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Islamic Microfinance: Challenges and Development

Nur Indah Riwajanti
State Polytechnic of Malang
nurindah12@gmail.com

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Abstrak

Studi ini bertujuan untuk mengetahui tantangan dan perkembangan keuangan mikro Islam berdasarkan studi literatur dengan pendekatan tematik. Tantangan yang dihadapi oleh lembaga perbankan dan keuangan Islam bervariasi dipengaruhi oleh ukuran organisasi dan gaya operasinya. Oleh karena itu, lembaga keuangan mikro syariah sebagai lembaga yang berukuran kecil, nampaknya menghadapi tantangan yang berbeda. Hasil penelitian menunjukkan bahwa tantangan yang dihadapi oleh keuangan mikro syariah meliputi isu-isu menyangkut kesesuaian dengan syariah, kurangnya diversifikasi produk, kekurangan dana, kekurangan pelatihan dan jaringan, kekurangan dukungan dalam bentuk peraturan dan strategi lembaga keuangan mikro, kurangnya wilayah cakupan karena lembaga keuangan mikro sangat berkonsentrasi hanya pada beberapa negara di Asia Selatan, dll. Namun di samping menghadapi tantangan tersebut, lembaga keuangan mikro syariah sudah berkembang di beberapa negara dengan memberikan beberapa alternatif pembiayaan didorong oleh potensi permintaan pasar Muslim dan non-Muslim, misalnya Tepi Barat, Gaza, Yordania, Algeria, Yaman dan Syria. Di belahan dunia lain, keuangan mikro Islam juga sudah menunjukkan perkembangan yang menjanjikan.

Keywords:
Islamic microfinance
Shari'ah
Challenges
Development

Abstract

The purpose of this study are to explore the challenges and development of Islamic microfinance worldwide based on literature survey using thematic approach. The challenges faced by Islamic banking institutions varied by size of organisation and nature of operation. As such, Islamic microfinance, being a small institutions providing micro financing, might face the different challenges. The findings suggest that Islamic microfinance face problems and challenges in terms of *Shari'ah* compliant issues, lack of products diversification, lack of fund, lack of training and networking, lack of supportive regulation and microfinance strategies, lack of wider outreach as Islamic microfinance mostly concentrated only in some countries. However, despite the above challenges, Islamic microfinance has been grown in some countries providing alternative financing driven by potential demand from both Muslims and non-Muslim market, eg. West Bank, Gaza, Jordan, Algeria, Yemen and Syria. In other parts of the world, Islamic microfinance also has shown promising growth.

1. Introduction

Currently, Islamic microfinance has been one of the Islamic banking forms which gain wider recognition due to its emphasize on provision of wider access for the poor and its role poverty alleviation. In its operation, Islamic Microfinance is characterised by Islamic values set out in the Quran and *hadiths* (the prophet's saying). Islam prefers community-based activities (QS. 5:2), a value also featured in flourishing microfinance institutions which operate under a group-based approach and joint liability. Thus, it can be argued that the above characteristics seem to be able to cover almost all aspects required by the poor.

Models applied in Islamic microfinance include the innovated *Shari'ah*-compliant Grameen model, village banks, credit unions and self-help groups. In addition, the character of Islamic microfinance might include: credit appraisal is conducted carefully with empathy and aims to provide clients with the best services, and commitment of board management to offer capacity-building programmes and technical assistance. (Obaidullah, 2008b: 14-17; Obaidullah and Khan, 2008c: 17).

The role of microfinance in fulfilling social and development requirements is essential. Asutay (2009) argues that, as part of the whole financial system, Islamic Banking and Finance (IBF) has a unique character and it should apply the Islamic values contained in the Islamic Moral Economy (IME). The intention of the IBF should be more focused to achieve both economic and social objectives, and these social objectives cannot be separated from IBF due to its obligation to implement the IME, to achieve "human-centered economic development" (Asutay, 2009). On the other hand, the criticism that IBF is operating similarly to conventional banking and failing to realise its social responsibility cannot be ignored (Asutay, 2009).

However, as the objective function of micro-finance - to act as a development tool through capacity-building - is aligned with Islamic values, Asutay (2009) suggests that the most suitable method of implementing IME in IBF is by conducting social banking and Islamic microfinance (IMF). Therefore, it can be said that IMF has become a fundamental part of IME and IBF due to its ability to implement the values of IME in reality, hence bringing the idea of development into existence

Based on Islamic perspective, conventional microfinance has been criticised because it is likely to charge its clients high interest rates (Asutay, 2009) and considered to be *riba*[1], which clearly not allowed based on the Islamic law; this is known as the debt-based approach, as they are dragged into debt. Islam, hence, offers a more human and moral approach through a profit and loss-sharing approach in the form of *musharakah*[2], and *mudarabah*[3], modes of financing (Asutay, 2009). This is an assets-based approach as opposed to a debt-based approach, which seems more appropriate for the needs of microenterprises, since their profits from their businesses can be hard to predict.

Considering the specific character of Islamic Microfinance with its potential and the limited literature discussing the challenges and development of Islamic Microfinance, this paper aims to discuss the issues and development of Islamic Microfinance by applying thematic approach across available literatures.

2. Discussion

2.1 Problems and Challenges of Islamic Microfinance

Microfinance, which aims mainly to assist the poor to improve their socio-economic welfare, particularly by providing access to micro financing, has

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[1]*Riba*: Literally, it means increase or addition or growth. Technically it refers to the 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or an extension in its maturity. Interest as commonly known today is regarded by apredominant majority of fuqaha to be equivalent to riba.

[2]*Musharakah*: Partnership. A *musharakah*contract is similar to a *mudaraba*contract, the difference being that in the former both thepartners participate in the management and the provision ofcapital, and share in the profit and loss. Profits are distributed between the partners in accordance with the ratios initially set, whereas loss is distributed in proportionmto each one's share in the capital.

[3]*Mudarabah*: A contract between two parties, capital owner(s) or financiers (called *rabb al-mal*) and an investment manager (called *mudarib*). Profit is distributed between the two parties in accordance with the ratio upon which they agree at the time of the contract. Financial loss is borne only by the financier(s). The entrepreneur's loss lies in not getting any reward for his services.

been operating for more than 40 years since the failure of government-subsidised financing programs. The core challenges in their daily operations range from improving the quality of services, achieving a wider and deeper outreach, and reducing operational costs. Currently, microfinance is growing at around 20%-40% and is predicted to continue to grow strongly. Many researchers who have noted the contribution of microfinance suggest that microfinance plays an important role in economic development.

Generally, as their conventional counterpart, Islamic microfinance also faces problems and challenges in its operations. In this issue, Obaidullah and Khan (2008c) discuss in detail the challenges of Islamic microfinance on three levels: micro, meso and macro levels. Each level refers to certain category of institution. At the micro level, it directly touches upon the IMF providers, such as NGOs, Islamic Cooperatives, association etc, particularly in Indonesian's context it covers BPRS and BMT. Further, at the meso level, it particularly applies to the association or Apex organisation of the IMF in the micro level above, such as Puskopsyah (Pusat Koperasi Syariah), BMT Indonesia, Asbisindo (Asosiasi Bank Syariah Indonesia). The macro level relates to the government as regulator and supervisory body responsible to assist all IMFIs, particularly the Ministry of Cooperative and Small Medium Enterprises, OJK (Otoritas Jasa Keuangan/Financial Service Authority).

At the micro level, the challenges include the following:

(i) the diversity of organisational structure (ranging from NGOs, Islamic cooperatives, societies, trusts, foundations, associations *etc*.) making it difficult to register for legal status (Obaidullah and Khan, 2008c: 30);
(ii) *shari'ah* compliance issues are raised as none of the Islamic MFIs have set up Shari'ah Supervisory Boards; there are also *fiqhi* issues due to the influence of local culture in the judgement of *Shari'ah*-compliant products; and clients' perceptions of financing products are diverse (Obaidullah and Khan, 2008c: 31);
(iii) lack of product diversification as most financing is based on *murabahah* (Obaidullah and Khan, 2008c: 33);
(iv) weak linkages with commercial banks (both Islamic and conventional) and capital markets and lack of interest in microfinance due to the absence of guarantee systems (Obaidullah and Khan, 2008c. 33-34).

The challenges at the meso level, include the following (Obaidullah and Khan, 2008c. 42-43):

(i) lack of electronic payment system to enable safe, efficient and reliable payments among Islamic MFIs or their conventional counterparts;
(ii) lack of transparency of financial performance and information infrastructure;
(iii) lack of education and training is likely to become the main challenge; hence, resource centres should be developed to deliver training programmes;
(iv) lack of networking.

Obaidullah and Khan (2008c: 47) believe that the best role for the government in Islamic microfinance development at the macro level, is to build policies and regulations that might contribute to the growing number of competitive and diverse financial service providers. However, only three IDB member countries (Bangladesh, Jordan and Uganda) have developed the required microfinance strategies. An important part of the policy is to set up banking regulations and supervision that encourage microfinance providers to become feasible institutions; IDB requires two sets of laws, one for MFIs and one for Islamic Financial Institutions. Only Pakistan currently satisfies this requirement (Obaidullah and Khan, 2008c: 48).

Particularly in Bangladesh, similar to the above points, Ahmed (2002: 55-57), points out that the problems of Islamic MFIs are as follows:

(i) the Islamic mode of financing is not fully applied due to "lack of personnel, physical barriers, difficulty in accessing financial flows and other problems including lack of vehicles";
(ii) lack of funds because public deposits cannot be cached and there are other constraints on obtaining external funds, resulting in low benefits for employees; Islamic MFIs should consider seeking alternative funds from charities (*waqf*[4]);
(iii) lack of training in social development programmes, particularly in Islamic views.

Further, Ahmed (2012: 24) underlines that the problems of Islamic MFIs are quite similar to their conventional counterparts, particularly financing risks and dubious economic viability due to high operational

[4]*Waqf*: Appropriation or tying up a property in perpetuity for specific purposes. No property rights can be exercised over the corpus. Only the usufruct is applied towards the objectives (usually charitable) of the *waqf.*

costs. Thus, they turn to the same solution: credit risks are resolved through group financing involving social collateral and weekly repayments; meanwhile economic viability problems are mitigated by obtaining funds from external resources. Although governments offer funds to support Islamic MFIs, the terms and conditions imposed to gain access to the funds do not suit the character of Islamic MFIs, such as fixed interest/return charges for the government funds (Ahmed, 2012: 24). The economic viability, which is mostly related to lack of funds, seems to be a major problem that has further implications, such as lowering the Islamic MFIs' ability to provide reasonable salaries for employees, attract high-quality staff, conduct supervision, and hire a rea-sonable number of field workers, which affects the ratio of borrowers to staff, *etc*.

Generally, Islamic MFIs also face moral hazard problems, in which the action of a party contradicted to the contract agreement lead to financing risk, such as misused of fund by the customers, bad debts and fraud *etc*. However, as their products have Islamic characteristics, Islamic MFIs provide goods/assets instead of cash (such as *murabahah*[5], financing), which could eliminate moral hazards, as goods/assets tend to be used for productive purposes as intended in financing applications (Ahmed, 2012: 24).

Focusing more specifically on operational measurement, Ibrahim (2012: 99) points out that the challenges might include higher transaction costs, higher operational costs, less product diversity as more than 70% are *murabahah*, lower return on assets (ROA) and high portfolio risk ratio; all these problems are likely to be rooted in the business model of charities and grants as fund sources. There will probably be an urgent need to consider product diversification, shifting from the heavy application of *murabahah* financing, as the Consultative Group to Assist the Poor (CGAP) survey reports that murabahah accounts for over 70% of the products, to other products required by the clients, such as savings and housing products (Karim, et al., 2008: 12).

It is argued that there are two fundamental reasons for the lack of Profit and Loss Sharing (PLS) mode of financing, namely internal factors (lack of understanding and quality of human resources) and lack of regulatory support (Ascarya and Yumanita, 2006). In further discussion of the effect of heavy application of *murabahah*, Sultan (2012: 52) argues that widely applied *murabahah* contracts in Islamic MFIs are likely to contribute to debt creation, a situation that should be avoided in the Islamic perspective. Therefore, equity-based financing seems to a better solution to this problem (Sultan, 2012). Two other noted problems are lack of product innovation and lack of product development.

2.2 Outreach and Sustainability: A Challenge to Overcome

It is agreed commonly that there is a potential global demand for Islamic microfinance, particularly from those who cannot accept financing products that do not comply with Islamic values. However, currently 80% of Islamic microfinance clients are concentrated in Bangladesh, Indonesia and Pakistan, and the total outreach of global Islamic microfinance is very small, at around only 1% of the total microfinance outreach (Karim, et al., 2008: 7). The CGAP survey (2007) reports that the largest Islamic MFI in Bangladesh reaches only 100,000 active borrowers, which is considered a small number compared to conventional counterparts that can reach 22 million active borrowers (Khaled, 2011). Islamic microfinance in the Arab world faces the same situation (Khaled, 2011). This raises a question: why, in general, has Islamic microfinance lagged behind its conventional counterpart, in terms of total number of institutions, total amount of assets and total amount of financing? CGAP Focus Note in 2008 reported that:

> "Although there is ample evidence of demand for Islamic microfinance products, this demand can only be met if low income clients are convinced that the products offered are authentically Islamic. Critics of Islamic finance products suggest that the pricing of some products offered as *Sharia*-compliant too closely parallels (or even exceeds) the pricing of conventional products. For example, some institutions offering *Murabaha* seem to disguise interest as a cost markup or

[5] *Murabahah*: Sale at a specified profit margin. The term, however, is nowused to refer to a sale agreement whereby the sellerpurchases the goods desired by the buyer and sells them atan agreed marked-up price, the payment being settledwithin an agreed time frame, either in installments or in alump sum. The seller bears the risk for the goods until theyhave been delivered to the buyer. *Murabaha*is also referredto as *bay muajjal.*

administration fee" (Karim, et al., 2008: 12).

The outreach of Islamic microfinance varies region by region. The total outreach of Islamic microfinance in all Muslim countries is very small as compared to total national microfinance outreach, e.g. 3% in Syria and 2% in Indonesia, while the average outreach is only 2,400 clients per institution (Karim, et al., 2008: 7). This shows that Islamic microfinance still cannot provide financial services on a large scale (Karim, et al., 2008 dan Obaidullah and Khan, 2008c: 57).

In regard to the type of suppliers of Islamic MFIs using sample from some countries, among others are Indonesia and Syria as each of this country has specific type of IMFI, as can be seen in Table 1, the main players are NGOs, which accounted for 42% of the total outreach, with just 14 NGOs as the CGAP respondents in the 2007 survey; they are followed by commercial banks (Karim, et al., 2008: 8). It should be noted that, in Indonesia, with 105 BPRS accounting for 25% of the total clients, the outstanding loan portfolio is large (62%) due to significantly higher average loan size, because BPRS focuses on providing financing for small and microenterprises (Karim, et al., 2008: 9). Sustainability in Islamic microfinance has become a crucial issue globally. Among others, sustainability problems might arise from the source of funds and efficiency of Islamic MFIs' operations.

Obaidullah dan Khan (2008c: 15) argues that utilising *zakah* funds could raise the issue of sustainability. In this particular issue, the findings of a research survey in Indonesia suggest that the clients of zakat-based microfinance earn significantly higher annual income per capita than those in the non-client group (Yumma, 2013). Hence, Islamic MFIs are encouraged to utilise more *waqf* funds and other commercial sources from public funds and Islamic banking rather than *zakah* funds. Some researches has been conducting to find out whether the utilising *waqf* fund could be beneficial in microfinance (Haneef et al., 2013). Based on a research survey in Malaysia, Haneef et al., (2013) develop an integrated model by incorporating *waqf* based Islamic microfinance.

Focusing on the Rural Development Scheme (RDS), a programme managed by Islamic Bank Bangladesh (IBBL) Bangladesh, Parveen (2009: 17-18) argues that RDS has proved highly sustainable in serving the very poor people, in terms of financial sustainability, institutional viability, leadership, decentralisation, management style etc. However, it also encounters a high drop-out rate (Parveen, 2009: 16). Based on experiences of providing financing to the agricultural sector, Elhiraika (2003) argues that risk and return considerations affect the banks in their operations.

This mutual attraction between being financially sustainable and providing large-scale financing to farmers put them in a problematic situation, as the banks who achieved financial sustainability did so by limiting financing access to farmers who had financial feasibility (Elhiraika, 2003: 17). Overall, it is a challenge for Islamic microfinance to remain sustainable and achieve a wider scale, regardless of the challenges experienced in daily operational reality.

Table 1. Outreach of Islamic Microfinance (by Institution Type)

Institution Type	# of Institution	Total # of Clients		Total Outstanding Loan Portfolio (Islamic)		Avg. Loan Size (Islamic)
		#	% of Total	US$	Total	
Cooperative	1	6,671	2	926,251	<1	132
Village Bank (Syria)	1	2,298	1	1,838,047	<1	800
NGO	14	125,793	42	41,421,580	21	303
Rural Bank (Indonesia)	105	74,698	25	122,475,158	62	1,640
NBFI	3	4,293	1	1,893,207	<1	598
Commer-cial Bank	2	87,56	29	29,030,997	15	305
Total	**126**	**305,237**	**100**	**198,090,268**	**100**	**629**

Source: Karim (2008)

2.3 The Development of Islamic Microfinance Worldwide

Recently, Islamic microfinance has spread throughout the world, particularly to Muslim developing countries. Although the share of Islamic micro-finance worldwide in all Muslim countries is very small as compared to total microfinance outreach, there is a potential demand for microfinance in these countries, as 44% of the conventional worldwide microfinance clients are currently in Muslim countries (Karim, et al., 2008: 5). Karim et al., (2008: 5-6) report that Islamic microfinance has good potential for growth, since it has the ability to serve the potential demand: the people who currently avoid non-*Shari'ah*-compliant products offered by conventional microfinance. Based a number of International Finance Corporation (IFC) market studies, the potentially strong demand for Islamic microfinance, in both the Muslim and non-Muslim markets, can be found in the West Bank, Gaza, Jordan, Algeria, Yemen and Syria (Karim, et al., 2008: 5). In addition, the same CGAP report states that conventional microfinance's current clients are likely to switch to Islamic products, as found in Afghanistan, Indonesia, Syria and Yemen. There is also some movement in Islamic microfinance through the transformation of conventional MFIs into Islamic MFIs and a new policy of offering Islamic microfinance services in Islamic commercial banks (e.g. Yemen's Tadhamin Islamic Banks, Noor Islamic Bank and Emirates Post Holding in UEA *etc*). Among others, the support to develop Islamic microfinance comes from the Islamic Solidarity Fund for Development (ISFD) IDB, which is concerned with promoting microfinance and poverty alleviation in its member countries under the Microfinance Support Program (MFSP) in the amount of USD 500 millions (Karim, et al., 2008: 5). Another encouraging development in Islamic microfinance is the growing number of Islamic commercial banks offering Islamic microfinance products in some regions, such as Indonesia, Yemen, UAE *etc* (Karim, et al., 2008: 6). Hence, there is optimism that Islamic microfinance will experience a high demand in the market due to its compliance with *Shari'ah*; hence, it will achieve respectable growth (Ibrahim, 2012: 98).

In terms of outreach, the fastest growing region is Asia, followed by the Middle East and North Africa (MENA) region which has grown beyond USD 1.175 billions (Ibrahim, 2012). Similarly, CG-AP survey findings in 2007 also reveal that the supply of Islamic microfinance is highly concentrated in Indonesia, Bangladesh and Afghanistan, accounting for 80% of worldwide Islamic microfinance outreach (Karim, et al., 2008). The figures on Islamic microfi-nance outreach are presented on Table 2. The following is an overview of Islamic microfinance development, region by region:

Bangladesh is the home of established Islamic MFIs, namely Islamic Bank Bangladesh, Social and Investment Bank Bangladesh, Al-Fallah and Resque. Based on CGAP survey findings in 2007, Bangladesh has the largest Islamic microfinance outreach, having 100,000 clients and two active institutions; this is aligned with the largest outreach of conventional microfinance which reaches almost 8 million borrowers of whom only 1% take up Islamic microfinance (Karim, et al., 2008: 7).

The performance of Islamic microfinance has been quite promising. Obaidullah (2008a: 23) argues that the performance of RDS (Rural Development Scheme) of IBBL was better in terms of growth (12.5%), drop-out rate (5%), and operational efficiency compared to three conventional leaders in microfinance, namely Grameen Bank, ASA (Association for Social Advancement) and BRAC (Bangladesh Rural Advancement Committee). Charging a lower rate of return (10% with 2.5% rebate for on-time pay-ments) than other microfinance (16% to 22.5% interest) offers an advantage for the poor (Obaidullah, 2008a: 23-24). This type of microfinance also offers an active spiritual development programme with the purpose of improving members' awareness of social rights and responsibilities in order to forge better relationships with others (Obaidullah, 2008a: 19); such a programme has not been provided by conventional microfinance.

Having the largest Muslim population, Indonesia might represent the greatest diversity of both conventional and Islamic microfinance; it has around six thousand (6,000) formal and fourty eight thousand (48,000) semi-formal registered microfinance units with a total of 3,2 million borrowers (Seibel, 2012: 148). The main players in Islamic microfinance in Indonesia are Islamic Commercial Banks (ICBs), followed by Shari'a Rural Banks (BPRS) and Islamic cooperative. Indonesia is ranked second in terms of number of clients. However, this figure does not include the clients served by 4,500 Islamic cooperatives since the data are only based on statistics of Bank Indonesia which only cover data from *Shari'ah* Rural Banks

Table 2. Outreach of Islamic Microfinance by Country in 2008

Region	Included Institutions	% Female (Avg.)	Total of Clients	Total Outstanding Loan Portfolio	Avg. Loan Balance
Afghanistan	4	22	53,011	10,347,29	162
Bahrain	1	n/a	323	96,565	299
Bangladesh	2	90	111,837	34,490,490	280
Indonesia	105	60	74,698	122,480,000	1,640
Jordan	1	80	1,481	1,619,909	1,094
Lebanon	1	50	26,000	22,500,000	865
Mali	1	12	2,812	273,298	97
Pakistan	1	40	6,069	746,904	123
West Bank and Gaza	1	100	132	145,485	1,102
Saudi Arabia	1	86	7,000	586,667	84
Somalia	1	n/a	50	35,200	704
Sudan	3	65	9,561	1,891,819	171
Syria	1	45	2,298	1,838,047	800
Yemen	3	58	7,031	840,240	146
Total	**126**	**59**	**302,303**	**197,891,882**	**541**

Source: Karim (2008)

(BPRS) (Karim, et al., 2008). It is thought that the total number of Islamic cooperative borrowers is 80,000 (Karim, et al., 2008: 8). Hence, if one were to add the cooperative borrowers to the Indonesian outreach in Table 2, there would probably be a higher number of clients than in Bangladesh.

In Pakistan, Akhuwat could be considered successful Islamic MFIs, which applied a mosque-based model with strong brotherhood, offering *qardhasan*[6] organised mainly by volunteers, without any funding from international donors or financial institutions (Obaidullah and Khan, 2008c: 27). In addition, the Centre for Women's Cooperative Development (CWCD) in Pakistan transformed its services from conventional microfinance to Islamic microfinance, and now provides benefits in the form of better recovery rates and increased sustainability, as well as moving closer to poverty alleviation objectives, *etc* (Nabeel and Tariq, 2011). In addition, Tameer Bank in Pakistan has achieved much since its establishment in 2011; in 2013 it is likely to meet its expectation of high growth in its portfolio, a very large increase in the number of borrowers, etc (Mustafa, 2011).

Microfinance provision in southern India is dominated by minority funds; Nisar and Rahman (2012: 181) state that the funds (known as "*amana*" funds) have been increased successfully by improving their members' savings through small daily savings collections, without offering any return on the savings. The funds are channelled to members, and a fee is charged on the principal outstanding; this is different from the compound rates applied by other credit providers (Nisar and Rahman, 2012).

Muslim Aid (MA) in Sri Lanka has innovated and successfully implemented the combination of *sa-*

[6] *Qardhasan*: A loan extended without interest or any other compensation from the borrower. The lender expects a reward only from God.

lam[7] and *murabaha* financing in providing microfinancing to farmers for paddy cultivation following a tsunami and ethnic conflicts (Obaidullah and Mohamed-Saleem, 2012). This project works on a co-operative model basis, providing mutual benefits for both farmers and millers since the final net profit obtained from selling paddy is distributed to farmers; hence it contributes to farmers' independence and empowerment (Obaidullah and Saleem, 2012).

Jabal Al Hoss "Sanadiq" (village banks) in Syria provides an excellent model for global Islamic microfinance through the application of *musharakah* owned and managed by the poor, *murabahah* with net profits shared among members, *etc* (Obaidullah and Khan, 2008c: 26).

In Lebanon, the Mu'assasat Bait Al-Mal, a highly credible organisation with a good donor network, provides *qardhasan* based on volunteers managing the collection and disbursement of funds, while its sister organisation AL-Yusor offers profit and loss-sharing financing; (Obaidullah and Khan, 2008c: 26)

The Hodeidah Microfinance Program in Yemen, which replicates the Grameen model in implementing group-based and graduated financing, offers *murabahah* financing (Obaidullah and Khan, 2008c: 26)

In Iran, the government requires all the commercial banks to provide Islamic microfinance products (*Qarzul-Hasaneh* funds) to clients with urgent needs; they achieved a significant outreach of 3 million families in March 2008 (Karim, et al., 2008:7 dan Mollah and Uddin, 2013).

Despite a lengthy period of crises and conflicts in the country, Islamic microfinance in Afghanistan has achieved a successful rapid development, encouraging enterprises' improvement and poverty alleviation (Sait, 2012: 170). The Islamic Investment and Finance Cooperatives (IIFCs), as credit unions set up by the World Council of Credit Unions (WOCCU) had an increased distribution in 2004 of nearly 8,000 items of working capital worth USD 7.4 million to micro and small business owners, increasing the number of members by 10% (WOCCU, 2012). In addition, FINCA's Village Banking in Afghanistan provides *qardhasan* based on "solidarity" group guarantee financing with upfront fees, targeting the working poor; this system is running well (Obaidullah and Khan, 2008c: 30).

The Tanzania eco-Volunteerism (TeV), a market-driven honey project, provides community development programmes and Islamic microfinancing (*qard-hasan*, *wadiah*[8] and *takaful*[9]) for rural poor communities. It has been able to sustain and increase the scale of operation (CGAP, 2011).

Al-Amal Microfinance Bank in Yemen, which has been offering various financial services products since 2010, has had remarkable success in increasing the number of active borrowers and savers, and has achieved a national microfinance market of over 25% (Karim and Khaled, 2011). This bank won the Islamic Microfinance Challenges 2010 organised by CGAP by proposing *ijarah*[10] products channelled by A-Amal Investment Fund to support their borrowers' enterprises (Al-Waeel, 2011).

Operating in former civil war areas, Azaouad Finances, a project initiated by GTZ (German Technical Cooperation) and KfW (German Financial Cooperation) in Northern Mali, Sub-Saharan Africa, could be considered the only Islamic MFI in the area that is well managed (Obaidullah and Khan, 2008c: 30).

In Australia, where 1.7% of the population is Muslim, Ahmad and Ahmad (2008) argue that there is a potential market for Islamic microfinance. Currently, the providers of Islamic microfinance are the Muslim Community Co-operative (Australia) Limited (MCCA), Islamic Co-operative Finance Australia Limited and Iskan Finance Pty Limited. As the largest provider of Islamic microfinance in Australia, MCCA manages more than AUD 100 million/year of Islamic

[7] *Salam*:A sale in which payment is made in advance by the buyer and the delivery of the goods is deferred by the seller.

[8] *Wadiah*: A contract whereby a person leaves valuables with someone for safekeeping. The keeper can charge a fee, even though in Islamic culture it is encouraged to provide this service free of charge or to recover only the costs of safekeeping without any profit.

[9] *Takaful*: An alternative for the contemporary insurance contract. A group of persons agree to share certain risk (for example, damage by fire) by collecting a specified sum from each. In case of loss to anyone of the group, the loss is met from the collected funds.

[10] *Ijarah*: Leasing. Sale of usufruct of an asset. The lessor retains the ownership of the asset with all the rights and the responsibilities that go with ownership.

home finance and equipment assets (Ahmad and Ahmad, 2008: 11).

With regard to providing better services to customers and based on the discussion, Islamic researchers share the same notion that there should be improvements and innovation in the way Islamic microfinance is operated. Among others, the urgent need for social services is widely addressed. In the future, Islamic microfinance should improve the provision of social development programmes for micro-enterprises (Ahmed, 2002); Ahmed even emphasises the need for specialised institutions to perform this duty (Ahmed, 2012).

Concerning the organisational development, Wilson (2007) suggests two models: i) *wakala*[11] model: establishment of fund manager under *wakala* principle with fixed management fee; this model aims to ensure that the funds from *zakah*, NGOs and *tabarru*[12] are securely managed; and ii) *mudaraba* model: set up fund management company as fund providers to borrowers under *mudaraba* scheme. Hence, he basically underlines that microfinance services should be provided by specialised financial institutions rather than Islamic Banking institutions.

In contrast to Wilson's concept, Ahmed (2012) has recently proposed two models of Islamic microfinance organisation. First, Islamic banks could manage Islamic microfinance through the establishment of a microfinance division, which applies the same format of group-based financing and weekly repayments. This proposal is based on the arguments that Islamic banks have more capable staff to manage financing, and a large number of branches/networking which might reduce administration costs; hence Islamic banks' operation of Islamic microfinance is likely to be more effective than that of Islamic MFIs (Ahmed, 2012: 25-26). Furthermore, the economic viability of Islamic banking is likely to be higher compared to Islamic MFIs in terms of available funds and lower operational costs due to its wider operation. Subsequently, microfinancing and social services could be provided with more effective and efficient management.

Second, there is the potential to develop the provision of Islamic micro financing through traditional Islamic instruments such as *zakah*, *waqf*, *qardhasan* and *sadaqat* (Ahmed, 2012: 27-29). Currently, researchers have become increasingly interested in the implementation of this concept. Aligned with this concept, Zarka (2012) argues that microfinance should be provided by *waqf* institutions rather than Islamic banks. In his scheme, he suggests the establishment of a guarantor of liquidity and a guarantor of losses with the purpose of strengthening the security of funds; hence, this is expected to contribute to the improvement of credit standing (Zarka, 2012: 78-79).

In particular, in response to the urgent need to provide both financial and social services with good management, Ibrahim (2012) proposes a dual model with a separate function of microfinancing provision by a profit institution called "NewCo", while another institution called 'Microfinance Foundation" carries out the function of research and development, technical expertise, governance and limited guarantee for "NewCo". This scheme aims to ensure the sustainability and profitability of Islamic microfinance and cater for the economic welfare of the customers (Ibrahim, 2012).

The conceptual development of Islamic microfinance can be viewed not only from the organisational development perspective, but also from the perspective of utilising other financing products rather than just widely using *murabahah*. Ghalib (2012) suggests reconsidering *ijara* (leasing) to enhance the opportunity of the poor to establish microenterprises.

2.4 Islamic Microfinance in Indonesia

Provision of financial access to poor people will enable them to increase their income and economic well being, develop assets and reduce weaknesses (Obaidullah, 2008b: 4). The lack of financial access seems to be the main reason for their inability to become involved in development (Obaidullah, 2008b: 4).

IMFIs might be able to alleviate poverty because they are not debt-based; hence, they will not drag their clients into an even worse situation. Islamic teaching also encourages the waiving of credit if clients are in deep trouble.

Islamic microfinance plays a significant role in promoting microenterprises. A study of the Islamic Banking industry in Indonesia found that it has both a positive effect-based on financial measures, sales im-

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[11] *Wakala*: Contract of agency. In this contract, one person appoints someone else to perform a certain task on his behalf, usually against a fixed fee.

[12] *Tabarru*: Actions/contracts the purpose of which is not commercial but is seeking the pleasure of Allah.

provement, and accumulation of working capital and an ability to improve the tough synergy with a national programme for development of small enterprises and microenterprises (Antonio, 2004). In addition, it is capable of filling the gap between the poverty alleviation approach and commercially-based methods of microfinance (Antonio, 2004).

However, Siebel presents a different view, noting that Islamic microfinance in Indonesia has low assets compared to conventional banking due to the lack of regulatory and supervisory aspects in Islamic values (Seibel, 2005). The two proposed options are as follows: 1) to focus completely on Islamic commercial banks and the "establishment of branch networks with Islamic microfinance products"; and 2) "to reassess the challenges and realistic opportunities for Islamic rural banks and cooperatives" (Seibel, 2005: 41). Although this finding might be true for this specific research area, it could not be generalised to all areas of this country. As Obaidullah maintains, the BMT (*Baitul Maal wat Tamweel*/Islamic Coopera-tive) in Indonesia represents a success story in the linkage programme between a group of microenterprises, BMT and Islamic Banks (Obaidullah, 2008a: 53-54). Given its ability to cooperate with the poor in the surrounding area, BMT seems to be the most suitable institution to serve the poor (Ascarya and Sanrego, 2007).

3. Conclusion

While microfinance began hundreds of years ago, Islamic microfinance is a relatively young industry, serving particularly to meet the demand of a specific market whose members cannot accept the conventional financing product which contradicts Islamic principles. Apart from the usual problems it shares with its conventional counterpart, Islamic microfinance has issues in terms of *Shari'ah*-compliant products. It is also criticised for charging higher returns than conventional microfinance. Ideally, equity-based financing should be more favourable in the market; however, most of the market members still use debt-based products (*murabahah*) due to their simplicity and similarity to conventional products. In regard to poverty alleviation and economic development, it seems that Islamic microfinance has played a significant role, although there is some scepticism regarding the limited government supervision and monitoring.

Therefore, in considering the above problems, scholars offer a number of propositions. To be successful, Islamic microfinance providers, particularly in micro level which is the IMF, must learn certain lessons from conventional microfinance in CGAP, since they have been operated long time earlier than Islamic Microfinance, thus have more technical experiences in handling the customers. It should not be misunderstood that the conventional microfinance is better than the Islamic microfinance. The Islamic Microfinance should basically seek to provide wider access to the poor, and be sustainable institutions that can achieve a "market-based for-profit approach", supported by an efficient system and transparent reporting, with the focus on capacity-building, combined with integration between microfinance and the official financial system (Obaidullah, 2008b: 9-10). However, the Islamic approach emphasises some important points: provision of financing and non-financing services to improve microenterprises, transparency, understanding and cooperation (Obaidullah, 2008b: 10). Based on the findings of an Islamic microfinance survey by CGAP in 2007 covering 125 institutions in 19 Muslim countries, Karim et al., (2008: 16-17) suggest two important points to impro-ve the performance of Islamic microfinance which could replicate the lessons learnt from conventional counterparts:

(i) improving operational efficiency by introducing innovations to reduce financing and administrative costs;
(ii) reducing risk management, not by imposing physical collateral but by imposing social collateral (e.g. peer pressure, discipline for collection).

In addition, new strategies are offered by Dusuki (2008), who suggests utilising SPVs (Special Purpose Vehicles) into Islamic Microfinance as an alternative way of distributing funds to the poor (Dusuki, 2008). Moreover, he also argues that an effective way of reducing the cost of transaction and risk is by "building human capacity through social intermediation" and a group-based approach (Dusuki, 2008). Obviously, these proposed alternative solutions are not the only solutions, however, by applying these properly, it would help to ease handling the problems.

Finally, in attempt to encourage the development of Islamic Microfinance, it is suggested that the Islamic microfinance industry should offer and provide more education to the customers and to apply non-debt based financing product (eg. *Musharakah* and *mudarabah*). This will solve the problem of financing product diversity as large majority of customers prefer debt based financing due to simplicity of the product and limited knowledge about non-debt based financing. In addition, since Islamic microfinance is under the of the government authority, is also suggested to provide more attention to Islamic microfinance industry by providing more sufficient and supportive regulatory base along with proper monitoring which is really required now to protect both the institutions and the customers. Recently, a new regulation to address the issue of *Shari'ah* compliant issue has been published; it is now required for IMFIs to have *Shari'ah* board to ensure that the banking products offered to customers comply with *Shari'ah* law.

This paper has limitation on exploring these issues since it is only based on literature review. Hence, for further research, it is suggested that more analysis and elaboration on the empirical analysis on the challenges of Islamic microfinance and focusing more on discussion of the Islamic microfinance sustainability would be beneficial to support the research on Islamic microfinance.

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