infancy, seeks to provide an economic empowerment tool for poor or disadvantaged people. Based on Islamic financing methods that avoid

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9. Gates Foundation 2015
10. Islamic Development Bank 2015
interest, which is forbidden in Shari’a as it is seen as exploitative, focus is on trade and investment in productive activities, encouraged by the ethical teachings of the Quran and Sunnah. Similarly to conventional microfinance, Islamic microfinance targets a sector that is usually regarded by the mainstream finance industry as ‘unbankable’ due to the absolute or relative lack of collateral to secure loans against. In this sense, Islamic microfinance is at the heart of the microfinance movement by breaking down the barriers to broader access to development finance.

In many countries with a significant Muslim population, however, it is also thought that the fact that loans are interest-bearing excludes Muslim borrowers from finance and microfinance. But a number of market studies reveal that, for example in Algeria and Jordan, approximately only 20% of the poor cite religious reasons for not seeking conventional microfinance, while, in Yemen and Syria, this percentage rises to 40%. In a 2008 CGAP survey, local practitioners and key informants suggested similar demand trends in Indonesia, Afghanistan, Pakistan, and the Palestinian territories as well as in Muslim majority areas of India, Sri Lanka, Brunei, Cambodia, and the Philippines. With about 44% of the 1.3 billion people who live below the poverty line reside in Muslim countries, this reflect that there are millions of people who could benefit from Islamic microfinance.

“Broadly speaking, the market for microfinance in the Muslim world can be divided into three segments: 1) individuals who only use Shari’a-compliant products; 2) individuals who state a clear preference for Shari’a-compliant finance but, due to unavailability or price differentials, accept conventional finance, and finally; 3) individuals who will accept conventional finance products. The ratios of these groups fluctuate by region.”(Mohammed Khaled, CGAP 2011)

**Islamic Microfinance Models**

Islamic microfinance in an important component of the Islamic financial system that offers financial services to the poor and microenterprises. The definition and operational description of Islamic microfinance are very much influenced by the way Islamic banking is defined and operated. It seems that the association between Islamic banking and Islamic microfinance goes beyond historical context of Mit Ghamr bank in Egypt. As Mit Ghamr may signify the birth of Islamic banking, and to a degree the emergence of Islamic microfinance, current practice of Islamic microfinance is strongly governed by theoretical, institutional and legal framework of Islamic banking.

The main characteristic of Islamic microfinance is the use of variety of contracts similar to Islamic banking. There are at least four types of contracts available in Islamic finance, namely equity based or partnership based, trade finance-based or micro-credit, rental based modes and charity based (Figure 5). Of these modes of financing or contractual arrangements, the partnership contract of musharaka is seen as the most suitable for microfinance institutions.

However, in practice, most of the IMFs predominantly use qard hassan and murabaha. It is evident from the Consultative Group to Assist the Poor (CGAP) study that the Islamic microfinance industry very heavily relies on murabaha due to the ease and simplicity of the structure, making it is very easy to deploy (Figure 6). According to CGAP statistics, there are some

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11. IFC 2007
12. The CGAP survey was carried in 2013 with the aim of building a more detailed picture of the global Islamic microfinance industry. But the survey suffers major drawbacks including low response rate and lack of comprehensive database of IMFs.
672,000 microfinance borrowers using murabaha with a total portfolio of assets of US$413 million. Both lenders and borrowers often used it because it offers lower risks compared to other financing schemes. However, this mode of financing faces challenges, particularly when used across different Islamic markets where the mark-up fee is seen as analogous to interest.

The qard hassan or benevolent loan is the second most popular microfinance product with an estimated 191,000 clients as reported by CGAP. It is said to be a purely social product that is closely linked to charitable donations that Muslims are obliged to give because borrowers are expected to repay only the principle, plus the administrative costs inherent to the loan. The use of qard hassan varies across IMFs. Some IMFs restrict it to education and health care; whilst other institutions such as IBBL in Bangladesh restricts it to collective rather than individual
In Pakistan, Akhuwat provides qard hassan for a range of needs, including marriages, emergencies, house building or purchase, and to pay down existing loans.

Despite its suitability, Islamic microfinance products based on musharaka and mudaraba are less favoured compared to murabaha and qard hassan as they require careful monitoring of the projects by the financier, which in this case is the Islamic MFI. Under mudaraba, IMFI acting as a financier or investor (known as rab-ul-maal) shares profits with the entrepreneur (known as mudarib) at an agreed predetermined ratio. However, any losses will be borne entirely by the IMFI whilst the mudarib bears the loss of his or her time and labour. Due to

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13. Kustin 2015
the features of mudaraba, IMFI acting as rab ul maal is exposed to the risk of capital erosion caused by the loss making operation of the entrepreneur. Since mudaraba does not require collateral, IMFI is also exposed to high credit risk on bad investments.

In musharaka, both IMFI and its borrower are partners in a business venture, where sharing of equity (one can contribute goodwill, cash or other form of assets) or profit or loss is agreed upon at the beginning of contract. Here, they will share profit at a predetermined ratio as well as share the loss based on capital contribution ratio. This form of contract provides adequate commercial incentive for IMFIs, while at the same time protects the borrowers from inflation pressure on their assets or investment. It could also provide a basis for sustainable form of financing. However, this form of partnership do involve high risk due to the need to have both capital and expertise to be directly involved.

Salam based microfinance provides a mechanism to meet the pre-cultivation financing needs of the farming community. Hence under salam, IMFIs offer farmers a cash advance against a guaranteed purchase price for their crops. Bank of Khartoum’s IRADA Islamic microfinance programme is a good example of how salam based financing is used to open economic opportunities of low-income rural families and increase their livelihood (see Box 9.2). However, most IMFIs shy away from offering salam financing to due exposure to market risk, operational risk, catastrophic risk and counterparty risk. These risks are greater when the financier lacks expertise on the agricultural commodity it is financing and has low understanding of the economics of pricing in the agricultural sector, which could result in adverse prices and subsequently incur losses as it tries to sell the crops upon delivery by the farmer.

Others modes for Islamic microfinance include the following:

**Ijarah** is a leasing contract typically used to finance equipment, such as agriculture machinery and farming tools. Under ijarah, IMFI buys the equipment on behalf of the micro entrepreneur and then leases it out to him or her in exchange for regular repayments. In order to avoid any speculation, duration of the lease and related payments must be determined in advance. IMFI maintains liability for the asset throughout the duration of the contract.

**Diminishing musharaka** allows for equity participation and sharing of profits between IMFI and micro entrepreneur who jointly purchase an asset, which remains in the use of the micro entrepreneur for which he pays rent. This mode of finance provides a method through which IMFI reduces equity held in the asset, ultimately transferring ownership of the asset to the micro entrepreneur until it ceases to be a partner.

**Istisna** is a pre-delivery financing instrument used to finance projects where commodity is transacted before it comes into existence. Hence, it is similar to salam in the sense that it is an order to manufacture and payment of price. However unlike salam, the price of the commodity under istisna may be paid in advance upon signature of the contract or in installments at different stages of the manufacturing process or on delivery of good. Istisna addresses the needs of small and micro scale producers or entrepreneurs who require longer-term financing for infrastructure, agricultural or manufacturing projects, whereby instalment payments can be tied to project progress.

**Waqf & Zakat.** Microfinance can also operate based on other instruments like waqf and zakat whereby they may be used in providing necessary funds to fulfill consumption needs of poor people and ultimately used for poverty alleviation. By covering their basic needs of consumption through the utilisation of zakat funds, micro entrepreneurs can allocate all their
BOX 7.2: 
SALAM BASED FINANCING – A CASE STUDY OF IRADA MICROFINANCE

Bank of Khartoum (BoK), in partnership with Islamic Development Bank, established an Islamic private microfinance institution known as IRADA with the aim of addressing poverty alleviation by empowering Sudan’s poorest and marginalised people to undertake and expand income-generating activities that will create sustainable livelihoods and generate employment.

Under the Moringa and Jatropha Bio project, IRADA provided salam financing to 150 low income rural families (in groups of 10 farmers) to produce 3 major crops, namely alfalfa, moringa and jetropha. Financing given is used to purchase various support facilities (electricity, water, equipment and implements), agricultural inputs (seeds, fertilizers, pesticides) and living expenses (vegetable cultivation and livestock breeding). In addition, a number of support services were also provided to the micro entrepreneurs by Ishraqa Khadra Company, which included technical expertise to ensure production quality and guarantee of delivery of products by farmers. These initiatives have allowed small-scale farmers to secure the necessary funds to support infrastructure development, including the equipment necessary to support irrigation from underground reservoirs.

As depicted below, BoK enters into a salam contract with groups of 10 farmers each where BoK is the buyer of the crops and the farmers are the sellers who undertake to embark on future delivery. The salam delivery is 6 months for alfalfa, and 12 months for moringa and jetropha. A back-to-back salam was entered between BoK and Ishraqa Khadra Company where the latter commits to buy the products of the farmers from BoK once they are delivered by the farmers.
resources to succeed in their businesses. Additionally, they also benefit from lower refundable loan, as no return can be realised from zakat fund. For example, zakat or special waqf fund could be established to provide training, health care and education to the needy and poor. This fund could also be utilised to provide capital investment and working capital financing for micro projects. Implementing an integrated Islamic microfinance model incorporating the two modes of financing, zakat and waqf, may resolve fund inadequacy problem of IMFIs.  

14. Hassan 2006
Islamic Microfinance Institutions

Islamic microfinance has been acknowledged as an important component for economic development of a country, at least to countries with predominantly Muslim population. This has among others noted in the World Bank’s Global Financial Development Report 2014, with a special coverage on Islamic finance and financial inclusion. The report highlights the important role of Islamic finance in improving financial access in the access in the countries where majority of the population shy away from formal financial institutions for religious reasons, i.e. avoidance of interest. Such preference is explained by the high religiosity of Muslims, especially those residing in the countries that are members of the Organization of Islamic Cooperation (OIC).

Currently there are least three major types of IMFIs. The first model is based on non-profit model or operating as non-governmental organisations (NGOs) and they offer mostly qard hassan products to the poor. One notable example of this model is Akhuwat, a community development NGO based in Lahore, Pakistan. Since its establishment in 2001, Akhuwat has disbursed more than US$25 million in 2013 and served over 235,000 active borrowers. One of the unique features of Akhuwat is its mass disbursement and collection system, which is conducted mainly at the mosques or churches. While this is not specifically prescribed in Islamic finance practice, the disbursement system that is unique to Akhuwat has been very successful in maintaining near 100% repayment rate.

In contrast to mass disbursement, commercial banking model is also an emerging model in Islamic microfinance. One such example is Family Bank (Bank Al Usrah) in Bahrain, which is a new generation of commercial banks that focus exclusively on small and medium enterprises and micro banking. It was established in 2009 in a country with relatively very few poor families. As a commercial entity, the bank works with Grameen Trust to assist the bank in micro lending and provide microenterprises with micro to small loans. This model of commercial micro bank is certainly quite popular, as similar banks have recently been established in Pakistan, Indonesia, Yemen, and perhaps even much earlier in Sudan.

Bank of Khartoum in Sudan is perhaps one of the most innovative Islamic banks when it comes to Islamic microfinance. The bank’s microfinance program, known as IRADA, is experimenting with new and innovative models of intervention to make inroads on chronic social problems, such as poverty and unemployment.

The International Fund for Agricultural Development (IFAD) for example works with various service providers including both Islamic banks and commercial banks that have opened Islamic finance windows to tap into this growing market. In Azerbaijan, the Integrated Rural Development Project, financed by IFAD and IDB is currently introducing Shari’a-compliant instruments in the regions of Agdash, Oghuz, Sheki and Yevlakh. Whilst IDB provided US$65 million for irrigation schemes under istisna mode, IFAD extended a US$2 million loan in the form of qard hassan to support IFAD resources.

The IFAD also funded the Idleb Rural Development Project in the Syrian Arab Republic to improve food security and incomes of farmers and rural women in 140 of the country’s poorest

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15. The World Bank 2014
17. The Islamic microfinance experiment in Sudan has been described by the World Bank’s Consultative Group to Assist the Poor (CGAP) as “a laboratory for Islamic microfinance delivery.”
19. IFAD a specialized agency of the United Nations and was established as an international financial institution in 1977 to finance agricultural development projects primarily for food production in the developing countries.
villages. Micro credits in the form of murabaha are channelled through sanadiq, which are local, autonomous microfinance institutions providing loans to disadvantaged rural people. Sanadiq are owned and managed by local communities as village funds. To date, about 48 villages in Idleb have established sanadiq with more than 6,600 shareholders and repayment rates of 98%.

The other model is cooperative or rural banking model, such as Baitul Mal wat Tamwil (BMT) in Indonesia. BMT literally means “Social and Business House” and is the largest, oldest, and most prominent IMFI in Indonesia. BMT is essentially an Islamic cooperative offering micro loans and savings to the local communities across Indonesia. Despite having 2.2 million members, total BMT holdings are small, with 550 branches and cumulative balance sheet

<table>
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<th>No.</th>
<th>Islamic MFIs</th>
<th>Country</th>
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Source: MIX Market (www.mixmarket.org), and author’s calculation based on data from IMFIs (IBBL/RDS, Family Bank Bahrain, Prva Islamska.

Note: Data is for 2014, unless otherwise stated or marked: ‘ 2011, “” 2012, “”” 2013. The ‘^’ indicates number of new borrowers recorded for the year (2014), not active borrowers.
assets of US$800 million. Similar to Akhuwat, some BMTs use qard hassan as their primary mode of financing, with some others also use the commercial mode of murabaha. One unique feature of BMT is its ability to mobilize savings and voluntary donation from members or the public, which is not common under a NGO model.

The Islami Bank Bangladesh Limited (IBBL) launched its Rural Development Scheme (RDS) in 1995 with the aim of uplifting the overall socioeconomic plight of the rural poor. RDS caters to the investment needs of the agriculture and rural sector to create opportunity for generation of employment and raising income of the rural people with a view to alleviate poverty. Presently, some 569,820 active members of which 78% are female, are involved in this scheme.

Table 1 illustrates the state of selected IMFIs across the Muslim world, based on their outreach and loan portfolios. With the estimated growth rate of borrowers in 2014 around 9.2%, down from 10.3% in 2013 due to slower growth in Latin America (Microfinance Barometer 2015), overall microfinance sector is still attractive. In the regions where most of IMFIs are located, such as East Asia and the Pacific, South Asia, and Eastern Europe and Central Asia, double digits growth is still being recorded.

Overall, IMFIs are relatively smaller and geographically concentrated compared to conventional MFIs. The largest IMFIs in Bangladesh, RDS of IBBL, for instance managed to extend a loan portfolio of US$267 million, while the largest MFI in Bangladesh BRAC has booked a loan portfolio of US$1.2 billion in 2014. Similar situation occurs in other countries like Indonesia, Pakistan, and most of the countries in MENA region, with the exception of Sudan where all MFIs are Islamic.

**Best Practice Models of Islamic Microfinance Institutions**

CGAP has taken the lead in identifying innovative and effective business models. It runs a global contest, the Islamic Microfinance Challenge and invites applications from providers of Shari’a-compliant microfinance products. Through a US$100,000 grant award, the Islamic Microfinance Challenge hopes not only to spur innovation, but also to help scale up the application of Shari’a-compliant products by financial institutions already serving large numbers of poor.

The first, held in 2010, was won by Yemen’s Al Amal Bank. The second contest was held in 2013-14 with the theme “encouraging product development beyond murabaha”. Wasil Foundation (Pakistan) was the award recipient for that year. The Challenge has been co-sponsored by the Islamic Development Bank, the German International Co-operation Agency GIZ, Al Baraka Banking Group, and Triple Jump.

More recently a couple of other frontrunners have emerged. Firstly, the Islami Bank Bangladesh’s RDS is perhaps the oldest and largest commercial Islamic microfinance programme in the world. As the first fully-fledged Islamic Bank in South Asia, the IBBL (since the launch of the RDS in 1995) has worked with almost 5 million people. In 2015 the scheme provided micro-credit to over 940,000 people in over 18,000 villages throughout the country. Whilst the RDS is operated through the IBBL branch network, outreach transaction costs are high and, to some extent the programme might be a loss-leader that allows the bank to graduate RDS clients into more commercially interesting products over time.

Akhuwat in Pakistan has displayed a meteoric rise since its inception in 2007 and is based on a philosophy of volunteerism and exclusively uses qard hassan. Currently, nearly 1 million
poor people are served and service delivery is sustained through major contracts by 2 provincial governments as well as Akhuwat’s amazing ability to mobilise donations from the rising middle class and its own clients. Both models, apart from being large national organisations, are really at opposite ends of the business model spectrum ranging from charity to commercial bank. This shows to some extent that with the right kind of support (technical, regulatory, funding) two very different models can actually produce success.

In 2014, Bank of Khartoum (BoK) won the Ethical Finance Innovation Challenge & Awards for its innovative Islamic microfinance solutions, which aimed at empowering the poor by doing business with them and targeting the society’s needs. An example of such project is Wad Ballal, a village of 400 families working primarily in cattle breeding. The project uses a structure that channels investment through a community company, on a diminishing partnership basis. The company would then lease the services to the poor herders who would then be able to nurture their cows. Eventually the herders would be able to repay both the bank and the services fees as well as start to grow their own savings. The foundation of this project is partnering with communities, transforming them from underprivileged customers into tomorrow’s businessmen.

However, with the advancement of technology, microfinance is now being offered through the internet. An example is the crowdsourced microfinance site Kiva, which enabled anyone with an internet connection to lend as little as US$5 to alleviate poverty. Through its pilot programme, Kiva Zip, lenders come forward to lend in the spirit of benevolence. As such, they do not receive any financial returns, while being exposed to many risks – risk of default, catastrophic risk, risk of fraud on the part of the borrower and exchange rate risk for multi-country transactions.

Although Kiva Zip was not intended as an Islamic microfinance experiment, it is now adjudged as one of the world’s best Islamic microfinance experiment as it provides zero-cost microfinance.20 As Kiva Zip operates online and uses mobile payment technologies, it is able to expand its outreach to remote areas and to the marginalized poor as well as reduce the cost of microfinance loans, which is in sharp contrast to conventional loans as well as murabaha loans by IMFIs. As of the end of April 2015, the Kiva Zip pilot had disbursed loans to about 8,700 small businesses via about 50,000 trustees in Kenya and USA. Repayment rates is a satisfactory 89.4%.21

Challenges for Islamic Microfinance

Clearly a more concerted effort among stakeholders is needed to harness Islamic microfinance’s momentum in developing a more diverse market where more providers offer a broader array of products based on evidence related to customer needs and behaviors. This ambitious vision of Islamic microfinance requires tackling a number of key issues—chief among them is understanding the nature of client demand. Too little is known about how target customers view Shari’a-compliant products: to what extent is client preference for such products outweighed by extra cost, how do clients evaluate Islamic “authenticity,” and do such products effectively meet diverse client needs?

Nonetheless, there are specific challenges to overcome in developing sustainable Shari’a-compliant microfinance programmes in addition to the challenges that all microfinance programmes face such as the lack of capital before Islamic microfinance can become a more

20. Kiva was awarded the Islamic Economy Award 2013 as the world’s best provider of Islamic microfinance.
widespread and effective tool for poverty alleviation. In order to provide access to sustainable services on scale, it is imperative for the industry to adopt innovative and sound practices, and to prove that these models work. Development of such models is expected to follow a track similar to that which was used to develop conventional microfinance models, while advancing more quickly, benefitting from over 30 years of experience.

Size is certainly a significant issue for Islamic microfinance, as illustrated above. In addition, there are other fundamental challenges that need to be considered before Islamic microfinance sector can embark on a journey to participating in SDGs. The good news is that some of these challenges are also common in the conventional side of microfinance; hence the solutions might be available from the experiences of conventional MFI's.

a. Socio-economic realities and challenges

A number of IMFIs are working in fragile states or regions with large enclave of vulnerable and marginalized communities. These regions or countries are often avoided by other MFIs or development organizations, due to the high cost nature of such interventions. It is in such fragile environments that many IMFIs decided to create an impact for the most distressed communities. For instance, a leading relief organization in the UK has its microfinance institutions located in the regions that are affected by conflicts, famines, and disasters. Hence, it is no surprise that IMFIs face tremendous challenges - socially and economically.

The current state of many Muslim countries provides IMFIs without a choice but to continue their best to fight poverty and serve the poor. IMFIs are not only working in an economically or politically demanding environment, i.e. high poverty or unemployment rate, but also providing services in hostile environment caused by prolong armed conflicts or recurring natural disasters. In addition, most of the countries in which IMFIs are operating have a low case of bankability, indicated by among others lower percentage of population with bank accounts. The lower access to financial services may suggest a lower awareness among the population, or a lack of adequate financial infrastructure and financial services penetration in the country.

In recent years, there have been positive development in the microfinance sector as MFIs are now making inroads in countries where conflicts and natural disasters exist. Microfinance institutions or microfinance programmes in these markets have proven that microfinance is an effective tool to alleviate poverty, provide income security in insecure environment, and most importantly provide the poor with some dignity and hope. The high growth potentials are also accompanied by a relatively high economic growth and gross domestic savings ratio in few of these countries, such as Indonesia and Bangladesh. These relatively healthy economies may be able to elevate the capability of IMFIs through government support and active involvement of private sectors in terms of funding or enabling infrastructure.

Finally, apart from working in a challenging macroeconomic environment, Islamic microfinance sector is structurally unique. IMFIs in the same country may adopt different approach to lending or financing (i.e. group-based model, individual financing model), use different legal contracts or product schemes (qard hasan, murabaha), as well as rely on a range of funding models (from individual, seasonal fund raising to regular corporate or institutional contribution). Although this diversity is not a handicap, managing such complexity is an extraordinary challenge for most IMFIs, and most importantly for regulators.

b. Regulatory and Business Environment Challenges

Regulatory and business environment is an extraordinary challenge for microfinance insti-
tutions. Increasing pressure from regulators, investors and donors have required IMFiS to make further adjustment in their design and delivery of microfinance programmes. Most countries have in recent years adopted a more stringent regulatory regime to microfinance, after allowing the sector to self-regulate for almost two decades. This stand may have been caused by some failures and crises in the microfinance sector, most notably the Andhra Pradesh crisis in 2010. As a result, most countries now demand better risk mitigation or portfolio management by IMFiS, as well as an improved way to analyse or select their clients.

Table 2:
MICROFINANCE BUSINESS ENVIRONMENT

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Source: The Economist Intelligence Unit (EIU)

In the Global Microscope on the Microfinance Business Environment series of report, Muslim majority countries are performing quite poorly, with the exception of Pakistan that rank consistently high among the 55 countries covered by the Report. The lower rank means that the country is having a less favourable business environment for all MFIs (conventional or Islamic) constituted by the lack of well-defined regulatory framework, absence of supporting institutional framework, and political and economic instability. Table 2 summarises the ranks of selected Muslim countries for the overall category of microfinance regulatory and business
The indicators suggest that, for instance, better regulatory frameworks are positively associated with larger loan sizes, greater gender diversity of the borrowers and lower shares of portfolio risk. Meanwhile, strong performance in the institutional framework suggests that the MFIs tend to reach larger number of borrowers (high outreach and penetration). Apart from socio-economic factors such as business potential, the regulatory environment is increasingly becoming an important consideration for business decision-making.

Pakistan is more advanced among other countries with respect to regulatory readiness and is said to have one of the world’s most favourable regulatory environments for microfinance.\(^{22}\) However, this only applies to the 35% of providers that are microfinance banks and under the purview of the State Bank of Pakistan (SBP). The SBP has issued guidelines for Islamic microfinance in 2007. The guidelines stipulate four types of institutional arrangements for offering Islamic microfinance - Islamic microfinance banks, Islamic banks, conventional banks, and conventional microfinance banks. The central bank also issued guidelines on Shari’a compliance, and has stated its intention to adopt the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards in this instance.\(^{23}\)

This high regulatory standards aspired by the SBP will require MFIs in Pakistan to operate within strict operational guidelines. This is an important reason for the microfinance programme to move faster to a more advanced Management Information System (MIS) environment. The success of Pakistan’s microfinance sector is due in part to restrictive rules imposed by the SBP, including requirements for account reporting and publishing, internal and external audits, governance structures, and high capital reserves.\(^{24}\)

Despite being hailed as one of the global leader of Islamic microfinance, regulations or guidelines for Islamic microfinance in Bangladesh are scattered where IMFIs are subject to different regulatory authorities depending on their structure. For example MFIs come under the purview of the Microfinance Regulatory Authority, commercial banks are regulated by Bangladesh Bank and NGOs are subject to the NGO Affairs Bureau.

As many cases have signified, regardless of the ranking and current regulatory environment of a country, MFIs will become necessarily more regulated going forward. With more MFIs entering the markets each year, many lawmakers are considering to regulate MFIs in a stricter manner. The case of Pakistan above, and many other countries, is evident of such a move from an unregulated sector that provides small loans to the poor to a more regulated full-scale microfinance industry. Hence, prudential regulation of markets is essential to ensure healthy and adequate competition among the players and thereby, remove abnormal and/or illegal profits through mispricing.

c. Impact: Is Poverty Affected by Microfinance?

The role of microfinance in poverty alleviation is well documented in literature, particularly in a context of rural development, region or country case studies, financial inclusion, and improvement in the income of poor household. For instance, a study by Imai et al. (2012), which examined the effect of microfinance outreach on poverty in 61 countries, finds that microfinance outreach has indeed a significant negative relationship with poverty. This result entails

\(^{22}\) Economist Intelligence Unit 2012. Pakistan’s microfinance business environment ranked 3rd best globally, behind Peru and Bolivia.

\(^{23}\) Karim et.al, 2008

\(^{24}\) Kustin 2015
that an increase in microfinance outreach will reduce poverty, which is consistent with many other researches and case studies.

Greater understanding is needed on the impact of Islamic microfinance in order to influence development donors and institutions to engage with it. This is a particular challenge not just for the Islamic microfinance sector but also for conventional providers as the body of evidence for the poverty reduction impact of such lending is mixed. For IMFs, relying heavily on murabaha, not dissimilar to the commercial Islamic finance industry, represent a further challenge since it has been argued that Shari’a-compliant mark-up finance imitates the economic function of interest. This dilemma makes it difficult for Islamic financiers to argue that their products are actually stronger in terms of poverty reduction. The overreliance on murabaha also stifles product development since IMFs prefer the simplicity of mark-up finance to mudaraba and musharaka, given the potentially increased moral hazard and the lack of a quasi-guaranteed return on investment, albeit antithetical to the profit and loss sharing ethos of Islamic finance.

In this respect, the contribution of Islamic microfinance sector in reducing incidence of poverty is an important prospect to ponder. According to CGAP, there are more than 600 million of Muslims living with less than US$1.5 a day, of whom nearly half would not accept financing support or loan from interest based institutions. 25 Although some researches assign the task of poverty alleviation to the more developed Islamic banking, the different needs of micro entrepreneurs and the poor make it harder for Islamic banks to serve this segment. The creation of specialised IMFs is seen as a necessity, and there are evidences that linked MFIs with poverty alleviation.

At the country level the role of Islamic microfinance is gradually gaining momentum, especially in countries where microfinance sector is near maturity such as Bangladesh and Indonesia. Here, IMFs are seen to improve lives and income level of the poor, and at the same time contribute positively to employment creation in the country. However, there are still some deficiencies that need to be addressed by IMFs, especially in terms of outreach, customer education and product delivery innovation.

The ‘Islamicity’ of IMFs or the strong adherence of the poor to their respective religions is certainly not a hindrance for them to engage with financial institutions. In fact, religion and in particular Islam ‘does not appear to be a drag on (economic) growth’, which at the same time disputes other studies on the subject matter. 26 The role of IMFs in reaching out to the poorest segment and hence contributing to poverty alleviation efforts is also shared with MFIs that are based on other beliefs, such as Christianity. 27

A more robust assessment on the impact of Islamic microfinance to poverty is not currently available, hence urgently required. At the same time, Islamic microfinance sector should be expanded further in countries where Muslims are majority, in order to create any meaningful impact on poverty. As IMFs constitute only a fraction of the microfinance sector, any attribution to poverty reduction can still be debatable. Yet, it is indisputable that IMFs have the potential to contribute to poverty alleviation in many Muslim countries, since the scale of Islamic finance sector would increase over time.

d. Trade-off between Profitability and Outreach

At the heart of microfinance debates, the issue of trade-off between outreach to the poor

25. El-Zoghbi and Tarazi 2013
26. Noland 2005
27. Mersland et al. 2013
and sustainability of MFIs continue to attract equal number of supporters on both sides. There are three strands of researches that have emerged from the trade-off debates in the literature: (1) refute any trade-off between outreach and profitability, (2) assert that trade-off is possible and exists, and (3) advocate the importance of balance between outreach and financial sustainability or profitability.

The first group suggests that the focus on outreach would not reduce profitability or sustainability of microfinance institutions. This camp finds little or no evidence of trade-off between financial sustainability and poverty outreach, either in a single country context or cross-country analysis. In fact, Quayes (2012) finds a positive and complementary relationship between outreach and financial sustainability.

The second group finds that there is a trade-off between outreach and performance, which include studies at country specific or cross-countries levels. Similarly, there are studies that find a negative relationship between outreach and other performance indicators, or proxy to sustainability, such as efficiency. In this category, there are also studies that vaguely admit the presence of trade-off or find limited trade-off between outreach and sustainability, for example by Mersland and Strøm (2008).

Finally, there is also growing number of recent studies that have tried to bridge the trade-off gap and provide a different perspective on the debate. They assert that MFIs can still maximize its outreach targets while maintaining a decent rate of profitability. This can be achieved in certain circumstances, such as where financial sector in the country is underdeveloped or prevalent of subsidy.

While this issue will continue to be contested by researchers, increasing commercialisation of microfinance sector suggests that there is perhaps some level of trade off, including in Islamic microfinance. It means that IMFIs will have to choose either a sustainability route and sacrifice certain level of outreach, or pursue poverty mission in the form of outreach while foregoing profitability or sustainability.

The recent development of increasing competition and conversion of NGO based MFIs into rural bank or other commercially structured MFIs are evidence of the above claim. Another argument to support the trade-off claim is the dominance of financial indicators in the performance measure of all MFIs. If this claim holds, then stakeholders of IMFIs need to consider the future of Islamic microfinance more carefully; would it be profitability at the expense of outreach and poverty mission, or otherwise?

e. Performance and Organizational Efficiency

The main pillars of performance measurement of the majority of MFIs are financial ratios, following the so-called banking logic that has dominated microfinance field in the past decade. Among the ratios measured by most of the MFIs are those related to cost efficiency in managing the MFIs, particularly related to staffing, loan disbursement, and costs related to recovering the loans that have been extended.

Efficiency of MFIs, Islamic or otherwise, does not depend on the country where they operate, but the type of institution they are operating are relevant and important; and in most cases NGOs are found to be more efficient than other MFIs. Portfolio quality is also an important

aspect to gauge performance and efficiency of IMIFIs. For instance, in a study involving 350 MFIs from 70 countries, findings suggest that lower portfolio at risk and lower write-off rates are associated with higher proportions of women borrowers. The result confirms existing strategy of many MFIs to work exclusively or largely with women borrowers and target two objectives at once, performance and affirmation.

In the case of Islamic microfinance, there are very few empirical studies that are available related to the performance and efficiency of global IMIFIs. The few studies that are published in reputable journals highlighted some cases of lack of efficiency and slightly poor performance of IMIFIs. For instance a study by Widiarto and Emrouznejad (2015), which measured the social and financial performance of IMIFIs by comparing them to conventional MFIs, found that conventional MFIs surpassed IMIFIs in financial and social efficiency under an output-orientated strategy. This study serves as a reflection and wake-up call to IMIFIs to improve future performance thus contributing towards the development of Islamic microfinance.

It should be noted at this point that although financial performance and efficiency of IMIFIs may be discouraging, the social performance i.e. poverty alleviation mission of IMIFIs is quite reassuring. However, the ideal situation of any MFIs should be attaining superior financial performance and at the same time achieving high impact in poverty alleviation objectives, hence double bottom line. This ideal goal would only be achieved if Islamic microfinance sector confronts the issues of inefficiency and inferior financial performance, which are attributed to relatively high operational cost and unsustainable funding sources of IMIFIs.

f. Lack of Market Data and Standardisation

Whilst nearly 2,000 MFIs report on the Microfinance Exchange, only a handful of Shari’a-compliant providers are listed. This provides a challenge for social and commercial investors alike since there is no market, social and financial performance data available to make informed decisions. Although Islamic microfinance is currently a growing sector both within the NGO and banking industry, best practice of financing operations and models are still being developed. International standards for Islamic finance such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB) principles are still not customised to micro-financial applications, nor are either standards yet fully globally agreed amongst the different stakeholders.

What’s Next for Islamic Microfinance

The comparatively small number of existing IMIFIs have not yet developed a successful model to reach a large number of clients on a sustainable basis and to show their potentials. So far, they have failed to convince Islamic banks to invest in their portfolio, as they are still considered a very risky business. As such we need a larger pool of MFIs applying Islamic Shari’a law in order to increase the chances of having very successful ones.

When the conventional microfinance movement began in the 80s, pioneers at the time questioned conventional banking and its business models and came up with new models which, over the years, proved that the poor are creditworthy. These new models showed that the poor can pay interest rates that not only cover the cost of operations but also enabled MFI to make a profit. Collaterals were replaced by group guarantees, and later by character checks. While it is important to keep in mind the knowledge and experience acquired from both Islamic finance

and conventional microfinance, we need to go beyond. We need to innovate and come up with new business models that comply with Shari’a and that provide financial services to millions of poor Muslims, on a sustainable and profitable basis.

Basically, IMFIs have been limiting themselves to specific Islamic contracts, which could be implemented in a similar way to conventional microfinance’s loan products. There are...
IMFIs focusing on either qard hassan products with no interest rate or fees, or products with a small fee, such as Akhuwat in Pakistan. These IMFIs have been unable to cover operational and financial costs and they remain dependent on subsidies, which prevent wide outreach. Also, there are IMFIs using only or mainly murabaha. Apparently they are adapting a more expensive form of conventional microcredit, which has numerous limitations and has raised suspicions about their compliance with Shari’a law. Moreover, to be sustainable, the cost mark-up that these IMFIs charge on the murabaha is equal or higher than the rates of conventional loans, making clients wary due to high service costs.

Practitioners need to develop new business models, instead of merely adopting an Islamic product which closely resembles a conventional loan product. As an alternative, business models should combine the various and well diversified financing instruments and contracts promoted by Islam. It has been argued that a for-profit approach will help to address the issues of operational efficiency, transparency, risk management, product diversification and authenticity and will help to establish much needed performance benchmarks. Unless microfinance providers cover their costs, they will always be limited by the scarce and uncertain supply of subsidies from governments and donors.

To help bridge the gap between pent-up demand and possible investors a market mechanism could be devised to kick-start the whole process of Islamic microfinance. This mechanism, perhaps an Islamic microfinance investment vehicle, should target investors looking initially at Islamic microfinance as an alternative investment, in which participants might like to engage, and subsequently as an asset class on its own, for which participants might like to invest. The mechanism should appeal to Islamic investors because it will provide a convenient method of acquiring a position in a new class of assets that combines the objective of having a social impact and providing a reasonable return to the investors. This Islamic Microfinance International Fund should be based in a country recognised as a financial center, having extensive experience and skills in the investment funds industry (with particular focus on the microfinance funds) and attractive and flexible regulations for the various types of microfinance investment vehicles.

In order to shape an almost irresistible proposition, regulatory frameworks and incentives need to be put in place. These includes a modern legal, regulatory and supervisory framework continuously updated and easily adaptable to other national legislations so to enable registration and distribution in foreign jurisdictions; the implementation of pragmatic regulations, a friendly tax regime for the fund industry with regards to dividends, expenses and capital gains; and the existence of double taxation treaties with OIC countries. To achieve a more balanced world it would require US$21 billion to provide microfinance facilities to world’s poorest 100 million families. The final outcome will also contribute towards inclusiveness and the integration of Islamic microfinance into the Islamic financial system.

Despite all of the above challenges, there are many opportunities for Islamic microfinance in the SDGs’ framework, or more generally in confronting the problems of poverty in the world. While the government and international donors may come in to address political or socio-economic and regulatory issues, IMFIs themselves must play their part and deal with organisational challenges.

The use of technology may be the solution to many of the challenges outlined above. To illustrate, many IMFIs are still using simple tools such as spreadsheet to manage their clients’

portfolio. While this kind of tool is serving these IMFIs well, to a certain level, it is time-consuming and burdensome for the back office or manager of these institutions to produce any standard financial or portfolio reports. Another example is the use of technology as part of delivery channels. Majority of IMFIs are still relying on traditional disbursement and collection through regular meetings with borrowers. This method, as has been illustrated by lack of efficiency with many IMFIs (including MFIs), could hinder a much-needed rapid expansion of Islamic microfinance. Many successful MFIs are now relying on variety of technology-based delivery channels to mitigate high operational costs and reach out to more customers in remote areas.

Although not many IMFIs have the financial capability to invest in simple MIS, mobile banking, or other technology based infrastructure; ignoring the importance of technology is imprudent and might be more costly in the longer term. The recent Microfinance Barometer 2015 report suggests that the role of technology in microfinance will be more influential to increase outreach and at the same time achieve sustainability and profitability. The successful example of M-Pesa in Kenya and other examples in South Asia exemplify how technology can enhance the capability of IMFIs to serve the poor.

The other possible area of concern is funding sustainability for IMFIs. Islamic microfinance needs to increase diversity of its funding sources. There have been some efforts to tap a growing significance of crowd funding, such as by a fully Islamic platform Wafaa, and also Kiva, through its dedicated Shari’a-compliant funding product. However, the other source that needs to be considered more seriously is impact or ethical investment funds, which has grown to more than US$50 billion in recent years.

Finally, IMFIs should also conceive ways to invest more significantly in talent development and enhance managerial capacity of their officers. High staff turnover is one of the many challenges faced by IMFIs in the field, especially in countries or regions where competition is high. Experienced field officers of many small sized IMFIs are recruited by much larger MFIs or commercial banks, which offered them higher salary, to take advantage of their experiences and knowledge of the field. These challenges are underpinned by the relative lack of Islamic finance professionals, that is more pronounced in the non-for-profit sector, where qualified and experienced staff managing microfinance programmes in the field are more attracted by the remuneration that can be found in the commercial Islamic finance industry. While staff turnover is inevitable, Islamic microfinance sector as a whole should anticipate and embrace the new realities of intensifying competition. The role of educational institutions, research institutes, and dedicated consultancies will certainly be useful in this undertaking. In the end, only when all stakeholders are joining hands then only Islamic microfinance has a better chance to become a key player in the global initiative of SDGs, and not a bystander.

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