CHAPTER 25

Global Islamic microfinance landscape

25.1 Introduction

The global success of the Islamic finance industry has generated growing calls for a paradigm shift in Islamic finance towards poverty alleviation. With the ultimate goal of maximising social benefits as opposed to profit maximisation, Islamic finance through Shari'a-compliant microfinance can be a viable alternative to the socio-economic crisis that has impacted the Western paradigm. However, Islamic financial institutions have yet to make any significant inroads into the area of microfinance despite the fact that Islamic finance seeks to promote social justice, equity and inclusion.

Islamic finance has now expanded in terms of product range and geographical reach but the number of Islamic financial institutions offering microfinance products in compliance with Islamic principles and serving the un-bankable Muslims continues to lag behind. Islamic microfinance, a confluence of two rapidly growing industries – Islamic finance and microfinance- has the potential of providing financial access to the poor Muslims who currently reject microfinance products that do not comply with Islamic law. Although Islamic microfinance has emerged as a market niche, the sector is still in its infancy.

25.2 Inclusive role of Islamic microfinance

A large body of evidence points to financial exclusion of the poor as a major factor contributing to their inability to participate in the national development process and overall economic development. Generally, the formal financial system of a developing economy serves not more than 20% to 30% of the population. Thus, the vast majority of those who are excluded from the financial system are the poor segments of society. Poor and low income households are left with no access to financial services, particularly credit facilities and savings. In most cases, they resort to using unofficial services such as informal moneylenders paying exorbitant interest rates.

Without access to basic financial services at a reasonable cost, these households are at risk of remaining at the margins of economic opportunity as they continue to face great constraints in raising income, building assets, financing their children's education or cushioning themselves against adverse shocks. Thus, financial exclusion binds the poor into a vicious circle of poverty. Building an inclusive financial system has therefore become a central policy goal of governments and central banks in many countries. The importance of financial inclusion in overall economic development is reflected in the Millennium Development Goals (MDGs) set by the United Nations in the year 2000[1].

Traditionally, the poor has been viewed as un-bankable by the formal financial system due to the lack of collateral, small loan sizes and low repayment potential. However, the success of microfinance initiatives in numerous countries worldwide has challenged the myths that the poor do not save and are bad borrowers. In fact, studies have shown that not only do the poor save; they have high repayment rates when they borrow. The success stories of microfinance institutions such as Grameen Bank, Bank Rakyat Indonesia (BRI) and Americans for Community Co-operation in Other Nations (ACCION) are testimony that the poor are creditworthy. Hence, microfinance has proven to be an effective development tool in alleviating poverty and important means of achieving MDGs.

Akin to its conventional counterpart, Islamic microfinance has a positive role in poverty alleviation with

[1] The Millennium Development Goals are a set of 8 development targets agreed by members of the United Nations which centers on halving poverty and improving the welfare of the world's poorest by 2015.

huge untapped potential as an effective socioeconomic development tool. However, the dearth of Islamic microfinance institutions is a glaring absence in the Islamic financial industry. Islamic microfinance is an extension of Islamic finance concept of interest-free financing arrangements. Based on Islamic doctrines of social and economic justice, ethics, wealth distribution and public interest (Masalih al-Mursalah); Islamic microfinance advocates economic empowerment through entrepreneurship, risk sharing and financial inclusion. Hence, the nexus between poverty alleviation and Islamic microfinance is the combination of two different roles that promote the real sector economy – financial modus operandi and piety. Thus, there is great potential for Islamic microfinance in achieving the MDGs,

Recent negative development in the microfinance industry, such as the microfinance crisis in India where high interest rates in the private microfinance institutions were linked to suicide, is evidence of conventional microfinance institutions charging exorbitant interest rates thereby causing serious hardship on borrowers in servicing their debt. In a study conducted by the Bangladesh Economic Association, it was revealed that the effective rate of interest charged by microfinance institutions, including Grameen Bank, was as high as 30% to 45%.[2] Sacrificing essential consumption and, in some cases, resort to borrowing from unscrupulous moneylenders to service their debt fosters a vicious debt cycle which has the potential to lead to a rise in social unrest.

In the face of this development, it is important that access to credit is provided to the poor on more humane, interest-free basis. Islamic microfinance which promotes ethical investment and business practices among micro-entrepreneurs focuses on fairer lending to the poor vis-a-vis conventional microfinance. It also promotes economic justice since risks are shared between the financier and entrepreneur. By mobilising resources and making them available to the poor through expansion of opportunities for investments and production to fulfil basic needs; Islamic microfinance institutions contribute to the reduction of inequalities in income and wealth.

The development of Islamic microfinance was is part of the Islamic Financial Services Industry Development Ten Year Framework and Strategies Report.[3] The report outlined strategies for developing Islamic microfinance as a top priority initiative in order to align Islamic financial services industry with poverty alleviation. The latter is a key strategic objective of the Islamic Development Bank after development of the Islamic financial services industry. The report further envisaged that the assets of the Islamic microfinance sector will account for almost 8 – 10% of the total Islamic financial institutions assets in the next ten years.

25.3 Islamic microfinance structures

In the Islamic finance domain, microfinance takes the form of various different structures: micro credit, micro equity and charity finance. Charity financing instruments such as zakat, sadaqa and waqf take a central position in poverty alleviation in Islam. Zakat which is an important tool for the redistribution of income and a mechanism in poverty alleviation as it is meant to finance the poor and destitute. Sadaqa, or voluntary charity, can also be geared towards eliminating abject poverty. Waqf can also play an important role in poverty alleviation by targeting its benefits towards the poor as it has the potential to create and preserve long term assets that generates income flows. Unlike the conventional microfinance sector, where institutions give cash directly to a client for financing purposes, Islamic microfinance can maximise social services by using these Islamic charity instruments as sources of funds for microfinance programmes, which fulfil basic needs and increase the participation of the poor. These programmes can take the form of community-based group lending, self-help groups or cooperatives.

However, Islamic microfinance need not be restricted to non-profit financing modes only, as the poor also needs a variety of services and products to cater for their financial needs. Islamic microfinance institutions also offer micro credit using a variety of mechanisms based on Shari'a principles such as qard hasan, murabaha, bai bithaman ajil, ijarah and salam. Qard hasan is regarded by many as the purest and most effective way of financing the poor as borrowers need only repay the principal. However, Islamic microfinance institutions are allowed to charge the borrower a service fee to cover administrative costs incurred in disbursing the loan.

Murabaha is the most widely offered Shari'a-compliant financing by Islamic microfinance institutions where over 70% of the Islamic microfinance products offered are based on the murabaha principle. Murabaha financing involves the resale of a commodity by the Islamic microfinance institutions at a mark-up and is commonly used for financing assets or working capital inputs such as raw materials, machinery or equipment. Repayments are made on an instalment basis with the ownership of the commodity or assets remaining with the microfinance institution until full settlement. Ijara instruments are generally used to finance equipment such as machinery. The Islamic microfinance institutions buy the equipment and rent it out to the entrepreneur over a fixed period. As with a typical leasing contract, Islamic microfinance institutions retain ownership of the equipment and are responsible for its maintenance. Salam (spot sale with future delivery) is also well suited for microfinance especially to finance agricultural activities. Under the salam contract, Islamic microfinance institutions purchase the agricultural commodity and pay in full the spot price but delivered at a specified future date by the entrepreneur with a predetermine quality and quantity. This mode of financing is not very popular amongst microfinance institutions as it is costly to implement.

Islamic microfinance institutions can also raise funds through participatory profit-loss-sharing modes such as mudaraba and musharaka. The mudaraba structure can take a simple form whereby the Islamic microfinance institution provides capital and the borrower, or micro entrepreneur, in this case, becomes a partner by using his or her skills to invest the capital in a business venture. Profit from the venture will be shared amongst

[2] Microfinance institutions generally charge higher interest rates than commercial banks. This is due to 2 main reasons: (1) higher transaction costs and (2) as interest rate is the major source of income, a high interest rate need to be imposed in order to recover operational costs. Interest rates between 20% and 50% are generally common in the microfinance industry.

[3] This framework is a joint initiative taken by Islamic Development Bank, Islamic Research and Training Institute and the Islamic Financial Services Board with the aim of drafting a ten-year roadmap for the orderly development of Islamic financial institutions.

them according to a predetermined ratio. However, financial loss will be borne entirely by the microfinance institution (i.e. capital provider) under the premise that the micro entrepreneur (mudarib) invests the capital received on a trust basis. Hence, he is not liable for losses incurred unless it is due to negligence or misconduct on the part of the micro entrepreneur. Under the musharaka structure, the Islamic microfinance institution enters into a partnership with the micro entrepreneur. Here, profit and loss are shared amongst them based on pre-agreed ratio as both parties provide capital and are involved in the management of the business venture. Musharaka financing is more suitable for existing business that needs new additional capital for expansion purposes. Exhibit 1 shows the most commonly and widely used structures of Islamic microfinance.

25.4 Demand for Islamic microfinance

Despite its strong appeal and demand in Muslim countries, Islamic microfinance represents less than 1% of global microfinance outreach in spite of the fact that almost half of microfinance clients worldwide live in Muslim countries[4]. Although the supply of Islamic microfinance is concentrated in a few countries, the demand for Shari'a-compliant microfinance products is very strong. It is estimated that about 17,000 million people worldwide live below the poverty line of which almost 44% of them reside in the Muslim majority countries. According to the World Bank, Asia Pacific has the highest proportion of people living in poverty whereby around 60% of the world's Muslims live in the region and 67% of the poor are surviving on USD1 or less a day[5] (see Exhibit 2).

The figures presented in Exhibit 2 also indicate that the establishment of Islamic microfinance institutions in the Asia Pacific region would have the potential of eradicating poverty amongst Muslims. Furthermore, since the 2.7 billion unbanked includes a vast majority of Muslims, expanding the outreach of Shari'a-compliant microfinance services has the potential to elevate the Islamic microfinance industry on a global scale. This implies the huge untapped potential for Islamic microfinance to respond to the unmet demand of this segment of the society who command products that are consistent and compatible with financial principles set forth in Islamic law.

A number of studies concluded that there exists a strong pent-up demand for Islamic microfinance products across the globe. Amongst the major studies are:

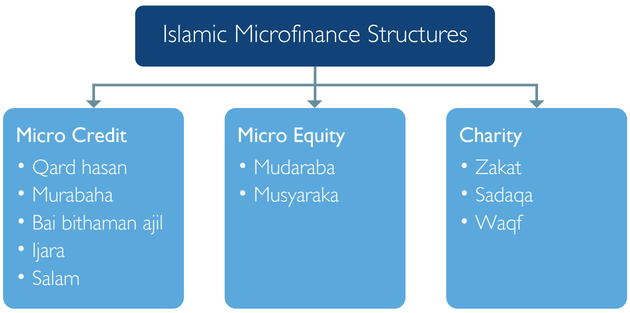

Exhibit 1: Most Commonly Used Islamic Microfinance Structures

Region	% in USD1.25 a day poverty	Population (millions)	Population in USD1 a day poverty (millions)
East Asia and Pacific	**16.8**	1,884	316
Latin America and the Caribbean	**8.2**	550	45
South Asia	**40.4**	1,476	596
Sub-Saharan Africa	**50.9**	763	388
Total Developing Countries	**28.8**	4,673	1,345
Europe and Central Asia	**0.04**	473	17
Middle East and North Africa	**0.04**	305	11
TOTAL		**5,451**	**1,372**

Exhibit 2: Population and poverty distribution of different regions
Source: World Bank (2010)

[4] World Bank estimates that there are over 7,000 microfinance institutions serving more than 16 million poor individuals in the developing countries.

[5] World Bank, 2010. *World Hunger and Poverty Facts and Statistics* in Replicate the World Bank's Regional Aggregation., World Bank.

- The Consultative Group to Assist the Poor (CGAP) surveys in Jordan, Syria and Algeria revealed that 20% to 40% of respondents cite religious reasons for not accessing conventional microfinancing.[6]

- Studies by USAID and IFC/FINCA found similar results whereby 24.9% and 30% of respondents in Jordan, respectively cited the same religious reasons for not seeking conventional loans.[7]

- A study by the Frankfurt School of Finance and Management on microenterprise owners in Algeria showed that 20.7% of them did not apply for micro-loans due to religious reasons.[8]

- An IFC report indicated that 43% of respondents in Syria acknowledged religion to be the main obstacle to obtaining microcredit whilst 46% never applied for a loan due to religious reasons.[9]

- In Yemen, the demand for Islamic financial services by the poor is estimated to be at 40%. Respondents were even willing to pay a higher price for Shari'a-compliant products.[10]

- Bank Indonesia reported that about 49% of rural people in East Java, Indonesia stated their preference to bank with Islamic institutions.

- About 54.4% of microfinance clients in Indonesia preferred Islamic microfinance. They cited religious factors as the basis for their preference.[11]

- A study conducted in Bangladesh to assess the prospects of Islamic microfinance programmes in poverty alleviation revealed an inelastic demand for Islamic microfinance products. It is estimated that more than 80% of respondents claimed a preference for Islamic products over conventional ones.[12]

- About 38% of borrowers in Kosovo whom sought loans from SMART (a Shari'a-compliant microfinance institution established by Islamic Relief) indicated that religious beliefs attributed to their decision. When asked if they would switch to interest-based financing if the loans provided by SMART became more expensive, 70% replied that they would remain with SMART.[13]

- A survey conducted Al Huda Centre of Islamic Banking and Economics in Azad Kashmir, Pakistan exhibited that 99% of respondents showed strong demand for Islamic microfinance services.[14]

25.5 Development of Islamic microfinance across the globe

The Islamic finance industry has made great strides over the last 40 years. Currently valued at USD1.357 trillion, the Islamic finance industry has been growing in prominence and importance as a viable and efficient alternative model of financial intermediation. Nonetheless, Islamic microfinance sector is still in its infancy and remains underdeveloped in the broader Islamic finance industry. Many critics have argued that Islamic microfinance has yet to demonstrate it can provide financial services that meet the needs of the poor on a large scale.

In its 2007 global survey on Islamic microfinance, the CGAP revealed that a dearth in Islamic microfinance services and a visible gap between the demand and supply of Islamic microfinance worldwide.[15] According to the report, Islamic microfinance accounts for a very small proportion, 0.005% of total global microfinance outreach. The 125 Islamic microfinance institutions surveyed had only about 380,000 clients in total. Providers of Islamic microfinance also tend to be relatively small in size[16] and mainly concentrated in Indonesia, Bangladesh and Afghanistan. These three countries account for about 80% of the total global outreach of Islamic microfinance as shown in Exhibit 3. In Bangladesh, which has the largest segment of conventional microfinance, the market share of Islamic microfinance in the country is only 1%. The survey also revealed that some 72% of people in Muslims countries refrained from using interest-based microfinance services, citing religious injunctions against paying interest.

Apart from the study conducted by CGAP, statistics and data on the Islamic microfinance sector worldwide remains scarce and inconsistent. However, recent developments have clearly indicated that Islamic microfinance has gained traction with a swift rise in the number of institutions offering microfinance products that are Shari'a-compliant across Muslim and non-Muslim countries in recent years. It is estimated that there are currently 300 Islamic microfinance institutions operating worldwide in about 32 countries which expand across six continents of North Africa, Sub-Saharan Africa, the Middle East, Central Asia, South Asia and Southeast Asia. Anecdotal evidence suggests that the demand for Islamic microfinance is tremendous given that there are around 1.3 billion Muslims worldwide.

Despite strong demand for Shari'a-compliant microfinance products and services, the growth of the Islamic microfinance sector has been slow. This is mainly due to the fact that such facilities are generally provided by specialised institutions such as NGOs and donors instead of Islamic banks. The KFH Islamic Microfinance report stated that Islamic banks are discouraged from getting involved in microfinance due to four main factors: (1) concerns about the lack of real profitability of microfinance, (2) inherent risks posed by microfinance, (3) lack of knowledge and expertise to undertake such activities proficiently, and (4) widespread belief that the poor are poor because of their lack of skills.

In the next pages, we will look at the state of Islamic microfinance in Pakistan, Bangladesh, Malaysia, Indonesia and the MENA region.

25.6 Conclusion

Even though Islamic microfinance has gained some traction, it has yet to develop as an important component of the Islamic financial system. Hence, for the Islamic microfinance industry to reach its fullest potential in poverty

[6] CGAP Focus Note No. 49, August 2008. *Islamic Microfinance: An Emerging Market Niche.*

[7] IFC/FINCA, 2006. *Business Plan for a Microfinance Institution in Jordan.* Commissioned by IFC and FINCA, 26 September, 2006.

[8] Frankfurt School of Finance and Management (Bankakademia International), 2006. *Access to Finance in Algeria, Final Report.* Frankfurt: Frankfurt School of Finance and Management, July.

[9] IFC, 2007. *Syria Microfinance Market Assessment, Draft Report.* Washington DC:IFC/The World Bank, November.

[10] Cited from Karim, N., M. Tarazi and X. Reille, 2008. *Islamic Microfinance: An Emerging Market Niche.* Focus Note 49. Washington D.C: CGAP, August.

[11] Masyita, D. and Ahmed, H., 2011. *Why is Growth of Islamic Microfinance Lower than Conventional? A Comparative Study of the Preferences and Perceptions of the Clients of Islamic and Conventional Microfinance Institutions in Indonesia.* A paper presented at the 8th International Conference on Islamic Economics and Finance, Qatar, 19-21 December 2011.

[12] Haque, M. S. and Yamao, M., 2011. Prospects and Challenges of Islamic Microfinance Programmes: A case study in Bangladesh. International Journal of Economic Policy in Emerging Economies, Vol. 4, No. 1, pp. 95-111.

[13] Khan, A. A. and Phillips, I., 2010. *The Influence of Faith on Islamic Microfinance Programmes.* Islamic Relief Worldwide.

[14] http://www.slideshare.net/alhudacibe/overview-of-microfinance-by-syed-mohsin

[15] Karim N, Tarazi M. and Reille X., "Islamic Microfinance: An Emerging Market Niche", Focus Note No. 49, CGAP, Washington DC, USA, 2008.

[16] Islamic microfinance institutions have an average client base of just 2,400.

Region	No. of institutions	Total no. of clients	Total outstanding loan portfolio (USD)	Avg. loan balance (USD)
Afghanistan	4	53,011	10,347,029	162
Bahrain	1	323	96,565	299
Bangladesh	2	111,837	34,490,490	280
Indonesia	105	74,698	122,480,000	1,640
Jordan	1	1,481	1,619,909	1,094
Lebanon	1	26,000	22,500,000	865
Mali	1	2,812	273,298	97
Pakistan	1	6,069	746,904	123
West Bank and Gaza	1	132	145,485	1,102
Saudi Arabia	1	7,000	586,667	84
Somalia	1	50	35,200	704
Sudan	3	9,561	1,891,819	171
Syria	1	2,298	1,838,047	800
Yemen	3	7,031	840,240	146
TOTAL	**126**	**302,303**	**197,891,882**	**541**

Exhibit 3: Outreach of Islamic microfinance by country
Source: CGAP Survey, 2007

alleviation, governments and regulators should integrate this industry into the mainstream banking and finance system. However, the challenge for the further development of a vibrant Islamic microfinance industry remains fundamentally meeting the needs of the clients who demand affordable, authentic and market-driven products. The report titled "The Role of Microfinance in Poverty Alleviation" released by Islamic Development Bank in 2008 points out to this very issue facing the Islamic microfinance industry and cautioned that a "one-size-fits-all solution" to poverty alleviation is not workable. The report put forward that greater creativity is needed to develop Shari'a-compliant Islamic microfinance products in addressing the poverty issue of Muslim populations in developing countries.

Capacity building is also critical at all levels to realize the full potential of Islamic microfinance. As such more efforts are needed to train Islamic microfinance professionals including development of training courses and certification that imparts microfinance related special skills to finance professionals and those involved in the microfinance industry. Finally, a supportive and enabling environment that is conducive for the development of Islamic microfinance should be given the upmost priority by policy makers and regulators alike.

CASE STUDY 1

Islamic Microfinance in the MENA

Arguably, the earliest attempt for Islamic microfinance in modern times originated from Egypt with the establishment of the Mit Ghamr bank in 1963. The bank extended interest-free loans to poor farmers who lacked necessary funds to finance the purchase of seeds, farm animals to plough the land or even to finance their subsistence and basic needs until the crop was cultivated and sold in the market. Although short-lived due to political reasons, its success laid the foundation of modern Islamic banking. The second attempt in Egypt was the establishment of the Nasser Social Bank in 1971 which provided interest-free micro-credit loans for small projects on a profit-sharing basis. Although the bank is still in existence, its Islamic microfinance portfolio no longer makes up a sizable portion of its business activities.

Despite being the birthplace of Islamic microfinance, this sector remains less developed in the Arab world than in Asia. The so called Arab Spring had temporarily halted the development and growth of the microfinance industry in these markets. However, the MENA region boasts several successful microfinance initiatives in countries like Yemen and Syria.

Yemen

The poorest country in the Arab World, Yemen is ranked 133 out of 169 countries on the UNDP's 2010 Human Development Index. With a Human Development Index score of 0.439, Yemen is said to have a low human development level. The first Islamic microfinance experiment in Yemen was the Al-Hudaidah Microfinance Programme. Launched in 1997, the programme was funded by grants from the Yemen's Social Fund for Development (SFD) and the United Nations Development Program (UNDP). Based on a group lending approach, the programme uses the murabaha model of cost plus markup for its target clientele. Five years into operations, the Al-Hudaidah Microfinance programme had 1,365 active borrowers, 11% of whom were women, and outstanding loans of USD205, 245. In 2006, the SFD agreed to provide Al-Hudaidah with an additional funding of about USD190, 000 to ensure its continuous flow of funds of which the third and final instalment of USD67,500 was paid to Al-Hudaidah in 2007. By the end of 2008, Al-Hudaidah had disbursed a total number of 30,094 loans with a cumulative value of USD 3.32 million (Exhibit 1).

	2002	2003	2004	2005	2006	2007	2008
Number of Active Borrowers	1,365	1,005	1,135	2,490	3,551	3,804	1,870
Percentage of women borrowers (%)	11	12	89	83	85	79	79
Outstanding loans (USD)	205,245	136,572	36,341	100,342	191,562	209,806	86,659
Repayment rate	-	-	100	100	100	87.5	76
Number of loan (cumulative)	5,048	5,072	6,729	14,524	22,710	28,824	30,094
Amount of loan (cumulative in USD)	1.47 mln	1.46 mln	1.55 mln	1.92 mln	2.41 mln	3.01 mln	3.32 mln

Exhibit 1: Performance of Al-Hudaidah microfinance programme
Source: Social Fund for Development, Annual Report (various years)

A notable microfinance player in Yemen is the Al Amal Microfinance Bank which is the first microfinance bank in Yemen and the MENA region. The bank was set up under the Law No. 23 of 2002 and is the outcome of the joint efforts and partnership of the Yemeni government represented by the Social Fund for Development (who owns 45% share), the Arab Gulf Program for United Nations Development Organizations (35% share) and the contribution of the private sector (20% share). The main objective of Al Amal is to provide economically active poor micro enterprises with small and micro-loans, with a focus on women and young entrepreneurs. When it first started operations in 2009, the bank had three offices. Today, Al Amal has about 14 branches all over Yemen. As of 30 June 2011, Al Amal had 14,164 active borrowers with women constituting 57% of total borrowers and about 20,000 depositors. Operating for just over two years, Al Amal had already captured over 25% of the country's microfinance market. In 2011, the bank was named as the winner of the Islamic Microfinance Challenge 2011 for its Islamic leasing product.[1]

	2009	2010
Gross loan portfolio (USD)	705,444	2,593,513
Number of active borrowers	4,123	14,722
Deposits (USD)	147,498	5,440,789
Number of depositors	3,979	18,597

Exhibit 2: Performance Indicators of Al Amal Microfinance Bank, Yemen
Source: mixmarket

[1] Islamic Microfinance Challenge 2010 is a partnership launched by CGAP, Deutsche Bank, Grameen-Jameel Pan Arab Microfinance, and Islamic Development Bank to encourage the reach of Islamic financial services to micro-entrepreneurs. The objective of this global competition is to uncover viable business models that provide micro-finance products compatible with Shari'a. A total of over 130 applications from 43 countries were received for this competition.

Syria

An early Islamic microfinance experiment was in the rural region of Jabal al Hoss, which is one of the poorest regions in the country. As a joint initiative between the Syrian Ministry of Agriculture and Agrarian Reform and the UNDP, the Rural Community Development Project (RCDP) was set up in 2000 with the prime objective of establishing rural savings and credit services through village development funds. The RDCP applies the village-bank-like approach or sanadiq in Arabic to promote local ownership. The sanadiq system had successfully adopted the musharaka-type structure whereby villagers buy shares to become owners and receive annual dividends using a profit-sharing scheme. In terms of a loan disbursement methodology, the RCDP emphasises flexible lending with no standardised loan terms. Hence, the size of loan, duration of loan as well as instalment periods may vary to accommodate the needs of each member. The profit margin is set according to the murabaha.[2] The programme has been successful in alleviating poverty and empowering local communities in the Jabal al Hoss region.

	2006	2007	2008	2009	2010
Number of active borrowers	2,279	2,358	1,884	-	1,128
Gross loan portfolio (USD)	1,501,505	1,923,487	1,812,011	1,833,406	1,118,966
Deposits (USD)	-	315,769	324,962	330,363	-
ROA (%)	-	6.78	4.72	-	3.99
ROE (%)	-	11.25	8.3	-	5.16
Operational self-sufficiency (%)	-	250.09	223.22	-	434.43
Portfolio at risk > 30 days	10.36	15.89	25.53	-	-
Portfolio at risk > 90 days	-	14.87	25.37	-	-

Exhibit 3: Performance of the RCDP Jabal al Hoss
Source: mixmarket

Iraq

Iraq is largely dominated by NGOs. At present there are approximately 14 microfinance institutions serving 70,000 clients with total outstanding loans of USD109 million. Out of this, six microfinance institutions are providing Islamic microfinance services to over 7,000 micro enterprises whereby 14% are women-owned small businesses. The Islamic microfinance sector in Iraq has been registering double digit growth of 68% as compared to the average growth rate of the microfinance industry of 36%. Nonetheless, the Islamic microfinance sector constitutes only 10% of the total industry portfolio. The absence of distinct regulatory framework for Islamic finance and a national Shari'a Board has impeded the expansion of Islamic microfinance providers in the country. The experience of Al Takadum, the pioneering Islamic microfinance institution in Iraq, demonstrate the time consuming process that Islamic microfinance providers would have to undergo in order to meet the acceptance and endorsement of different local sheikhs and imams in different cities of the same province. Al Takadum was registered with the Iraqi NGO Office of the Ministry of Civil Affairs in mid 2007. It currently has 3 branches spread across the Al Anbar province. Al Takadum only offers individual loans based on murabaha principle. The performance of Al Takadum is shown in Exhibit 4.

	2008	2009	2010	30 June, 2011
Assets (USD)	4,164,329	5,664,187	8,688,420	9,486,104
Number of borrowers	-	3,408	6,529	7,732
Gross loan portfolio (USD)	3,406,597	4,226,605	7,856,141	8,959,081
ROA	-	2.85%	1.51%	3.48%
Operational self-sufficiency	80.96%	120.42%	109.49%	119.11%
Portfolio at risk > 30 days	-	9.84%	3.61%	8.63%
Portfolio at risk > 90 days	-	4.78%	0.51%	2.84%

Exhibit 4: Performance of Al Takadum, Iraq
Source: mixmarket

[2] Imady, O. and Seibel, H., 2003. *Sanduq: A Mirofinance Innovation in Jabal al Hoss, Syria.* NENARACA Newsletter, September 2003.

Sudan

The Islamic microfinance industry in Sudan is at an infancy stage despite the fact that Sudan was one of the earliest countries to embark on the process of converting the banking system to be in line with Shari'a principles. The Islamic microfinance industry is reported to be fulfilling a mere 3% of the country's demand for Shari'a-compliant financing. The main providers of micro loans to the poor remain NGOs and the rural development projects. Although a number of Islamic banks such as Sudanese Islamic Bank, Faisal Islamic Bank and the Islamic Cooperative Development Bank have started providing Islamic microfinance services, their outreach remains limited.

In May 2011, Faisal Islamic Bank allocated SDG5 million (USD1.87 million) for microfinance in collaboration with Chamber of Zakat. As with most countries, the main financing mode is murabaha (40%), followed by qard hasan (17.6%), ijara (14.5%), salam (10%) and mudaraba (3.7%). The microfinance programme was named as a "security purse" and had the objective of increasing the income of the poor and needy as well as assisting them in realising self-sufficiency. As part of the strategy to develop the microfinance industry, the Central Bank of Sudan (CBOS) set up a microfinance unit in 2007 with the objective of promoting the Islamic microfinance as a tool for poverty alleviation and economic development. In 2010, CBOS issued a ruling in 2010 that all banks in the country must allocate a minimum 12% of their portfolios to microfinance. The CBOS Policies 2011 also required all banks to establish specialised units for microfinance.

Conclusion

The microfinance industry in the MENA region suffers from a lack of an appropriate infrastructure. In most cases, the legal and regulatory framework is either underdeveloped or partially applied. However, a number of countries in the region have taken initiative to regulate their microfinance industry. Exhibit 5 illustrates the degree to which regulatory frameworks have been implemented in the MENA region.

		Deposit-taking allowed?		
Country	**Microfinance specific legislation**	**By MFIs**	**By MFIs**	**By Credit Unions**
Egypt	Yes	-	-	-
Jordan	-	-	-	-
Lebanon	-	-	-	-
Morocco	Yes	-	-	-
Syria	Yes	Yes	Yes	-
Tunisia	Yes	-	-	-
Yemen	Yes	Yes	Yes	-

Exhibit 5: Regulatory Frameworks in selected countries in the MENA region
Source: Khaled, M., 2010; Sanabel/CGAP/MIX,2010

Countries such as Syria, Yemen and Egypt have introduced laws and regulations for the industry. Egypt, for example, introduced regulation for non deposit-taking microfinance institution, while Yemen and Syria passed laws permitting the establishment of deposit-taking microfinance institutions. In Iraq, the central bank, with the assistance of USAID-Tijara, issued an SME Finance Companies Ordinance to support the commercialisation of the microfinance industry. The ordinance helped pave the way for the transformation of NGOs microfinance institutions into non-banking financial intermediaries. Except for Sudan, Syria and Yemen, the microfinance industry in MENA faces restrictive regulations for deposits. As the majority of microfinance institutions are registered as NGOs, they are restricted from offering deposits in addition to loans. This raises the issue of sustainability especially as savings play an important role in the safety net for the poor and their cash flow management. Due to these reasons, many commercial banks and investors are reluctant to finance NGO-microfinance institutions. Hence, donor dependency and government funded lending programmes continues to plague the microfinance industry in the region.

Other challenges facing the industry in the region includes insufficient financial and operational capacities of microfinance institutions to reduce the huge gap in market outreach whereby an estimated 5 million potential micro entrepreneurs do not have access to microfinance services. The products offered by microfinance institutions do not respond sufficiently to the diverse needs of these entrepreneurs. Furthermore, microfinance institutions in the MENA region depends too heavily on only one product, namely credit for enterprise investment. One of the major impediments of growth remains the lack of commitment by policy makers in creating a more professional microfinance sector.

CASE STUDY 2

Islamic Microfinance in Pakistan

The history of microfinance in Pakistan started in the early 1980s with the Aga Khan Rural Support Programme. The success of the project led to a paradigm shift in thinking and practice of microfinance as a poverty alleviation tool. Since 2004, the microfinance sector has recorded substantial growth of 40% annually. Although the market for microfinance (both conventional and Islamic) is large and growing, sustainability and market outreach remain key challenges.

In a country where 56% of the adult population does not have access to any formal financial services, about 40% or 45 million of Pakistanis are living below the poverty line. This clearly underlines the huge potential for microfinance growth and development. But despite substantial growth of its microfinance sector, penetration rate remains low at only 7.5% of the potential microfinance demand.[1] Evidence suggests that many potential borrowers choose not to participate due to factors such as lack of awareness, low financial literacy and religious beliefs.

Pakistan is home to over 178 million Muslims and is projected to surpass Indonesia as the most populous Muslim nation with an estimated population of about 256 million by 2030.[2] Currently, there are about 14 Islamic microfinance institutions operating in the country. Notable ones include Akhuwat and Islamic Relief.

Akhuwat, a non-profit organisation, was established in 2001 with the aim of providing the poor with interest-free microfinance so as to enhance their standard of living. Principles of social justice and brotherhood are the underlying philosophies that have driven the success of Akhuwat as a pioneer of micro-credit based on Islamic principles in Pakistan. The organisation offers qard hasan as well as diversified loan products to meet the needs of the poor. Besides Islamic microfinance loans, Akhuwat also offer its clients services such as business development, insurance and health related services. Its mandate extends beyond financial transactions as Akhuwat makes every effort to guide, support and empower the poor[3] by providing social guidance, capacity building and entrepreneurial training to the poor. Another unique characteristic of Akhuwat is its mosque-based model where all transactions

including loan appraisals, disbursements and collections take place at the local mosque. Hence, all activities revolve around the mosques and involve close interaction with the community. Apart from mosques, Akhuwat also uses other religious centres such as local shrines and churches for loan disbursements and fund raising. Akhuwat adopts a collateral-free group and individual financing based on mutual guarantees; and has an exceptional 99.8% recovery rate.

From its first loan of only USD100, Akhuwat has disbursed over USD17 million with an outstanding loan portfolio of USD3.9 million as of December 2011. Akhuwat's market share of the total microfinance sector in Pakistan stands at 0.9% in 2010. The number of active borrowers has doubled to 31,543 clients in 2010 from 15,013 in the previous year (see Exhibit 1). Evident of the outreach of Akhuwat microfinance loans can be seen from the increases in the number as well as volume of disbursements. Unlike other microfinance institutions that depend on international funding, Akhuwat's source of funding is mainly from local philanthropists and the community. One of the most remarkable features of Akhuwat is how a significant portion of its borrowers who have gained economic stability through its micro-credit schemes have become donors to the institution. Akhuwat also has recorded positive growth in the donations received in the period from 2004 to 2010.

	2004	2005	2006	2007	2008	2009	2010
Gross loan portfolio (USD million)	0.304	0.637	0.842	-	1.187	2.796	2.931
No. of active borrowers	-	3,023	6,069	8,734	-	15,013	31,543
Donation Received (USD)	78,803	121,098	312,489	195,337	244,356	414,683	915,057
Disbursements (USD)	93,739	350,650	727,894	991,566	1.35 mil	1.81 mil	2.78 mil
percentage increase		274.1%	107.5%	36.2%	36.2%	34.1%	53.3%
Disbursements (numbers)	836	3135	4398	8674	11672	13874	21625
percentage change		275%	40.3%	97.2%	34.6%	18.9%	55.9%
Operating costs (USD)	6,228	22,090	52,524	91,193	148,347	190,487	-
Percentage change		254.7%	137.8%	73.6%	62.7%	28.4%	-

Exhibit 1: Performance of Akhuwat from 2004 – 2010
Source: Mixmarket, Akhuwat Annual Report

[1] Khalid, K., 2010. *Micro-WATCH: A Quarterly Update on Microfinance Outreach in Pakistan Issue 18: Annual.* Pakistan Microfinance Network.

[2] Pew Research Center's Forum on Religion and Public Life. The Future of the Global Muslim Population, January 2011.

[3] Siddiqi, K., 2008. Potential of Islamic Microfinance in Pakistan. Master Thesis. Loughborough University.

Exhibit 2 shows the disbursement efficiency and operational self-sufficiency ratios from 2004 until 2010. The disbursement or operational efficiency refers to the efficiency of the loan disbursement system. The disbursement efficiency ratio has been low but is increasing. The operational self-sufficiency ratio, on the other hand, measures whether the revenue generated by the micro-credit programmes of Akhuwat is sufficient to cover its overhead. Despite not charging any interest on loans, Akhuwat covers around 60% to 80% of its operating costs.[4]

Ratios of Akhuwat 2004 -2009

	2004	2005	2006	2007	2008	2009
Disbursement Efficiency	6.64%	6.30%	7.22%	9.20%	10.99%	10.52%
Operational Self-sufficiency	68.47%	87.61%	82.36%	64.83%	79.36%	64.43%

Exhibit 2: Disbursement efficiency and operational self-sufficiency
Source: Mixmarket, Akhuwat Annual Report

Since its establishment in 1992, Islamic Relief Pakistan (IRP) has successfully implemented various relief and development projects. The IRP has carried out both large and small scale emergency projects in response to earthquakes and other natural disasters in Pakistan. In 2001, IRP introduced its microfinance programme which aims to provide enterprise development services to the urban poor though the following activities[5]:

• Provision of microfinance services
• Investment in income-generating activities
• Financing social needs to improve standard of living
• Enhance micro-enterprises trough trainings and other business development services

Unlike Akhuwat which provide qard hasan loans to its needy customers, Islamic Relief Pakistan predominantly advances mudaraba financing to individuals based on a combination of personal guarantors, group savings accounts and community recommendations to ensure repayment. The guarantee mechanisms adopted by IRP have proven to be highly efficient and effective with a recovery rate recorded at 99%. To date, IRP has disbursed a total of 44 million rupees to over 3,500 clients. Anecdotal evidence suggests that IRP's microfinance programmes have a positive impact in raising income of its clients and hence, contributing significantly to the socio-economic uplift of the poor.[6] Similar to other NGOs, its main source of income is from international donations as well as its own assets.

Pakistan is an example of a country that has developed its microfinance industry at the micro, meso and macro level. The State Bank of Pakistan (SBP), which already has a legal and regulatory framework in place for conventional microfinance institutions, developed guidelines in 2007 for the rapid expansion of Islamic microfinance. The guidelines are aimed at broadening the market outreach of microfinance programmes to the poor at the macro level. In order to enhance the breadth and depth of the industry, the guidelines allowed Islamic microfinance services and products to be offered through four types of financial institutions, namely full-fledged Islamic microfinance banks, Islamic microfinance services by full-fledged Islamic banks, Islamic microfinance services by conventional banks and Islamic microfinance services by conventional microfinance banks. The guidelines also described requirements on licensing, appointment of Shari'a advisers as well as the segregation of Islamic products funds and related documentation by both banks and microfinance institutions that offer conventional as Islamic products.[7] Pakistan has been recently ranked as the global leader in setting microfinance regulation by the Economist Intelligence Unit, implying that the country has a very strong regulatory regime, essential for the effective and efficient operations of microfinance institutions.[8] In the overall microfinance business environment rankings, Pakistan is ranked third globally but top in Asia.

[4] Akhuwat initially levied 5% loan processing fee on the borrowed amount to cover its operational expenses. However with effect from 25th March, 2009, this fee has also been abolished.

[5] http://www.islamic-relief.org.pk/new/index.php?option=com_content&view=article&id=23

[6] Ullah, A., Khan, Z. and Yasin, H. M., 2011. *Cooperative Microfinance Myth or Reality: An Economic Analysis of the Welfare of Marginalised Segments.* Paper presented at the 8th International Conference on Islamic Economics and Finance, December 25-27, 2011, Doha, Qatar.

[7] Guidelines for Islamic Microfinance Business for Financial Institutions (Annexure to Circular No. 05 of 2007), State Bank of Pakistan Islamic Banking Department, available at http://www.sbp.org.pk/ibd/Annex-c5.pdf

[8] Economist Intelligence Unit, 2011. Global Microscope on the Microfinance Business Environment 2011. The Economist, London.

CASE STUDY 3

Islamic Microfinance in Bangladesh

Bangladesh is one of the earliest countries to adopt microfinance with the introduction of the Grameen Bank project in 1976 by its founder Professor Muhammad Yunus. The country is also regarded as the first to adopt Islamic microfinance practices and its Islamic microfinance sector currently accounts for about 1% of Bangladesh's overall microfinance industry. With an estimated 100,000 Islamic microfinance clients in Bangladesh, the country is said to have one of the largest global market outreach. The main types of institutions providing microfinance services in Bangladesh include microfinance-NGOs (MFI-NGOs), Grameen Bank and commercial and specialised banks' microfinance programmes or divisions.

Leading Islamic microfinance providers in Bangladesh include commercial banks such as Islami Bank Bangladesh Limited (IBBL) and Social Investment Bank Ltd as well as MFI-NGOs such as Al-Fallah and Rescue. The IBBL is the largest provider of Islamic microfinance in the country. In 1995, IBBL launched its Islamic microfinance programme called the Rural Development Scheme (RDS). The main objective of RDS was to eliminate rural poverty by adopting a community development approach, providing small and micro investments. At present, the scheme is being implemented through 177 branches in 12,857 villages under 61 districts. Under the scheme, IBBL has disbursed a total of USD 504.9 million (cumulative since 1995). As of June 2010, some 608,703 members were involved in RDS. Exhibit 1 shows a satisfactory trend in the growth of members and branches which reveals the successful outreach of RDS in the rural development of Bangladesh.

	2005	2006	2007	2008	2009	2010
# of branches	101	118	129	136	139	177
# of villages	4560	8057	10023	10676	10751	12857
# of members	217445	409575	516725	577740	492475	608703
Investment outstanding (USD million)	13.21	26.77	34.44	35.96	44.80	51.59

Exhibit 1: RDS of IBBL (Microcredit)
Source: Islami Bank Bangladesh Limited

The RDS is a group based microcredit scheme modelled after the Grameen Bank and practices murabaha, mudaraba, bai muajjal, bai salam, hire purchase shirkatul milk or leasing and musharaka modes of investment for financing the participations of the scheme. Nonetheless, bai muajjal remains the main mode of investment for RDS. The rate of return for these investments is 12.5% out of which 1.5% is kept as welfare fund. RDS also provides a 2.5% rebate for timely payment.[1] The financial performance of RDS from 2005 to 2009 is presented in Exhibit 2. In terms of operational self-sufficiency, the high ratios correspond to the high loan officer productivity. Although the financial self-sufficiency shows a negative trend since 2006, the numbers still indicate the sustainability of RDS. The RDS have also been able to maintain high portfolio quality (on time recovery of loan) of 99% in the years analysed. Average loan size is also increasing.

	2005	2006	2007	2008	2009
Outreach					
Active customers (#)	217,425	409,575	526,725	577,740	492,475
Active Borrowers (#)	164,116	295,012	350,278	321,484	312,036
Borrowers/customer ratio (%)	75.48	72.03	67.79	55.65	63.36
Average loan size (Taka)	10,178	10,731	12,139	13,963	18,800
Operating Efficiency					
Loan officer productivity (#)	250	299	300	357	326
Portfolio per loan officer (Taka)	1,270,000	1,640,000	1,670,000	1,860,000	2,480,000

Exhibit 2: Financial Performance Indicators of RDS, 2005-2009
Source: Alamgir et al (2011)

[1] Rahman, M., Jafrullah, M. and Islam, AMN, 2008. *Rural Development Scheme of Islami Bank Bangladesh Limited (IBBL): Assessment and Challenges.* IIUM Journal of Economics and Management 16, no. 2 , pp. 139-163.

	2005	2006	2007	2008	2009
Portfolio Quality					
On time recovery rate (%)	99	99	99	99	99
Profitability Analysis					
Operating self-sufficiency (%)	206	197	213	163	181
Financial self-sufficiency (%)	120	122	115	100.2	109

The RDS offers financial services to all four segments of the community – hardcore poor, moderately poor (mainstream microcredit), microenterprise and marginal and small farmers. However, the bulk of its investment is for the moderately poor family and mainly concentrated in the agricultural sector (as shown in Exhibit 3).

Sector of Investment	Duration	Ceiling of Investment (Taka)
Crop production	1 year	25,000
Nursery and commercial production of flowers & fruits	1 year	50,000
Agriculture implements	1 – 3 years	50,000
Livestock	1 -2 years	50,000
Poultry	1 year	35,000
Fisheries	1 -2 years	50,000
Rural transport	1 year	20,000
Rural housing building	1 – 5 years	50,000
Off-farm activities	1 year	50,000

Exhibit 3: Sector, Period and Ceiling of RDS Investment as at the year 2010
Source: Alamgir et al (2011)

The MFI-NGOs in Bangladesh are regulated by the Microcredit Regulatory Authority (MRA) which was established in 2006 to ensure transparency and accountability of microfinance operators. Under the MRA Act 2006, the Authority assumes the power of issuing and cancelling licenses of MFI-NGOs as well as overseeing, supervising and facilitating their activities. Commercial banks with microfinance programmes, on the other hand, are regulated by the central bank whilst Grameen Bank (the country's largest microfinance institution) is regulated by a separate law - Grameen Bank Ordinance of 1983.

CASE STUDY 4

Islamic Microfinance in Malaysia

The microfinance sector in Malaysia is dominated by small and medium enterprises (SMEs) where 90% of the SMEs are categorised as micro enterprises.[1] These micro enterprises constitute more than 80% of all businesses in Malaysia and employees over 1.2 million people. The majority of the micro enterprises (about 88%) are in the services sector with significant involvement in the retail, food and transportation sub-sector. Given that a significant percentage of SMEs are micro enterprises, adequate access to financing for this segment of businesses is vital in developing a sustainable microfinance industry.

Microfinance providers in Malaysia take four distinct forms namely microfinance institutions, cooperative, development financial institutions and commercial banks with microfinance schemes. The three main microfinance institutions are Amanah Ikhtiar Malaysia (AIM), Yayasan Usaha Maju (YUM) and Economic Fund for National Entrepreneurs Group (TEKUN). Whilst AIM is a non-government organization, both YUM and TEKUN are under the purview of the Ministry of Agriculture and Agro-based Malaysia. The AIM and YUM offer loans to the poor and the extreme poor female members whilst TEKUN concentrates on the poor and moderately poor segments of the population.

Development institutions such as Bank Rakyat, Bank Simpanan Nasional and Agrobank (formerly called Bank Pertanian Malaysia) have been mandated by the government to provide micro credit facilities. Bank Rakyat offers an Islamic pawnbroking scheme, Bank Simpanan Nasional offers microloans to finance non-agricultural activities whilst Agrobank provides microfinance to micro enterprises in the agriculture and agro-based sectors. Commercial banks in Malaysia are also allowed to offer microfinance through their participation in the Pembiayaan Mikro (Micro financing) scheme introduced in 2006. The main purpose of the scheme is to support the growth of micro enterprises by improving their access to the formal financial system.

Under the scheme, participating financial institutions offer microfinance loans to micro enterprises ranging from RM500 to RM50,000. These micro financing facilities are meant only for business financing such as for working capital and capital expenditure. The participating financial institutions are not allowed to give out personal micro credit under the scheme. Apart from Bank Rakyat, Bank Simpanan Nasional, and Agrobank, other participating financial institutions are CIMB Bank, Maybank, Alliance Bank, AmBank, Public Bank, United Overseas Bank and EONCAP Islamic Bank. Under the recent financial sector liberalisation programme, locally incorporated banks were allowed to venture into microfinance. These banks were allowed to establish up to 10 branches throughout the country for this purpose. The commercial interest rate charged on micro financing loans is determined by the respective participating financial institutions based on their assessment of the borrower's risk profile.

The annual growth for total microfinancing outstanding was 30% which amounted to RM776 million (USD255 million) with the total number of clients over 570,000 as of the end of 2010. Outstanding financing under the Pembiayaan Mikro scheme as of 2009 was RM617 million (USD 202.7 million) and microfinance borrowers numbered 449,703. This growth has been complemented by the 1Malaysia Micro Protection Plan (1MMPP) which was developed to provide a financial safety net for micro enterprises and individuals against unexpected events such as death, illness, accidents, fires and loss of property.

Microfinance products offered in Malaysia are already Shari'a-compliant products based on the concepts of rahn(provided by Bank Rakyat), qard hasan (by AIM) and bai inah (provided by several participating financial institutions). The two main Islamic microfinance providers in Malaysia are AIM and Bank Rakyat. AIM was established in 1987 as an NGO with the aim of eradicating extreme poverty and is considered to be the oldest Grameen Bank replication in Asia. The objective of AIM is to give out qard hasan to low-income households to finance income-generating activities in order to improve their socio-economic condition and ultimately lift these poor households from poverty. Funded through interest-free loans from the Malaysian government, AIM has proven to be an effective poverty alleviation tool and was integrated into the national development plan beginning from the Fifth Malaysia Plan period (1986-1990). Under the Sixth Malaysia Plan (1991-1995), AIM was allocated a loan of RM20 million and received another allocation of RM200 million during the Seventh Malaysia Plan (1996-2000). Another RM100 million was allocated to AIM in response to the Asian financial crisis.

After 25 years of operation, AIM had established 106 branches in nine states and provided financial services to more than 80% of the poor households. The AIM adopts a group lending methodology where five persons of the same gender who have no close relatives are grouped together and provided a small amount of credit without any collateral based on qard hasan. However, only those whose gross monthly household income falls below the poverty line income are eligible for the funds. The microcredit approach is based on a system of small repayments paid on a weekly basis during the centre meetings which AIM's members are obliged to attend. At present, almost 99% of the members are women and the loans are normally short term in duration of between 25 to 150 weeks.

As of November 2011, there are 71,234 groups in 7,614 centres, currently serving a total of 294,738 members referred to as Sahabat.[2] Since its establishment, AIM has disbursed some USD 2 billion in loans with an impressive

[1] In Malaysia, micro enterprises are defined as business concerns with less than five full-time employees, and an annual sales turnover of less than RM250,000 in the manufacturing sector and RM200,000 in the agricultural and services sectors

[2] In the Malay language, sahabat refers to friend.

repayment rate of 99.61%. Exhibit 1 shows that the loan portfolio and deposits have increased on a yearly basis whilst the AIM has been enjoying a high operational self-sufficiency ratio.

Year	Loan portfolio (USD million)	No. of active borrowers	Deposits (USD million)	No. of depositors	Operational self-sufficiency
2010	275.16	241,965	57.34	241,965	**182.33**
2009	185.03	206,379	48.51	-	**169.6**
2008	132.98	165,286	37.95	192,101	**132.75**
2007	110.97	-	34.25	-	**149.58**

Exhibit 1: Performance of AIM from 2007 - 2010

There are mainly four types of financing mainly economic, recovery, education and multipurpose. Under economic financing scheme, AIM provides I-Mesra, I-Srikandi, I-Wibawa and I-Wawasan. Recovery financing is provided under the I-Penyayang which is intended for members facing repayment difficulties. The I-Bistari scheme is finance given to members to help them and their family members in obtaining vocational and educational facilities. For multipurpose needs, members can apply for I-Sejahtera financing to cater for needs such as purchase of land, houses or other items that are not in breach of the law or religious injunctions.

Anecdotal evidence have shown that participation in AIM's microfinance programmes have improved the ability of poor households to generate income as well as their standard of living. Studies conducted revealed that 98% of AIM members experienced an increase in household income whilst household savings increased significantly by 84%.[3] Other findings pointed to the increase in household income, which had enabled members to improve their housing conditions and increase their expenditure on food, nutrition, medical and education.[4] In 2008, AIM launched a new microfinancing scheme targeting the poor and lower income households in urban areas. Unlike its rural microcredit programme, the "Urban Micro Finance Program" as it is known, select clients with a household income below RM2,000 or has a capita below RM400 a month.

Another alternative Islamic financing mode is rahn (pawning). Bank Rakyat, as the largest Islamic cooperative in Malaysia, offers microfinance financing to its member cooperatives. The bank which comes under the auspices of the Ministry of Domestic Trade, Cooperatives and Consumerism, is the first cooperative in Malaysia to offer an Islamic pawnbroking scheme known as Ar-Rahnu in 1993. Although several other institutions are offering rahn such as Agrobank, Bank Islam and YAPEIM, Bank Rakyat controls over 25% of the Islamic pawnbroking market share with loan outstanding totalling RM1.2 billion (USD 394 million) annually. In October 2011, RHB Islamic Bank and Bank Muamalat Malaysia announced their plans to expand their pawnbroking services through their branches nationwide.

Ar-Rahnu is based on the concept of qard hasan (benevolent loan), wadia yad-amana (trustworthiness), al-ujra (the fee for safekeeping) and wadia yadhomana (safekeeping with guarantee). Under wadia yad-amana, the borrower is required to produce returnable collateral to ensure repayment of the loan and entrust the lender to look after the belongings during the loan period. The Shari'a principle of al-ujra states that the lender is allowed to charge a reasonable fee for keeping the pawned items safe and in good condition. The principle of wadia yadhomana refers to the responsibility of the lender to replace the missing or stolen items to the owner if the lender fails to keep the agreement.

Since its introduction, the Ar-Rahnu scheme of Bank Rakyat has shown an average yearly growth of 20%. In 2010, the scheme registered USD 373.13 million in financing and USD 31.99 million of deposits (Exhibit 2). In the beginning, Bank Rakyat had only 6 Ar-Rahnu outlets under the supervision of Bank Negara Malaysia. In 2006, Bank Rakyat launched the Ar-Rahnu X'Change which is an Islamic pawnshop franchise and operated by the bank's subsidiary, Rakyat Management Services Sdn Bhd. To date, there are 26 Ar-Rahnu X'Change, of which 9 are owned by the bank and the other 17 are owned by cooperatives under the Ar-Rahnu franchise business. In 2010, Ar-Rahnu X'Change had disbursed some RM121.7 million (USD 40 million).

	2004	2005	2006	2007	2008	2009	2010
Financing (USD million)	82.99	97.43	226.94	196.58	243.09	310.91	373.13
Deposits (USD million)	7.47	8.22	15.0	16.35	16.35	19.24	31.99

Exhibit 2: Total amount of financing and Deposits under Ar-Rahnu scheme (2004-2010)
Source: Bank Rakyat Annual Report (various years)

[3] Research and Development Unit, 1990. *Second Impact Study,* Amanah Ikhtiar Malaysia, Selangor, Malaysia. Research and Development Unit, 1991-1993. *Third Impact Study,* Amanah Ikhtiar Malaysia, Selangor, Malaysia

[4] Al-Mamun, A., Adaikalam, J. and Abdul Wahab, S., 2012. *Investigating the Effect of Amanah Ikhtiar Malaysia's Microcredit Program on Their Clients Quality of Life in Rural Malaysia.* International Journal of Economic and Finance, Vol. 4, No. 1, pp. 192- 203.

Besides Ar-Rahnu facilities, Bank Rakyat in 2007 started to offer Islamic microfinancing schemes to its members using bai inah structures and adopting the self-help group methodology. This Micro Financing-i Scheme or MUsK was introduced in response to the government's aspiration of developing the cooperative sector as the third engine of growth. Under the scheme, cooperative members who are involved in a business venture on a full time basis can apply financing for either expansion in productive capacity or for working capital purposes.

Since the inception of the New Economic Policy in 1971, microfinance has been part of the main agenda of the Malaysian government's economic development policy.[5] Various microcredit schemes have been introduced to meet the different needs of the poor and micro enterprises. In contrast to other countries, Malaysia's policy inclination has been to establish comprehensive microfinance institutional frameworks that will lead to the development of a sustainable microfinance industry. The National SME Development Council approved such a framework in 2003 which identified banking institutions, development financial institutions and cooperatives as microfinance providers to complement the existing government sponsored programmes such as AIM and TEKUN. The participation of banking institutions in the development of the microfinance sector through the Pembiayaan Mikro scheme were seen as important because of their large funding and network of branches which is critical in ensuring wide market outreach. Since microfinance was incorporated into banking practices, the number of Malaysians having access to financial services has increased to 80% of the population.

The framework also identified three strategic initiatives namely: defining the parameters of appropriate microfinance products, raising awareness on microfinance and attracting financial institutions to participate in providing microfinancing solutions. As part of Bank Negara Malaysia's' initiatives to create greater awareness of the availability of microfinance, a national microfinance logo was introduced in 2007 whereby all participating financial institutions will display this logo at their branches. Similarly, borrowers of microfinance are encouraged to display the logo at their business premises.

Under the Government Transformation Plan and New Economic Model introduced by the Malaysian government, several new microfinance programmes were initiated with the aim of eradicating poverty and raising living standards of poor households. Programmes, such as the 1AZAM, were introduced with the objective of providing those in extreme poverty with the opportunity to generate income through the four core 1AZAM pillars which are Azam Kerja (Work), Azam Tani (Agriculture), Azam Niaga (Business) and Azam Khidmat (Services). The 1AZAM programme aims to ensure that the low income families earn between RM720 and RM2000 a month, hence lifting them out of the poor and extreme poverty categories. In the first half of 2011, a total of RM21 million was disbursed to over 3,400 poor households. This amount is part of the RM231 million allocated for Azam Niaga and Azam Khidmat initiatives.[6]

Several other government initiatives to develop the Islamic microfinance sector and increase its market outreach were also announced in the recent Budget 2012. TEKUN which had been allocated a sum of RM120 million in 2011 was given a higher allocation in 2012 amounting to RM300 million. On the other hand, AIM received RM2.1 billion from the budget. In an effort to reduce cost of doing business for micro enterprises, a 100% stamp duty exemption was given on loan agreements, up to RM50,000 under the Microfinance Scheme.

Microfinance is also part of Malaysia's plan to become a financially inclusive country. The recent Financial Sector Blueprint (2011-2020) released by Bank Negara Malaysia reinforces the government's initiatives towards this end. Recognising the financial needs of the Muslim poor who demand access to financial services which do not compromise their religious beliefs regarding interest prohibition, the Blueprint advances the central bank's agenda for an inclusive financial system including Islamic financial inclusion and microcredit. The Blueprint also sets out to facilitate the takaful industry in developing microtakaful products particularly to the underserved segment of the community so that they have adequate protection against unexpected adverse events in a cost-effective manner.[7]

[5] The New Economic Policy (1971-1990) was directed to reducing poverty and income disparities between ethnic groups in Malaysia.

[6] http://www.themalaysian-insider.com/malaysia/article/business-loans-for-poor-from-1azam-rm21m-already-approved/

[7] Bank Negara Malaysia, 2011. *Financial Sector Blueprint 2011 – 2020: Sustaining Our Future.* Bank Negara Malaysia, Kuala Lumpur.

Islamic Microfinance in Indonesia

Arguably, the earliest attempt for Islamic microfinance in modern times originated from Egypt with the establishment The character of Indonesia's economy is shaped by the presence of its microbusinesses[1] which represent 98.85% of the 53.8 million businesses in Indonesia. The rest is split between SMEs with 1.14% and 0.01% big corporations.[2] The broad spread of microbusinesses has a long history in Indonesia and unsurprisingly, Indonesia was one of the first countries to develop commercial microfinance in Asia, with regulated financial institutions providing the bulk of microfinance-services through the archipelago.

Microfinance in Indonesia comprises of approximately 7,000 formal and 50,000 semi-formal registered microfinance units serving about 55 million depositors and 34 million borrowers. A majority of microfinance institutions in Indonesia are found in rural and semi-urban areas. Although there are a significant number of microbusinesses, their contribution comprises only 34% of Indonesia's GDP[3] or USD 228 billion. The rest of approximately 600,000 small and medium enterprises contribute roughly 23% to the GDP. The remaining 43% GDP is being generated by the big corporations, which numbers only 4800.

Indonesia's microfinance initiatives are recognised as having played a key role in the country's declining poverty rate from a high of 40% in the 1970s to 12.4% in 2011. This success is largely attributable to Indonesia's national development strategy introduced in the 1980s. In 1994, the government made microfinance a major component of its poverty reduction strategies and programmes. According to the Bank Indonesia, the central bank, Islamic microfinance is estimated to account for about 70% of Islamic financing in the country. The central bank also estimated that outstanding Islamic financing to micro, small and medium-sized businesses will increase to USD 5.1 billion by year end.

Indonesia's Islamic Finance Demand Side

One of the main advantages of Indonesia's Microfinance development has been its outreach, especially in the rural areas. There are approximately 22.1 million potential customers in the consumer mass market segment. Average financing size for credit class and lower mass is IDR 8-10 million and IDR 1-2 million respectively; and the net interest margin is around 32% both for credit class and lower mass with the estimated financing revenue pool at IDR 13 trillion (Exhibit 1)

There are approximately 50 million households classified as the mass market in Indonesia and represent the microbusiness on the self-employed side, and on the employed side, split between lower mass having an income range of USD 560 - 2700 per annum per household and the credit class with income ranging from USD 560 – 16,500 per year.

Indonesia's microfinance segment finances microbusinesses ranging from USD 110 to 550 per annum in case of lower mass segment and USD 550 to 5,500 p.a. for the credit class. The microfinance side manages a turnover of USD 1100 to 39,000 per annum with millions of micro enterprises such as stall owners and petty traders. Notable is that a significant market has been largely untapped. While 94% of the customers have borrowing needs, only 35% borrow from commercial banks. Other than banks, they borrow from conventional rural banks, friends or relatives, pawn shops and informal money lenders.

Islamic microfinance with its increasing popularity intends to deliver their services to the broader market in Indonesia. In addition, Islamic commercial banks appear to be focusing their attention in Islamic banking on training young and

		Number of entities Millions	Average loan size IDR millions	Total loan potencial IDR trillions	Loan spread Percent	Revenue pool IDR trillions
Self employed	Small business	~0.7	~84	~58	9% -15%	~8
	Micro business	18.8	7-9	123-180	27% -32%	36-53
Employees	Credit class	2.9	8-10	23-29	32%	7-9
	Lower mass	19.2	1-2	19-38	32%	6-2

Exhibit 1: Islamic microfinance outreach in Indonesia

[1] Micro enterprises are classified as businesses with net worth lower than USD 5.500 and revenues below USD 34.000; small businesses with net worth of USD 5.500 – 55.000 and revenue of USD 34.000 – 280.000; medium size enterprises range from net worth of USD 56.000 – 1,1 million and revenue of USD 280.000– 5,6 million; big enterprises with net worth higher than USD 1,1 million or revenues above USD 5,6 million; according to the Law of the Republic of Indonesia Number 20, as of 2008

[2] Bank Indonesia, Islamic Banking Statistics as of September 2011

[3] Indonesian GDP at current prices 2010 of USD 706,752 billion, Indonesian Ministry of Cooperatives and SMEs

dynamic people with experience in Islamic microfinance.

A framework for Islamic finance institutions

The growth of the microfinance sector has been largely influenced by government policies on poverty alleviation as well as financial sector development. A target policy for the priority sectors such as agriculture and small enterprises was adopted, which included the BIMAS programme, Small Enterprise Development Program and the Community Direct Assistance programme. Besides this, government programmes have also dominated the microfinance landscape in Indonesia. Most of the programmes introduced were aimed at poverty reduction through different ministries or government institutions.

Islamic microfinance in Indonesia, both formal and informal, has evolved since it was first introduced in 1990s. Islamic microfinance providers in Indonesia may be categorised into 3 segments, namely the microfinance division of Islamic banks, Islamic rural banks, also known as Bank Perkreditan Rakyat Syariah and the Islamic financial cooperatives (such as the Baitul Maal wa Tamwil). Bank Rakyat Indonesia (BRI) is recognized as one the largest and most successful microfinance institutions in the world with more than 3.5 million borrowers and outstanding micro loans of USD 7.4 billion in 2011. Although BRI operates based on a commercial model, the bank is also responsible to roll out government finance schemes.

Islamic rural banks or BPRS (Bank Pembiayaan Rakyat Syariah) fall under the same regulation and supervision as Islamic commercial banks. However, being banks without deposit demand and without being implemented in the banking clearing system grants them the regulatory flexibility to meet client demands and address the distinct issues pertaining to micro-financing.

Islamic cooperatives (BMTs), which exist as general purpose and financial services cooperation, offer several savings and deposits accounts, and grant more flexibility and outreach than BPRS. Additionally, in contrast to the BPRS, they do not fall under the banking regulatory purview. Indonesia also has a well-established system of Islamic pawn shops which can either be state provided, offered by Islamic banks or offered by Islamic cooperatives.

Business model and its fiqh contracts

There are four business models providing the framework for the interaction of the market microfinance supplier and client as practiced in Indonesia. Either the Islamic commercial banks work directly with the micro, small and medium enterprises (MSMEs) or it conjuncts with Islamic rural banks, Islamic cooperatives or a venture company that manages a pool of cooperatives in order to standardise and ensure good governance and service quality.

Models 1,3 and 4 in Exhibit 2 are conducted as a two step financing process consisting of a mudaraba leg, which describes the contract between the Islamic commercial bank and the Islamic rural bank or cooperative (intermediary); and the murabaha leg, which is the contract between the intermediary and the MSMEs as end users.

Model 2 is short term based on Work Order. The structure consists of a line facility (wa'ad) mudaraba and several aqad mudaraba when the customer needs to drawdown money. The customer will repay it to the bank once the project is completed and is remunerated by the project owner.

Case 1: Short term based on work order

- Islamic Bank "X" and SME "A" have a line facility for short term mudaraba, a total of USD 500,000, 3 years
- SME "A" got a work order USD 60,000 payable after project completion of 3 months. Project cost is USD 40,000
- After evaluating credibility of project owner, Islamic bank approves mudaraba facility, 3 months, portion 70:30
- At the end of project, Islamic bank get
- 30% x (60,000 – 40,000)

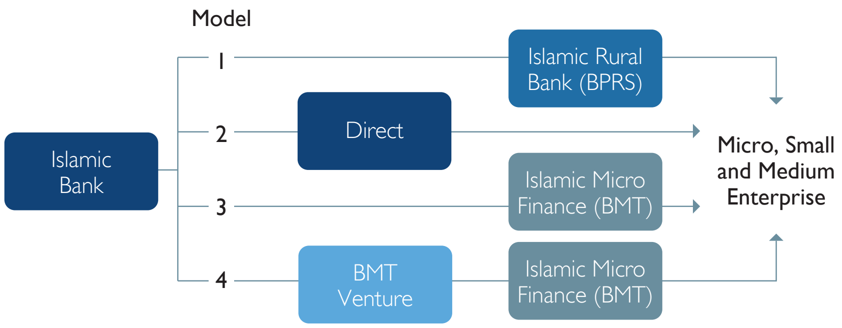

Exhibit 2: Indonesia's microfinance business model

Model 2 is a bridging finance[4] transaction, hence it is important to check the credibility of the project owner, the liquidity of the project owner and the probability as well as the ability to repay if there is no take out funds, for examples the market flexibility to sell a project to another investor.

Case 2: The importance of market flexibility

A telecommunication provider "ONE" orders a BTS (Based Transceiver Station / telco relay tower) to SME "A", USD 60,000, 3 months

• At the end of month 2, provider "ONE" cancel the project and pay penalty
• SME "A" offers BTS to another tele-providers, get paid, and repay mudaraba to Islamic bank
• Only give financing to project with market flexibility

Essentially, Islamic microfinance programmes in Indonesia serve two broad categories of clients: (i) clients with existing businesses and successful operations for at least two years; and (ii) new entrepreneurs without prior business experience. The vast majority of clients fall within the first category and are usually financed through Islamic financial products such as murabaha, musharaka and mudaraba involving some form of profit-sharing. A small minority of clients fall within the second category and are usually financed through soft loans (qard al-hasan) without any interest charge or profit-sharing.

Indonesia's Islamic (micro) finance supply side

• Islamic Rural Banks (Bank Pembiayaan Rakyat Syariah)

Bank Perkreditan Rakyat Syariah (BPRS) or Islamic rural bank opened in 1991 as a result of the ruling by the Majelis Ulama Indonesia on the prohibition of riba.[5] With the aim of supporting the community and micro entrepreneurs, the main business activities of BPRS are to serve small businesses and communities in rural areas. The BPRS is supervised by Bank Indonesia under the National Act No. 7/1992 and the amended National Act No.10/1998. Under the National Act No. 21/2008 on Islamic banking, BPRS is defined as a bank that conducts business in accordance to Shari'a principles but is only licensed to accept deposits, offer financing facilities and transfer of funds. BPRS is not allowed to provide payment services and its operations are restricted to a designated district area. Each BPRS has its own Shari'a board that ensures its businesses and transactions conforms to the Islamic principles.

After a promising start in the early 1990s, the development of BPRS was almost stagnant by 1997, predominantly due to the Asian financial crisis. By 2003, the number of BPRS showed an increasing trend. At present, there are 154 BPRSs operating in Indonesia with a total of 362 bank offices throughout the country. However, after two decades development, BPRS only constitute a minute part of the rural banking sector in Indonesia as well as the overall Islamic banking industry. The financial performance of BPRSs is shown in Exhibit 3.

By the end of 2011, there were 154 Islamic rural banks with an 8.4% market share of the rural banking sector and assets of 3.73 trillion IDR or approximately 6% of its conventional counterpart[6]. Each BPRS has a Shari'a board to monitor the conformity of products to Islamic principles. Indonesia's BPRS provided working capital and investments using 65.4% of its financing capital or USD 186 million.[7] Murabaha dominates as the preferred mode of finance (79%), followed by musharaka (10%). Mudaraba and qard hasan constitute only about 3% of the total financing. A closer look at the return on asset (ROA) and return on equity (ROE) shows that both ratios have been rising except for a sharp drop in 2010. The operational efficiency ratio indicates that BPRSs were able to cover 70% to 80% of their operating costs.

Loan officers offer doorstep collection services. Returns are calculated on a monthly basis. Annual averages vary from 7 percent to 12 percent; the un-weighted mean is 8.3%. The revenue-sharing arrangements in the case of time deposits vary between the banks from 40:60 to 70:30. They also vary by maturity. Current accounts are usually remuneration-free. An exception is BPRS Harum Hikmahnugraha, which pays a voluntary bonus. Some banks, like BPRS Artha Fisabilillah offer a savings product for religious purposes, which carry no remuneration.

Islamic rural banks needs to be revamped and an overall development plan for the BPRS sector agreed upon by all stakeholders is needed together with a strong banking association to provide a full range of support services to their members. Recently, the trend of Islamic commercial banks is setting up branch networks of Islamic MFIs throughout the country. Some of the more successful Islamic rural banks thereby serve as exposure training sites for future managers in other BPRS.

• Baitul Maal Wat Tamwil

[4] Bridge Financing is generally defined as project financing that bridge a period of time up to a specific event that generated sufficient funds for repayment of the loan. See for example Bank Management, Hempel, Simonson and Coleman, 1994, 4th edition

[5] Majelis Ulama Indonesia is the formal organization of Islamic Clergy, consisting of many Islamic organizations in Indonesia.

[6] Bank Indonesia, Islamic Banking Statistics as of September 2011

	2007	2008	2009	2010	2011
No. of institutions	114	131	139	151	154
No. of bank office	185	202	223	286	362
Asset (USD million)	135.18	188.25	236.08	304.47	372.61
Financing (USD million)	99.02	139.7	176.42	229.07	291.3
Deposits (USD million)	79.81	108.48	128.74	178.3	226.26
% non-performing financing	8.56%	8.38%	7.03%	6.5%	7.3%
ROA	3.21%	2.76%	5%	3.49%	2.39%
ROE	11.21%	14.77%	21.55%	14.29%	16.05%
Operational efficiency ratio	76.58%	80.85%	64.69%	78.08%	78.23%

Exhibit 3: Performance indicators of BPRS 2007 - 2011
Source: Islamic Banking Statistics, Bank Indonesia

Although microfinance providers are large in numbers, they remain small in size, with less than 10,000 clients each. The microfinance sector in Indonesia has a broad range of institutions providing microcredit to low income populations such as commercial banks, rural banks, credit unions and cooperatives. Whilst these are considered as formal financial institutions; non-bank non-cooperative microfinance institutions such as Baitul Maal waa Tamwil (BMT) are categorized as the informal financial providers. Aside from these formal and informal microfinance institutions, there are about 800,000 channelling groups and probably millions of local rotating savings and credit associations in the country.[8] In Indonesia, commercial banks dominate the bulk of the microfinance market share and accounts for 90% of total micro loans disbursed.

Cooperatives are the main informal providers of micro credit in Indonesia. It is reported that the first cooperative in Indonesia originated in the year 1896 when Duke R. Aria Wiraatmadja established the first cooperative for civil servants. Present BMTs, however, operate as IMFIs and were initially community based organizations in the 1980s. These institutions struggled to keep afloat but by the mid 90s, they experienced tremendous growth following increased national support for the model and its objectives. BMTs were initially grass-root development programmes supported by funds from Islamic community members. Today, BMTs serve around 3.5 million people with 3900 BMTs and over 60000 employees. In the past five years there have been 700 new BMTs set up, with managed assets increasing by 150% from USD 224 million to USD 560 million. The pool of served clients rose by half a million people.[9]

In contrast to BPRS, the Baitul Maal wa Tamwil (BMT) is a community-based financial institution that operates under the cooperative system. BMTs usually operate on the principle of profit-sharing and apply Islamic moral values and group solidarity to encourage repayment of loans. As a community-based financial institution, BMTs offer three types of services to their members and the community – (1) microfinancing, (2) zakat and social welfare programmes, and (3) entrepreneurship trainings. Structurally, BMT functions as both a baitul maal and baitul tamwil. As a baitul maal, BMT collects and disburses social and religious funds such as zakat, infaq and sadaqa. In its role as a baitul tamwil, BMT conducts financial intermediations through deposit mobilisations and financing of commercial ventures. The activities of BMT are supervised by the National Centre for Incubation of Small Businesses (Pusat Inkubasi Bisnis Usaha Kecil or PINBUK). However, the further development and growth of BMT as a powerful poverty alleviation tool suffers from the lack of supervision and reporting. Although BMTs are required to be registered with PINBUK, they do not have any legal status

Currently, it is estimated that there are about 3,000 BMTs around the country serving 2 million savers and 1.5 million borrowers.[10] However, only about 17% of them are registered with the Ministry of Cooperatives as savings and credit cooperatives. It is also reported that a majority of BMTs are either dormant or technically bankrupt.[11] Their outreach is negligible as BMTs have less than 1% of total borrower outreach of the cooperative sector. Even their loan portfolio accounts for a mere 0.2% of the microfinance sector.

At the National Conference in April 2010, PBMT Indonesia released a blueprint entitled "The Compass of BMT 2020" with the aim of identifying the main challenges to be faced by the BMT movement over the next ten years. The blueprint contains an explanation of the identity of BMT, the kind of identity and self-image that underlies the operation as well as what is needed to inspire active BMTs. Further, it explores a set of strategic initiatives with clear priorities, so that the stakeholders in business development activities can have guidelines to harmonise their activities. BMTs usually operate on the principle of profit and loss sharing and are based on Islamic moral values and group solidarity, which encourages repayment of loans. BMT has managed savings mobilisation using its deposit funds and

[7] Ibid

[8] http://www.rendev.org/docs/resources/reports/RENDEV_WP5_%20D14_MFIS_Indonesia_ap09.pdf

[9] According to compiled data from the Indonesian BMT Association, the Indonesian Ministry of Cooperatives and BMT Ventura.

equity for the financing activities. BMTs outreach and network has gained repute in the MFI world. BMTs provide financial services, research, as well as networking and technical assistance for capacity building. Their outreach has been impressive and figures show an increase in the numbers of people served by a BMT. However, regulation and supervision of Islamic financial cooperatives needs to be enhanced in order to provide a more enabling framework for the cooperative sector and building associations and federations providing a full range of support services. Institutionally, Indonesia's establishment of BMTs cooperative microfinance network still needs to optimise its service provision ensuring sustainability and easy access.

In addition to the success of microfinance providers, there has been the development of numerous subsidies government programs, local community-based financial institutions, cooperatives and NGO's. The emerging Islamic microfinance sector in Indonesia, particularly rural banks and financial cooperatives has not yet reached its full potential which brings both great opportunities and challenges.

Pawnshops

Another type of microfinance provider in Indonesia is the pawnshop which plays an important role in providing short-term credit for small scale enterprises or for individual consumption or productive activities. Pawnshops are profit-oriented state-enterprises and run by the Perum Pegadaian (the state-owned pawnbroker). In 2001, PP established a Shari'a Pawn Service Unit Division for implementation of pawning practices based on Shari'a pursuant to Article 7 of Government Regulation No. 103 of 2000. Through the Shari'a Pawn Service Unit Division, pawnshops provide fast loans based on collateral in the form of physical assets (e.g. jewellery, precious metals, electronic devices etc.)[12], which do not require complex procedures to operate. During the lending period, pawnshops provide a place for safekeeping the pledged assets and, in turn, charge the borrowers a fee for costs related to their maintenance and safekeeping. Upon maturity, pawnshops have the right to sell or auction the pledged assets upon giving notice to the borrowers, unless the borrowers repay the debt and reclaim the pledged assets. These Shari'a-compliant pawning practices are regulated and governed by Fatwa (Edict) No. 25/DSN-MUI/III/2002 and Fatwa (Edict) No. 26/DSN-MUI/III/2002 issued by the National Shari'a Board of the Indonesian Ulema Council

In 2011, there were 4,920 branches of pawnshops operating in 14 regional offices throughout the country. It has a large outreach mostly in rural areas with more than 20 clients. Perum Pegadaian provided USD 8.2 billion in 2011, an increase of 32.42% from USD6.2 billion in 2010. Pawnshops provide small and large loans against movable assets including gold, jewellery, household items, electronic goods, motor vehicles and valuable fabrics and hard-woven cloth.

Pawnshops in Indonesia are an important source of microcredit to the poor, low income households and micro entrepreneurs as they are often the most convenient source of quick short-term liquidity, particularly as a source of funds for personal purposes in times of emergencies or crisis. The pawnshops have proven to be a reliable and popular lender of microfinance for several reasons. The simple and fast procedure coupled with low transaction costs are the main competitive features. Furthermore, pawnshops are located in almost every district and increasingly sub-district capitals, making them easily accessible to the rural poor.

Since its introduction, Islamic pawnshops or Rahn have attracted some 1.65 million customers in 2011. Based on the ijara principles, Rahn charges between Rp80 and Rp90 for every 10 days of credit period and on every multiple of Rp10,000 from the collateral value. Disbursements of these Islamic pawnshops increased by 75.7% to record USD 763.76 million in 2011 from USD 434.69 million in the previous year. At present, there are 594 branches of such Islamic pawnshops and they are located in 25% of the 490 cities in Indonesia. Gold has so far dominated the financing activities by 90% of total collateral accepted, while the remaining is in form of other goods. In April 2011, Perum Pegadaian obtained USD 38.9 million financing from Bank Syariah Mandiri to fund its syariah unit's expansion. Through this planned expansion, Perum Pegadaian expects its Islamic pawnshops will grow by 65% in 2012 and expand its market outreach to 50% coverage in the country.[13]

Apart from its Rahn product, Perum Pegadaian also offers three other Shari'a-compliant products, namely MULIA, ARRUM and Amanah. MULIA, which was launched in 2008, is a gold sale investment scheme offered by Perum Pegadaian to the public through either cash or instalment basis. ARRUM or Ar Rahn for Micro Business provides small entrepreneurs Islamic financing for their business development. The Amanah pawn was introduced in 2011 and is a murabaha financing scheme for motor vehicles. Although these products are not the core business of Perum Pegadaian, they have recorded impressive growth in terms of total loans disbursed and total loans outstanding as shown in Exhibit 5.

Recently, a number of Islamic banks have started to venture into pawnshop services although Perum Pegadaian still maintains its dominant position. Islamic banks such as Bank Syariah Mandiri, Bank Syariah Mega, Bank Negara Indonesia, Bank Rakyat Indonesia and Bank CIMB Niaga Syariah are competing to for a slice of the estimated USD 8 billion a year market.

In January 2012, Bank Indonesia announced that it will issue a new regulation to curb down the activities of "gold farming"[14] at Islamic banks as most customers are using gold pawning for speculation purposes. The central banks want to limit the transaction value per customer and will set the financing-to-value ratio at a maximum of 80%. This

[10] http://mikrobanker.wordpress.com/

[11] Siebel, H., 2005. *Islamic Microfinance in Indonesia.* http://www.gtz.de/de/dokumente/en-islamic-mf-indonesia.pdf.pdf

[12] See also International Development Law Organisation, Islamic Microfinance report Allen & Overy

means that customers who wish to pawn their gold have to provide gold worth 20% of the amount of funds borrowed. The bank also wants to cap the amount of transaction to Rp100 million per customer.
Islamic Micro insurance

	2003	2004	2005	2006	2007	2008	2009	2010
Number of Customers	12,994	111,015	226,424	321,557	446,984	570,342	819,830	1,286,829
Loan disbursed (USD million)	2.2	19.4	34.3	65.75	107.2	179.5	299.2	497.6
Outstanding loan (USD million)	1.2	5.4	9.5	16.6	25.9	44.9	78.6	133.2
Collateral (thousand items)	20,197	157,251	268,329	407,100	559,047	715,406	1,253,586	1,728,982

Exhibit 4: Performance of Islamic pawnshops of Perum Pegadaian
Source: Perum Pegadaian Annual Report (various years)

The emergence of insurance that complies with the principles and laws of Shari'a[15], have a major impact on the potential for micro insurance. Insurance companies are now recognizing the importance of responding specifically to Indonesia's needs and requirements.

Most Shari'a-compliant insurance currently focuses on the upper-middle and high-income markets. It is people in the low-income market, however, who are most likely to be reluctant to purchase products that do not comply with Shari'a. When low-income people have a choice between Shari'a and non-Shari'a-compliant products, the Shari'a products would have an advantage. Therefore, it is possible that having Shari'a-compliant products could aid institutions that are trying to reach the low-income market.

	2008	2009	2010
MULIA:			
Total Loan (USD)	83,871	5.29 million	19.6 million
Total Loan Outstanding (USD)	19,355	851,613	2.82 million
ARRUM:			
Total Loan (USD)	810,901	5.06 million	10.26 million
Total Loan Outstanding (USD)	758,621	3.32 million	7.66 million

Exhibit 5: Performance of MULIA and ARRUM
Source: Perum Pegadaian Annual Report (various years)

There is a potential high demand amongst workers within groups and organisations throughout Indonesia for Shari'a-compliant products but insurers have yet to approach them. These could yield a major source of micro insurance policyholders for the insurer who is innovative and willing to take a chance.

A big opportunity in the Islamic micro field is the combination of micro finance and implemented micro insurance. For example, PT Asuransi Allianz Life has permanently included an Islamic micro insurance product line in its portfolio after the successful completion of a two year pilot. The product 'Payung Keluagra'[16], or "Family Umbrella" is specifically tailored to meet the needs of low income customers. The company was the first international insurer to offer a micro insurance product that complies with Islamic law. Insurers are currently collaborating with several domestic micro-banks that offer micro insurance policies to the Indonesian market. An increase in cooperation network is expected to create around 600 micro-banks in Indonesia. There is also considerable potential in large commercial banks which are entering the microfinance sector.

Companies have been able to build up a sustainable customer base. New distribution concepts make products more accessible in combination with specialist microfinance service providers, representatives and brokers at micro banks. Further there is potential for a diversified product portfolio providing health and life insurance as well as children's education, which are important considerations for low income families.

In Indonesia, Islamic insurance is governed by the Ministry of Finance and its Insurance Directorate, but licensing and continued operation as a Shari'a insurer or Shari'a Insurance division is dependent on the continuing approval of the National Board of the Shari'a Council. The 18 members of the National Shari'a Board must approve requests

[13] http://en.bisnis.com/articles/pegadaians-Shari'a-based-loan-disbursement-jumps-in-11-months

[14] Gold farmers are essentially gold speculators who use the money obtained from pawning their gold to buy more gold which is then pawn to buy yet more gold. If gold price rises, gold farmers then buy back the gold and sell it at a profit. They typically pawn gold bars as opposed to jewelry.

[15] Takaful in Arabic means "joint guarantee". However, Indonesia uses the term, Shari'a insurance.

for new Islamic insurance products before the Insurance Directorate will begin their approval process. This process involves a review of several aspects of the product in order to confirm conformity with Shari'a law. This includes: how transactions are managed, how investments are made, into which investments Shari'a premiums will be placed, and how earnings will be distributed.

Recently, two new financial regulations have been issued by the Ministry of Finance (PMK) concerning Islamic Insurance and Reinsurance companies in Indonesia. PMK number 11 tackles the issue of solvability and Risk Based Capital (RBC). Insurance in Indonesia requires three funds. One is the participant's tabarru' fund where the insured risk is shared amongst the policy holders. The second is the insurance companies fund which is used if the tabarru' fund needs liquidity, issuing a qard if there is a deficit in the tabarru' fund. Third, there is the participant's investment fund. The new regulation declares for the first two funds a need for solvability requirement known as RBC. Solvability of tabarru' fund is measured by RBC of the tabarru' fund and the solvability for the companies fund is measured by RBC of that particular fund.

On the other hand, regulation PMK number 18 issued in 2010 is the interpretation of the fundamental contract (aqd) requirements and structures, the use of surplus tabarru fund, retained surplus tabarru fund, and eligible parties entitled for that surplus. This regulation translates the 2006-fatwa issued by the National Shari'a Board and implements it as Indonesian law.

Outlook

Although Indonesia has the largest number of microfinance providers in the world, the country ranks at number 33 in terms of the overall microfinance business environment by the Economist Intelligence Unit. Bank Indonesia has been actively promoting Islamic microfinance and putting in place the necessary regulation and supervisory framework to ensure the development and sustainability of the sector. In 2002, Bank Indonesia released its Islamic banking development blueprint which included the development of the Islamic microfinance sector and the support for development of Islamic rural banks as well as BMTs.

On the regulatory side, Bank Indonesia recognised the constraints that microfinance providers are facing and have taken the necessary initiative to address the issue of strengthening the legal framework for microfinance institutions, both formal and informal. Having a strong regulatory framework is important in order to develop a vibrant and comprehensive financial system that takes into account the contribution of the microfinance sector towards financial inclusion in the country.

In 2012, Islamic banking became more polarised. Previously, each bank tended to offer the same product to the same market segment. Polarisation now means banks want to innovate by offering different products to different market segments. This is the main driver for some banks to tap into the microfinance market by using a different market model. So it is expected an extensive customer base will develop with more specialised micro financing, with a higher and healthy growth.

This phenomenon will provide millions from the former lower-income layer of the society to open their banking accounts for the first time in their life. If the chance is missed to give them the confidence to join Islamic banking, then the Islamic Finance Industry will have failed.

[16] Compare GTZ, Allianz, UN's global development network (UNDP), Micro insurance in Indonesia, 2006