

FINANCING MICROENTERPRISES: AN ANALYTICAL STUDY OF ISLAMIC MICROFINANCE INSTITUTIONS

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While conventional microfinance institutions (MFIs) have expanded their operations in the last two decades, poverty-focused MFIs based on Islamic principles are lagging behind. This paper provides the theoretical basis, operational framework, and empirical support for the establishment of Islamic MFIs. After critically evaluating the conventional MFIs, an Islamic alternative is presented. The theoretical part of the paper shows that there is a great potentiality of Islamic MFIs that can cater for the needs of the poor. Islamic MFIs have some inherent characteristics that can mitigate some of the problems faced by conventional MFIs. Empirical evidence from three Islamic MFIs operating in Bangladesh, in general, supports some of the theoretical assertions. The case studies, however, reveal that Islamic MFIs have not yet tapped some of the sources of funds, nor have they used the variety of financial instruments in their operations.

1. INTRODUCTION

With the failure of experimenting in top-down (trickle down) development policies for a few decades to alleviate poverty in most developing countries, financing microenterprises is considered a “new paradigm” for bringing about development and eradicating absolute poverty.¹ Though the importance of developing small-scale enterprises has been discussed for a long time, the innovative poverty focused group-based financing of microentrepreneurs is a relatively new concept. Pioneered by Professor Muhammed Yunus of Grameen

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¹ For an extensive study on microfinance, see Hulme and Mosley (1996a & b), *Journal of International Development* (Vol. 8, No. 2), Kimenyi, et al (1997), Otero and Rhyne (1994) and Schneider (1997).

Bank in Bangladesh, microfinance institutions (MFIs) providing credit to the poor has burgeoned in both developing and industrialized countries. A total of USD 7 billion has been disbursed to over 13 million people worldwide by microfinance institutions (Parker 1998, p. 8). "Microcredit Summit 1997"² envisages that 100 million poor would have access to microfinance by 2005.

Most of the microfinance institutions (MFIs), however, have non-Islamic characteristics. Their financing is interest-based. Furthermore, apart from the delivery of finance to the poor, many MFIs have social development programs that are mostly secular in nature. Given that microfinance can facilitate poverty alleviation, this paper studies the prospects of microfinance from an Islamic perspective. We first outline the features of the conventional MFIs and critically examine their strengths and weaknesses. A model for Islamic microfinancing is then outlined drawing from the strengths of conventional MFIs. Apart from identifying the differences between the conventional MFIs and their Islamic counterpart, the paper addresses how the latter MFIs deal with some of the inherent problems of the former. These theoretical discussions are complemented with the experiences of three Islamic MFIs operating in Bangladesh.

The paper is organized as follows. In section 2 we first define microenterprises and then discuss the economics of financing these activities. Given the important role of development that microenterprises play in poverty alleviation, this section argues for social intermediation by specialized microfinance institutions. It then critically evaluates the operations of conventional MFIs. In section 3, an Islamic alternative is presented and compared with the conventional one. Sections 4 through 7 are based on the results of a field survey conducted on three Islamic MFIs operating in Bangladesh. While section 4 gives basic information regarding these MFIs and their beneficiaries, section 5 evaluates the performance of these institutions. Section 6 identifies some of the problems faced by the Islamic MFIs and section 7 critically evaluates the operations of Islamic MFIs surveyed and concludes the paper.

2. FINANCING MICROENTERPRISES: THEORY AND INSTITUTIONS

Microenterprises can be defined differently, depending on country's stage of development, policy objectives, and administration (World Bank 1978, p.18). Micro and small enterprises are identified as those having fixed capital or the number of workers under certain threshold levels. Microenterprises constitute small

² The Microcredit Summit was held on February 2-4, 1997 in Washington DC. The Summit was participated by 2,900 people from 137 countries. A nine year campaign was launched to provide credit to 100 million poor by year 2005. For more information on Microcredit Summit, see www.microcreditsummit.org.

businesses and shops, cottage industries, transport services, etc.³ Three broad categories of economic activities can be identified namely, production, trading, and providing transport services. In production, the poor may be involved in agricultural or non-agricultural activities. Agricultural activities include farming, cattle rearing, poultry rearing and fisheries. Non-agricultural production can cover a wide variety of activities ranging from food processing to producing different handicrafts and household items like pots, mats, cloth, etc. Trading includes shop-keeping, small business, and selling specific items like vegetables, fish, etc. Providing transport services can be through rickshaws, boats, or motor vehicles used as taxis.

Growth in microenterprises or small enterprises can be important means for employment generation and development of poor countries. High population growth rate and limited employment opportunities in the agricultural sector and the modern manufacturing sectors leaves a vast majority of the labor force without productive employment. Microenterprises can play a significant role in employing the surplus labor force productively. Other than generating employment, a World Bank study (1978) points out the advantages of microenterprises as increasing the aggregate output, enabling the efficient use of capital and labor, initiating indigenous enterprise and management skills, bringing a regional balance, and improving the distribution of income. The problems associated with microenterprises are identified as low wages, high price of finance, and use of primitive technology. Furthermore, limited input and output markets and inadequate infrastructure facilities can hinder the growth of small enterprises.

Smaller firms usually do not have any access to funds from traditional financial institutions (Berger and Udell 1998). The underlying theoretical explanation for this phenomenon lies in the traditional problems of asymmetric information in financial intermediation. The problems of adverse selection and moral hazard worsen in case of smaller enterprises in developing countries due to some added constraints and problems. Bennett (1998) points out some barriers that can arise between the financial institutions and the clients in a developing economy perspective. These barriers can accentuate the asymmetric information problems. Physical barriers of poor infrastructure like lack of markets, roads, power, communications, can worsen both the adverse selection and moral hazard problems. Physical constraints inhibit the financial institutions to gather information on their prospective clients and once credit is advanced, it is difficult to monitor the use of the funds. Socioeconomic factors of clients like low numerical skills due to illiteracy, caste/ethnicity/gender aspects preventing interaction also add to the adverse selection problem.

³ Though in some writings, a difference is made between microenterprises and enterprises financed by microfinance institutions, in this paper we consider these two kinds of enterprises to be the same.

Microentrepreneur's lack of collateral due to poverty can increase the moral hazard problem. These barriers would make assessment of projects and monitoring the use of loans (to minimize adverse selection and moral hazard problems) very costly. Furthermore, as the size of the loan for microenterprise is small, the administering cost of loans increases. These economic factors make it impossible for traditional financial institutions to offer credit to microenterprises.

While small-scale business has been the focus of some development policies, the smallest amongst them were left out from these programs. The problems of financing pointed out above become more acute in case of microenterprises run by impoverished. As these enterprises are important means to increase employment and reduce poverty, there is a need for a social financial intermediation of funds for the microentrepreneurs. Bennett (1998, pp. 106-7) points out two approaches of financing microenterprises. First, the linking approach under which conventional financial institutions are linked to the target group (i.e., the poor) through some intermediary like a government agency, a non-government organization (NGO) or a local group. The other approach is to provide microcredit through specialized organizations, like NGOs, government agencies, cooperatives, and development finance institutions. Almost all of the financing for microenterprises in recent times has come from the latter kind of institutions. We discuss the nature of these institutions next.

2.1. Specialized Financial Institutions for Microenterprises

Traditionally, sources of credit in developing countries can be broadly classified as institutional and non-institutional. While institutional sources include financial institutions and cooperatives, non-institutional supply of credit comes from friends, relatives, and money-lenders. Even though the importance of developing small-enterprises has been recognized, the poor microentrepreneurs do not have access to the institutional sources, as some physical collateral, which they often lack, is a prerequisite for getting loans from these sources. Moreover, as pointed out above, the banks are not interested in financing microenterprises since the transaction cost per unit of credit is high. Thus, the non-institutional loans form the bulk of the credit for the poor.⁴ With the exception of credit from friends and relatives, the interest rate on these loans is exorbitant. In some cases, the poor loose their land or other assets against which credit is provided.

Pioneered by the Grameen Bank in Bangladesh, MFIs have developed as specialized financial institutions that cater to the needs of the poor.⁵ Microfinance

⁴ For example, before the operations of MFIs in Bangladesh, only 10-15 percent of the rural credit requirements in Bangladesh came from institutional sources (Ahmed 1983, p. 18).

⁵ Though different approaches to microfinance have evolved, the dominant among these is the Grameen Bank model (Morduch 1999).

is a new concept in banking and has distinct characteristics. In order to understand the nature of MFIs as specialized financial institutions, we briefly outline their operations and activities next.⁶

To get finance from MFIs the client or beneficiary has to be poor. Different institutions define their target group in different ways. For example, a household must own less than 0.4 acres of land and must not have assets exceeding the market value of one acre of cultivable land to be eligible to get credit from Grameen Bank. A person must form a group of five like-minded people with similar socioeconomic status to get credit. Male and female groups are formed separately and relatives cannot be in the same group. A group is usually trained for couple of weeks to be familiar with the rules and procedures of the MFI. Each group elects its own chairman and secretary. A number of groups are federated into a center with a center chief and deputy center chief elected from amongst them. Weekly meetings of the center are held at a convenient place in the locality. All members (i.e., beneficiaries) of the center are required to attend these meetings. An MFI official attends the meeting to conduct the transactions and other business of the center.

MFIs provide small amount of credit on interest to the poor without any physical collateral.⁷ Instead, social collateral is introduced by forming groups. Loan repayment by an individual member of a group is the collective responsibility of all the members in the group and default by a member disqualifies all members to get new loans. Members in the group monitor the activities of each other and peer pressure induces the repayment of the loan. This format of peer monitoring mitigates the problem of asymmetric information and reduces transaction costs (Huppi and Feder 1990, Morduch 1999, Stiglitz 1990).

Borrowers are involved in multiple activities, which mostly do not require special skills (Dichter 1996, p. 263). Loans are given for three months to a year at market rate of interest and repaid with interest in weekly/monthly installments. Borrowers meet weekly/monthly at centers where an official from the MFI institution collects installments. Most MFIs target women as they are considered better borrowers in terms of use and repayment of funds (for example over 94 percent of Grameen borrowers are women). By providing much needed financial capital to the poor, these institutions enable them to be self-employed in productive activities thereby increasing their income levels. Most MFIs have various (forced) savings programs. In case of Grameen Bank, 5 percent of the loans is deducted for group (risk) fund and a quarter of the total interest amount is collected as emergency (insurance) fund when the principal is handed over to a member. While

⁶The format discussed here is that of Grameen Bank, which serves as the dominant model for most microfinance institutions, *ibid*.

⁷ Other than meeting the target group criterion and the description of the project for which funds are sought, the prerequisites may include knowing how to sign names, memorizing of certain rules, regulations, and slogans that form the basis of the social development program.

the beneficiaries can borrow from the risk fund in case of major social event (like wedding ceremony), the emergency fund is given to members in times of distress. In addition, the members are required to put aside a small amount (Taka 1) every week in their personal savings account. Sometimes, MFIs also extend credit to individuals for building houses and to a group or center for collective enterprise.

Most MFIs have a social development program along with their credit programs. The objective of this program is to generate personal and social consciousness among the members. These programs include aspects that affect behavioral changes (such as personal hygiene, sanitation, drinking clean water), moral teachings (like teaching to be honest, disciplined and cooperate among themselves) and social customs (like accepting family planning, not practicing the dowry system). Knowing these principles and norms are prerequisites to obtain loans from the MFI and are continuously inculcated in the members during the weekly meetings. Sometimes, workshops and exchange visits are also organized to complement the teachings inculcated in weekly meetings. At times, necessary inputs to implement these social programs (like tube wells for water, oral re-hydration salt) are provided by the MFI on subsidized basis.

As can be observed, MFIs being banks for the poor operate quite differently from the conventional commercial banks (see Table 1). Whereas commercial banks are profit-maximizing firms, MFIs are either government or non-government organizations (NGOs) formed to provide the poor with much-needed finance. Given this nature, most MFIs have a social development program along with its credit facilities. Furthermore, the structure of liabilities is different in case of two institutions. A conventional bank is a financial intermediary linking the savers and investors in the economy, with deposits forming the bulk of a bank's liabilities. For MFIs, funds from external sources form the bulk of the liabilities. The savings of their clients (beneficiaries) are the only deposits. Moreover, unlike conventional banks where clients come to the bank, MFIs go to the people to extend financial services.

2.2 MFIs: Prospects and Problems

Microfinance initiative is acclaimed as a new approach to poverty alleviation and to bring about development. Microfinance alleviates poverty as the credit given in successive years is used in productive economic activity(ies), increases the household income and saving and enables the household to build up its own capital. Income and saving eventually increase to a level where the household does not depend on borrowed capital. At this stage, the household graduates to non-poor status and becomes a full-fledged microenterprise. This process of graduation is termed by Muhammed Yunus, as the *virtuous* circle of 'low income, credit, investment, more income, more credit, more investment, more income' (see Hulme and Mosley 1996a, p. 108). While a vast literature exists that shows the success of

MFI⁸, some recent studies point out the failure of these institutions in meeting some of their objectives. Some of the problems identified are given below.

Table 1
Comparison between Conventional Banks
and Microfinance Institutions

Conventional Banks	Microfinance Institutions (MFI)
A profit-maximizing firm	Non-profit Government/Non-government Organizations
Financial Intermediary between savers and investors in the economy	Funds from external sources provided to the poor
Deposit forms the bulk of the liability	Savings (forced) of the clients only deposits
Does not include social/educational programs	Includes social/educational programs
Physical Collateral required to get funds	Social collateral through group and center formation
Clients are relatively well-off	Clients are poor
Clients come to the bank	MFI goes to the people
Amount of loan is large	Amount of loan is small
Capital and interest usually paid at the maturity of the contract	Capital and interest paid in weekly/monthly installments over a year.
Most clients are men	Most clients are women

1. **Asymmetric Information Problems:** The bulk of the loan by microfinance institutions is targeted towards women. In reality, however, the male members of the household initiate taking loans and control the funds received by the female members. Furthermore, loans taken from the bank are often used for purposes other than those for which the loan is sanctioned (Rahman 1999, p. 75). When loans are used for non-productive purposes, the chances of default increase. Buckley (1996, p. 390) reports that in 1993, 46 percent of the Malawi Mudzi Fund's (a MFI in Malawi) borrowers were in arrears because they diverted the funds for consumption purposes. Among the defaulters (those who did not pay more than 4 installments), the corresponding number was 33 percent.

⁸ See Bornstein (1996), Fuglesang and Chandler (1993), Goetz and Gupta (1996), Hashemi, et al (1996), and Hossain (1983, 1987).

2. **Economic Viability of MFIs:** Due to lack of fund mobilization and the high administrative cost, most MFIs are not economically viable. Bennett (1998, p. 116) reports that administrative cost of five MFIs in South Asia is in the range of 24 percent to more than 400 percent of per dollar lent. Reed and Befus (1994, p. 190) study five MFIs and find average return on assets for three of these to be below 2 percent, one at 3.5 percent and the other at 14.6 percent. Hashemi (1997) and Khandker, et. al. (1995) point out that Grameen Bank would operate at a loss without grants. A Subsidy Dependence Index (SDI) developed by Yaron (1992) indicate that in 1996 Grameen Bank would have to increase its lending interest rate by an additional 21 percent in order to breakeven without subsidies (Hashemi, 1997). Similarly, Hulme and Mosley (1996a, p. 52) find that 12 out of 13 MFIs from six countries have positive SDI ranging from 32 percent to 1884 percent.

3. **Low Rate of Return on Investment:** The type of activity for which the funds are used may also be low productivity activities. Furthermore, MFIs target women and some studies find that rate of return on credit given to women is low as they engage in relatively low productivity activities (Hossain 1987, Rahman and Khandker 1994). Osmani (1989) points out that one factor that forces some households out of microcredit schemes is that the resulting increase in the supply of output causes the rate of return on loans to be lower than its cost of borrowing.

4. **High Drop-out Rate and Non Graduation from Poverty:** Ditcher (1996), Hulme and Mosley (1996a), and Montgomery (1996) report that microfinance institutions do not serve the poorest who are either not given loans or drop out of the credit schemes.⁹ Karim and Osada (1998) observe that there is a steady increase in dropout rate from Grameen Bank (15 percent in 1994) and that 88 percent of the total dropouts did not graduate to the status of non-poor. Assaduzzaman (1997) finds that whereas microfinance does increase the income level of the poor, the current operations of MFIs are not very effective in improving the lives of the extreme poor. Hulme and Mosley (1996b, p. 114) report that the average income of a household borrowing for a third time from Bangladesh Rural Advancement Committee (BRAC), a microfinance institution in Bangladesh, is less than a household that has borrowed only once (average income being 58 percent and 68.5 percent of the poverty line respectively). Ahmed (1998) finds that longer association with Grameen Bank reduces the household income.

5. **Debt Trap:** In a recent survey, Rahman (1996 a, b, 1999) discovers that the Grameen Bank borrowers often take loans from other sources to pay installments and are trapped in a spiraling debt cycle.¹⁰

⁹ For example, dropout rates for the Grameen Bank and BRAC are 15 percent and 10-15 percent per annum, respectively (Hulme and Mosley 1996a, p. 122).

¹⁰ Newspaper reports allege that "the poor are falling victims of vicious cycles of creditors and NGOs" (Holiday, Feb. 7, 1977, p. 8) and that instead of removing poverty, the Grameen Bank is "robbing whatever resources people had" (New Nation, October 26, 1996).

6. Targeting Women as Recipients: The declared objective of targeting women as recipients of funds is to empower them (Khandker 1998 and Rahman 1999). Khandker (1998), however, finds that financing women rarely empowers women. Rahman (1999) further reports that targeting the women as beneficiaries of credit by MFIs creates tensions within the household and increases frustration and violence in the family. This is because receiver of funds and the user are different people. The male members put pressure on the female members to obtain funds, as it is easier for women to get funds. While the women apply for the funds and are responsible for its repayment, it is often men who use the funds. At the other end, the MFI puts pressure on the female members to repay the installments, who in turn put pressure on their male counterparts.

Note the points 1 and 2 mentioned above relate to the fundamental problem of financial intermediation mentioned before. As asymmetric information exists, the monitoring/supervision costs of financial institutions increase. Points 3, 4, and 5 relate to borrowers' investment decisions and viability of the projects they invest in. Point 6 relates to social issues of microfinancing. Given these drawbacks in conventional microfinancing, and recognizing that microfinance can be an important vehicle in poverty alleviation, we discuss an Islamic alternative to microfinancing next. After discussing the approach to Islamic microfinancing, we discuss the results from field survey on three Islamic MFIs operating in Bangladesh. While we touch on different problems mentioned above, the discussion will focus primarily on the asymmetric information problem and profitability/viability of MFIs.

3. ISLAMIC MFIS AND CONVENTIONAL MFIS: A COMPARATIVE ANALYSIS

Initiatives in Islamic banking and conventional microfinancing started concurrently in the mid-1970s. Given the newness of Islamic banking, researchers and practitioners have, until recently, overlooked issues related to Islamic microfinance. Though there has been discussion on financing small-scale enterprises by specialized institutions and Islamic banks using Islamic modes (see Mohsin 1995 and Yousri 1995), the new innovative poverty-focused format used by MFIs has not been examined. As mentioned earlier, the innovative operational format of MFIs suits the poor, whose lack of physical collateral disqualifies them to borrow from traditional commercial banks. Group based microlending acts as social collateral and lessens the asymmetric information problem that exists in financial intermediation. Islamic microfinance institutions (IMFIs) can retain this innovative format of operation of conventional MFIs and orient the program towards Islamic principles and values. Though the basic format of Islamic MFIs will be similar to that of its conventional counterpart, there will be certain

qualitative differences among them. The nature of Islamic MFIs and their differences from conventional MFIs are discussed below.¹¹

3.1 Sources of Funds

Other than being interest-free, IMFIs would differ from conventional MFIs in several important ways. On the liability side, the sources of funds of conventional MFIs come mainly from foreign donors (both multilateral and national agencies), government and the central bank. IMFIs, in addition, can get funds from religious institutions of *waqf* and other forms of charities. The institution of *waqf* originated during the time of the Prophet (peace be upon him) and entails the use of cash, land, real estate for charitable purposes.¹² There are certain conditions governing *waqf*, but the objective is to serve the poor and the community. The presence of *waqf* and charities on the liability side of IMFIs is compatible with the social financial intermediation role of MFIs.

3.2 Modes of Financing

On the asset side of the balance sheet, the bulk of the assets of conventional MFIs are interest-bearing debt, given for different activities (trade, production, transport services, etc.). Interest (one form of *riba*) being prohibited in Islam, the assets of IMFIs will comprise different types of non-interest bearing financial instruments. Important aspects of Islamic modes of finance are that financial capital cannot claim a return on itself and that the transaction must involve a real good or object. Principles of Islamic financing are many and varied. The type of financing instrument will depend on the type of activity for which funds are granted. As discussed earlier, the economic activities that microenterprises usually engage in are production, trading and providing (transport) services. We point out the appropriate Islamic modes of financing for these activities below.

Other than interest-free loans (*qard-hasan*), the principles of Islamic financing can be broadly classified as partnerships (*shirakat*) and exchange contracts (*mu'awadat*).¹³ Partnership can be on the basis of profit sharing or output sharing.

Though there are different kinds of exchange contracts, the important among these is the deferred-trading principle. Deferred-trading contract can either be a price-deferred sale or an object-deferred sale. What is relevant for microfinancing is the price deferred sale (*bay'-mu'ajjal*) in which the object of sale is delivered at

¹¹ The information on IMFIs in this section was gathered in a field survey and interviews with the officials of these institutions conducted by the author.

¹² Çizakça (1996) discusses the cash *waqfs* in Turkey during the Ottoman period giving its legal background. For detailed discussions of *waqf* see Basar (1987) and Çizakça (1998).

¹³ Detailed expositions of the different principles of Islamic financing are found in Kahf and Khan (1992) and Ahmad (1993).

the time of the contract but the price is paid later. The price can also be paid in the future in installments. One type of financial transaction under this format is mark-up sale (*murabahah*), in which the IMFI buys a good or asset and sells it to the client at a mark-up. The client pays for the good or asset at a future date or in installments. *Ijarah* is a leasing contract in which the client uses an asset by paying rent. One form of this arrangement can be the hire-purchase scheme or lease-purchase scheme (*ijarah wa iqtina'*), in which the installment includes rent and part of the price. When the installments are fully paid, the ownership of the asset is transferred to the client.

From the discussion above, we see that various kinds of financing arrangements can be used to finance different kinds of activities. *Musharakah* principle can be used in production (agricultural and non-agricultural). The IMFI can provide part of the financial capital to produce an output and in return receive a share of the profit. In trading, the IMFI and the client can jointly finance the purchase and selling of a certain good and distribute the profit. Production undertaken under *mudharabah* principle would imply that the IMFI finances and the client manage the project. In agricultural production, output sharing can take the form of *muzara'ah*. The IMFI may fund the purchase of irrigation equipment, fertilizers, etc., which the landowner uses on his land to cultivate a certain crop. The harvested crop is then shared by the landowner and the IMFI at an agreed ratio. Other than profit-sharing principle discussed above, *murabahah* and *ijarah* forms of financing can also be used in production. For example, if a client is in need of initial physical capital (equipment, gadgets, etc.), the IMFI can buy the items and sell these to the client at a mark-up.

In trading, profit sharing schemes and deferred trading contracts can be used. The *murabahah* principle can be applied where the items to be traded are first bought by IMFI and then sold at a mark-up to the clients. The clients pay back the IMFI once they sell the goods. In transport services, both mark-up principle and the leasing principle can be applied. For example, if a client wants to buy a rickshaw, the IMFI can purchase it and sell it to the client at a mark-up. The client then pays the price on an agreed installment plan. Alternatively, hire-purchase arrangement can be made in which the client pays rent plus a part of the price in his installments. Once the installments are fully paid, the client becomes the owner of the rickshaw.¹⁴

3.3 Financing the Poorest

It has been pointed out above that the poorest sections of the population are left out by conventional MFIs. One reason is that extreme poverty leads to the diversion of

¹⁴ Some hypothetical examples to illustrate some ways in which Islamic financing principles can be applied can be found in Ahmad (1998).

funds from productive activities to consumption and asset purchases. This lowers the overall return on investment and makes it difficult for the poor to repay the loans. The IMFIs, however, can combine the institution of *zakah* and other forms of voluntary charity (*sadaqah*) in microfinancing to provide financial services to the poorest.

*Zakah*¹⁵ and *sadaqah* in Islam are important tools for the redistribution of income and growth. *Zakah* is one of the five pillars of Islam and obligatory on every wealthy Muslim. *Zakah* and other forms of charities can be used to increase the participation in production of the poor (El-Ghazali, 1994, p. 48). *Zakah* can be integrated into the microfinance program in a variety of ways to benefit the poorest beneficiaries. It can be transferred to the poor as outright grants or given as *qard-hasan* and can be used either for consumption or for investment purposes.¹⁶ In case of the extreme poor, *zakah* can be given as grants to stop the diversion of funds for consumption purposes so that the funds from IMFI can be used exclusively in production. As *zakah* will reduce the need for diverting funds meant for investment to unproductive use, it is expected that investments in productive activities will increase the overall return decreasing the probability of default.¹⁷ Thus, integrating *zakah* with microfinancing will not only improve the economic condition of the poor, but also ensure the repayment of the funds to the IMFI.

3.4 Amount of Funds Transferred to Beneficiaries

As mentioned above, once a loan is sanctioned, conventional MFIs deduct a part of the principal for different funds (group and emergency funds). The beneficiary, however, pays interest on the total amount sanctioned. As a result the effective interest rate that the beneficiary pays to the MFI increases.¹⁸ Furthermore, it is easier for a beneficiary to divert funds to non-productive uses once cash is received. Under Islamic modes of financing this is not possible. In principle, when a good is being transferred by the IMFI, no deductions can be made. As cash is not handed out, the scope of diverting money for other uses becomes difficult, if not impossible.

¹⁵ For detailed discussion on *zakah*, see El Ashker and Haq (1995).

¹⁶ Though there is a view that *zakah* should involve transfer of ownership of funds, a few scholars have opined that it can be given as *qard-hasan* (Qardawi 1980, p. 634 and Moududi 1985, pp. 56-57). OIC Fiqh Academy (resolution no. 3), Kuwait Finance House (Fatawa Nos. 247 and 426) and Kuwait Zakat House (Fatwa No. 81) opinion that *zakah* can be used for investment purposes.

¹⁷ This was pointed out by Mohammad Muzahidul Islam, Associate Professor, Department of Finance, Dhaka University.

¹⁸ For example, Grameen Bank charges 20 percent on its loans and deducts 5 percent for the Group fund. If Tk.1000 is sanctioned, a beneficiary receives Tk.950 and pays Tk.200 as interest, making the effective interest rate to be 21.05 percent.

3.5 Group Dynamics

There will be some qualitative differences in the group dynamics of the beneficiaries of IMFIs compared to that of conventional ones. Group guarantee in repaying the funds back to the IMFIs may take the form of *kafalah*, making the group members guarantors for repayment. The members in the group can agree to help each other in case of inability of any member to pay the installment. One way to do this is to provide *qard-hasan* (interest-free loans) to the person facing problems in paying the installments.

3.6 Social Development Program

Whereas the content of the social development program of conventional MFIs is secular (and sometimes anti-Islamic) in nature,¹⁹ the counterpart of IMFIs has Islamic content. In the social development program different behavioral, ethical, and social aspects are introduced in the light of Islamic principles. Islamic approach has a couple of benefits. First, people feel more comfortable adapting to these norms as they take them as part of belief and worship. Second, the Islamic social development program builds the social capital (e.g., feeling of brotherhood and comradeship, obligation to repay debt), which helps repayment of installments regularly.

3.7 Objective of Targeting Women

As mentioned above, the majority of the clients of conventional MFIs are women. The objective of targeting women in the conventional approach is to empower them. The rationale is that women use the funds productively to increase their income levels. As a result, they become more independent and this increases their self-respect. As pointed out above, however, some recent studies show that this is not the case (Khandker 1998 and Rahman 1999). The male members of the household usually persuade the women to obtain credit and often use it. The women, however, are responsible for the repayment of the installments. This creates tensions in the family.

Though the majority of beneficiaries of Islamic MFIs are women, the underlying objectives of choosing them are very different from those of the conventional approach. IMFIs target group is the family. This is evident in the contract between the IMFI and the beneficiary. Both, the women and the spouse sign the contract and are liable for the repayment of the funds. IMFIs deal with women, as it is more convenient and efficient. It is easier for women to attend the weekly meetings, as men go out to work and are not available. Another important externality of dealing with women is that they are at the receiving end of the social

¹⁹ See Ahmad (1998) for a discussion.

development program. It is believed that imparting Islamic teachings to women serves the purpose of dissemination better as they convey these values to the other members of the family (particularly children). This attitude, along with the other religious content of the Social Development Program (discussed below) does not create tensions in the family.

3.8 Work Incentive of Staff Members

Given the Islamic approach of IMFIs, the attributes of staff members working in them are different from the conventional MFIs. All three IMFIs inform that they recruit employees by first advertising the positions in newspapers. The candidates have to take a written examination and then face interview. Other than profession related skills, the IMFIs also seek Islamic orientation and a desire to work for the betterment of the poor in the candidates. The employees, as such, not only work to earn a living but also take the work as part of their religious duty. This acts as an incentive to work effectively and decreases the shirking behavior of the staff members of IMFIs.

3.9 Dealing with Default

To deal with arrears and default, conventional MFIs use group and center pressure. When this fails, sometimes threats are made and in extreme cases assets are sold. IMFIs approach has certain advantages when it comes to dealing with arrears and defaults. The spirit of brotherhood and mutual help created by Islamic teachings induces members of a group or the center to assist in paying the arrears. Other than the group/center members, the spouse of the member can also be approached. Furthermore, the Islamic doctrine of not paying back debt as sinful also motivates the members to repay their dues. The differences between Islamic MFIs and conventional MFIs are summarized in Table 2.

Table 2
Differences between Conventional and Islamic MFIs

	Conventional MFI	Islamic MFI
Liabilities (Sources of Funds)	External Funds, Savings of clients	External funds, Savings of clients, Islamic Charitable Sources
Assets (Mode of Financing)	Interest-based	Islamic Financial Instruments
Financing the Poorest	Poorest are left out	Poorest can included by integrating <i>zakah</i> with microfinancing
Funds transfer	Cash given	Good transferred
Deductions at inception of contract	Part of the funds deducted at inception	No deductions at inception
Target group	Women	Family
Objective of targeting Women	Empowerment of women	Ease of availability
Liability of the loan (when given to women)	Recipient	Recipient and spouse
Work incentive of employees	Monetary	Monetary and religious
Dealing with Default	Group/center pressure and threats	Group/center/spouse guarantee, and Islamic ethics
Social Development Program	Secular (or un-Islamic) behavioral, ethical, and social development.	Religious (includes behavior, ethics, and social)

4. IMFIs AND THEIR BENEFICIARIES: NATURE AND CHARACTERISTICS

In this section, we present the information gathered from three IMFIs operating in Bangladesh and their beneficiaries. The discussion is based on information collected in a field survey and interviews with the officials of these institutions. After briefly outlining the field survey, we discuss the different characteristics of the IMFIs and their beneficiaries below.

4.1 Field Survey: A Brief Preview

The field survey was conducted during the period of August 18, 1999 to November 10, 1999 in Bangladesh. Islamic Economics Research Bureau (IERB), Dhaka was approached to assist in the field survey. They identified four field surveyors and contacted Association of Muslim Welfare Associations in Bangladesh (AMWAB) to identify the IMFIs. After discussions with officials of IERB, it was decided that surveyors would survey beneficiaries and officials of three IMFIs. The surveyors were trained and mock interviews were conducted.

After discussions with the officials of IERB and AMWAB, Al-Fallah Aam Unnayan Sangstha, Noble Educational & Literary Society, and Rescue were chosen for the survey. The criteria for choosing the IMFIs were age and ease of accessibility. Of these three, two (Al-Fallah and Rescue) are engaged in microfinancing, the other (Noble) has other schemes (education, fisheries and forestry, etc.). The field surveyors went to the head offices of the respective IMFIs and had interviews with the officials. Information on beneficiaries was gathered by going to the weekly meetings and randomly choosing the beneficiaries for interviewing. The author personally interviewed the officials of these IMFIs to have a better understanding of the operations of these institutions.

4.2 Management Structure of IMFIs

Though the specific management structure varies from one IMFI to another, they appear to have a similar pattern in general. Often the initial activities of the IMFI start with the contributions of the members of the Board of Directors. The members in the Board constitute a group of conscientious people interested in the welfare of the poor. The Board of Directors is the policy making body of the institution. The Executive Director runs the institution and is responsible for implementing the decisions taken by the Board of Directors. Under the Executive Director, Managers of Accounts and Administration take care of their respective departments. The General Manager oversees all microfinance operations carried out at the branch level. The Branch Manager is responsible for his branch activities. Under him, supervisors direct Field Workers who do most of the work at field level. Field workers (and sometimes supervisors) attend the weekly meetings at locations, train the beneficiaries, receive application for funds, collect installments, etc. The management structure of a typical IMFI is given in Appendix-I.

4.3 IMFIs: Facts and Figures

Before discussing the performance of IMFIs, we elaborate the characteristics of the institutions and their beneficiaries. We discuss the attributes of the IMFIs in

this sub-section and outline the characteristics of the beneficiaries in the next sub-section.

Table 3 gives the basic information of three IMFIs included in the study. Al-Fallah located in Dinajpur district started its operations the earliest (1989) is the largest of the three IMFIs in terms of having the most beneficiaries (6,793), employees (40), and highest disbursement (Tk.23,918,000). It also has the highest disbursement of Tk.3521 per beneficiary. Next is Noble, based in Bogra, started its operation most recently (1993). It has the fewest number of beneficiaries (2,251), but a relatively larger disbursement of Tk.3127 per beneficiary. The last IMFI, Rescue of Rangpur district, started its operation in 1991. It has 2515 beneficiaries and an average disbursement of Tk.2148 per member. Female beneficiaries are dominant in all three IMFIs, particularly in Al-Fallah (98.6 percent) and Rescue (97.5 percent). The dropout rate in Noble and Rescue averages 3.75 percent. Savings per beneficiary equal Tk.276.9 and Tk.352.7 for Noble and Rescue respectively.²⁰ The officials of IMFIs inform that the members seldom want to cut off dealings with IMFIs. Most of the dropouts are released at the initiative of the IMFIs as disciplinary actions against some unwelcome behavior.

Table 3

Basic Information on IMFIs

	Al-Fallah	Noble	Rescue
Location of Operation	Dinajpur	Bogra	Rangpur
Year of Establishment	1989	1993	1991
No. of Beneficiaries	6,793	2,251	2,515
Total Disbursements ^a (Tk.)	23,918,000	7,039,000	5,402,000
Disbursement/Beneficiary (Tk.)	3521	3127	2148
Number of Employees	40	32	19
Female Beneficiaries (% of total)	98.6%	67.7%	97.5%
Dropout Rate (% of total)	-	3.7%	3.8%
Members Savings (Tk.)	-	623,231	886,933
Risk Fund (Tk.)	-	20,288	156,622 ^b
Members Savings/beneficiary (Tk.)	-	276.9	352.7

a. For the fiscal year 1998-1999 (July 1, 1998 to June 30, 1999)

b. Risk Management Fund

²⁰ Data on dropout rate, and the breakdown of member savings and risk fund was not available for Al-Fallah.

Table 4 shows the asset structure of the IMFIs. The bulk of the assets for all three IMFIs is earning assets (79.9 percent for Al-Fallah, 85.4 percent for Noble, and 80.9 percent for Rescue). Noble has relatively large share of fixed assets (12.3 percent of the total). While Al-Fallah has a relatively high percentage of deposits with banks (15.9 percent), Rescue holds 12.9 percent of assets as cash.

Table 4
Asset Structure of IMFIs

	Al-Fallah	Noble	Rescue
Total (Tk.)	14,585,516	1,931,524	3,908,541
Deposits with Banks (Tk.)(% of Total)	2,323,316 (15.9%)	45,514 (2.4%)	152,297 (3.9%)
Earning Assets (Tk.) (% of Total)	11,657,375 (79.9%)	1,648,700 (85.4%)	3,161,137 (80.9%)
Fixed Assets (Tk.) (% of Total)	585,182 (4%)	237,310 (12.3%)	90,196 (2.3%)
Cash (Tk.) (% of Total)	19,643 (0.13%)	-	504,910 (12.9%)

Table 5 shows the capital and liability structure of the three IMFIs. Al-Fallah has the largest capital fund (13.2 percent) and Rescue the smallest (2.2 percent). Similarly, Al-Fallah has mobilized beneficiaries' funds to the tune of Tk.7,077,286 (48.5 percent). Rescue has the lowest amount of beneficiary accounts (4.4 percent) and the highest amount of net borrowing (92.4 percent) from external sources.²¹ More than 50 percent of Noble's liabilities are borrowed, while a quarter of Al-Fallah's liabilities constitutes net borrowing.

Table 5
Capital and Liability Structure of IMFIs

	Al-Fallah	Noble	Rescue
Total (Tk.)	14,585,516	1,931,524	3,908,541
Capital Fund ^a (Tk.) (% of Total)	1,932,108 (13.2%)	241,105 (12.5%)	87,467 (2.2%)
Beneficiaries Accounts (Tk.) (% of Total)	7,077,286 (48.5%)	643,519 (33.3%)	172,747 (4.4%)
Net Borrowing (Tk.) (% of Total)	3,622,767 (24.8%)	1,046,900 (54.2%)	3,612,494 (92.4%)
Other liability (credit) (Tk.) (% of Total)	1,653,355 (11.3%)	-	35,833 (0.9%)

a. Includes Net Profit from current year operations.

²¹ All three IMFIs have borrowed funds from Palli Karma Sahayak Foundation (PKSF), a national organ created to finance microfinance activities in Bangladesh.

Table 6 shows the income earned from different income earning assets. Bulk of the financing takes place in the form of *bay[mu'ajjal*. Income earned from this mode of financing is 86.4 percent for Al-Fallah, 86.2 percent for Noble, and 75.9 percent for Rescue. Only Noble has income from some other Islamic instruments. Seven percent of its income comes from *musaqah* and *musharakah* from forestry and fishery activities.

Table 6
Income and their Sources of IMFIs

	Al-Fallah	Noble	Rescue
Total (Tk.)	3,347,860	491,623	807,476
Deposits with Banks (Tk.) (% of Total)	463,965 (13.9%)	18,941 (3.9%)	15,146 (1.9%)
<i>Musharakah</i> (Tk.) (% of Total)	-	34,500 (7%)	-
<i>Bay[mu'ajjal</i> (Tk.) (% of Total)	2,491,805 (74.4%)	423,763 (86.2%)	613,045 (75.9%)
Other Income/Grants (Tk.) (% of Total)	392,090 (11.7%)	14,419 (2.9%)	179,285 (22.2%)

4.4 Characteristics of IMFI Beneficiaries

The basic characteristics of the beneficiaries included in the sample are shown in Table 7. The sample size for Al-Fallah, Noble, and Rescue are 50, 52, and 50 respectively. Of these, majority of the beneficiaries interviewed were women (100 percent, 76.9 percent, and 92 percent for Al-Fallah, Noble, and Rescue respectively). Average age of the beneficiaries is around 30 years (28.9, 30.4, and 30.7 for Al-Fallah, Noble, and Rescue respectively). The literacy rate of the beneficiaries of Al-Fallah is the highest (98 percent), followed by Noble (63.5 percent), and Rescue (58 percent). Note that these numbers are much higher than the national average of 38 percent). The average household size for Al-Fallah is 6.3 persons, 2.5 of whom are working. The average number of persons in a household for Noble and Rescue is 5 and 5.1 persons respectively, with 1.3 and 2 of them engaged in work respectively. The average value of assets that beneficiaries have is the highest for Noble (Tk.287,731). It also has the largest standard deviation indicating wide dispersion of the assets. The poorest group, in terms of assets, is that from Al-Fallah (Tk.100,490) followed by Rescue (Tk.179,621). It appears Al-Fallah is doing a better job in terms of targeting the poorer households.

Table 7**Basic Data of the Beneficiaries of IMFIs Included in the Sample**

	Al-Fallah	Noble	Rescue
Sample Size	50	52	50
Female (% of total)	100%	76.9%	92%
Average Age of Beneficiary (years)	28.9	30.4	30.7
	(9.7)	(8.2)	(6.7)
Literate (% of total)	98.0%	63.5%	58.0%
Average Household Size	6.3	5.0	5.1
	(10.3)	(1.8)	(1.6)
Average of Working Members	2.5	1.3	2.0
	(0.8)	(0.5)	(0.7)
Average Value of Assets (in Tk.)	100,490	287,731	179,621
	(213,373)	(559,618)	(450,576)

Note: The figures in parentheses are standard deviations.

5. PERFORMANCE OF IMFIs: FINDINGS FROM THE FIELD SURVEY

We analyze the operations and performance of three IMFIs in this section. In doing so, we highlight how IMFIs perform in dealing with some problems facing conventional MFIs pointed out in Section 2.

5.1 Profitability and Viability of IMFIs

The viability of any institution can be analyzed by examining its profitability and efficiency. Table 8 shows the income, expenditures and profitability of the IMFIs included in the study. We distinguish total income from operating income. Whereas total income includes income from all sources (including donations/grants), operating income includes that generated from investments and returns on deposits with banks. We observe that Noble has the highest share of income from investments (93.2 percent), while the other two IMFIs shares at around 75 percent. With a relatively large amount of deposits, Al-Fallah seems not to have any cash constraints. Large deposits, however, may also indicate limitations in the expansion of operations. On the cost side, most of the expenditures constitute operating costs (wages, rent, utilities, etc.). These range from 63.5 percent for Noble to 95.2 percent for Al-Fallah. Al-Fallah's borrowing costs are, however, the least (4.9 percent). This is due to the smallest net borrowing of Al-Fallah (see Table 5).

We define total profit as total income less total expenditures and operating profit as the difference between operating income and costs. Table 8 shows that for all three IMFIs, total profit is positive and greater than operating profit. Except Rescue, the operating profit is positive for the other two IMFIs. To have a clearer picture of these figures and the performance of the IMFIs we use the following ratios to measure profitability and efficiency.²²

1. Return on Assets (ROA) = (Net Income/ Assets)*100
2. Net Interest (Return) Margin (NIM) = [Total income from investment and interest - Total borrowing Cost (interest payments)/ Total Assets]*100
3. Operating Costs as a Percentage of Loan Disbursed (OCL) = (Operating Costs/Loan Disbursed)*100
4. Beneficiaries to Employee Ratio (BER) = Total Beneficiaries/Full-time Employees.

ROA is a measure of efficiency as it indicates how well the institution's assets (resources) are used to generate income. This ratio, however, may be misleading for MFIs if the total income is used since a part of the income of these institutions is in the form of grants. We instead use operating income to obtain the ROA. NIM indicates the efficiency of the intermediation of funds from different sources to users. Another measure of operating efficiency is the OCL. As IMFIs advance small size of loans/funds, this ratio will be larger than conventional banks. Among different MFIs, however, if the field workers are efficient in covering a larger number of beneficiaries, this ratio will be lower. Finally, we use a measure that has relevance to the operations of MFIs in particular. BER is used to measure the efficiency of the employees in reaching the beneficiaries. Note, however, that while a large number of beneficiaries may increase the income per employee, it may also lead to lack of supervision and increase the default rate affecting income adversely.

In order to analyze the performance of the IMFIs in proper perspective, we compare financial ratios of the IMFIs with a well-established and largest conventional MFI, Grameen Bank operating in Bangladesh.²³ The large size of Grameen Bank is apparent by the number of its beneficiaries. Grameen Bank served 1,892,287 beneficiaries in 1994. Note that Grameen Bank charges an interest rate of 20 percent while all three IMFIs charge a rate of return of 16 percent. Table 9 exhibits different measures of profitability and efficiency of IMFIs along with Grameen Bank.

²² See Rose and Fraser (1988, pp. 199-210) for a discussion.

²³ Grameen Bank was chosen as the relevant data was available. Data on Grameen Bank has been taken from Khandker, et al (1995) is for 1994.

Table 8
Income, Expenditure and Profit of IMFIs (Head Office)

	Al-Fallah	Noble	Rescue
Total income (including Donations/grants) (Tk.)	3,347,860	491,623	807,476
Income from investment (Tk.)(% of Total)	2,491,805 (74.4%)	458,263 (93.2%)	613,045 (75.9%)
Income from Deposits (Tk.) (% of Total)	463,965 (16.1%)	18,941 (3.9%)	15,146 (1.9%)
Total Expenditures (Tk.)	2,419,930	286,460	752,564
Borrowing Costs (Tk.) (% of Total)	115,810 (4.9%)	102,558 (35.8%)	93,900 (12.5%)
Operating Costs (Tk.) (% of Total)	2,304,120 (95.2%)	183,902 (64.2%)	605,978 (80.5%)
Total Profit (Tk.)	927,930	205,163	54,912
Operating Profit (Tk.)	71,875	171,803	-139,519

To sum up, IMFIs have performed relatively well when compared to the well-established conventional MFI in terms of profitability and efficiency. Among the IMFIs, Rescue has the poorest figures. Rescue, however, has some indicators that are better than Grameen Bank. For example, it has a higher NIM and lower operating costs (OCL) than Grameen Bank. Noble has performed the best among the IMFIs in terms of economic viability. It has the highest ROA and NIM and the lowest OCL. Noble, however, is not productive in terms of reaching the beneficiaries as it has the lowest BER. When this factor is considered, Al-Fallah appears to have the best record in terms of profitability and efficiency. It has a relatively high ROE, NIM, and BER and low OCL. Possible explanations of the relative performance of the IMFIs are given in Section 7.

Table 9
Profitability and Efficiency of IMFIs

	Al-Fallah	Noble	Rescue	Grameen Bank^a
Return on Assets (ROA)	0.49	8.89	-3.57	-0.5
Net Interest (Return) Margin (NIM)	19.5	21.4	13.7	6.9
Operating Costs as a percentage of Loan Disbursed (OCL)	9.6	2.6	11.2	12.7
Beneficiaries to Employee Ratio (BER)	169.8	70.3	132.4	174.2

a. Figures for Grameen Bank are of 1994 and taken from Khandker, et. al. (1995).

5.2 Asymmetric Information Problem

As mentioned above, asymmetric information problem may take place before and after a contract is signed causing adverse selection and moral hazard problems respectively. In the context of microfinancing, the former problem may exist if the intended use of fund is different from that applied for. The latter problem arises when funds are used for purposes other than it was sanctioned for. MFIs policy of targeting women as beneficiaries in households where their spouses (or other male members) make the financial decisions is the source of both adverse selection and moral hazard problems. Different problems that originate from this fact are discussed below.

a) ***Intended Use of Funds Contrary to what Applied for:*** This problem arises when the beneficiary applies for funds indicating use of funds in certain productive enterprise, but hides the intended use of funds which may be for other purposes (including consumption). Adverse selection problem exists, as the MFI does not know the intended use of funds by the beneficiary. When funds are sanctioned and the beneficiary uses the funds in activities other than that applied for, it is a case of moral hazard. In conventional interest-based debt the diversion of funds is possible as cash is handed out to the beneficiary, who can then use it on things other than what it is intended for.

In case of Islamic mode of financing used by IMFIs (i.e., *bay[mu'ajjal*) this problem cannot arise in principle as instead of handing over cash, the good/asset is handed over to the beneficiary. As a result, diversion of funds to other purposes is not possible. In some cases, however, when cash is given out instead of good/asset the possibility of misuse of funds is there. Table 10 shows if funds were used in the intended activities by the beneficiaries of the three IMFIs. Whereas Al-Fallah and Noble do not appear to have any problems of fund diversion to non-productive activities, Rescue has a few cases (12 percent) of fund diversion for consumption. Note that funds can be diverted mainly because cash is handed out instead of good/asset. Cash is often given out (not to the beneficiary directly but to a representative) due to the difficulties the IMFIs face in applying the Islamic mode of financing perfectly (discussed in section 6.1).

b) ***The User of Funds is Different from the Person Obtaining the Funds:*** The declared objective of many conventional MFIs to finance women is to empower them. In many cases, however, male members of the household initiate or coerce their spouses to apply for funds from MFIs. Once funds are obtained, the male members of the household determine how to use them. The approach of targeting women by conventional MFIs creates the dual problems of adverse selection and moral hazard as discussed above. Here, we focus on the problems related to the user of funds.

Table 10**Fund Use in Intended Activities by Beneficiaries**

Use of Funds	Al-Fallah	Noble	Rescue
Intended Activity	37 (74%)	50 (96.2%)	41 (82%)
Intended and other productive activities	1 (2%)	-	3 (6%)
Intended activity and Consumption	-	-	5 (10%)
Consumption	-	-	1 (2%)

In case of IMFIs, we also observe that it is male members of the household who not only decide on the use of funds but also use them. Table 11 illustrates the dominant decision-makers in the household regarding fund use for beneficiaries of the three IMFIs in the study. Whereas in most of the cases of Noble and Rescue, the spouse (husband) decides how to use funds (55.8 percent and 50 percent respectively), majority of the beneficiaries of Al-Fallah (78 percent) collectively make decisions regarding fund use. One way of determining who uses the funds is to examine who spends most of the time on the funded activity. Table 12 indicates that the spouse (husband) is most involved in the funded activity in majority of the cases. This holds true particularly for the beneficiaries of Al-Fallah as a large number of respondents (88 percent) indicate that their spouses use time mostly in the funded activity. The corresponding numbers for Noble and Rescue are around 42 percent.

Table 11**Decision of Fund Use by Beneficiaries Household Members**

Decisions Regarding Fund Use	Al-Fallah	Noble	Rescue
Self	1 (2%)	15 (28.8%)	16 (32%)
Spouse	10 (20%)	29 (55.8%)	25 (50%)
Together (self and spouse)	39 (78%)	7 (13.5%)	8 (16%)
Other Household Members	-	1 (1.9%)	1 (2%)

Table 12

Fund Use by Beneficiaries Household Members

Most Time used in Funded Activity*	Al-Fallah	Noble	Rescue
Self	1 (2%)	18 (34.6%)	28 (56%)
Spouse	44 (88%)	22 (42.3%)	21 (42%)
Other Household Members	12 (24%)	4 (7.7%)	
Hired Employees		4 (7.7%)	

*The percentage may add up to more than 100 percent as multiple cases are possible (for example the spouse and other household members may be spending most time in a funded activity).

The above figures from IMFIs, however, do not mean that problems of asymmetric information exist in these institutions. The asymmetric information problem in terms of user of funds disappears in case of IMFIs, as their approach is different from that of the conventional MFIs. As mentioned above, IMFIs' target is the family. Interviews with officials of all three IMFIs indicate that they know that funds given to women are largely used by the male members of the household. They, however, do not consider this to be a problem. Instead, they encourage participation of other members of the household in the funded activity. The IMFIs also involve the male members in the financial transaction by making them responsible in the contract (by making them sign the contract). As mentioned above, IMFIs deal with women because it is easier to conduct transactions with them. Given this approach of IMFIs, fund-use by a large percentage of male members is rather expected and encouraged and does not pose a moral hazard problem.

c) **Lack of knowledge about the beneficiary's skills and expertise:** Though MFIs finance mostly low skill activities, in some cases expertise of the beneficiary may be considered important. Skills of the beneficiary in the activity she is applying for may be unknown to the MFI. For example, prospective beneficiaries may apply for funds for use in a productive cottage industry, like weaving baskets. If the beneficiary does not know how to weave, then the default risk increases. Ascertaining the required skills of the beneficiaries before the funds are delivered to them can mitigate this adverse selection problem. Officials of all three IMFIs indicate that they scrutinize the skills and expertise that beneficiaries have before funds are sanctioned.

5.3 Group Dynamics

Forming groups and centers is an integral part of microfinance program as they serve as social collateral and ensure the repayment of funds to the MFIs. Recovery of funds and the success of MFIs depend on the strength and solidarity of the groups. From the MFIs perspective, a group is considered to be carrying out its functions when members of a group help/pressurize other fellow members in case of nonpayment of installment(s). Other than the usual social bonds that determine the strength and solidarity of a group, the IMFIs can also use an additional device to strengthen the relationship among group members. The concept of Islamic brotherhood along with religious duty of debt repayment can further improve the relationship of the group members and help clear the installments. The educational content in the Social Development Program is used to impart these ethics.

The officials of all three IMFIs affirm that they use group pressure to recover arrears in installment payments. They are also of the view that imparting Islamic teachings makes the beneficiaries better clients. Some other aspects of group dynamics are illustrated in Tables 13-16. Table 13 shows that almost all beneficiaries consult their fellow members regarding use of funds. Table 14 indicates that there are no arrears in payments for Al-Fallah and Noble, and 10 percent beneficiaries have fallen back on payments in case of Rescue. The arrears have occurred due to different negative shocks beyond their control.²⁴ Table 15 shows that majority of members are willing to help a fellow group member to pay arrears in installments. Table 18 indicates that in majority of cases, joining IMFI has improved the relationship with group members. One reason of this may be the Islamic educational content of the Social Development Program (discussed in the next sub-section).

Table 13

Group Dynamics: Consultation about Fund-use by Beneficiaries

Cousult Group-members	Al-Fallah	Noble	Rescue
Yes	50 (100%)	50 (96.2%)	49 (98%)
No	-	1 (1.9%)	1 (2%)

²⁴ For the five members who are in arrears, the reasons were stated as business failure (1), natural disaster (2), and family and other mishaps (2).

Table 14
Group Dynamics: Arrears in Payments by Beneficiaries

Arrears in Payments	Al-Fallah	Noble	Rescue
Yes	0	0	5* (10%)
No	50 (100%)	52 (100%)	45 (90%)

*The reasons of arrears were stated as business failure (1), natural disaster (2), and family and other mishaps (2).

5.4 Impact on Beneficiaries

Impact on beneficiaries can be discussed under two broad categories: economic and socio-cultural. The economic impact of the IMFIs' services is reflected on employment, economic activity, and assets of the beneficiaries' household. These are shown in Tables 16 and 17. Table 16 reveals that the IMFIs' funds have been successful in increasing the time spent on income generating activities by the beneficiaries and other members of the household. Al-Fallah appears to have the highest impact on the employment of beneficiaries and their spouses, followed by Rescue. Table 17 shows that funds from the IMFIs have helped the beneficiaries to increase output and diversify productive activities. The impact on output is the largest in case of Noble (53.8 percent) while a large number of beneficiaries of Al-Fallah have diversified production (36 percent). Majority of the beneficiaries of Al-Fallah have also increased their asset base and improved their premises (68 percent and 88 percent respectively). The economic impact on beneficiaries of Rescue appears to be relatively small in all respects.

Table 15
Group Dynamics: What Beneficiaries do if Others Arrears*

	Al-Fallah	Noble	Rescue
Help pay (with money)	46 (92%)	34 (65.4%)	48 (96%)
Pressurize	0	0	1 (2%)
Ask spouse/other household members	8 (16%)	0	1 (2%)
Do Nothing	0	1 (1.9%)	1 (%)

* The percentage may add up to more than 100 percent, as multiple cases are possible.

Table 16**Economic Impact: IMFI's Fund's Effects on Employment of Beneficiaries**

Increase in Time Used*	Al-Fallah	Noble	Rescue
Self	30 (60%)	20 (38.5%)	25 (50%)
Other Household Members	31 (62%)	21 (40.4%)	26 (52%)

*The percentage may add up to more than 100 percent, as multiple cases are possible.

Table 17**Economic Impact: IMFI's Fund Effects on Economic Activity and Assets of Beneficiaries**

Effect of Fund	Al-Fallah	Noble	Rescue
Increase in Volume of Goods/Services	2 (4%)	28 (53.8%)	5 (10%)
Diversification into new Goods/Services	18 (36%)	2 (3.8%)	2 (4%)
Increase in Assets	34 (68%)	8 (15.4%)	12 (24%)
Improved Premises	44 (88%)	9 (17.3%)	14 (28%)

Table 18 examines the social impact of IMFIs through their Social Development Program. Other than the overall view about IMFIs, the dealings related to IMFIs are included in this Table. Majority of beneficiaries indicate that association with IMFIs has not only benefited them financially but also in several other ways. As a result, they have a positive outlook towards the IMFIs. As Table 18 indicates, a large percentage of beneficiaries from all three IMFIs also have better relationship with their spouses and group members. This builds the solidarity within the family unit and group lowering the probability of default. The Islamic education content of the Social Development Program can be an input to this. Beneficiaries also maintain that they have a better understanding of Islam after joining the IMFIs.

Table 18
Social/Educational Impact on Beneficiaries

	Al-Fallah	Noble	Rescue
Knowledge of Islam increased	49 (98%)	51 (98%)	48 (96%)
Better relationship with Group Members	49 (98%)	52 (100%)	48 (96%)
Better relationship with spouse	49 (98%)	52 (100%)	35* (70%)
Have benefited (other than financially)	49 (98%)	47 (90.4%)	50 (100%)

*While 13 members said that the relationship with spouse was the same, one respondent said the relationship worsened.

The officials of the IMFIs inform that beneficiaries and the community at large have a positive outlook towards their activities. The main reason given is that, unlike the conventional MFIs, the Islamic orientation of the Social Development Program conforms to their values. In matters related to financial dealings, beneficiaries admire IMFI practice of not deducting anything from the sanctioned amount as done by conventional MFIs. Beneficiaries also believe that IMFIs have a more humane approach in dealing with arrears than that of conventional MFIs.

6. PROBLEMS FACING IMFIS

Interviews with the officials of IMFIs reveal that they face the following problems in their operations.

6.1 Dilution in the Application of Islamic Modes of Financing

The main mode of financing used by the IMFIs is *bay[*mu'*ajjal*. To make the transaction Islamically acceptable, the IMFIs should ideally buy the good/asset from the market and sell it to the beneficiary at a mark-up. The officials indicate that during initial stages of their operations, IMFIs have tried to follow this principle. With the expansion of their operations, however, IMFIs have gradually given up this practice. The reasons mentioned are that it is too costly (in terms of man-hours) and at times impossible to buy the goods/assets that beneficiaries want. For example, it becomes very difficult to accompany a beneficiary who may want a particular kind of good sold in a far off market. Instead of giving money to the beneficiary, the IMFIs now delegate someone else to buy the good/asset.²⁵ The

²⁵ Al-Fallah delegates center chief and a group member to buy the good/asset, Rescue delegates group leader, and Noble asks either the husband or son to do the same.

officials of IMFIs then inspect if the money was spent on the good/asset during the weekly meeting that follows.

It is apparent the Islamic mode of financing is being diluted by not providing the goods/assets. One way to overcome this is to use other profit-sharing modes of financing. The sharing modes of financing, however, have their own problems.²⁶ The main problem is the moral hazard problem arising from underreporting of profit. This problem can be mitigated by supervising the operations and monitoring accounts of beneficiaries. Supervision and monitoring, however, is costly. As pointed out above, additional obstacles arising in developing countries can further raise the supervision/monitoring costs. Some of the problems that officials of IMFIs indicate they face in supervision and monitoring are given in Table 19. Officials from all IMFIs indicate difficulty in assessing the financial accounts as one of the main factors that may hinder monitoring. Other factors that also obstruct monitoring include lack of personnel and equipment (vehicles to go around) and physical barriers (like distance).

Table 19
Problems Faced in Monitoring by IMFIs*

	Al-Fallah	Noble	Rescue
Lack of Personnel	-	4 (100%)	2 (100%)
Physical Barriers	-	1 (25%)	2 (100%)
Difficult to Assess Financial Flows	5 (100%)	3 (25%)	2 (100%)
Other (Lack of Vehicles)	-	3 (75%)	-

*The number of branches covered under the survey were 5,4, and 2 for Al-Fallah, Noble and Rescue respectively.

6.2 Lack of Funds

Officials of all three IMFIs state that expansion of their activities is hampered by lack of funds. The problem of generating funds is inherent in the very nature of these institutions. MFIs cannot attract deposits as commercial banks do. Other than the initial start-up capital provided by a few volunteers, most of the funds for conventional MFIs come from external sources and beneficiary savings. Need for funds is the greatest during the initial stages of operations of MFIs when the

²⁶ See Khan (1995) for a discussion.

beneficiaries' savings are nil or small. As the MFIs grow, the savings of beneficiaries accumulate. The savings can then be recycled in financing microenterprises. The time needed for an MFI to operate its activities based only on beneficiaries' savings may be very long.²⁷

Officials of IMFIs attest that there are certain problems in obtaining funds from external sources. First, the Islamic educational content of IMFIs deters some external sources from funding them. Second, though some funds are available from government agencies, they impose certain terms and conditions. These terms and conditions not only limit the flexibility in the operations of IMFIs, but may also be contrary to Islamic principles. For example, the funds are given on interest and the IMFIs are required to get a certain fixed rate of return on their investments to ensure repayment. As a result, certain Islamic modes of financing (like *mud'arabah* and *musharakah*) cannot be used employing funds received from these sources.

One implication of lack of funds is, as the officials of IMFIs indicate, that the benefits package given to employees in IMFIs is not as good as the one given by the established MFIs operating in the neighborhood. This sometimes induces employees with experience to move to other MFIs paying better pay and benefits. Findings from the field survey, however, indicate that IMFIs have not yet tapped the sources of funds from Islamic institutions of *zakah*, charity, and *waqf*. The ways in which these instruments can be used have been discussed before (section 4.2).

6.3 Training

Efficiency in operations can be improved by giving training on different aspects of MFIs' operations. Training in case of Islamic MFIs requires some unique features. These include training on different Islamic modes of financing and contents of Social Development Program. The officials of the IMFIs inform that while training on conventional topics (like accounting and administrative issues) was offered from time to time by the government agencies, training sessions on Islamic aspects are lacking. Association of Muslim Welfare Associations in Bangladesh (AMWAB) organized a few training sessions, but high costs of attending these courses hindered participation of IMFI officials.

7. IMFIs: A SYNTHESIS AND CONCLUSION

Microfinance initiative is widely acclaimed as a new approach to alleviate poverty and bring about development. While conventional MFIs have expanded their operations in the last two decades, poverty-focused MFIs based on Islamic

²⁷ Majority of the funds of large well-established conventional MFIs (e.g. Grameen Bank) still comes from external sources.

principles are yet to be developed. This paper provides the theoretical basis, operational framework, and empirical support for the establishment of Islamic MFIs. The theoretical discussions emphasize on the importance of social financial intermediation to finance microenterprises and a need to develop specialized institutions to do the same. Problems facing conventional MFIs include non-graduation from poverty, debt trap, high dropout rate, asymmetric information and economic viability of the project.

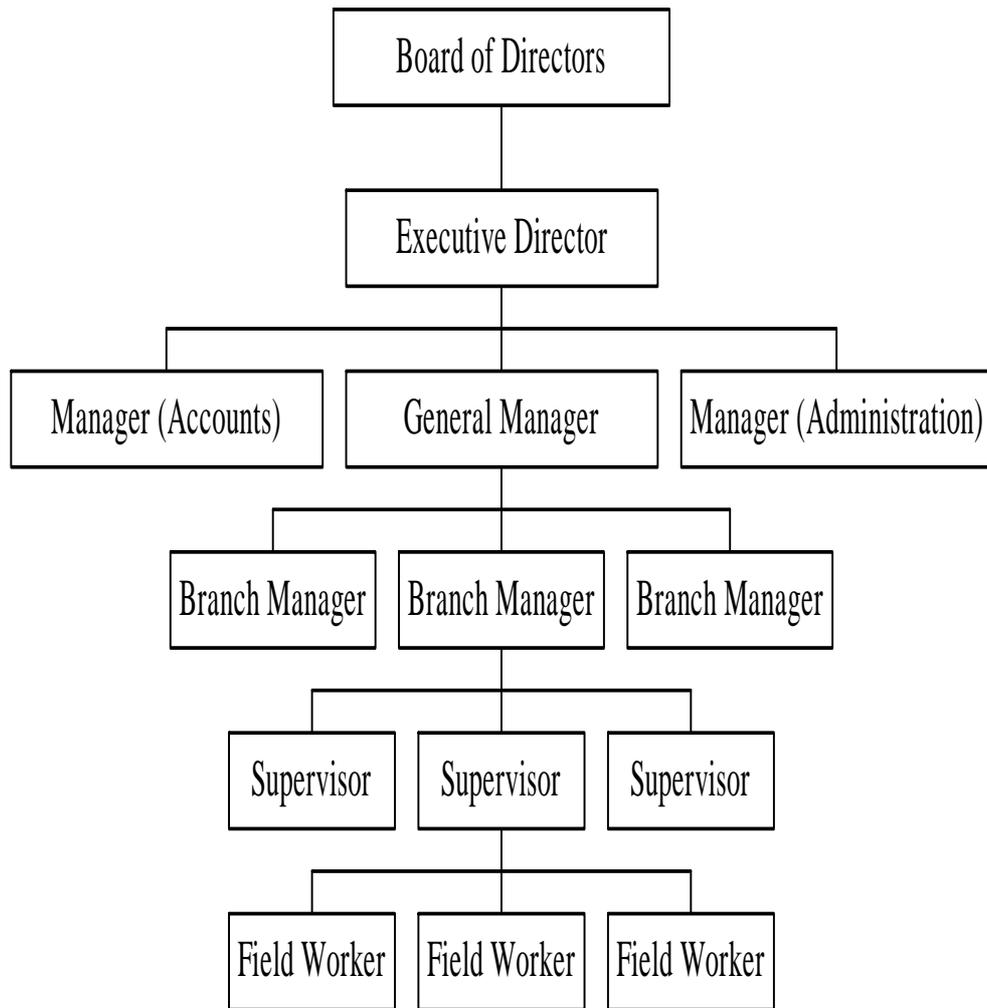
Discussions in different sections above have focused on various aspects of IMFIs' operations. In this section we assemble different elements to arrive at main findings and conclusions. We also attempt to explain some of the findings. The important elements related to IMFIs are summarized below:

- a) The theoretical part of the paper shows that there is great potentiality of IMFIs to cater for the needs of the poor. IMFIs are potentially richer, both, on the liability side and the asset side. On the liability side, IMFIs can tap some alternative sources of funds, like *zakah*, charity, and *waqf*. These institutions can be integrated into microfinance program to effectively alleviate absolute poverty. Similarly, IMFIs can use diverse financial instruments. Different Islamic modes of financing may be used for various activities. The case studies, however, show that IMFIs have not yet tapped some sources of funds, nor have they used variety of financial instruments in their operations.
- b) IMFIs appear to have performed better than Grameen Bank, a well-established conventional MFI. One possible explanation for this may be that IMFIs benefit from the social capital derived from Islamic values and principles. On the supply side, the employees have an incentive to work hard for the betterment of the lives of the poor in an Islamic financial institution. On the demand side, Islamic teachings increase solidarity among beneficiaries and thereby improve the quality of social collateral (see discussion in Section 5.3 above). Furthermore, the moral teachings of Islam make the beneficiaries better debtors as they consider repayment of debt as a religious obligation. The effect of this Islamic orientation induced social capital is the improvement in the profitability and viability of IMFIs. This occurs because, on the one hand there is an increase in the productivity of employees (i.e. reducing the costs), and on the other hand, it reduces the default rate (i.e., increasing the revenue).
- c) The Islamic approach of targeting the family and using Islamic modes of financing eliminates to a large extent asymmetric information problems arising in conventional microfinancing. As IMFIs deal with the family (via women), it mitigates the adverse selection and moral hazard problems resulting from the fact that the intended use and user are different from the

actual use and user of funds respectively. As Islamic modes of financing involve a real transaction, the moral hazard problem arising from the use of funds for purposes other than those intended is to a large extent eliminated.

- d) Some IMFIs have performed well relative to others in terms of profit. In particular Rescue has performed poorer than its counterparts. One possible explanation of the difference in performance is the dilution in the use of Islamic financial instruments. Giving away cash to the beneficiary instead of supplying goods or assets can result in diversion of funds to other uses causing moral hazard problem. This can be a possible explanation for Rescue's relatively poor performance. Rescue gives cash to the group leader who is responsible to ensure its proper use. Without proper supervision, however, diversion of funds is possible. As Table 10 shows, Rescue has the most cases of diversion of funds resulting in the highest arrears in payment of installments (see Table 14).
- e) The IMFIs can potentially benefit from varied sources of income and use of financial instruments but they have not yet exploited these means. The institution of *zakah*, *waqf* and other charities can be integrated into the program to finance the poorest. The IMFIs surveyed, however, have not yet incorporated other sources of funds available from Islamic institutions in their operations. One way to start doing this is to arrange collection of *zakah* and other charities locally. Furthermore, other modes of financing (like leasing and profit-loss-sharing) can be employed for certain kind of activities. Other than Noble, the two IMFIs surveyed use *bay' mu'ajjal* only. In some cases, like farming and fisheries, funds can be provided under sharing (output or profit) modes.

The growth and sustainability of IMFIs largely depend on the availability of external funds and their efficient operations. External funds are needed particularly during the initial stages of operation, when the savings of members are small. With the passage of time as savings of beneficiaries accumulate and get recycled, the dependence on external funds reduces. The IMFIs can operate efficiently if the employees are trained on a regular basis to acquire and upgrade relevant skills. IMFIs have a special need for Islamic oriented training courses. Nascent IMFIs' lack of funds prevents them from benefiting from costly training courses. Institutions like Islamic Development Bank (IDB) can play an important catalytic role to expand the activities of IMFIs. IDB can provide much-needed external funds to IMFIs on a commercial basis. By providing or financing training courses to the employees of IMFIs, IDB will be essentially increasing their efficiency and indirectly ensuring the return on its investment. Noting that financing microenterprises involves meager amounts of investment, a relatively small amount provided to IMFIs can go a long way in affecting the lives of a large number of poor households in member countries.

APPENDIX I**Organizational Structure of IMFIs**

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