Islamic Microfinance –
A superior microfinance model
Often in a wrong track

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Abstract

The purpose of this paper is to review the nature and practices of Islamic microfinance, and to see the long term viability of these experiences: sustainable and wide outreach. The methodology of this paper consists of critical review and examination of existing literature and experiences. The results indicate that Islamic microfinance witnessed few achievements, mostly limited and short lived. The experiments in the Islamic microfinance, with some exceptions, were based on a number of spares models and mechanisms and were short-lived and not integrated into the financial system as same are undergoing the trials phase, being set up by donors or religious groups and have yet to develop like their conventional counterparts. All acts like a charity funds, with no sign of market-orientation and outreach, and lack saving components and commitment for repayment.

With the exception of Bank Rakyat Indonesia (BRI), all other banking and non-banking microfinance experiences have limited outreach, and perhaps not sustainable. The success of BRI cannot be isolated from the sharp differences in practices compared with other experiences on Islamic microfinance. Most of its practices are described as best practices, and some features are unique to this experience. The relative success of Bank Rakyat Indonesia (BRI) as a government-owned bank in Islamic microfinance is partly related to scattered small units (outreach), the saving components, avoidance of subsidy or funds from government, effective leadership, strong commitment and political support. It is not enough to apply these best practices of Bank Rakyat Indonesia (BRI) for Islamic microfinance to be sustainable with wide outreach. There are also other challenges that require support by the governmental regulatory framework, expanding the use of technology services in microfinance, broadening the products and guarantees basis, and ensuring transparency.

Keywords: Microfinance, Islamic Microfinance, Microfinance institutions, Islamic Banks

1. Introduction

Microfinance is the program for advancing small loans to the poor to enable them to enter into income generating projects which will provide them and their families with means of living

(Microfinance Summit, 1997). The definition of the poor does not include the poorest at the lowest 10% who lacks a regular cash flow to serve their debts. Most of the poor who deal with microfinance are women below the lowest level of 50% of the total poor of the society. This paper deals with problems of conventional microfinance and the need for an Islamic microfinance. It also presents some Islamic microfinance projects and mechanism thereof in addition to some subjects which we deem necessary for the work of Islamic microfinance to meet the increasing demand for it.

2. Has the Conventional Microfinance Fulfilled its Main Objectives?

The conventional microfinance is considered as an opportunity for doing banking among the poor but not a treatment of poverty. It is a social finance which combines finance with developmental assistance. Up to 2008 there are more then 7000 establishments which render microfinance to about 24 million beneficiaries worldwide (Mohammed Aliyu and Hassan Zubair, 2008*)*. The main differences between the analysts regarding microfinance are due to two basic matters: i.e. can microfinance be basically considered as a mechanism to eradicate poverty? And has the previous experiences proved to be an actual success in realizing objectives thereof? Some see that it is effective as indicated by some successful international experiences, whereas others see that it needs radical reforms and a new understanding so as it becomes effective, and also some other group sees no big benefit can be expected to be brought about it if the aim from it is to fight poverty. The latter argument is led by Malcolm Harper as it provides a limited and low quality type of finance, yet he acknowledges that whatever is done by this type of finance is better than doing nothing and it grows with an astonishing speed, and in some instances its performance improved (Thomas Dichter and Harper, Malcolm, 2007).

Microfinance is, according to some, like a miracle for the treatment of the poverty issues, and to extend that microfinance was drawing significant international interest and attention sine the nineties. It was also drawing controversy and differences between the analyst and interested groups. Data and information on the impact of microfinance are limited and conflicting, yet it can be said that up till now microfinance has not covered a significant number of the poor as it was expected despite the elapse of a rather long period sine it was brought into application[1]. The number of poor people in the world is estimated to be about 3 billions and about 1.5 billion of them can enter into small size financing loans (Standards & Poors's, 2008). Yet according to other estimates, only half a million of the poor people whose total is estimated at 3 billions, can access the microfinance services in the regular financial sector (The Consultative Group to Assist the Poor, also see UICONS, 2006, p. 13). And if we assume that the average required to finance the project of each of the poorest whose

[1] The Third Millennium Summit aimed at reducing the number of poor in the world by 50% in 2015.

total estimated at 100 million, according to estimated of Microfinance Summit, 1997, is 200 US Dollar and 200 million poorest (according to the estimates of the Objectives of the Third Millennium Summit, 2000, up to 2015), then the world shall need not less than 20 billion US Dollar (40 billion US Dollar according to the estimates of the Objectives of the Third Millennium Summit up to 2015) to pull out the poorest groups from the poverty circle. It is to be noted that funds which were directed towards microfinance world-wide are estimated up till now at about 25 billion US Dollar only. With the increasing number of the poorest group since 1997, this means that microfinance is no longer going along with the increase in the number of poor people. The future estimates indicate that this industry needs not less than 10 times the financed amount (25 billion US Dollar) to cover all the needy people (Deutsche Bank Dec 2007)

The ardent supporters of microfinance have so far failed to present irrefutable scientific evidences that microfinance has accomplished its main objective i.e. eradication of poverty in a regular manner. However, the question which remains is: why has microfinance not accomplished its expected objective up to now? The reason is attributed to several causes, which include the studies conducted so far.

Most of the researches and studies assessing performance of microfinance lacked guidance. They were restricted to supply inside only (way of advancing microfinance, type of rendered services and repayment) and did not cover, with some extent, the side of demand for finance as well as the social impact of finance. The studies and researches of microfinance focused on studying the groups and presented some facts, but did not compare between the financed customers and non-financed ones, and the outcome of finance for those who had been financed compared with the period before finance (outcome before and after finance), and the number of financing rounds needed by customers as to manage without the same, and the other types of questions that need a specialized scientific methodology. The studies and researches in microfinance are up till now of a weak standard and suffer from fewness and weakness of methodologies of scientific research for assessing performance of microfinance or studying the demand side thereof. And despite that the studies which were conducted were in fact quantitative studies, yet they relied upon collecting weak and doubtful and incomplete information and data to conduct limited case study. They did not revert to assess success of these cases from time to time. Yet the results thereof were mixed as some simple arrived at limited success of the performance, some did not arrive at a result confirming that microfinance had treated poverty successfully and some came up with limited results. Those studies did not answer fundamental questions in the passageway microfinance e.g., what is the effect of microfinance? What is the effect of saving projects of microfinance and the sustainability of the granting institutions? What is the return on capital in the microfinance projects? Why many microfinance projects do not grow? How can the poor people face the risks, what are their point of view regarding interest rates or cost of funding?

These studies focused only on one method of granting microfinance (conventional way), and they did not consider the Islamic microfinance as an alternative or complementary to the conventional method, particularly in the Islamic societies world-wide?[2], noting that 44% of those dealing with the conventional microfinance worldwide belong to Islamic countries like Indonesia, Pakistan and Yemen (Microfinance Information eXchange; cited in Karim Nimrah et al, 2008), as ways of conventional microfinance do not meet their requirements. Also about only 2% of the loans under microfinance umbrella were made under Islamic modes of finance during 2006 in Islamic countries like Indonesia and 3% in Syria (UN Program in Alhos Mountain), (Karim Namrah, et al , p.7).

In the light of the practical results and studies we see that microfinance in its totality:

(1) Can not work to solve all problems of poverty in the world and is not suitable for all societies nor for all sections of the poor people. However, if that was possible in some of them, it should not be by one unified mechanism in view of the cultural and social differences in these societies. An example for this is Grameen Experience which proved not to be replicable in other societies.

(2) It started with a mistake when it did not follow the market methodology in respect to determining supply and demand and costs of finance.

(3) It was dominated by the international institutions which give finance at lower interest rates that distorted the local microfinance market, and worked against the efforts of the commercial banks (Muhammad Yunus and Karl Weber, 2007). Perhaps the best institutions which can be successful in such work are commercial banks, because the commercial banks would advance microfinance as part of their profitable activities with some social care which will not considerably reduce the profit objective.

Despite the international accomplishments which were realized during the past period in drawing the attention for the importance of microfinance and creation of commercial sector for it, there are still several issues which should be confronted so that this type of finance can work to meet the huge and increasing demand for same. Perhaps the most important matter in this context would be the principles declared by the Consultative Group to Assist the Poor, which were confirmed by the Summit of the Group of Eight in 2004. These principles can be considered as a matrix of best practices in the field of microfinance because they summarized to a great extent the path of microfinance, and indicated the

[2] According to estimates about 72% of population in Islamic countries with the majority of Muslim countries have no access of formal finance, see, for example, Karim, Nimrah, Michael Tarazi and Xavier Reille, 2008,

main aspects of weaknesses as well as the basic principles upon which microfinance should be founded. These principles can be summarized as follows:

(1) Insufficient donor support.
(2) Weak supervision over the institutions
(3) Weak administrative capabilities and absence of effectiveness of financial institutions
(4) Absence of methods of rural financing (Wikpedia.org/wiki/microfinance)

In respect of the institutions which grant finance, these principles referred to the necessity that:

(1) microfinance should cover its cost
(2) it should build up permanent institutions which are financially and socially transparent and working integrally with the country financial system
(3) The role of government should be limited to helping in establishment of these institutions and not rendering the services, and role of the donors should be complementary in this direction and not competing with them.
(4) focus on the corporate side of the supporting institutions
(5) Interest rates should be rewarding for increasing the supply of loans (Consultative Group to Assist the Poor (CGAP), 2004).

These principles, as I see them (in addition to the need for diversifying the mechanisms of microfinance), are summarizing the most important points of weaknesses which should be taken into consideration for developing the experiment of enhancing its effectiveness and the speed thereof.

3. Why market-oriented Islamic Microfinance model is workable?

In the field of diversification of microfinance mechanisms and treatment of some of its imperfections, we see that it is important to give serious consideration to Islamic Microfinance at a world-wide level. As a result of religious reasons or in view of the weakness of the conventional microfinance in confronting the poverty issues, there were talks for adopting Islamic Microfinance as an alternative. The proposal to expand the base of Islamic Microfinance was not the first one world-wide (Karim, Nimrah, 2008, Abdul Rahim Abdul Rahman, 2006, pp. 38-53, Balake Goud, 2010), and it was not unusual for Islamic finance because the first experiments of Islamic finance in Egypt were in the field of microfinance (Mit Ghamr experiment), which aimed at rural development, treatment of poverty and expanding the saving base. In the other side, the Islamic Development Bank- the biggest Islamic banking institution- has greatly understood this new trend and acceptance of Islamic microfinance as a strategic option in the framework of the development of the Islamic banks. Also the Bank established a fund, for developing microfinance, in the amount of US$ 500 million, and the Consultative Group to

Assist the Poor created a data base on it. And despite acceptance of the conventional microfinance in the Islamic societies till today, its continuation can not be forecasted in view of its conflict with the belief of these societies. Moreover, Islamic microfinance advances benefits not only to this section of the poor, but also to the other non-Islamic microfinance institutions. Following are among its most important advantages

- It amalgamates microfinance into the Islamic finance and builds up social financial institutions which enjoy financial sustainability and transparency and it integrates with the official financial system of the country. It also builds up joint bridges between the Islamic banks and the microfinance sector.

- It considers treatment of poverty as part of its social responsibilities (like social justice and equitable distribution of wealth and incomes) and it applies objectives of the Islamic banks in execution of the principle of becoming a successor over poverty in respect of microfinance whereas it follows the free market system which guarantees sustainability.

- It does not need strong guarantees because the Islamic system places focusing on the operations more than the customer's financial capabilities, as it is the case in the *Musharaka* because this formula of partnership in profit and loss is the best invisible security for microfinance and the customer does not have to pay against risks of loss. And since the Islamic system basically depends upon the principle of partnership then any request by the bank for a guarantee shall be a guarantee against cheating or procrastination in repayment and not to cover the risks of loss. The mostly used guarantee in the Islamic microfinance institutions are personal guarantees of a third party supported by a cheque, guarantee funds, mortgage of movable properties, guarantee funds for loans of the civil society organizations, undertakings of the local community, security of the monthly salary, attachment of savings, mortgage of salaries, incomes and pensions, keep documents in custody, legal undertakings not to dispose of assets etc[3]. The few international Islamic microfinance experiments also confirmed success in utilizing gold as a security which is available, acceptable price wise and successful in encouraging saving and micro-investment of the poor (Ar-Rahnu experiment in Malaysia), (Mohammed, Ali Baharum, 2005)

- The Islamic formulae have no Harmful financial dimensions in cases of loss, and using the formula of *Musharaka* in profit and loss does not require strong guarantee, does not leave the

3 The proposed guarantee is widely used in microfinance in the Sudan with a low risk rate, but the loan amount for which such guarantee is accepted does not exceed 10 thousands Sudanese pounds. In a survey conducted by Abu Kassawi, Mustafa, Jamal El Din et al on microfinance institutions in three states in Sudan, it was founded that lending against personal guarantee is bank branches covered by the survey represents 75% of the volume of microfinance loans in these institutions. Moreover, the percentage of portfolio expose to risk was 30% and (0-17%) if supported by a post dated cheques (Abu Kassawi, Mustafa Gamal El Din et al, 2007).

partner neither shacked by debts, nor obligates him to pay or any other type of entitlement in the case of loss. The partner does not bear the loss alone. In the formula of *Murabaha* if the customer is unable to commit himself to pay the liabilities due from him, he is granted a grace period without any additional charge.

- It avails the best non-material guarantee: All *Musharaka* formulae avail the best non-material guarantee such as sustainability of the project, credit records of the individuals and the tied follow-up by the granting institution.

- According to the nature of the practicing, the Islamic microfinance is less difficult for customers to recover the debts in cases of failure or delay through the other Islamic ways like granting a grace period without any additional financial charges to the customer.

- Islamic microfinance operates via a number of financing formulae which suit the targeted group like *Ijara, Murabaha, Musharaka, and Mudarabah* and others. And Instead of advancing loans to the poor, which can be utilized for another purpose, the Islamic versions dictate buying the assets or the necessary raw materials or enter with the partner in joint transactions. *Musharaka* version is appropriate for financing the fixed ands working capital and the customer can participate in kind. It brings high returns on investment to the bank and the partner. The few international experiences in the field of the Islamic microfinance proved to be successful in utilizing the opportunities of Murabaha (experiment of Islamic microfinance programme in Al-Hodeida, Yemen) and also in utilizing the opportunities of *Musharaka* (experiment of the Sudanese Islamic Bank in financing the productive families).

- The Islamic system includes *Zakat, Wagf, Qard Hassan* and Islamic insurance which can be complementary with (not replacing) the Islamic microfinance in providing other needs like housing and meeting other necessities. It is to be noted that *Al-Sadagat* (alms), *Zakat, Wagf* (endowments) and *Qard Hassan* are resources which are appropriate for microfinance because they do not aim at making profit and they are mechanisms for satisfying the consumption needs i.e. not suitable for establishment of profit making project yet they can be utilized as complementary resources to microfinance.

- Contrary to the conventional microfinance, the targeted group of the Islamic microfinance is men and women (the family) because it aims at improving the standard of living families and not only women as is the case in the conventional microfinance.

- Saving, according to the Islamic way, helps utilizing deposits in a profitable way, hence supports the culture of saving among the poor classes which participate in development.

- The existing Islamic banks enjoy some degree of administrative capabilities and efficiency in granting finance on a profitable and sustainable basis but they need to qualify special cadres to administer and practice activities of microfinance.

- The Islamic microfinance includes the Islamic communities in the non-Islamic countries under the umbrella of Islamic microfinance, hence creating a new international mechanism of microfinance required by these communities.

- Islamic microfinance is suitable for the non-governmental organizations operating in the Islamic countries as finance does not need institutions nor legislations under the Islamic designation. Therefore, its formulae can be utilized in the conventional microfinance without any need for the existence of Islamic banks in the non-Islamic countries[4]. It is noteworthy that the international organizations have successfully applied the basis of Islamic microfinance in a number of Islamic countries.

- The Islamic banks can grant the Islamic microfinance at a lower cost compared with the other microfinance institutions because they operate from the existing branches and therefore they do not need a new professional cadre. Moreover, most of Islamic banks have a surplus liquidity in view of the current non-existence of Islamic fiancé instruments which conform with the market instrument[5].

4. Nature and practices of Islamic Microfinance

During the past decades the integrated Islamic banks and the conventional banks which have Islamic branches have extensively spread out. In 2007 the number of Islamic institutions reached about 300 banks, investment banks, and insurance companies with total assets in the amount of US$ 500 billions (36% thereof in GCC states, 35% in South East Asia and North Africa and 25% in the remaining Asian countries and Africa). The rate of growth of assets of the biggest 100 institutions of them is 27% (The Banker, 2007). Also the conventional branches which apply the Islamic

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[4] To show how Islamic *Musharaka* is used by conventional banks to finance small and medium enterprises see Ibrahim, Badr El Din. 1999.

[5] The study conducted by the author covering liquidity in the Islamic banks in Sudan and the Gulf states investigated whether liquidity is affected by changing the system which is based on interest to a system which based on profit and loss. The study confirmed that the change in the assets and liabilities of the Islamic bank from conventional to Islamic way has no negative effect on the liquidity of these banks. The study attributed this absence of liquidity at the current date to the absence of investment opportunities and the finance via sales formulae on the assets side and to the large share of current account which has no financial obligation to the bank on the labiality side (see Ibrahim, Badr El Din. A., and V. J. Kumar, 2005).

methods in the conventional banks in India, China, Germany, Japan, Switzerland, Luxemburg, UK, USA and Canada have also spread out. This large number of the Islamic institutions has encouraged some of them to enter into the field of microfinance services, yet these services do not measure up with the big number of these institutions. Also during the past years, some of the microfinance institutions started serving the poor in some Islamic countries by offering products which comply with the Islamic principles of finance. These developments led to the appearance of "Islamic Microfinance" with microfinance in one financing institution where the first one offered financial services on the basis of the Islamic faith and the second one entered some of the poor people under the umbrella of the first one.

Microfinance grows at a rate of 15-30% per annum (about 6 billion US$ annually). Therefore, there exist an opportunity for the private Islamic capital to enter, noting that participation of the private capital is continuously increasing and expected to reach about US$ 20 billion in 2015 (Standards & Poors's RatingsDirect, 11 March 2008, p. 2). . According to the results of the survey conducted by the Consultative Group to Assist the Poor, the number of Islamic financial institutions offering microfinance is 120 representing 0.5% only of the total worldwide microfinance institutions currently serving about 389 thousands beneficiaries only. About 80% of the Islamic microfinance institutions are located in three Islamic countries i.e. Indonesia, Bangladesh and Afghanistan, whereas, according to the Survey, demand for it in Algeria, Jordan and Syria reached between 20-41% (Karim, Nimrah, Michael Tarazi and Xavier Reille, 2008).

The Islamic microfinance is still in its early stages worldwide. There is only a few numbers of Islamic microfinance banks and institutions which headed towards microfinance. According to estimates, the Islamic microfinance covers currently about 380 thousands clients only (CGAP, Microfinance Gateway, 2010), whereas the poor Muslims constitute 35% of the total number of Muslims estimated at 1.2 billions (Asia-Pasific Economic Cooperation, 2008). The UNDP estimated that there exist an opportunity for about 7 millions beneficiaries from Islamic finance and about 19 millions savers (Balake Goud, http://www.investhalal.org/articles/articles/IslamicMF.pdf.), which means that there exists a big market for Islamic microfinance and there exists also wider opportunities for such type of microfinance to spread in the Islamic countries but the results are less than expectations.

5. Worldwide Experiences of Islamic Microfinance by Banks

The Islamic banking microfinance is still covering a very limited number of experiments which included the experiments of rural banks in Indonesia and the microfinance banks in Bangladesh. The Islamic banks in Bangladesh adopted Grameen Model and the deferred sale formula i.e. that bank purchases the required commodity and sells same to the customer against a profit margin.

Also Al-Noor Bank in the United Arab Emirates announced the establishment of a company to extend the services of microfinance, insurance, credit cards and transfer of money on behalf of lower income earners in a way which conforms to the Islamic Sharia Law. In Mali, there is a microfinance bank which is financed by GTZ German Technical Cooperation and KFW (German Financial Cooperation), and uses *Musharakah* formula. In Iran, the Central bank obligates the branches to render the microfinance services to the low income earners so as they can meet their consumption requirements, marriage expenses, repayment of loans, repayment of rent, maintenance of houses, medical treatment and educational expenses and purchase of consumer goods through *Quard Hassan*. According to the available data for the year 2008, the number of beneficiaries of these services reached 3 million families (Karim, Nimrah, Michael Tarazi and Xavier Reille, 2008). In Indonesia (microfinance sections in the Islamic banks, Islamic rural banks and Islamic cooperatives) the microfinance uses *Murabaha* and *Musharaka. Ijara, Mudaraba* and *Qard Hassan*.

However, the Sudanese experience is considered the most fortunate and the first of its kind worldwide. It started during the nineties by applying the Financing Polices of the Central Bank of Sudan from 1994/95 which included "Craftsmen, Professionals, and Small Producers, including the Productive Families" among the classes which should have priority in bank financing[6]. These policies had as well specified reference percentages for the contributions of the partners in *Musharaka* formula and also the minimum profit margin for *Murabaha*. They also specified percentages for the financing of this sector that reached 12% of the total portfolio in the last financing policy[7]. The Central Bank of Oman set up a strategy for microfinance and established a microfinance unit inside the Bank for the purpose of improving position of the bank financing of this sector.

The Sudan has taken wide steps in the banking microfinance in all commercial banks through branches thereof, particularly in the rural areas. However, the financing percentage specified by the Central Bank of Sudan is still ambitious since during most of the years as from the end of nineties, the realized percentage of microfinance was less than 2%, and at an annual average of 3.45% during the period 1999-2002 (Ibrahim, Badr El Din and Faris Arbab, 2006). Also some banks like Faisal Islamic Bank and the Sudanese Islamic Bank had founded specialized branches. It was noteworthy that most widely spread experiment of microfinance – Geographically and volume-wise- compared with other banks was the experiment of Saving and Social Development Bank

[6] It is clear that the concept of microfinance in Sudan is very wide which includes (as stated in the financing policies) all small size sectors. Banks target one or all of these groups as groups including poor people, or target sectors without targeting the poor as the case of microfinance.

[7] To know the details of microfinance policies of the Bank of Sudan for the years up to 2006, see Ibrahim, Badr El Din A. and Faris Arbab, 2006).

where the average microfinance percentage during the period 1997-2000 reached about 14.2% (does not include financing of Social Development at an average of 8.1% during the same period). This means that the average of the two percentages reached 20.3 compared of the average percentage of microfinance which did not exceed 2% in other commercial banks (Ibrahim, Badr El Din and Faris Arbab, 2006).

Among the other successful experiments is the experiment of the Sudanese Islamic Bank in the nineties in the field of "Productive Families" which progressed in great strides in emphasizing the financing by the Islamic Bank to the minimum lower percentage of the poor (Ibrahim, Badr El Din , 2004). These branches of financing the productive families were opened in geographical areas to attract bank deposits from individuals and establishments situated there and then re-invest same basically by way of Musharaka formula (and other formulae like *Murabaha* and *Mudaraba*) in small units' family projects. Those branches were characterized by low administrative costs in those areas. The main concepts behind these branches was to avail microfinance at the level of the geographical area only and for the part of the targeted group who have skills for carrying out small size production or service oriented business inside or outside their houses. Users of this finance are not necessary required to contribute money but only their efforts, administration or their business or depreciation of equipment. This experienced achieved some success by the target groups whose incomes were reasonably enhanced and it had also brought some projects to the bank. Despite also considerably increased compared to the size of the bank branches. However, the experiment was cancelled when the top management of the bank was changed.

The forgoing survey gives a general glimpse of this activity. The most important thing in these initial experiments in Islamic microfinance is that they set up a methodology for Islamic microfinance which suits the nature of Islamic society. Despite of the acceptance of microfinance experiments, same has not progressed in the way which serves the targeted group; therefore there is still a lot to be done in this direction.

The highly cited success story of a large-scale Islamic banking microfinance experiences is Bank Rakyat Indonesia (BRI). To this we now turn.

5.1. Bank Rakyat Indonesia

Bank Rakyat Indonesia (BRI), (People's Bank of Indonesia), was founded in 1895 during the Dutch colonial period to serve small and medium enterprises. After the Indonesian declaration of independence, on 17 August 1945 the bank was officially nationalised and then re-named "B Bank Rakyat Indonesia (BRI). In 1970s BRI Units were established, and in 1984 the bank was redesigned into fully commercialized microfinance banking, with all Units moved from supply to demand driven to cater for microfinance clients' needs.

In 2003, BRI went public, and as of 2010 it is 70% government owned operating company. BRI is now the second largest bank in Indonesia by asset, with most extensive branch network, serving approximately 30 million retail clients through an extensive network of more than 4,000 retail outlets at the sub-district level, known as BRI village units (Unit Desa). BRI has the widest network in Indonesia with 13 Regional Offices, 324 Domestic Branches, 4,049 BRI Units (96% of which are profitable), 148 Sub-Branch Offices and 240 Village Service Posts. BRI has now irakyat.com.my internet banking and more than 500 automated teller machines (*http://www.facebook.com/pages/Bank-Rakyat-Indonesia/105591639473717;* and http://dbpedia.org/page/Bank_Rakyat_Indonesia*). By 2010 there are 7000 units (including regional offices, branch offices, sub-branch offices, cash offices and BRI Units), as well as over 3000 employees.*

Unit Desas operate on a full and semiautonomous commercial basis. It also has a comparatively small, but growing, corporate business. Each BRI unit is functioning as individual profit centers, their performance is monitored and specific staff incentives implemented. In addition, the Units are allowed to move their excess funds to BRI branches, where they are well remunerated, encouraging saving mobilization in Units. This allowed the Units to increase the number of loans and to be more sustainable (Robinson Marguerite S, 2002. see also Charitonenko Stephanie, Afwan (Ismah), 2003, BRI Annual Report 2003, and BRI website www.bri.co.id, and http://www.bwtp.org/arcm/indonesia/II_Organisations/MF_Providers/BRI.htm).

The BRI offers loans, deposits and voluntary (current and time) products, money transfer services, utilities bills, as well as training and consulting services (*http://www.facebook.com/pages/Bank-Rakyat-Indonesia/105591639473717).*

*C*carefully selected, the borrowers are given loans whose amount depends on the borrower's current income flow and always require some form of collateral (land, furniture, motorcycle, etc.). The minimum amount of loan is Rp.25,000 (approx. US$3), and the maximum is Rp.50,000,000 (approx. US$5,000). The minimum loan term period is one month and the maximum is 24 months for working capital loans or 36 months for investment loans. Loans can be repaid in monthly, quarterly or bi-annually instalments. The interest rate increased by 0.5% if the repayment is not made on time. The repayment rate is very high: 98.34%.

The following is a financial summary of the some selected basic indicators of BRI (in Billions Indonesian Rupiah –IDR- or Rp.)

Years	2003	2004	2005	2006	2007	2010
Profit Before Tax and Zakat	0.41	0.46	0.54	0.63	0.83	1.72
Assets	16.1	21.2	24.0	27.5	35.0	61.9
Deposits	13.1	17.1	19.6	22.7	27.3	Na
Financing	9.0	11.4	16.0	19.0	23.0	Na
Percentage Return on Average Shareholders Fund	17.98	15.24	15.04	17.19	21.82	Na
Non-Performing Financial Ratio (%)	3.33	-	-	2.75	2.37	Na

Source:
Figures are in Rp. Billions ($1= approx. 9028 Rp, as of February, 2012).

The expansion parameters (assets, deposits) as well as profit parameters (Profit before tax, return on shareholders funds) are on move since 2003, whereas non-performing financial ratios are declining overtime, and below the target of 5% set by the Central Bank of Indonesia. These indicators show the success of BRI.

5.2. Anatomy of Success of Bank Rakyat Indonesia (BRI)

The major features of the experience of Bank Rakyat Indonesia (BRI) is clients' saving, charging market interest, clients' honoring of obligations and repayments of loans. The lessons of success are mostly related to scattered small units (outreach), the saving components, no subsidy or funds from government, effective leadership, strong commitment and political support. The relative success of Bank Rakyat Indonesia (BRI) is partly related to the incorporation of many of the best practices and lessons learnt from conventional microfinance movements from across the globe. This experience clearly tells a lesson that large scale, market-led Islamic banking microfinance is possible, if certain conditions are met, and can have a positive impact on the lives of millions of people. The success story is not unrelated to the following:

- Efficiency and productivity have been key operating principles in the BRI Unit system. Any Unit system functions as an independent profit center, with no intervention from the headquarter. This independence and market-oriented characteristics have formed the basis for transparency in reporting, accountability, and efficiency in the use of resources.

- Technology and Human building/training rewarding and punishment systems.

- Effective leadership, strong commitment, and political support were crucial factors not only at the initial reform stage but also throughout the development process of the BRI Unit system.

- Much of its success may be attributed to the organizational set-up of the single BRI Unit as a highly decentralized and semi-autonomous financial entity. The BRI Unit is commonly found in a central location of the sub-district town, often near the market place. It typically rents a one room office in order to keep overhead costs low. A Unit covers about 16–18 villages at the sub-district, and currently serves an average of 10,000 savers and a little over 1,000 borrowers. The individual Unit was purposely kept small, by limiting the number of staff and focusing its operations (Klaus, Maurer, 2004).

- External factors played an important role for the initial reform. The oil price collapse in 1983 and the decline in oil revenues forced the government to impose austerity on budgetary expenses and subsidies. Economic pressures made politicians adopt a commercial approach to rural microfinance. During the scaling-up period, stable macro-economic conditions and a series of financial sector reforms provided a conducive environment in which the new unit systems could develop and prosper. A decade later, the BRI Unit system was stable and robust enough to weather the severe economic crisis.

- External assistance was crucial, especially in the early years. Technical assistance was provided by the Harvard Advisory Group, partially funded by the World Bank and USAID. Together with local bankers, the experts developed the initial design and principles of the new BRI Unit system. Financial resources were only required in the very beginning. With the know-how and the systems in place, the BRI Units were soon able to generate their own resources locally. A World Bank loan of US $97 million for KUPEDES on lending was disbursed in 1990, at a time when, strictly speaking, the BRI Unit system no longer needed outside funds.

6. Non-banking Islamic microfinance

Thinking about the non-banking Islamic microfinance started during the last years[8] and the first experiences in the non-banking Islamic microfinance to finance individuals and groups were reserved, weak and not continuous as they were isolated and dependent upon the mechanism of interest free loan by way of payments arranged between the two parties (experiment of Yayasan Tekun, Malaysia) to finance targeted poor Muslims who needed capital to start their small projects but they had no previous experience. Also this finance was amalgamated with Zakat to cover defaults of repayment and the group guarantee was utilized just like Grameen experience. Also

[8] The non-Islamic microfinance institutions include the local and international non-profit making governmental organizations, saving and lending societies, in addition to the governmental funds and international donors to rural development projects which avail rural financing.

Murabaha formula was used (microfinance experiment in Al-Hodeida, Yemen 1997) and *Mudaraba* formula by way of weekly distribution of profits and bearing by the supporting institution of any loss which may result from default whereas it can terminate the contract concluded with the partner in case of excessive loss. In the case of realizing profits the benefiting party purchases the shares of the small project whereas the financing institution is content with the principal of the loan and the weekly payments. This system encourages non-repayment; leads to manipulation cases and hiding the real profits in the absence of close follow up by the lending party. In Sudan, a large number of social programmers of NGOs (local and foreign), local community organizations, social government funds and rural development projects, advanced loans to small income generating projects as well as loans in emergency, medical treatment, educational and service cases, all under the Islamic formulae, particularly *Murabaha, Musharaka and Mudaraba*. There are no data on these parties but they were estimated to be at 100 governmental and foreign organizations[9]. This experience is particularly distinguished by its diversity one side and diversity of the targeted groups on the other side. These organizations grant fiancé to the refugees and the displaced people in the urban areas whereas the social funds finance to the poor persons, the old age persons with limited incomes, the graduates and pensioners. Yet the rural development projects which are financed by foreign bodies are targeting the rural communities which suffered from conflicts, drought, and natural disasters in order to strengthen productivity and enhance incomes (Unicons, 2006). In the Iranian experience of the interest free loan, some individuals of the society lodge funds in saving and financing institutions which utilize some in small projects. These funds also accept current and saving deposits like banks as these deposits can be withdrawn at any time. The interest free loans fund are utilized in advancing loans for marriage, medical treatment and housing purposes after satisfying certain conditions the most important of which is ability to repay the loan during one to two years and a guarantor should be there.

Experiment of Al-Hos Mountain in Syria adopted *Musharakah and Murabaha* formulae. And the experience of Moasat Bail Al-Mal in Lebanon relied upon volunteers for collecting the repayment of the amount which were financed by way of *Qard Hassan* and *Musharaka* formulae. Mowasat Bait al-Mal ahs good relations with the targeted group, has a net work of financiers and the repayment ratio is high in view of the assets security and the personal and bank guarantees. Afghanistan experience adopted *Quard Hassan* plus service fees payable in advance and relied upon the group guarantee. Also in Afghanistan experience of thee Foundation for International Community Assistance used *Murabaha* formula. There were also other experiments in Thailand, Azerbaijan, and Brunei. Philippines, Kazakhstan. The West Bank, Bangladesh, Indonesia (Islamic cooperatives) and

[9] For more information on microfinance in the social programs, NGOs and social funds see Ibrahim, Badr El Din A. and Faris Arbab, 2006), and Unicons, 2006).

Egypt. Despite the spread of these non-banking financing institutions, they did not cover the targeted poor people in the extensive way.

Akhuwat is an NGO microfinance experience in Pakistan. Akhuwat derives its name from 'mwakhaat' or brotherhood, the earliest example of which was seen in the fraternity formed by the Ansars (citizens of Medina) and the Muhajireen (or Meccans) who had migrated to Medina to escape religious persecution. Inspired by the spirit which induced the Medinites to share half of their wealth with the migrants, Akhuwat seeks to invoke this very concept of brotherhood through its operations. The idea of Akhuwat was made to correct the exorbitant interest rates on microfinance programs aimed at poverty alleviation. Akhuwat's running costs, and all of its funds come from voluntary donations. By 2003 donations to Akhuwat had reached rupees 1.5 million with the loan recovery rate remaining a steadfast 100%. With the passage of time Akhuwat's branches speaded, loan products were diversified, the clientele was expanded and the message of Akhuwat began to rapidly spread. The movement was being spearheaded by the generosity of the Civil Society as Akhuwat's reliance on philanthropy entailed tapping into the spirit of giving and volunteerism in the society. This experience marked the beginning of a new chapter in microfinance, one that found its inspiration not in economic logic but in the spirit of compassion and generosity of mankind.

Akhuwat provides interest free loans to the economically poor so that they may acquire a sustainable livelihood. It is a derivate of the practice of Qard-e-Hassan, an interest free loan offered to those in need. The Qard–e-Hassan is not as grand in terms of size and stature as Grameen Bank or Bank Rakyat Indonesia. In keeping with the principles of equity and social justice, burdening the poor with exorbitant interest rates is also viewed as undermining the overarching goal of poverty alleviation. http://www.akhuwat.org.pk/Microfinancewithadifference.asp. The total benefiting families up to 2011 were 121, 000, in 69 branches. 69% of clients are males. The formula is Qard Hassan. Application fees are RS. 100, and the insurance fees are 1% of the loan amount. The recovery is almost 99% (http://www.akhuwat.org.pk/progress_report.asp. The bank does adopt some interesting microfinance principles, like focusing on individuals/households and self help groups rather than solidarity lending groups. The Akhuwat Model institutionalizes the use of local religious places, for example mosques and churches, as centers for loan disbursements and avenues for community participation. No doubt the use of the vast existing infrastructure of religious places allows Akhuwat to minimize operational costs, have extensive outreach and function efficiently. This use also increases transparency and accountability, awareness and publicity of Akhuwat's campaign and the creation of a sense of good will amongst the community. (http://www.akhuwat.org.pk/Microfinancewithadifference.asp

Borrowers of Akhuwat provide two individual guarantors who vouch for his/her credentials and accept the responsibility of monitoring the borrower and give assurance to persuade the borrower for timely payment of loan. One of the two guarantors may be from the same family. Credit disbursement takes place 2-3 times a month and 100-150 loans are disbursed at one event usually held at branch office/mosque or church. Every borrower has to be accompanied by one of the guarantors. Other people present at the time of disbursement include community members, Akhuwat staff, from the branch and Head office. Social Guidance events are also held simultaneously in which the capacity of loanees is built to carry on their work more efficiently and effectively. They are also apprised of social agenda that includes: emphasis on girl's education, serving the community, protection of the environment and plantation, observance of traffic riules and local laws and following ethical business values.

The difference between Bank Rakyat Indonesia (BRI) and Akhuwat Bank, Pakistan is the outreach of the second is not as much as the second. Moreover, while the first depends on deposits and imposes market rate the second (like many other Islamic microfinance experiences) depends on donations and grant loans on an interest free –base system. Moreover, in the absence of interest rates and minimal registration fee of Akhuwat Bank (only 100/ 1.14 USD, in 2011) operation costs were kept very low. Extreme simplicity in operational activities, plain offices, use of religious places, high levels of volunteerism in the workforce ensured that Akhuwat realized its aim of minimal operational costs. To complement the efficient operational strategies of the organization, four core principles were identified; interest free loans, use of religious places, spirit of volunteerism and transforming borrowers into donors. These principles in time became the defining features of the Akhuwat Model. http://www.akhuwat.org.pk/lending_methodology.asp). Although the reasonable outreach of Akhuwat Bank is because of the less cost of using local religious places. Nevertheless, this model, cannot survive in the future if it is not turn to be market-oriented.

7. Challenges of the Islamic Microfinance.

Despite the huge demand for the Islamic microfinance, the banks and financial institutions which apply the Islamic formulae are still slow in meeting it. Most of the Muslims are also staying at the base of the pyramid of the group which is not accessing the conventional financing. The past experience in the making of this type of finance can only be considered as isolated trials, mostly in a wrong direction and short-lived. Therefore, the Islamic microfinance industry should prove that it is capable of extending finance bridges to the poor on sustainable and largely-based levels. As explained above there exist many opportunities for this type of finance, but there are as well challenges that require the following:

- Support by the governmental regulatory framework which plays a fundamental role in determining the future of the Islamic microfinance. The regulatory framework of the Islamic banks took several dimensions to include all the banking system as is the case in Sudan, whereas there exists a regulatory framework for both of Islamic banks and the conventional banks as in Brunei, Pakistan, Malaysia and Indonesia. In other countries (like Arab Gulf Cooperation, AGCC states), despite the rise of Islamic banks and conversion of some conventional banks into Islamic banks, yet there does not exist a special regulatory framework which is separate from the conventional banks. In the side of the Islamic microfinance, some Islamic countries enacted regulatory laws supporting microfinance i.e. in Pakistan, Sudan, and Indonesia. The Central Bank of Pakistan drew up in 2007 regulations and indicators for establishing microfinance banks and encouraging the offering of this type of finance with the aim of setting up integrated banks form Islamic microfinance and allowing Islamic banks to start Islamic microfinance windows and the conventional banks were allowed to establish branches to operate on an Islamic basis. Thailand is also studying the official introduction of Islamic microfinance and selection of the appropriate form for the Muslim community in Thailand, which estimated to be about 2 million, and which suit their way of living and religious beliefs.

- Supporting the current efforts of the Mix Market Database on microfinance through and coordinate with it and providing it with data on the Islamic microfinance from all countries which practice this type of finance. [10]

- Granting encouraging incentives initially to the Islamic banks so that they adopt the Islamic microfinance and start forming a financing fund which includes all the banks that work towards realizing this purpose, noting that most of the top officials in the Islamic banks consider microfinance to lie outside the framework of functions of their institutions, hence they lack the enthusiasm for participating or adopting microfinance activities[11]

- Creation of a sustainable model for the Islamic microfinance, or a number of conditions drawn from the institutions which follow good practices. This should be based upon the operational effectiveness, how to face the risks of default, how to find a formula for fieldwork and follow up of borrowers to ensure good performance of the projects and

[10] There are international data bases for microfinance the most important of which is Mix Market Database (contains more that 1300 microfinance institutions) and Micro Banking Database (contains more than 350 microfinance institutions and also Micro Summit Database (which includes more than 2000 microfinance institutions (see www.mixmarket.or; www.mixmbb.org/en/index.htm: www.microcreditsummit.org

[11] This information is part of the result of the study conducted by Abu Kassawi, Mustafa Gamal El Din et al, 2007 (See Abu Kassawi, Mustafa Gamal El Din et al, 2007, p. 23).

repayment either by way of training the employees or authorizing another specialized entity (which is close to the targeted group) to carry out this work against a pecuniary compensation, and studying experiment of group financing in some Islamic communities, just like Grameen experiment through using *Musharaka* and *Mudaraba* formulae.

- Expanding the use of technology services in microfinance: The Islamic banking system commenced diversifying its client's base by entering the poor people into the financing system. Also expanding the fields of its services which have now started to be applied like smart cards, mobile banking branches, mobile telephones and even utilizing the internet in advancing electronic small size loans.

- Ensuring the transparency of the Islamic microfinance institutions: Through finding and applying international indices in the financial reports of the Islamic microfinance institutions in respect of the accounting aspects. Pricing of services, and financial auditing works. We also suggest funding international base for rating the Islamic and conventional microfinance institutions in order to measure performance and encourage competition which is founded upon effectiveness in granting this type of finance. We see that each country, in which there exist Islamic microfinance institutions, should start testing local assessment and rating basis.

- Broadening the products and guarantees basis (according to the nature and culture of the benefiting communities) and the financing formulae (as to quantity, type and conformity with the nature of the communities) beyond the formulae of *Murabaha* and *Qard Hassan* which presently dominate the Islamic microfinance. Also advancing loans of progressive amounts according to performance of the clients (gradual increase in the loan amount according to performance) provided that the number of times in which the client should be financed should be fixed and this should be regarded as one of the most important measures of the success of the microfinance institutions in their clients coming out of the poverty borders.

- Building up a strong base for the Islamic microfinance based upon the best current international experience and practices in the banking industry in the field of microfinance. And also creating cadres which are qualified to work in the field of Islamic microfinance and to conduct distinguished researches for advancement of this type of finance.

- Introduction of saving (voluntary and obligatory) and other services like housing for the target group. In addition to finance.

- Bringing the international NGOs in the system of Islamic microfinance in a more extensive way and training the employees of these organizations in the practical fields related to the practical and theoretical aspects of the best international practices and basis of microfinance.

8. Conclusion.

The Islamic microfinance witnessed few achievements, yet its spread is very week. The experiments in the Islamic microfinance, except the limited banking experiments, were based on a number of models and mechanisms and were not integrated into the financial system as same are undergoing the trials phase, being set up by donors or religious groups and have yet to develop like their conventional counterparts particularly in volume and type. Like their conventional counterparts, the Islamic microfinance experiment used the formulae of *Qard Hassan*, *Murabaha* and *Musharaka* as the main mechanisms as well as the group guarantees and focused on women. And though the programmes of the Islamic microfinance could use funds of *Sadagat, Wagf,* and *Zakat* but most of the development of the Islamic microfinance programmes have till to date been financed through donors and government resources. This gave the impression that the Islamic microfinance should be carried only outside the banking system.

Perhaps from the forgoing analysis, with the exception of Bank Rakyat Indonesia (BRI), all other banking and non-banking microfinance experiences have limited outreach, and perhaps not sustainable. The BRI experience is a success story and a learning ground for microfinance parishioners. Moreover, this success of BRI cannot be isolated from the sharp differences in practices compared with other experiences on Islamic microfinance. Most of its practices are described as best practices, and some features are unique to this experience. Its major lesson is a sustainable (with no subsidy or funds from government or donors). The major reasons for successes identified in 5.2 above can be a guideline for the best practices of Islamic microfinance.

Some experts believe that a "sustainable application *(of shariah-compliant partnership finance)* to microfinance is difficult on a large scale, if not impossible". (Harper, Malcolm, 2011; emphasis added). I strongly believe that the application of *shariah*-compliant partnership has not gone far enough to detect and to solve the constraints. There are always problems with any new system. A refined system would probably require more time and extensive theoretical and practical efforts. I really appreciate that the Islamic banking has done something on this line, based on conventional partnership. But unfortunately the share of 'partnership' in microfinance is low compared to the share of sales-based formulae, mainly because it is easier and more profitable.

The past experiences on Islamic microfinance can only be considered as isolated trials in the making of this type of finance. I still believe that there exist many opportunities for the application of this type of finance to be on a large-scale. But, this should be on the basis of the successes governed Bank Rakyat Indonesia (BRI). These includes scattered, independent and accountable small units (outreach), inclusion of saving components, avoidance of subsides and funds from government, effective leadership, strong commitment and political support, and the incorporation of many of the best practices. Moreover, it is not enough to apply these best practices of Bank Rakyat Indonesia (BRI). There are also other challenges that require support by the governmental regulatory framework, expanding the use of technology services in microfinance, broadening the products and guarantees basis, and ensuring transparency.

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