ISLAMIC RESEARCH AND TRAINING INSTITUTE

A MEMBER OF THE ISLAMIC DEVELOPMENT BANK GROUP

ROLE OF MICROFINANCE IN POVERTY ALLEVIATION

LESSONS FROM EXPERIENCES IN SELECTED IDB MEMBER COUNTRIES

Mohammed Obaidullah

ISLAMIC RESEARCH AND TRAINING INSTITUTE

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The Islamic Research and Training Institute (IRTI) was established by the Board of Executive Directors of the Islamic Development Bank (IDB) in 1401H (1981). The Executive Directors thus implemented Resolution No. BG/14-99 which the Board of Governors of IDB adopted at its Third Annual Meeting held on 10 Rabi Thani 1399H (14 March 1979). The Institute became operational in 1403H (1983).

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ii- To provide for the training and development of professional personnel in Islamic Economics to meet the needs of research and *sharī'ah* observing agencies;

iii- To train personnel engaged in development activities in the Bank's member countries;

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Location

The Institute is located in Jeddah, Saudi Arabia.

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In the name of Allah, the Most Merciful, Most Beneficent

Contents

Foreword

Poverty alleviation and development of the Islamic financial services industry (IFSI) are two key strategic objectives of the Islamic Development Bank (IsDB) Group in addition to enhancing economic cooperation among its member countries. It is now an accepted fact that the challenge of poverty alleviation can be addressed by developing microenterprises. This requires a holistic approach involving microfinance or provision of financial services to poor and low-income people whose low economic standing excludes them from formal financial systems. Additionally, the microentrepreneurs need to be provided technical and other forms of assistance.

The Islamic Research and Training Institute (IRTI) has accorded due priority to the subject of microfinance and poverty alleviation. Accordingly several major initiatives have been taken in this area. During 2007 the Institute organized the 'First International Conference on Islamic Inclusive Financial Sector Development' in collaboration with the University of Brunei Darussalam. This was highly instrumental in taking stock of the existing knowledge about Islamic microfinance services. Second, a policy dialogue paper was prepared on "Islamic Microfinance Development: Challenges and Initiatives" and discussed by various stakeholders in different forums. Finally, the Institute addressed the 'Role of Microfinance in Poverty Alleviation' through this case study of three member countries of IsDB.

It is hoped that together these three works will provide valuable insight and guidance to researchers and practitioners working in the field of poverty alleviation through Shariah-compliant microfinance. The comments and observations of readers are invited to enhance the knowledge base in this domain so that the challenge of poverty alleviation can be addressed much more effectively.

Bashir Ali Khallat
Director General, IRTI

Executive Summary

Poverty alleviation through microfinance requires a composite approach. Poverty levels vary across countries. So do cultures. Alleviating poverty through development of microenterprises therefore, requires different approaches and diverse models. This study proposes a two-pronged strategy to poverty alleviation through microenterprise development in member countries of the Islamic Development Bank (IsDB) based on the dichotomy between livelihood and growth enterprises. The focus of the study is on provision of Shariah-compliant financial services for microenterprises. It reviews thematic issues in the light of case studies from three IsDB member countries – Bangladesh, Indonesia, and Turkey. It draws valuable lessons from the case studies in terms of the two complimentary approaches to microenterprises development contributing to poverty alleviation.

Programs for developing livelihood enterprises have poverty reduction as their main objective. They entail bringing about small improvements for many enterprises, often providing only credit, which is why, they are sometimes characterized as “minimalist.” Chapter Two of the study focuses on such programs. The Grameen model of group-based and graduated financing for developing livelihood enterprises is presented with a case study of Rural Development Scheme of Islami Bank Bangladesh, a Shariah compliant replication of this model. The Islamic replication is free from many of the "cultural and religious negatives" of the Grameen model from the standpoint of a highly conservative rural Muslim society of Bangladesh. Like Grameen it has embarked on empowerment of women with ninety-four percent of its clients being women. However, this has been attempted in a culturally compatible manner that promotes family integration by popularizing the concept of "family empowerment". Like Grameen it has attempted to promote healthy social practices by ensuring participation of all members in social activities. However, the practices now exclude behavior that are repugnant or unacceptable to Islam and detrimental to the institution of family and include codes of ethics and morality that promote unity and cohesiveness in society. Like Grameen it has provided collateral-free finance to the poor using the concept of group and graduated financing. However, it has brought in Shariah-compliant modes of financing that do not involve *riba* and at a fraction of the costs charged by Grameen and other flagship Microfinance Institutions (MFI). The study also highlights some areas of concern and makes suggestions to overcome them.

The next chapter deals with developing growth enterprises. Growth-oriented microenterprise programs have enterprise development as their immediate objective and attempt to lift microenterprises to a qualitatively higher level of sustainability, setting them on the path to long-term growth, and seeking to provide a comprehensive range of services, including credit, training, technical assistance, and improvement of business skills. The study presents a case study of KOSGEB in Turkey, an organization highly successful in providing an array of non-financial business development services. It is noted that such a scheme could possibly be replicated with donor funds where the catalyst organization could be structured as a *waqf*.

An important factor contributing to the general lack of interest among commercial banks in microfinance is the absence of institutional credit guarantee systems. The study undertakes the case study of a specialized institution providing credit guarantee in Turkey and notes that such experiments could be replicated elsewhere and at the same time the process could be made Shariah-compliant in the framework of *al-kafala*.

While livelihood programs have a direct impact on poverty, they tend to leave out certain sections of the poor – the "poorest of the poor" and the destitute and the "graduated" poor. Programs to develop growth enterprises appear to target the "not-so-poor". Notwithstanding the success achieved by the programs in their objective of serving the target population, they only partially address the issue of financial exclusion. What is needed is a systemic financial services approach to the issue of poverty alleviation under which, all sections of the society have access to appropriate, low-cost, fair and safe financial products and services from formal providers. This is the subject matter of Chapter Four.

A financial services approach to development of microenterprises is highlighted in this chapter. This study considers the issue of establishing linkages among various components of the financial system at three levels – micro, meso and macro levels in the context of the Indonesian microfinance system. It demonstrates how various organizations at various levels, such as, the government agencies, central bank, commercial banks, rural banks, companies, cooperatives, self-help-groups and engaged in diverse activities, such as, provision of for-profit microfinance; technical, managerial and spiritual assistance; meeting of basic consumption needs and economic empowerment using charity and community funds could be interlinked so that they strengthen each other and produce the desired results – of enhancing financial inclusion, development of microenterprises and poverty alleviation.

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Dr. Mohammed Obaidullah
IRTI-IDB, Jeddah
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List of Abbreviations

ADB	Asian Development Bank
ASBISINDO	Asosiasi Bank Syariah Indonesia
ASA	Association for Social Advancement
BI	Bank Indonesia
BRAC	Bangladesh Rural Advancement Committee
BMT	Baitul Maal wat Tamweel
BMM	Baitul Maal Muamalat
BMI	Bank Muamalat Indonesia
BRI	Bank Rakyat Indonesia
BPRS	Bank Perkreditan Rakyat Syriah
IBBL	Islami Bank Bangladesh Limited
IsDB	Islamic Development Bank
KGF	Kredi Garanti Fonu
KOSGEB	Small and Medium Industry Development Organization
MFI	Microfinance Institution
NPO	Not-for-Profit-Organization
PKSF	Palli Karma Sahayak Foundation
RDS	Rural Development Scheme
PINBUK	Pusat Inkubasi Bisnis Usaha Kecil
PNM	Permodalan Nasional Madani
SHG	Self-Help Groups
SMFI	Syariah Microfinance Institution
UNDP	United Nations Development Program

Chapter 1

INTRODUCTION

Poverty alleviation remains the most important challenge before policy makers in the Islamic world that is characterized by high and rising poverty levels. The poverty levels are also associated with high inequality alongside low productivity. In Indonesia alone with world's largest Muslim population, over half of the population - about 129 million are poor or vulnerable to poverty with incomes less that US$2 a day. Bangladesh and Pakistan account for 122 million each. A recent IRTI study[1] reveals that only five of the member countries - Indonesia, Bangladesh, Pakistan, Nigeria and Egypt - account for over half a billion (528 million) of the world's poor with incomes below $2 a day or national poverty line. With another five countries - Afghanistan, Sudan, Mozambique, Turkey and Niger, they account for over 600 million of the world's poor.

1.1. Poverty Alleviation: A Composite Approach

This study proposes a multi-pronged strategy to poverty alleviation through microenterprise development in IDB member countries given their heterogeneity. It uses the livelihood-growth enterprise dichotomy (ADB, 1997, p26) and a financial services approach to review thematic issues in the light of case studies from three IDB member countries – Bangladesh, Indonesia, and Turkey. It draws valuable lessons from the case studies in terms of the complimentary approaches to microenterprise development contributing to poverty alleviation.

A livelihood (survival) enterprise is said to be one into which the entrepreneur is often pushed for want of more profitable alternatives, whereas one is attracted, or pulled into a growth (viable) enterprise by considerations of profitability, and is an entrepreneur by choice. (ADB, 1997, p27) Microenterprise development programs often involve a trade-off between making a short-term impact on poverty through livelihood enterprises and self-employment on the one hand, and longer-term growth oriented enterprise development and expanded employment for a much smaller number of direct beneficiaries on the other. (ADB, 1997, p36 and Harvie, 2003, p04) Programs aimed at livelihood activities have poverty reduction as their main objective, and the vast majority of microenterprises are livelihood enterprises. They entail bringing about small improvements for many enterprises, often providing only credit, which is why they are sometimes characterized as "minimalist."

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[1] *Islamic Microfinance Development: Challenges and Initiatives, 2008, IRTI, IDB*

Credit is very often neither the only nor the most important requirement for the success of an activity. Noncredit inputs such as design, product development, market information, marketing assistance in both domestic and export markets, appropriate technology development and the provision of common facility centers usually are much more important for a large number of manufacturing activities. Generally speaking, noncredit inputs and business development service are particularly important for growth-oriented microenterprises (ADB, 1997, p36).

A number of studies on poverty indicate that the reason poor households are unable to participate in the development process is their exclusion from the financial system. This is the fundamental flaw of conventional formal financial systems. Among the various factors contributing to financial exclusion, one that is particularly relevant in Muslim societies is the presence of *riba* in conventional financial contracts. Islamic *riba*-free finance is seen by many as a panacea for enhanced financial inclusion. The special characteristics of Islamic finance can provide alternative means to reach underserved groups in small rural areas and agricultural producers. (ADB, 2006, p03) Indeed, microfinance facilities can expand their reach by offering Islamic financial services in communities reluctant to deal with conventional financial instruments (Hawari and Grais, 2005, p02).

Microfinance – provision of formal financial services for the poor - helps people fight poverty on their own terms, in a sustainable way. Poor people use loans, deposits, and other financial services to reduce their vulnerability, seize opportunities, and increase their earnings. Indirectly, microfinance improves schooling, health, and women's empowerment. In most settings, however, microfinance does not reach the people at the very bottom of the socioeconomic scale—the "poorest" (Hashemi, 2006, p01). Arguably, there is a need for "social safety nets" to take care of the consumption needs of the poorest and the destitute before they could be provided microfinance. Hashemi (2006) provides a few good case studies that suggest ways in which links can be established between safety net programs and microfinance programs and show how appropriate sequencing of support can produce good results for the poorest. Starting with grants to meet immediate consumption needs and build "micro-assets," these programs then provide skills training, business management training, savings services, and sometimes small credit to prepare clients for running microenterprises. Those who successfully move forward in this sequencing are likely to be ready to graduate to become microfinance clients. In the context of Islamic societies, a similar framework integrating *zakah* and *awqaf* with "for-profit" Shariah-compliant microfinance needs to be developed. Though traditionally these two institutions have been used as instruments of poverty alleviation and economic empowerment, their potential is vastly untapped (Kahf, 1999, p26).

1.2. Objectives of the Study

Recently two major initiatives by the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank Group have provided valuable insight and guidelines on how microfinance may be provided in a Shariah-compliant framework. The first initiative involved “stock-taking" of knowledge in the field of Islamic microfinance by organizing an international conference on Islamic microfinance resulting in a publication titled "*Islamic Finance for Micro and Medium Enterprises*" (See Box 1.1). The second initiative involved intensive dialogue among various stakeholders in the global microfinance industry that resulted in a policy paper on *Islamic Microfinance Development: Challenges and Initiatives*. The present study is the third initiative by IRTI in this direction. Needless to say, all the three should be viewed as companion texts supplementing each other.

Box 1.1. Stock-Taking of Knowledge in Islamic Microfinance

"Islamic Finance for Micro and Medium Enterprises" is a publication of IRTI that provides a collection of research studies seeking to examine the principles and practices of microfinance across several Muslim societies. The studies highlight key issues relating to development of Islamic microfinance. The issues addressed in the volume fall into five broad areas: (i) Islamic contracts and products for microfinance; (ii) models of microfinance; (iii) integrating *zakah* and *awqaf* with microfinance; (iv) education and training for microfinance; and (v) role of government in enhancing financial inclusion through microfinance. These are captured in seventeen papers that have been short-listed from thirty-six papers presented at an international conference focusing on this theme held at Brunei Darussalam in April 2007. Together, the papers provide a glimpse of state-of-the-art research being undertaken in various universities and research centers across the globe in this exciting field.

The present study advocates a financial services approach to developing microenterprises as distinct from a trade-oriented approach. The financial services approach looks upon the improvement of financial services for the poor as a worthwhile objective in its own right. As such, it extends far beyond the provision of credit for the development of livelihood as well as growth enterprises - in contrast to a trade-oriented approach that focuses solely on developing growth enterprises.

The financial services approach has earlier been highlighted in the policy paper on *Islamic Microfinance Development: Challenges and Initiatives,* prepared by IRTI. The paper argues that while poverty is widespread in the Islamic world, access to financial services is either inadequate or exclusive. It asserts that the needs of the poor in Islamic countries are no different from the poor in other societies except that these are conditioned and influenced by their faith and culture in a significant way. The poor need a range of products, from credit (beyond enterprise finance), to savings, to money transfer facilities, and insurance in many forms. Beyond financing microenterprises, microcredit now encompasses financing of consumption (this will be highlighted further in the present study). Poor people want secure, convenient deposit services that allow for small balances and transactions and offer easy access to their funds. The poor also want remittance services for transferring cash to their family members, since many are forced to leave in far-off places to earn a livelihood. Few poor households have access to formal insurance against such risks as the death of a family breadwinner, severe illness, or loss of an asset including livestock and housing. These shocks are particularly damaging for poor households, because they are more vulnerable to begin with. Provision of the above financial services – microcredit, microsavings, microtransfers and microinsurance - to the poor is expected to lead to poverty alleviation. In the Islamic world provision of these services must also comply with Shariah so as to enhance financial inclusion. The paper identifies major challenges to developing Shariah-compliant microfinance at three levels: micro, meso and macro and suggests strategies to tackle them (Box 1.2). A similar holistic approach is examined in the present study that considers the issue of establishing linkages among various components of the financial system at the three levels in the context of the Indonesian microfinance system.

The present study is undertaken with the following specific objectives and sub-objectives:

- To examine the relative significance of the financial services approach as distinct from a trade-oriented approach to poverty alleviation through microenterprise development and income generation;
- To examine alternative models of microenterprise development in view of their heterogeneity in the context of different Muslim societies characterized by varying levels of poverty and diverse cultures;
- To assess and develop models of inclusive microfinance for Muslim societies based on real-life case studies and experiments; identify problem areas and suggest appropriate measures to address them;
- To develop a model for linking social safety nets to microfinance in view of the limitation of the latter to reach out to the poorest of the poor and the destitute through the Islamic institutions of *zakah* and *awqaf*;
- To identify problem areas and growth constraints in programs of microenterprise development – with respect to livelihood and growth enterprises and suggest policy interventions to tackle them;
- To understand the need for managerial, technical and spiritual assistance and business development services as a means to promote livelihood and growth enterprises; and

- To develop a model for linking managerial-technical-spiritual assistance and business development services with microfinance based on insights from real-life case studies;

Box 1.2. Strategies for Developing Islamic Microfinance Services

An effective strategy for development of microfinance would require concerted efforts by all stakeholders.

At a micro level, self-help groups, cooperatives and non-profit organizations (NPO) should act as catalysts of change involving community assets; combine social and economic agenda with synergized effect; recognize sustainability as the core factor in development; and develop linkages with banks and capital markets. The Islamic financial institutions should develop linkages with NPOs for reaching out to poor, engage in direct and indirect microfinance. The *awqaf* and *zakah* funds should institutionalize voluntary giving in order to guarantee sustainability of assets and their income generating abilities, preserve and develop assets under *waqf* to add to productive capacity and create capabilities for wealth creation and distribute *zakah* funds to the destitute and the poorest of poor who are not bankable.

At a meso level, the multilateral development agencies, apex bodies, networks and associations should enhance mutual cooperation and coordination in matters of common interest and initiate and participate in dialogue with policy makers and regulators.

At a macro level, the government should formulate supportive policy and regulatory environment and create supportive infrastructure through its agencies.

Source: Islamic Microfinance Development: Challenges and Initiatives, 2008, IRTI, IDB

1.3. Method of Study

The study uses a case-study method to find answers to the above research questions. The case studies involve microenterprise development projects from three countries across the Islamic world - Bangladesh, Indonesia, and Turkey. Some relevant facts about the countries under study are presented in Table 1.1.

Bangladesh with as high as eighty-two percent of population earning less than US$2 a day and thirty-six percent of population in abject poverty earning less than US$1 a day is suffering from acute rural-urban economic disparity coupled with illiteracy, lack of proper health and sanitation facilities. With a rank of eighty-two in terms of the Human Development Index compiled by UNDP it figures in the bottom one-third of the one hundred and twenty developing countries for which the Report compiles the Index.

Table 1.1. Poverty Levels and Financial Access in Bangladesh, Indonesia and Turkey

Name of Member Country	Human Poverty Index Rank	Income Poverty Index Population Below			Population In Millions	No of Poor in Millions	Financial Access %age (Honohan, 2007)
		US$1 a day (%)	US$2 a day (%)	Natl. Poverty Line			
People's Republic of Bangladesh	85	36	82.8	45	147.37	122.0	32
Republic of Indonesia	41	7.5	52.4	17.8	245.45	128.6	40
Republic of Turkey	21	3.4	18.7	20	70.41	13.2	49

Source: Islamic Microfinance Development: Challenges and Initiatives, 2008, IRTI, IDB

Bangladesh is well-known for its "minimalist" Grameen program focusing on livelihood enterprises and others like BRAC, PKSF, ASA and IBBL, who use a similar model involving group-based and graduated financing schemes. What differentiates IBBL from the flock however is its Rural Development Scheme (RDS) that seeks to ensure Shariah-compliance in its microfinance services. The present study undertakes an intensive case study of the IBBL project.

Turkey is at the other end of the spectrum with lesser poverty levels at about twenty percent of its population earning less than US$2 a day and better financial access for about half of its population of about seventy million. It also performs better in terms of the Human Development Index with a twenty-first rank. Turkey is also known for its focus on "trade-based" or growth enterprises and its rather mature policies and institutions in promoting microfinance and trade. An institution that has played a crucial role in promoting the growth of microenterprises is the Small and Medium Industry Development Organization called KOSGEB. This organization has become a role model in providing a wide range of business development services through its incubator centers, trade-promotion centers and collaborative initiatives in providing guarantee and other financial and non-financial services to artisans and microentrepreneurs. KOSGEB along with its affiliate organizations is therefore, under focus in the present study. It may be noted that various services provided by such organizations in Turkey do not involve any major Shariah-related issues because of their non-financial nature and may therefore be easily replicated in any Islamic model of microfinance.

Indonesia offers an interesting case of a deeply rooted and well-integrated rural financial system. With over fifty percent of its population earning less than US$2 a day, poverty alleviation has been a key objective of its economic and financial system. The striking feature of the Indonesian microfinance system is its rather long history, wide variety and outreach of its microfinance institutions. A conscious attempt is underway to link all its rural and microfinance institutions beginning from the nano-sized groups, microcooperatives to larger agricultural banks, commercial banks and the central bank. The chain of such institutions now forming part of the formal financial system is expected to substantially enhance financial inclusion. Apart from the "push" towards formal and integrated financial system, the other interesting feature of the Indonesian experiment is its well-coordinated move towards Shariah-compliant financing at all levels.

Data for this study are in the nature of primary data collected through personal visits and interaction by the researcher to various organizations in the three countries.

1.4. Organization of the Study

The study comprises five chapters. Chapter One provides an introduction to the issue. It undertakes a review of literature to examine the significance of the financial services approach to poverty alleviation through microenterprise development focusing on livelihood enterprises and growth enterprise. It also highlights the relative importance of financial and non-financial inputs for the two types of enterprises. Additionally, the chapter outlines the objectives, organization and scope of the study.

Chapter Two deals with financing of livelihood enterprises with a focus on Microfinance Institutions (MFI) from Bangladesh. It examines the impact of such livelihood programs on poverty alleviation. It presents a case study of the Rural Development Scheme of the Islami Bank Bangladesh Limited.

Chapter Three focuses on developing growth enterprises using both financial and non-financial inputs. It examines the issue of mitigation of high default risk associated with microfinance that acts as a deterrent for mainstream financial institutions with the help of third-party guarantees. It also deals with the issue of providing various business development services involving enhancement of entrepreneurial, technical and managerial skills, market matching and promotion. The chapter uses a case study of KOSGEB, the small and medium industry development agency of the government of Turkey - a highly successful model that could be replicated in other IDB member countries.

Chapter Four focuses on establishing linkages between grass-root institutions and the formal financial system as is being attempted in Indonesia. The case studies provide replicable models of microfinance that may be attempted elsewhere in the Islamic framework. The models also allow for integrating *zakah* and *awqaf* with Shariah-compliant for-profit microfinance.

Chapter Five provides the conclusions and recommendations highlighting the role that a developmental agency may play in reducing levels of poverty through microenterprise development.

Chapter 2

DEVELOPING LIVELIHOOD ENTERPRISES

Programs for developing livelihood enterprises have poverty reduction as their main objective. These programs seek to upgrade the productivity or increase the turnover of the multitude of livelihood enterprises and augment the income of the poor. They entail bringing about small improvements for many enterprises, often providing only credit, which is why they are sometimes characterized as being “minimalist.” In contrast, growth-oriented microenterprise programs have enterprise development as their immediate objective and attempt to lift microenterprises to a qualitatively higher level of sustainability, setting them on the path to long-term growth, and seeking to provide a comprehensive range of services, including credit, training, technical assistance, and the inculcation of business skills. At the same time, growth-oriented microenterprise programs can reach a much smaller number of enterprises. There is a trade-off, therefore, between making a short-term impact on poverty mostly through self-employment on the one hand, and longer term growth-oriented enterprise development on the other, but for a much smaller number of direct beneficiaries. (ADB, p36). In this chapter we focus on developing livelihood enterprises based on case studies in Bangladesh.

The following are the key characteristics of livelihood enterprises:

- The enterprise is often one of many part-time or seasonal enterprises undertaken to support family income. Often seasonality is tied to crop cycle, school year, major festivals etc. It is one of several “multiple” enterprises to compensate for seasonality and low returns. It mostly uses family labor with infrequent use of hired labor. It makes a secondary but vital contribution to family income.
- The enterprise usually involves no skills or very rudimentary skills, except for skills acquired traditionally, as in handicrafts. Therefore, there are very low-entry barriers to the activity resulting in overcrowding.
- Cases of surplus earnings are limited. Net earnings tend to be used for survival and ploughed back into household expenditure.
- A higher proportion of livelihood enterprises tends to be owned and operated by women.
- A higher proportion of livelihood enterprises are in livestock, backyard poultry, food processing, and petty trading.

While the potential for growth for such enterprises is limited in terms of new employment generation, there is considerable scope for increases in sales, productivity, profitability, and income. It may be noted that the surpluses in earnings generated by the enterprises tend not to be reinvested for expansion and tend to be applied instead to household expenditure. This is simply a reflection of the poverty of the entrepreneurs who operate them. Therefore, they face a continuous need for external financing.

The poverty of the entrepreneurs raises the all-important issue of collateral. Collateral is supposed to mitigate the risk of defaults and delinquencies. In the absence collaterals, mainstream financial institutions are reluctant to provide financing to such entrepreneurs. The main point of departure of microfinance from mainstream financial systems is its alternative approach to collateral that comes from the concept of joint liability. In this concept individuals come together to form small groups and apply for financing. Members of these small groups are trained regarding the basic elements of the financing and the requirements they will have to fulfill in order to continue to have access to funding. Funds are disbursed to individuals within the group after they are approved by other members in the group. Repayment of the financing is a shared responsibility of all of the group's members. In other words, they share the risk. If one defaults, the entire group's members face a setback. This is a basic but effectual credit scoring mechanism that may mean a provisional suspension from the program and therefore no access to financing for the group or other penalties. In most cases, microfinance programs are structured to give credit in small amounts and require repayment at weekly intervals and within a short time period– usually a month or a few months. The beneficiary looks forward to repetitive financing in a graduated manner and this also helps mitigate risk of default and delinquency.

The model that has popularized the above methodology and has been replicated in many countries in a wide variety of settings is the *Grameen Bank* model. The model requires careful targeting of the poor through means tests comprising mostly of women groups. Services are strictly targeted to a well-defined set of clients - to the landless or near-landless households. The model requires intensive fieldwork by staff to motivate and supervise the borrower groups. Groups normally consist of five members, who guarantee each other's loans. Lending activities are supplemented by training activities in areas ranging from entrepreneurial skill development, management of microenterprises like shop keeping, and crafts production, to education on social awareness and family planning activities. Groups are required to contribute to an emergency fund that may be used when members experience household and other emergencies.

A number of variants of the model exist; but the key feature of the model is group-based and graduated financing that substitutes collateral as a tool to mitigate default and delinquency risk.

Table 2.1. Positive Impact of Microcredit on Poverty

Author	*Study Description*	*Major Findings*
PKSF (2005)	Follow up monitoring and evaluation system (MES) study	Absolute poverty declined by 9 percent and moderate poverty declined by 5 percent.
Chowdhury & Bhuiya(2004)	Wider impact of BRAC poverty alleviation program	Positive impact on human well-being, survival rate and schooling of children
Amin *et al.* (2003)	Impact of microcredit on clients of Grameen Bank, BRAC and ASA	Microcredit program was more successful in reaching the poor, but less successful in reaching the hardcore poor.
Khandker (2003)	Impact of microcredit on borrowers of Grameen Bank, BRAC and Bangladesh Rural Development Board (BRDB)	Microfinance helps reduce extreme poverty more than moderate poverty. Welfare impact was positive for all households availing credits.
Latif (2001)	Effects of microcredit on the household saving of Bangladeshi borrowers	Saving-income ratio was significantly higher for the participants than the non-participants.
Zaman (2001)	Impact of microcredit on poverty and vulnerability for BRAC clients	Positive impact on income, decision-making ability and in reducing gender disparity.
BIDS (2001)	Impact study on the microcredit borrowers under the partner organizations of PKSF	Positive impact on the income of microcredit program participants in comparison to non-program participants.
Ahmed *et al.* (2000)	Impact of BRAC's Integrated Rural Development Program (IRDP) on gender equity.	Mobility was low among households of BRAC members compared to non-members.
Khandker (2000)	Impact of microcredit on savings and informal borrowings	Microcredit increased voluntary savings and this was more pronounced in case of women than men. Borrowing from informal sources had reduced.
Hakim (2000)	Impact of microfinance program	Higher social interaction and mobility among women clients, positive impact of MF on asset-ownership
Zohir (2000)	BIDS Study on PKSF’s monitoring and evaluation system	MFIs have positively and significantly contributed to income, food security and family planning,
Mosley and Hulme (1998)	Possible conflict between growth and poverty alleviation	Income and assets of the borrowers had increased. Higher income households had experienced higher impact of micro-credit than the households living below the poverty line.

Table 2.1. (Continued)

Author	*Study Description*	*Major Findings*
Halder (1998)	Identification of the poorest and the impact of credit on them	Higher calorie consumption for BRAC members compared to non-members
Khandaker (1996)	Impact of microcredit on borrowers of Grameen Bank and BRAC	Five percent of participant households came out of poverty annually.
Pitt and Khandaker (1996)	Impact of microcredit on borrowers of BRAC, BRDB and Grameen Bank	There was a positive impact of the program on women employment, total per capita weekly expenditure and women's non-land assets. Credit programs could change villagers' attitude and other behavior
Hulme and Mosely (1996)	Impact of microcredit on incomes of borrowers	There was a positive impact on the poor borrower's income with around 30 % over that of the non-borrowers,
Chowdhury et al (1996)	Impact of targeted credit on nutritional status of the poor	Most clients meet calorie requirements in food.

2.1. Role of Grameen Bank & Similar Microfinance Institutions (MFIs)

MFIs in Bangladesh serve a total number of over 20 million members, with Grameen Bank leading the flock with 7.2 million, ASA with 6.4 million and BRAC with 5.3 million members. The average size of the loan stands at BDT8,000, making the Bangladesh microfinance segment a vibrant US$2.3 billion industry. All the MFIs claim to have reported excellent repayment rates at 98 percent and above.

The impact of Grameen bank and similar MFIs on poverty alleviation in Bangladesh has been the subject of a large number of empirical studies. A brief synopsis of such studies and their key findings are presented in Table 2.1. Studies that have focused on microcredit borrowers and compared them with non-borrowers with similar initial socioeconomic characteristics have provided supporting evidence that microcredit contributes to reducing poverty. According to most of these studies, microcredit led to a discernible improvement in the income and savings of the members of MFIs, such as, Grameen bank and BRAC.

Since poverty is a multi-dimensional concept, studies have also examined the impact of micro-credit on non-income dimensions of poverty such as children's education, health and nutritional status. There seems to be evidence of a positive contribution of micro-credit along these dimensions both through the impact of increased incomes and the social mobilization messages delivered during group meetings. The studies also found that microcredit has contributed to gender equity or female empowerment. There was positive evidence of greater decision-making power of women within the household, enhanced mobility and participation in local elections. (Uy & Zaman, 2003, p03)

Some of the reported studies however, point towards areas of weaknesses. In a widely quoted study "Does microfinance really help the poor?" Morduch (1998) undertakes an evaluation of the flagship programs of leading MFIs in Bangladesh. The study finds serious methodological problems with some known empirical studies that document a positive impact of Bangladeshi MFIs on poverty. Using an alternate methodology, it asserts that “access to the programs is associated with substantially lower variation in labor supply and consumption across seasons -- a benefit that may be considerable for poor agriculture-based households. At the same time, no evidence was found to support claims that the programs increase consumption levels or increase educational enrollments for children relative to levels in control villages” (Morduch, 1998, p30). The most important potential impacts are thus associated with the reduction of vulnerability, not of poverty *per se.*

Amin et al (2003) also note that microcredit programs of leading MFIs, such as Grameen and BRAC were more successful in reaching the poor, but less successful in reaching the hardcore poor. These are households which are often severely undernourished, are marginalized in society and often ill or unable to work for various reasons. Proponents of microcredit believe that “for some of these households, small amounts of credit can play a role in improving their socio-economic status, if it is delivered appropriately. The delivery mechanism will have to be more staff-intensive in order to motivate these households that it is worthwhile to borrow and the loan sizes are likely to start off smaller than the regular microcredit loan. Moreover, credit alone will not be enough for this group of households - the importance of skill training and social mobilization activities are critical”(Uy & Zaman, 2003, p03). This may not be true however for the simple reason that such people are not economically active and hence, may be pushed into penury that is more serious and perpetuating through availing credit that has a cost factor associated with it. Such people need to be supported with charity to take care of their immediate consumption needs; an institutional mechanism to improve their skill level required to make them economically active; and a financing mechanism that does not penalize the new entrepreneurs with a cost should there be an incidence of failure in their respective ventures. In Islamic societies, the institutions of *zakah*, *awqaf* and *qard hasan* are supposed to perform the above three functions respectively.

Some negative dimensions of a drive for gender equity and women empowerment have been documented by Sadeq (2007). The issues relate to increased family tensions, divorce rates due to greater social assertion and mobility by women members, abandonment of *hijab* and cultural de-Islamization.

A major issue relates to high cost of microfinance. Interest rates charged by microfinance institutions are "excessively high". Critics feel that poor people cannot afford these rates and will perpetually remain in a poverty trap if interest rates are not lowered. Proponents however, prefer to compare interest rates charged by MFIs with those by village money lenders. They contend that around 85 percent of NGOs in Bangladesh charge between 11-15 percent flat interest rates as compared to around 120 percent charged by the village money-lenders (Uy & Zaman, 2003, p01). MFIs charge higher interest rates than commercial banks on the ground that transaction costs are much higher when dealing with small average loan sizes and taking financial intermediation directly to the village doorstep. Further, if there is a surplus that is generated from these operations, they are revolved back through the loan fund in order to be able to service more clients and provide larger loan sizes. The bottom line, therefore, is that poor people value having access to credit much more than the rate of interest. Any measures to control interest rates by the State would only serve to undermine the sustainability of this source of financing for the poor.

The contrary view is articulated by Mannan (2007) who asserts that Grameen Bank like other MFIs charges an interest rate that is as high as 54.95 percent per annum, if the hidden cost for documentation of membership fee, obligatory provision for blocked amount are taken into consideration. Since non-reducing method of accounting is applied in case of the repayment loan installments, this raises the interest rate by additional 31.46 percent pushing the total interest rate to a whopping 86.41 percent. This is clearly exploitative and cannot be justified by higher monitoring costs and other rational factors (Mannan, 2007, p03).

Another issue of significance is access to credit for the vulnerable non-poor and "graduate" microcredit borrowers. There are entrepreneurial households who require loans in excess of the average microcredit loan in order to set up new small enterprises or expand existing ones. In such cases, there is a need to depart from the group guarantee mechanism while finding a way out for maintaining high repayment rates.

2.2. Case Study of IBBL Rural Development Scheme in Bangladesh

A question that has not been addressed by the rather large body of literature pertaining to microfinance in Bangladesh is the issue of client preference for *riba*-free microfinance. None of the evaluation studies seem to have examined the degree of discomfort of clients with *riba* in the highly conservative culture of rural Bangladesh that is sensitive to Islamic prohibitions. It is however, a fact that the Shariah compliant MFIs, such as Islami Bank Bangladesh Limited (IBBL), Social Investment Bank Limited (SIBL) and others attribute their existence and growth to this abhorrence and discomfort factor. The following section undertakes a case study of the Rural Development Scheme (RDS) of IBBL which follows a modified Grameen model of microfinance, making the necessary changes in the products and methods that are unacceptable or repugnant to an Islamic population.

Launched in 1995, the Rural Development Scheme (RDS) aims to develop the rural economy and establish model villages that are gradually freed from wide-spread poverty and destitution. The RDS is not an MFI by itself, but uses the infrastructure and branch network of its parent, the IBBL for its microfinance operations. Its stated objectives are:

- To extend investment facilities to agricultural, other farming and off-farming activities in the rural areas;
- To finance self-employment and income generating activities for the rural people, particularly the rural unemployed youth and able-bodied poorest of the poor;
- To extend facilities for hand tube-wells, sanitary latrines and rural housing to ensure safe drinking water, proper sanitation and decent living;
- To propagate the divine message of acquiring knowledge and education to have a humanly living.

2.2.1. Key Features of RDS

Geographical Coverage:

Since the RDS uses the existing branch network of its parent, the IBBL, the first step is to select suitable villages within 16 kilometers radius of an existing IBBL branch. The criteria used in selecting a village are: (a) easy communication; (b) availability of agriculture and other off-farm activities; (c) abundance of low-income people; and (d) predominance of Islamic values and ideas. As of now, RDS covers sixty out of sixty-four districts in the country through 129 Branches of IBBL leaving aside the metropolitan and the hill tract areas.

Criteria for Eligibility:

After primary selection of a project area consisting of four to six villages, the Branch conducts detailed Baseline Survey to identify the target group and verifies possibility of economic activity in the area. The RDS like Grameen employs strict means-test criteria to identify the potential beneficiaries. The eligible beneficiaries are restricted to (i) able-bodied & industrious rural poor having age between 18 to 50 years and the permanent resident of the selected area;

(ii) farmers having cultivable land of a maximum of 0.50 acres and the sharecroppers; (iii) persons engaged in very small off-farm activities in the rural areas; and (iv) destitute women and distressed people. Persons having liabilities with other banks/institutions are not eligible for financing under the Scheme.

Formation of Groups and Center:

The target people are organized in groups of five - preferably comprising people of similar occupation. It takes a minimum of two and a maximum of eight such groups to set up a center that is put under the direct supervision of a Field Officer (FO). At least four hundred beneficiaries are placed through the centers under one FO. Each group selects a group leader and a deputy group leader. The group leaders in a center select the center leader and the deputy center leader who are responsible for overall discipline and performance of the center. At times, the centers are named after prominent Islamic personalities.

Weekly Meetings:

The center has to conduct regular weekly meetings on a fixed date and time in the presence of the FO to collect compulsory savings and weekly installment payments. Center meetings are recorded in a Resolution Book along with signature of the members (members who do not know how to sign must learn it). Attendance in the center meeting is the first requirement to become a dependable client of RDS. Weekly meetings begin with recitation from the holy Quran followed by discussions on the Islamic way of life. This is followed by discussions on proposals for new enterprises that are expected to lead to self-employment and generate income for the microentrepreneurs. Proposals are submitted for approval with recommendation from the members and the center leader. The discussions also involve some of the eighteen commandments for the members. Every attempt is made to resolve disputes, if any, among members. The meeting is followed by physical inspection of at least two client-locations to see whether the goods financed have been actually purchased and are in possession of the client.

Group Guarantee:

Each member of the group is required to provide a guarantee against defaults and negligence of other members of his/her group. If any member of a particular group does not comply with the principles or rules of the group, then the remaining members are expected to pressurize him/her to observe group discipline. In case of default, they are held liable and responsible for recovery. A defaulting member is invariably expelled from the group for breach of group discipline and is never allowed any financing facility or any other benefit from the Bank in future.

Savings Plans:

RDS stipulates mandatory savings for its members. Each member is required to individually open a *mudharabah* savings account that is a non-checkable account with the Branch from the very inception of the group activity. The compulsory savings of a minimum Tk.10.00 per week is intended to inculcate a savings habit among members. The deposits may be withdrawn by a member if he/she does not have any other liability with the Branch.

Financing Plans:

Financing is restricted to *bai-muajjal* (deferred-payment sale) mode in practice, though RDS intends to use various Shariah-compliant modes like *mudharabah*, *ijarah* and *bai-salam*. No collateral is required for financing. A request for financing is considered eight weeks after the date of enrollment of an individual as a member of the group. The initial financing is kept in the range Tk.8,000-10,000 (US$115-145). The upper limit for financing under the scheme is Tk.30,000/US$435 (Table 2.2). Each member is required to make a compulsory savings of Tk.10/US$0.15 every week. The total debt (principal amount plus profit) is to be cleared by the client member over a one-year period in forty-four equal weekly installments. No payment is to be made during remaining eight weeks to allow for holidays. The profit rate is uniform and reasonably low at ten percent with a further discount of two and half percent for timely repayment. If compared with bank interest rates on a declining balance basis, the relevant rate for RDS would be around fifteen percent.

Table 2.2. Financing Plans under RDS

Sl.	Sector of Investment	Duration (year)	Ceiling of Investment(Tk.)	Equivalent US$
1	Crop Production	1	15,000/-	214
2	Nursery and commercial production of Flowers & Fruits	1	30,000/-	429
3	Agriculture Implements	1 to 3	30,000/-	429
4	Live stocks	1 to 2	30,000/-	429
5	Poultry & Duckery	1	20,000/-	286
6	Fisheries	1 to 2	30,000/-	429
7	Rural Transport	1	10,000/-	143
8	Rural House Building	1 to 5	20,000/-	286
9	Off-firm activities	1	30,000/-	429

As discussed earlier, a major issue with group-based financing relates to financing of "graduate" clients once they grow larger and the maximum permissible financing under existing schemes is not large enough. There are also entrepreneurial households which require loans in excess of the average microcredit loan in order to set up new small enterprises or expand existing ones. To satisfy the needs of "graduate" clients who have already availed the highest limit of financing under off-farm activities, a special scheme has been designed under RDS called Microenterprise Investment Scheme (MEIS) under which financing is provided in the range of Tk.30,000 (US$429) to Tk.200,000 (US$2860).

Microtakaful:

In addition to individual savings plans, RDS also requires each member of a group to deposit a minimum Tk.2.00 per week in a pool in the name of its center. The pool of funds - maintained with IBBL as a *mudharabah* savings account in the name of the respective center essentially aims to provide a kind of microinsurance against unforeseen adversities. Out of the *takaful* fund, assistance is provided to members by way of *qard* as per decision of the center in the weekly meeting. The *mudharabah* account that is refundable, is jointly operated by the leader and deputy leader of a center.

Linkage with Charity:

Donations have played a major role in the microfinance scenario of Bangladesh. Most of the flagship MFIs, such as, Grameen, BRAC, ASA and others have been recipients of recurring doses of support from overseas donors. While donations are deemed indispensable by many especially in the initial stages of a non-profit organization venturing into microfinance, such dependence is supposed to decline as organizations become self-sustaining. In case of RDS, the initial support has come not in the form of donations, but through hand-holding by its parent. Another form of support that enables RDS to take on competition is the linkage it has established between its financing and other development activities that are funded through charity. While provision of education and healthcare are not profit-yielding commercially viable sectors, especially in the rural areas, these constitute important dimensions of development. Such activities are undertaken and financed by Islami Bank Foundation, a non-profit service-oriented sister organization of IBBL, but linked to financing scheme of RDS. A member-borrower of RDS with a good track record of repayment over two years may seek financing based on *qard-hasan* for purchase of hand tube-well for safe drinking water and the articles for sanitary latrine.

Non-finance Activities:

Besides its financing activities RDS undertakes a number of non-finance activities. For instance, in the rainy season, the RDS members are encouraged to go for plantation. IBBL provides to each of the RDS members one small plant free of cost if he/she agrees to plant at least three. During natural calamities like flood, storm etc. the IBBL distributes relief among the affected RDS members.

Spiritual Development:

RDS has an active moral and spiritual development program. It also seeks to inculcate in its members an awareness about their social rights and responsibilities. Discussions and deliberations in the weekly center meetings contribute to overall development of the members that includes an appreciation and striving for an Islamic way of life. It is interesting here to juxtapose the sixteen-point declaration of Grameen with the eighteen-point declaration of RDS (Table 2.3). There are ten points of clear congruence (shaded). The remaining six points in case of Grameen and eight points in case of RDS demonstrate the priority accorded by them to various socio-cultural and religio-cultural factors respectively. While Grameen emphasizes on replacing the existing culture with what it perceives as ideal (e.g. the need for family planning, collective participation in all social activities), RDS emphasizes on spiritual uplift of the faithful and perfection in *muamalat* (faith in Allah SWT, mutual help, honoring promises, striving for knowledge, freedom from corruption etc.).

Table 2.3. Influencing Culture through Microfinance

The Sixteen Decisions of Grameen Bank	**The Eighteen Decisions of RDS of IBBL**
We shall 1. follow the four principles of Grameen Bank – Discipline, Unity, Courage and hard work - in all walks of our lives; 2. bring prosperity to our families; 3. not live in dilapidated house, repair our houses and work towards constructing new houses at the earliest; 4. grow vegetables all the year round, eat plenty of them and sell the surplus; 5. During the plantation seasons, plant as many seedlings as possible; 6. plan to keep our families small, minimize our expenditures, look after our health; 7. educate our children and ensure that we can earn to pay for their education; 8. always keep our children and the environment clean; 9. build and use pit-latrines; 10. drink water from tube-wells. If is not available, boil water or use alum; 11. not take any dowry at our sons' weddings, neither shall we give any dowry at our daughters' wedding; keep centre free form the curse of dowry; not practice child marriage; 12. not inflict any injustice on anyone; neither allow anyone to do so; 13. collectively undertake bigger investments for higher incomes; 14. always be ready to help each other; if anyone is in difficulty, we shall all help him or her; 15. If we come to know of any breach of discipline in any centre, we shall all go there and help restore discipline; 16. take part in all social activities collectively.	We shall 1. seek help of Allah, the Almighty, in all conditions of life, speak truth and lead honest life; 2. order others for good deeds and prohibit them from bad deeds; 3. be law abiding, not do illegal work and not allow others to do the same; 4. not remain dependent on others rather stand on our own feet; 5. bring prosperity to our family *Insha Allah*; 6. grow vegetables at the surroundings of our house, eat plenty of them and sell the surplus; 7. During the plantation season, plant as many seedlings as possible; 8. not remain illiterate, establish night school if necessary; 9. arrange education for the children; 10. help each other, try to rescue any member of the Centre from danger if any; 11. give preference to others, compete in good deeds and encourage others in it; 12. Build and use sanitary latrine, if not possible, build latrine digging hole; 13. drink water from tube-well, otherwise drink boiled water; 14. keep our children and environment clean; 15. take care of health, take balanced food so far; 16. not take any dowry at our son's wedding, neither shall give any dowry at our daughter's wedding, tell others that it creates a social problem; 17. follow discipline, unity, courage and hard work in all walks of our lives; 18. keep words (*Wadah*) with others, not embezzle the deposit (*Amanah)* and tell a lie.

2.2.2. Performance Measures of RDS

The Rural Development Scheme (RDS) of IBBL was launched in 1995. As at the end of 2007, 129 Branches of the Bank have been operating the Scheme. These Branches are working among the poor in 10,024 villages covering 926 unions under 220 thanas of 61 districts of the country. Over a period of twelve years one may observe a phenomenal growth in all the performance-related measures of RDS. The performance measures of RDS up to December 31, 2007 are presented in the Table 2.4. A further analysis reveals that the number of centers, groups, and group members have experienced a growth of 23-26 percent over just one year, i.e. 2006-27. Cumulative disbursement increased by a whopping 50 percent; number of clients who actually availed financing grew by 18 percent and present outstanding bounced by 29 percent over 2006-07. Over the same year, savings increased by 44 percent, *takaful* funds held with centers grew by 48 percent.

Table 2.4. Performance Measures of RDS

		Figures in Million Taka				
Sl. No.	Areas of performance	Number & Volume		National Position*	Share of RDS on Dec-07 in %	Share of RDS on Dec. 06 in %
		Dec-07	Dec. '06			
1	No. of Branch handling the Scheme	129	118	----	-----	-----
2	No. of Villages	10023	8057	87,319	11	9
3	No. of Unions	926	906	4484	21	20
4	No. of Thanas	220	215	508	43	42
5	No. of Districts	61	61	64	95	95
6	No. of Divisions	6	6	6	100	100
7	No. of Centers	18897	15321	---	---	---
8	No. of Groups	103345	81915	---	---	---
9	No. of Group Members	516725	409575	18,793,990	2.75	2.18
10	No. of Clients (who availed financing)	350278	295012	13,941,823	2.51	2.12
11	Cumulative disbursement	13969.01	9303.12	431230.50	3.24	2.16
12	Sanctioned amount against running accounts	4252.14	3165.75	---	---	---
13	Average size of investment	0.012	0.011	---	---	---
14	Present outstanding (total)	2884.66	2242.21	55681	5.18	4.03

Table 2.4. Performance Measure of RDS (Continued)

Figures in Million Taka

Sl. No.	Areas of performance	Number & Volume		National Position*	Share of RDS on Dec-07 in %	Share of RDS on Dec. 06 in %
		Dec-07	Dec. '06			
15	Amount of overdue	12.13	5.41	---	---	---
16	Percentage of Recovery	99	99	96.33		
17	No. of Field Officer	1819	1436	65766	2.77	2.18
18	Average no. of villages per F.O.	5	6	---		
19	Average No. of Members per F.O.	284	285	286	99	100
20	Average investments per F.O.	1.59	1.56	---	---	---
21	No. of Members under MEIS	6447	2487	---	---	---
22	Cumulative disbursed under MEIS	483.77	139.40	---	---	---
23	Avg size of investment under MEIS	0.049	0.052	---	---	---
24	Present outstanding under MEIS	293.80	110.28	---	---	---
25	Balance of personal savings	922.86	639.45	20344	4.54	3.14
26	Balance of Center Fund	130.70	88.22	---	---	---
27	Waiver (Current year)	2.47	1.04	---	---	---
28	No. of Tube well provided (Since inception)	6242	5525	---	---	---
29	Amount disbursed against Tube-well (Since inception)	12.12	10.27	---	---	---
30	No. of Sanitary Latrine provided (Since inception)	3551	3147	---	---	---
31	Amount disbursed against Sanitary Latrine (Since inception)	3.51	2.88	---	---	---

** National position of Microcredit activities & coverage available in Credit & Development Forum (CDF) Statistics (December-2005)*

** *MEIS - Microenterprise Investment Scheme*

All these have resulted in a significant improvement in the share of RDS in the national aggregates. It should be noted that RDS has consistently granted waivers to clients who genuinely deserved to be treated compassionately. Waivers increased by a 138 percent over the one-year period. Another unique feature of RDS is the provision of tube-wells and sanitary latrines through *qard hasan* mode.

2.2.3. Comparative Performance of RDS

A comparative statement for RDS and other leading MFIs in Bangladesh along various dimensions and parameters is presented in Table 2.5. For a proper cross-sectional comparison, the study uses data for 2006. As mentioned in the section above, all the measures have experienced substantial revision upwards during 2006-07. While absolute numbers on outreach of RDS may not be very impressive as compared to the leaders, one must take into account the fact the RDS was launched about one and half decades after Grameen and over a couple of decades after BRAC and ASA. The relative numbers however tell a different story. RDS has fared marginally better or at least as good as the three conventional leaders in terms of repayment record. Some striking facts about the operational efficiency of RDS stand out.

1. It is far ahead of others in terms of growth with a rate as high as 12.57 percent as compared to six-seven percent for others. While one may argue that the high growth with RDS may be partly attributable to a low base, the growth rate in measures during 2006-07 has been quite impressive.

2. It has the lowest drop out rate at five percent only as compared to around fifteen percent for Grameen and ASA. BRAC fares slightly better with eight percent. It also has the lowest overdue loans as a percentage of total outstanding loans.

3. In terms of operational efficiency, it is far ahead of others if we use total disbursements per staff as a measure. It fares better than BRAC in terms of total members per staff. The situation has further improved during the year 2006-07.

4. The rate of profit charged by RDS is much lower compared to others. It does not charge any membership fees, passbook costs, which other MFIs usually charge. The effective rate for good clients is as low as less than fifteen percent as compared to a minimum of thirty-five percent for other MFIs. While too high rates raise the issue of exploitation, too low rates are bound to raise concerns about sustainability. Whether RDS operations are sustainable at such low rates of profits is an open question. A close scrutiny of RDS operations reveals that some elements of costs of RDS are currently absorbed by the parent IBBL, such as, part of the overheads and

Table 2.5. Comparison of RDS with Major Bangladeshi MFIs

Sl. No.	Areas of performance	RDS	Grameen Bank	ASA	BRAC
1	Year of Establishment	1996	1983	1978	1972
2	Districts	60	64	64	64
3	Villages	7788	78101	70047	69421
4	Branches	116	2422	3057	2806
5	Female member (mil.)	0.339	6.935	6.206	5.312
6	Male member (mil.)	0.029	0.231	0.146	---
7	Total member (mil.)	0.368	7.166	6.352	5.312
8	Member per branch (no.)	3177	2959	2078	1893
9	Total staffs / Field Officer	1391	22169	18782	42693
10	Disbursement (mil)	8894.94	45900	43000	36900
11	Recovery (mil.)	8690.35	37700	37400	37500
12	Outstanding loan (mil.)	1944.47	31700	23200	20900
13	Overdue loan (mil.)	6.68	700	200	900
14	Overdue % of outstanding	0.34	2.2	0.7	4.4
15	Profit / Interest rate (flat) %	10	22.5	20	16
16	Average investment size (mil)	0.0110	0.0126	0.0073	0.0120
17	Rate of recovery %	99	98.28	99.85	98.65
18	Growth rate %	12.57	6-7 (2003)	6.83	7 (1997)
19	Drop out rate %	5	15 (2002)	14 (2002)	8 (1996)
20	Total Member/Total Staff	264.5	323.2	338.2	124.4
21	Disbursement/Total Staff	6.39	2.07	2.29	0.86
22	Membership fees	Not Required	Required	Required	Required
23	Cost of pass book	Not Required	Required	Required	Required

Figure in the parentheses indicates respective year of the information.
Adapted from Rahman S.M. (2008)

staff costs. In the interest of a fair comparison with other MFIs such costs should be allocated to RDS if its sustainability as an independent MFI is to be assessed. Discussions with RDS officials reveal that RDS is currently barely able to recover its costs with the present arrangement with its parent. Therefore, as an independent MFI, it would have to charge a higher rate of profit on its financing if it is to absorb all its costs itself and show a modestly healthy bottom line as any other sustainable business operation.

5. Though there are thousands of MFIs working in Bangladesh, ethical development of the rural poor is not part of their mission statements with the notable exception of the Islami Bank Bangladesh Limited (IBBL). In a recent study Rahman (2008) finds that elderly and educated clients having several years' of involvement with the RDS program are ethically and morally more developed than the young and illiterate new clients.

2.2.4. Key Lessons and Issues of Concern

The performance of RDS has been impressive compared over time and across other leading MFIs. It has used a very successful model of attacking poverty – the Grameen model – but without the "cultural and religious negatives" from the standpoint of a highly conservative Muslim society of Bangladesh. Like Grameen it has embarked on empowerment of women with 94 percent of its clients being women. However, this has been attempted in a culturally compatible manner that promotes family integration and cohesiveness by popularizing the concept of "family empowerment". Like Grameen it has attempted to promote healthy social practices by ensuring participation of all members in center activities. However, the practices now exclude behavior that are repugnant or unacceptable to Islam and detrimental to the institution of family and include codes of ethics and morality that promote unity and cohesiveness in society. Like Grameen it has provided collateral-free finance to the poor using the concept of group and graduated financing. However, it has brought in Shariah-compliant modes of financing that do not involve *riba*. Notwithstanding the laudable achievements of RDS, several areas of concern remain.

One, a close look at the working of the RDS in the field reveals certain anomalies. RDS uses *bai-muajjal* - where the bank is supposed to purchase the commodity required by its client from the vendor and resell the same to the client at a profit - as the Shariah-compliant mode of financing. In order to ensure that this mode is distinct from conventional *ribawi* loan, scholars of *fiqh* insist on several conditions that must be fulfilled. For example, the financing must involve two distinct transactions – between the bank and the vendor or supplier of the commodity and then between the bank and the client. However, when the *bai-muajjal* is executed in actual practice involving recurrent and copious transactions on a day-to-day basis, the separation between the two transactions in each *bai-muajjal* financing seems to get blurred to an extent that the end result is often a cash-for-cash transaction. Further, it is an important requirement of Shariah compliance that the commodity must remain in *ownership* of the bank for some time between the two transactions. It is the risk of ownership factor that justifies the profits as a reward for risk. Ownership is often evidenced by related documentation. Such checks and balances are easily put in place in case of mainstream IFIs where financing involves large amounts and transactions are fewer in number. Microfinance by definition, involves small amounts in large frequencies. The informal setting of rural markets and businesses do not make documentation any easier.

An indicator of such practical problems leading to a near-breakdown of Shariah-enforcement mechanism is the fact that the *bai-muajjal* financing provided by RDS invariably involves a uniform amount (like the basic loan of Grameen). One would expect the amount of financing to vary given the wide range of commodities financed having varying prices. The commodities are not perfectly divisible either. For example, neither the price of a cow and a goat are same, nor can one buy, say, one and half goats for a pre-determined amount of funding.

While RDS apparently makes use of all permissible Islamic modes of finance, a review of actual contract(s) used for financing reveals that *bai-muajjal* is the only mode of financing used. *Bai-muajjal* obviously is not suitable for financing all kinds of income-generating activities. For example, many of RDS clients need financing for growing vegetables, fishing and other agri-based activities. Theoretically, *bai-muajjal* can be used to finance the purchase of saplings, fertilizer, fishing nets and so on. In practice, however, the client would need funding not just for the physical asset(s) involved, but for the complete project and cannot be expected to approach some other agency to finance the working capital component. This is a possibility in mainstream finance, but not in microfinance with few options for the poor client. The result is not very unpredictable. RDS clients often receive funding the same way as clients of Grameen – in cash to be repaid in cash. RDS must think in terms of using "appropriate" contracts for financing such livelihood enterprises.

One option is *mudharabah*. While this would help RDS overcome the issue of Shariah non-compliance in financing working capital in addition to physical assets, it is fraught with practical problems. Informal livelihood enterprises are either extremely reluctant or simply do not know how to maintain proper books of accounts. This makes calculation and sharing of profits quite difficult as required under *mudharabah*. Considering the nature of many livelihood enterprises, *muzarah* or share-cropping that involves output-sharing instead of profit-sharing should be experimented with. The *mudharabah* mode could however, be tried with success for the moderately poor under the Microenterprises Investment Scheme of RDS if accompanied by suitable training inputs in book-keeping, cost-estimation, business plan development and communication.

A major problem cited by RDS personnel relates to adequacy and effectiveness of supervision. A recent internal study by IBBL (Rahman, 2008) admits that there are cases of non-compliance but puts the blame on the field officers (FO) who may not be properly educated or trained in Shariah. While this is partially true, a more serious problem relates to span of management and supervision. It is practically impossible for an FO to continuously monitor purchases and sales relating to *bai-muajjal* for the 400 plus clients on a daily basis. Arguably, monitoring costs even for the simple conventional microloans is quite high. These would be far higher for *bai-muajjal* financing if proper monitoring of end-use including Shariah compliance is undertaken. This also underscores the need for public provision of Shariah audit services, such as through a supervisory agency, or through a self regulatory body that should spread the costs and enable individual programs like RDS to contain the costs of compliance.

RDS is a humane scheme. However, it would be nothing short of a miracle if RDS can ensure proper monitoring and Shariah compliance, and at the same time charge as low as 7.5 percent rate of profit and still manage to break-even and become a sustainable entity.

A key feature of Islamic commercial finance is asset-backing. There is perhaps merit in the argument that end-use of funding must be monitored and funds must flow into productive assets. However, the argument loses its strength in the context of the poor and the destitute whose needs are all basic in nature and do not allow much room for choice between present and future consumption. It is perhaps not a sensible idea to finance an income-generating asset through *bai-muajjal* for a hungry man without finding a way to meet his immediate need – food for him and his family. He would most certainly need cash to fulfill his immediate needs in addition to the physical asset of course to create wealth and generate income that would satisfy his future needs.

As a recent ADB study asserts "successful MFIs recognize that the household and business finances of most microenterprises are intertwined, and that efforts to restrict their use of funds to specified business purposes are typically futile and counterproductive....Therefore, to best serve the interests of poor borrowers, poverty-oriented microcredit programs should include consumption credit, and programs should evolve in the direction of a more holistic financial services approach where the objective is long-run financial sustainability. The attempt to focus on production credit alone is inevitably unsuccessful." (ADB 2003, p09)

Given the above constraints of financing the poor, it appears that *qard-hasan* is perhaps the most appropriate way of financing livelihood enterprises accompanied by caring advice and guidance by RDS on the desirable way to use the cash received. *Qard-hasan* allows for recovering actual costs through levy of service charge. It follows from the historical record of RDS that bolstering the bottom-line of its parent is not one of its aims. Current financials indicate that it is effectively operating on a not-for-profit basis. It is barely able to recover its costs even after transferring some overheads to the parent. Therefore, it may consider explicitly employing *qard hasan* – a not-for-profit mode of finance. This would better match the requirements of the poor clients, make supervision easy (the apparent reason cited now for flouting the Shariah conditions of *bai-muajjal*) and offer a workable and transparent model for replication elsewhere. It should be noted that such a model is already being tried in the Indian subcontinent, but perhaps on a much smaller scale and often without using group or graduated financing methods. RDS has all the potential to make a winner out of this model.

Chapter 3

DEVELOPING GROWTH ENTERPRISES

As distinct from livelihood enterprises, growth enterprises usually involve the moderately poor or the graduated poor who have been largely successful in coming out of extreme poverty and destitution and are seeking to move upwards. The former could still form part of the lowest strata of the society in terms of their income and wealth in a country that is relatively wealthier and more developed. The case of the latter has already been highlighted in Chapter 2. Developing growth enterprises is therefore, an essential component of any composite strategy of poverty alleviation.

The following are the key characteristics of growth enterprises.

- The enterprise is often the main source of family income.
- The entrepreneur usually has some education. The entrepreneur needs to possess considerable experience and skills. This is more often acquired through vocational training and/or previous wage employment. The skill requirement restricts entry into such enterprises that are mostly in manufacturing and services sector.
- The enterprise often occupies “niche” market with considerable scope for specialization and product differentiation.
- Compared to livelihood enterprises, growth enterprises are less affected by seasonality and function throughout the year, even if at varying levels.
- Part of the surplus is reinvested in the expansion and growth of the enterprise. However, this is usually inadequate to meet the growing need for funds resulting in dependence on external capital.

While credit is available from a wide range of informal and semiformal providers, mainstream formal financial institutions are reluctant to extend credit in the absence of collateral. An alternative to collateral as a mechanism of mitigating risk of default is provision of third party guarantee.

Credit is very often neither the only nor the most important requirement for the success of an enterprise. Credit tends to be relatively more important in capital-intensive activities which do not require any demanding skills. Examples are many forms of processing where working capital requirements are high or in transportation services where the initial fixed capital outlay is lumpy. Retailing and wholesaling are also working-capital intensive. However, noncredit inputs such as design, product development, market information, and marketing assistance are usually much more important for a large number of manufacturing activities. These are particularly important for growth-oriented microenterprises, and activities. (ADB, 1997, p64-65)

3.1. Providing Credit Guarantee Services

Commercial banks – both Islamic and conventional – have generally accorded low priority to microfinance because of its distinct features. The reliance on reputational collateral and lack of physical collateral are not easily comprehended as sound banking by traditional bankers. If microfinance is to help build inclusive financial systems, it must develop strong linkages with the formal banking sector. Most of the IsDB member countries are characterized by the absence of such linkages with the exception of certain economies like Malaysia and Indonesia.

An important factor contributing to the general lack of interest among commercial banks in microfinance in Muslim countries is the absence of institutional credit guarantee systems. The individual borrower guarantee that is prevalent mitigates the risk of loss of the business due to natural hazards, death or disability of the borrower. The "portfolio" guarantee approach, whereby the guarantor covers whole or part of the default of the microfinance institution according to a specific agreement, is generally non-existent. This is considered an imperative in the context of an integrated system of financing microenterprises where mainstream commercial banks can supply credit and other financial services wholesale to non-bank microfinance institutions and/or use the non-profit organizations with social agenda to reach out to poor.

In the following section we present a case study of a credit guarantee organization established in Turkey at the apex level.

3.2. Case Study of Kredi Garanti Fonu (KGF)

Kredi Garanti Fonu (KGF) in Turkey is a Credıt Guarantee Fund targeting the small and medium enterprises (SMEs) sector. It was established in 1993 with an authorized capital of TL60 million and paid up capital of TL20 million by several government agencies including TOBB (51 percent), KOSGEB (48.54 percent), TESK (0.43 percent) and Halbank and two others holding 0.01 percent each. It has currently fifteen braches in all major cities and regions in the country. In addition to providing credit guanrantees KGF also provides other services that include: (i) configuring credit demands of small enterprises according to their needs, (ii) consulting services on management and organisation, (iii) facilitating restructuring of loans and (iv) preparing market and sector analysis reports. The Fund in its activities gives emphasis to innovative investments, technological investments that raise productivity, priority areas for development, investments that raise the employment level supporting exports and supporting women and young entrepreneurship.

3.2.1. Operational Principles

Risk Sharing:

The Fund provides guarantee within a lımıt of YTL0.75 million per enterprise on a risk sharing basis with a cap on its sharing at 80 percent. At least 20 percent of the risk must be shared by credit institution/foundation. This requirement does not apply to export-related loans.

Type of Coverage:

All cash and non-cash loans including leasing transaction are covered by the guarantee. KGF also provides gurantees for agricultual credits involving organic agriculture, livestock fattening, apiculture, cattle breeding, agricultural technology etc.

Partner Banks:

KGF works with a wide range of partner institutions that include three state banks, an investment bank, the EXIM banks, five leasing companies, nine private banks and three interest-free banks (Al-Baraka Türk, Asya and Türkiye Finans.

Guarantee Process:

1. Company applies to bank for credit.
2. Bank evaluates the application. If bank approves the application but there is a lack of collateral, then bank sends the application to KGF.
3. Applications are evaluated in 15 days by KGF in respect of credit amount.
4. Credit demands up to YTL0.1 million are evaluated by General Management, credit demands higher than YTL0.1 million are evaluated by KOK (Credit Approval Committee).
5. KGF declares the decision to related Bank with guarantee terms/conditions.
6. Company signs written covenant and fulfills the guarantee conditions. Then, back pay covenant is sent to Bank for credit to be used by company.

Evaluatıon Crıterıa:

1. Applicant must be an SME. The criteria for an enterprise to be classified as SME is presented in Table 3.1
2. Project must be “profitable”, “realizable” and “achievable” .

3. Management team of the project should have adequate project skills and experiences related to project.
4. Project should increase the employment volume and maintain the current employment.
5. Project should have “acceptable risks”.

Distribution of Guarantees:

The distribution of guarantess according to tenure as per the data available at the end of 2007 is as follows. : 64 percent of total guarantees was for long term credit; 25 percent for medium term credit and 11 percent for short term credit.

Table 3.1. Criteria for Classification as SME

Scale	Head Count	Annual Turnover (Million YTL)	Annual Balance Sheet (Million YTL)
Micro (78%)	1-9	Less than 1	Less than 1
Small (17%)	10-49	Less than 5	Less than 5
Medium (4%)	50-250	Less than 25	Less than 25

Most of the beneficiaries of KGF are limited companies (64.88 percent), followed by joint-stock companies (25.71 percent) and personal companies (8.63 percent). Partnerships and cooperatives constitute the lowest categories with 0.18 and 0.09 percent respectively. Of these beneficiaries, existing entrepreneurs account for 91.8 percent while young entrepreneurs and women entrepreneurs account for 7.1 and 1.1 percent respectively.

The manufacturing sector accounts for 83.9 percent all guarantees while the services sector accounts for 13 percent, energy and agriculture sectors account for 2.5 percent and 0.4 percent all guarantees respectively.

As to the form or type of guarantees, most of it was cash at 87.2 percent; non-cash accounted for 8.8 percent and leasing accounted for 4 percent of total guarantees. Regarding the type of cash credit, 45 percent was related to working capital financing. Investments, exports and R&D accounted for 33.8 percent, 18.1 percent and 2.4 percent respectively.

KGF charges a fee of 3 percent per anum for providing guarantees to cash-credits and 2 percent per anum for non-cash credits. Defaults on such guarantess have generally varied between sectors - manufacturing (5.4 percent), services (2.51 percent) and mining (4 percent).

3.2.2. Key Lessons and Issues of Concern:

As is obvious from the information presented above, KGF plays a vital role in mitigating risk of default of micro, small and medium enterprises who may find it reasonably difficult to avail credit from mainstream banks due to absence of collateral. It is essentially a governmental initiative and an apex organization where all guarantee-related services within the economy are concentrated. There may be several advantages in establishing such apex institutions as follows:

- An apex institution is able to buildup a critical minimum level of expertise in credit evaluation and guarantee within a single institution.
- By virtue of specialization in the particular economic function, such an institution is in a position to build up its database and expertise related to credit risk assessment and monitoring enjoying the benefits of economies of scale.
- An apex institution due to its diverse client base and exposure to diverse sectors enjoys the benefit of diversification.
- Finally, an apex institution provides a means of moving towards an integrated financial system, linking the formal banking sector with the SME sector.

A strategic response to increase the attractiveness of microfinance to commercial banks in Muslim countries is establishment of Shariah-compliant credit guarantee institution. While KGF deals with both interest-based and interest-free partner institutions, its credit guarantee schemes do not seem to be Shariah compliant. It is however, possible to modify the same in the framework of *al-kafala* for possible replication in other Muslim countries. According to accepted *fiqhi* opinion of scholars, the guarantor is allowed to receive a fee for the guarantee provided (according to some, the fee should neither be too high, nor in proportion to quantum of debt guaranteed). The credit guarantee scheme could therefore, be designed both in a non-profit and for-profit framework. The institution providing such guarantee could also be set up as an agency of the government like KGF or in the voluntary sector as a waqf.

Another alternative form of a credit guarantee mechanism, highly relevant in the context of poverty alleviation, is possible via a *zakah* fund (since *zakah* may legitimately be used to pay-off unpaid debt of the poor). However, care must be taken to ensure that the coverage of such a scheme is restricted to the extremely poor and the destitute only.

In the following section we present case study of KOSGEB from Turkey that seek to provide various non-financial services for the development of growth enterprises.

3.3. Providing Business Development Services (BDS)

Business development services may broadly relate to (i) product development; (ii) technology assistance; (iii) marketing promotion and assistance; (iv) skills training; (v) consultancies (often conducted on-site and related to solving a specific problem) (vi) counseling (or business advice or mentoring on a range of topics, usually delivered through one-on-one interaction) and; (vii) subcontracting and franchising. Various delivery mechanisms for such services are (i) networks and associations; (ii) business incubators or common facility centers; (iii) referral centers. In the following section we present a case study of Small and Medium Industries Development Agency (KOSGEB), Turkey.

3.4. Case Study of KOSGEB

KOSGEB provides various forms of financial support to new and existing enterprises – for training, consultancy, technological research and development including procuring industrial property rights. The purpose for all such support is to encourage entrepreneurship, establishment of new enterprises and also to transform existing enterprises so that they are globally competitive. The quantum of supports have respective caps and are in the nature of cost-sharing with the enterprise according to pre-specified ratios.

It is required that the enterprises and all related organizations wishing to benefit from the KOSGEB support, must exist in the KOSGEB database. Such enterprises are evaluated according to their current situations, those carrying common characteristics are grouped and the enterprises are intimated of their status.

3.4.1. Training and Consultancy

KOSGEB provides financial support to enterprises – new and existing so that they may meet their training needs and procure consultancy services. The purpose of such support is to enable new and existing enterprises to improve their knowledge and skills in planning, investment, modernization, technological research, development and technology adaptation, manufacturing, marketing, information, management and similar subjects.

For providing training-related support, KOSGEB maintains a database of a wide range of local training organizations in private and public sector. Enterprises may procure specialized training services from such organizations. KOSGEB also organizes training programs itself. It organizes general training programs in accordance with the training requirements of the enterprises. It also organizes entrepreneurship development programs for entrepreneurs who plan to establish their own business or those who plan to improve their existing enterprises. The programs cover preparation of business plans and the transition to operational management based on business plans. Specific entrepreneurship development programs are offered for students of formal educational institutions and universities as well as for those who have just graduated from these institutions.

For providing consultancy support, KOSGEB maintains a database of a wide range of consultants that includes professional consultancy organizations, independent business experts, universities – both local and foreign. It usually groups enterprises showing similar characteristics and facing similar problems for providing such support.

3.4.2. Technological Research and Development

KOSGEB encourages new ideas and inventions and has a clear strategy in place for providing technological research and development in order to give an impetus to the process of development of new products and processes.

It comprises supports to enterprises through various technological development centers, technology incubators without walls, technology innovation centers, R&D projects that have been put in place in collaboration with universities and other establishments. The coverage of support is comprehensive and includes, subject to a maximum limit according to pre-specified ratios:

- Provision of materials, equipment and prototype production and provision of raw materials for trial purposes;
- Quality improvement and technologic hardware provision for successfully completed projects; (support for items a and b are mutually exclusive)
- Consultancy support obtained from the universities with which a cooperation has been established;
- Publication, promotion and announcement of R&D results in the form of books, brochures, CD and similar documents;
- Rental of techno park;
- Participation of the enterprises in congresses, conferences, technological fairs abroad related to R&D matters, as well as meetings and visits abroad for technology transfer purposes; and
- Allocation of workshops in the buildings of the KOSGEB units to the enterprises for a period up to twenty four months extendable by a further twelve months for existing enterprises and by twenty four months for newly established enterprises.

KOSGEB also provides support for industrial property rights. If as a result of the studies carried out by the enterprises an invention results in a patent certificate, a beneficial model certificate, an industrial design record or an integrated circuit topographies registration certificate, then financial support is made available towards covering the expenses required for obtaining the same within and outside the country.

3.4.3. Information Technology

Support for the provision of computer software:

This comprises computer software support provided to enterprises so that they can procure computer-aided design/manufacturing, manufacturing planning follow up and control, institutional resource planning, maintenance-repair software.

Support for orientation to E-Trade:

This comprises support for beginning and carrying out e-trade towards purchase of computer hardware and software to serve the synergy focal points that have been established within the organizations and support for making a place in the national and international e-trade portals.

3.4.4. Quality Improvement

Support for general test-analysis, calibration and test-analysis related to CE marking:

This is the support provided for the test-analysis, calibration services as well as test-analysis and inspection expenses within CE marking conformity evaluation activities that are carried out in national/international public or private organization/institution laboratories, in accordance with criteria determined outside KOSGEB. The purpose behind such support is to ensure quality improvement and conforming to international quality standards.

3.4.5. Market Research and Export Improvement

Support for participating in the industrial fairs:

This comprises support for participation in industrial expertise and general industrial fairs and international industrial expertise fairs in the country, and abroad determined by KOSGEB in order to enable the enterprises to increase their market shares, obtain information on new products, technologies and competitors and establish a brand image for their products.

Promotion support:

This is the provision of support to the enterprises for their promotional activities and covers expenses relating to brochures, product catalogs, CDs and websites.

Brand orientation support:

This comprises support for the expenses related to studies that the enterprises carry out for their orientation to brands within and outside the country, in order that they have a desire to create a distinct brand image for themselves in national and international markets. This may take several forms, such as, payments made to the relevant organization for Brand Registration Certificate abroad, expenses for placing advertisements in periodic magazines, especially international airlines and rental expenses of billboards in the airports within and outside the country.

Support for participation in export purposed trips abroad:

This is to provide support to enterprises for their participation in export purposed business trips abroad which are organized by sectoral institutions in countries approved by KOSGEB. This is to enable them to undertake research for exports and explore collaboration in technological, investment and finance areas.

3.4.6. Business Matching

It is the provision of support for the expenses related to the services to be received from matching centers which have been established abroad within the context of KOSGEB matching center models and that have been approved by KOSGEB, in order to serve the enterprises in their orientation to foreign trade, joint production/investment and similar international cooperation, enable them to compete in international markets and obtain a share.

3.4.7. Developing Entrepreneurship

New entrepreneur support:

It comprises compensation related to initial expenses of the new entrepreneurs in establishing a business within maximum three years from the date of the support agreement as well as the machinery-equipment and hardware expenses.

Business development center support:

It comprises support provided to compensate for the operational expenses of the business development centers, which have been established by KOSGEB within the scope of national and international projects and have been resuming their activities by the operating organization.

Table 3.2. Performance of TEKMERs

	Name of the Collaborating University	*Supported Enterprises*
1	İstanbul Technical University	419
2	Middle East Technical University	117
3	Ankara University	90
4	Blacksea Technical University	26
5	Yıldız Technical University	43
6	Boğaziçi University	55
7	Gebze Institute of Higher Technology	98
8	Erciyes University	43
9	September 9th Eylül University	16
10	İstanbul University	41
11	Ege University	11
12	Pamukkale University	25
13	Hacettepe University	15
14	Gaziantep University	12
15	Gazi University	30
16	Isparta Süleyman Demirel University	6
17	Samsun Mayıs 19th University	16
18	Konya Selçuk University	21
19	Fatih University	83
20	Sakarya University	6
Total		1256

3.5. KOSGEB Technology Development Centers (TEKMERs)

KOSGEB TEKMERs are technologically oriented incubators that are in operation since 1991 as a collaborative project with multiple universities. These centers essentially act as a bridge between universities and the industry, supporting technology-oriented young enterprises. Popularizing the concept of spin-offs, these

Table 3.3. Performance of ODTU – TEKMER

1992 – 2008		
	No. of Enterprises	
Existing	37	
Graduated	65	
Unsuccessful	15	
Total	117	
Sectoral Concentration		
Sector	No. of Enterprises	Percentage
Electronics	48	41
Software	44	38
Mechanics	5	4
Chemistry	3	3
Mechatronics	4	3
Food	2	2
Biotechnology	2	2
Mol. Biology	2	2
Medical	3	3
Others	4	3
Start-Ups Vs. Pre-Existing Enterprises		
	No. of Enterprises	Percentage
1992 - 2008		
Start - up enterprises	74	63
Pre-existing enterprises	43	37
Types of Enterprises		
	No. of Enterprises	Percentage
Limited companies	102	87
PLCs’	9	8
New starters	6	5
No. of graduated companies who have moved to Technoparks = 21		

centers transfer the results of R&D studies into economical value. TEKMERs use three major criteria in the selection process of enterprises for providing support: technological innovation, economical value and entrepreneurship. The process of application is simple requiring potential and existing enterprises to submit a business plan document with detailed information on background of entrepreneur, product and/or technology to be developed, marketing perspectives, technical efficiency, financial and administrative data, estimated investment cost of the initiative and projections of the stages of the project. Upon approval the enterprises are provide office and workshop space for an initial two year period, extendable up to a maximum of four years, shared office services, shared internet services, conference hall, meeting rooms and access to university facilities. Enterprises are also eligible to avail support under the KOSGEB training and consultancy schemes and technology research and development schemes as stated in sections 3.4.1 and 3.4.2. Table 3.2 provides data on the number of enterprises supported by TEKMERs at twenty universities in Turkey over the period 1992-2008. A closer look at one of the TEKMERs at the Middle East Technical University (ODTU) in Table 3.3 provides some further insights into their performance.

Though ventures in high-technology sectors face a high risk of failure, this is not reflected in the performance of the center at ODTU with failure rate at less than one in seven. Electronics and software dominate the portfolio with seventy-nine percent. Start-ups account for nearly two-third the portfolio. Most of the enterprises (eighty seven percent) are limited companies. About twenty percent of supported enterprises have matured and moved to Technoparks.

3.6. KOSGEB Business Matching Models (BMM)

The rationale underlying Business Matching Models of KOSGEB is to enhance the competency of small enterprises in international business arena. Small enterprises fall behind their large counterparts in understanding the characteristics and peculiarities of foreign markets and customers, locating foreign business partners, employing professional service providers etc. BMM aim to strengthen and enhance the information and other resources at the disposal of small enterprises by forging a continuous relationship among KOSGEB and a foreign counterpart and bring in facilitators called Business Matching Center Operators (BMCO) who would provide a variety of services focusing on building a common database of relevant information and matching the business needs of small enterprises from both countries.

The enterprises are carefully selected for business matching from among manufacturing enterprises that have a global vision and an understanding of international economic relations and developments in the world market. Ideally these should have the following additional characteristics - continuously developing, innovative, participatory, productive and efficient, flexible and dynamic, stable and technology-oriented. These should also have qualified human resources, have a strategic perspective for global competitiveness, and commitment of top management for sustainability. These should have the international quality certifications and above all, a vision for a global economy.

BMM is governed by a protocol between KOSGEB and counterpart in a foreign country. The protocol determines the exact business matching model to be used, provides for sharing of information and experience and determines the nature of and identifies the providers of services to be provided to SMEs.

The Business Matching Center Operators (BMCO) play an important role in the model. It is expected that they should know the regıon well, cultivate and maintain excellent relations with KOSGEB's counterpart and bureaucracy. They are expected to perform the following tasks:

- Improve penetration of small enterprises into international markets and increase their market shares within the framework of bilateral and multinational agreements
- Provide effective and productive marketing activities
- Encourage the improvement of bilateral trade, investment and cooperation mechanisms
- Improve logistics services according to the needs
- Activate databases
- Encourage usage of alternative ways of e-commerce by SMEs
- Provide establishment of "Information Center Portal"
- Seek to minimize the unnecessary costs in international arena
- Seek to remove bureaucratic barriers through changes in rules and regulations
- Develop structures and practices in order to coordinate public sector, private sector and civil society organizations for improving bilateral trade relations and for removing related barriers in this area
- Inform public establishments about the importance of exports and help to change the mentality for handling export formalities with number one priority
- Coordinate training and consultancy services to be performed according to the objectives.

3.6.1. Services of BMM

The services that will be provided by the matching centers have been divided into four groups:

- *Basic services:* These include: finding a potential match in the target country, notification of the requests received from the relevant country, satisfaction of additional information requests, exhibition of member catalogs and samples, fair research, orientation on catalog publication, visa/invitation letter preparation service, hotel reservation service, aid in obtaining residency permission, finding clients outside the database, phone, fax, internet service and similar services.
- *Organizational services:* These include: web page/virtual catalog preparation service, supply of office devices such as projection and computer, organization of commercial visits abroad, change of license, aid in driver/vehicle rental, banking/insurance/security services, meeting room

rental, interpretation, translation services, participation/representation services in fairs, guidance and similar services.

- *Consultancy services:* These include: supplier research for raw material, machinery/workbench research, contract evaluation/research, competition research, request characteristics research, local legislation research, research for financial resources, joint investment/feasibility study, joint investment/contract preparation, technology research, human resources research, specialist/technical specialist research and similar services.
- *Permanent exhibition/showroom services:* These include: standard stand construction, standard stand decoration, the two-way transportation of the products between the local depot and the permanent exhibition/showroom area, the unloading-storing- loading expenses of the products abroad, as well as general security, general cleaning of the Permanent exhibition/showroom area, the customs procedures of the products as well as the transportation insurance procedures abroad and similar services are included.

3.6.2. BMM Types

There are four types of BMM. The first two do not include KOSGEB financial support and are used through a web portal. The last two include KOSGEB financial support and the application software is used via the Internet.

- Model One used through a web portal does not involve any counterpart.
- Model Two involves a counterpart but functions without the BMCO component.
- Model Three contains all the components - involves BMCO and use of application software developed and supplied by KOSGEB that is used via internet.
- Model Four is the same as Model Three, with the addition of the permanent show-room service.

So far, KOSGEB has had three successful implmentation of the BMM.

3.7. Key Lessons and Areas of Concern

The highlight of the KOSGEB model is the comprehensive nature of support provided. In the absence of data, no attempt has been made in this study to quantitatively measure the impact of such support and draw conclusions about financial efficiency of the KOSGEB model. The support provided is mostly in the nature of grants to cover a proportion of expenses incurred. The remaining part is borne by the entrepreneur. Such a scheme could possibly be replicated with donor funds where the catalyst organization could be structured as a *waqf*.

A limitation of business development services is that these are too varied in nature. Given the multiplicity of inputs required for various activities, only an organization with a detailed understanding and considerable experience in a particular subsector is in a position to identify all the inputs and support services required. It takes considerable field experience to identify all the bottlenecks constraining an activity because many constraints reveal themselves only in the process of implementation. Notwithstanding the apparent success of KOSGEB in providing a fillip to small enterprises in Turkey, a replication in the government sector in other countries is perhaps fraught with risks and uncertainties, given the demonstrated inefficiencies in this sector in most parts of the globe. A better alternative to a monolithic government agency in a poor country is perhaps several sub-sector-specific non-profit organizations that may complement organizations in the government sector. Usually operating in a smaller area, they would have the advantage of detailed local knowledge, better motivated staff, more flexible procedures, and a more focused commitment to the micro and small sector.

Chapter 4

ESTABLISHING LINKAGES

The previous two chapters have highlighted selected initiatives to develop microenterprises – livelihood enterprises in Bangladesh and growth enterprises in Turkey. While livelihood programs have a direct impact on poverty, they tend to leave out certain sections of the poor – the "poorest of the poor" and the destitute and the "graduated" poor. Programs to develop growth enterprises appear to target the "not-so-poor". Notwithstanding the success achieved by the programs in their objective of serving the target population, they only partially address the issue of financial exclusion. What is needed is a systemic financial services approach to the issue of poverty alleviation under which, all sections of the society have access to appropriate, low-cost, fair and safe financial products and services from mainstream providers. This would require taking into account both demand side and supply side considerations.

4.1. Demand Side Considerations

Social safety-nets for the poorest of the poor:

Individuals and families belonging to this strata of the society are not "economically active" and hence, are not inclined to opt for a credit product because of their perceived inability to repay. Programs at this level have to be charity-based to take care of their immediate and basic consumption needs. The conventional financial system usually offers a choice between two alternatives – grants and low-cost loans for such programs. An Islamic system offers possibilities of several layers in between. *Zakah*-based programs may take care of the immediate and basic consumption needs of the poorest of the poor. Efforts should then be directed at imparting necessary skills - also financed by charity to enable them to earn a living and transform them into productive units in the economy. Clearly, *sadaqa* and *awqaf* are ideal mechanisms to create the community assets that can be used to undertake such skill improvement programs. Where the beneficiaries can be clearly identified as the poorest of poor, *zakah* funds can also be used for such programs. Once the beneficiaries of such programs are ready to become nano-entrepreneurs or microentrepreneurs, they may be provided cost-less financing in the *qard-hasan* mode.

Relevant products:

Financing of livelihood enterprises in the manner discussed earlier should be attempted for poor who do not fall in the above category. The program should aim at recovering the costs or even making moderate profits to ensure sustainability of operations. As discussed earlier, needs of the poor dictate that financing is provided without restrictions on end-use. At the same time the poor in Muslim societies are highly conscious of restrictions imposed by Shariah on the nature of financial services. The mechanism of *murabahah* that is commonly used by Shariah-compliant MFIs is not supposed to provide funds in the hands of the clients and therefore, is ill-suited in meeting the consumption needs as well as working capital financing needs of the microentrepreneurs. Therefore, *qard-hasan* with service charge appears to be an ideal not-for-profit mode for financing such enterprises. Participatory modes like *mudharabah, musaqah* and *musharakah* are ideal for-profit modes that share both risks and rewards in an equitable manner. For financing growth enterprises a combination of for-profit modes including debt-based modes, such as, *murabahah* and *ijarah* may be suitable. The issue of lack of collateral may be addressed through guarantee mechanism as discussed earlier. The need for various non-financial business development services assumes greater significance in the context of growth enterprises. Such services could be provided in a number of ways involving grants by government agencies, charity organizations allocating *zakah* and *sadaqa* funds, *awqaf*. They also permit generation of profits through use of various fee-based and participatory modes.

4.2. Supply Side Considerations

On the supply side, the most important issue relates to establishment of linkage between various organizations that are part of the process of provision of financial and non-financial services. It is perhaps useful to consider these organizations at three levels – micro, meso and macro levels.

At a micro-level, the organizations may be broadly categorized as not-for-profit and for-profit ones. Non-profit-organizations (NPOs) include associations of individuals, mutuals, credit unions and cooperatives, societies, trusts, non-profit-companies and non-profit-non-banking-finance-companies - at times functioning as *zakah* funds, *sadaqa* funds, *qard-hasan* funds and *awqaf.* NPOs have clearly led the way in the development of microfinance. They are often donor dependent, particularly the smaller ones, because many were launched with donor funds. Their governance structures are unsuited for bearing fiduciary responsibility, since board members do not represent shareholders or member-owners with money at stake. The range of financial services they can offer is restricted. When regulated, NPOs cannot usually mobilize savings legally; this function is limited to banks and other intermediaries supervised by banking authorities. NPOs often have a social agenda along with microfinance. But they are often deemed suitable as conduits for distribution of microfinance because of their strong focus on the poor. Among NPOs, the member-based organizations are preferred over others forms of organizations as these involve much broader representation and involvement of stakeholders.

For-profit organizations include venture capital companies, guarantee providers, leasing companies, banks and financial institutions. Such institutions may cater to the mainstream clientele or may specialize in serving the poor, such as, the Grameen bank. Banks – especially those in the private sector have a far greater degree of sophistication than NPOs. They also have the advantage of being able to raise funds in the form of deposits. Public sector banks in many countries have the advantage of a wide branch network in rural areas.

Several forms of linkages are advocated. For instance, there are banks that may be "linked" with mutual institutions of the poor including informal savings and credit or "self-help" groups which lend directly to such groups through NPOs acting as facilitators of such lending. In another "wholesaling model" the banks and apex finance institutions lend to NPOs and other MFIs as credit intermediaries, with NPOs being willing to borrow and on-lend at their own risk. (ADB 1993, p45)

At a meso level, organizations are in the nature of professional networks, auditors, rating agencies, trade associations, credit bureaus, transfer and payment systems, information technology, technical service providers and trainers. A strong linkage between the meso level organizations and the microfinance providers at micro-level is advocated. Networks are important because a large number of activities that cannot be undertaken individually can be done collectively by a network due to economies of scale and scope - such as, initiating dialogue on legal frameworks, regulations; creating and updating information base; conducting training programs etc. Meso-level organizations provide for the basic financial infrastructure and provide the range of services required to reduce transaction costs, increase outreach, build skills, and foster transparency among the microfinance providers.

The most important player(s) at a macro level is of course the government and various government sponsored apex bodies and organizations. From the standpoint of linkage with meso level and micro level providers of financial services, the most important organization is the central bank. Policies and rules set by the central bank as well as the ministries of finance, industry and cooperation impinge upon the functioning of micro level and meso level players. Central banks all over the globe seek to bring the informal finance providers within the ambit of regulatory supervision and control, and thereby ensure that everyone has access to appropriate, low-cost, fair and safe financial products and services from formal providers. This calls for establishing strong vertical and horizontal linkages across all levels and all organizations that are part of the financial system.

4.3. Case Study of Rural Finance System in Indonesia

In a distinct category of its own, the approach to poverty alleviation in Indonesia through developing microenterprises involves a diversity of regulated financial institutions providing rural financial services. These range from national-level institutions with substantial outreach and extensive networks to small, local institutions occupying particular market niches. Two unique features of the Indonesian model stand out. One, certain regulated financial institutions in Indonesia, both public and private, have been able to extend sustainable financial services deep into the countryside, reaching many of the poor through a wide network of local and community-based institutions. Two, unlike countries like Bangladesh known for their successes in the microfinance sector, the Indonesian NPOs are dominated by member-based cooperatives. Though in terms of quantum of funds mobilized or distributed their role in the provision of microfinance services is not so significant, they serve a fairly large number of the poor.

4.3.1. Major Components of the System

Apex Bank(s) & Institution(s):

At a macro level, Bank Indonesia (BI) as the central bank has regulatory oversight of most of the major institutions engaged in microfinance and has participated actively in shaping them. In this it is unlike its counterparts in other countries with strong microfinance sectors, such as Bangladesh, where the central bank has been largely irrelevant to microfinance. Bank Indonesia has a strong "developmental" mandate. Another important apex institution is the Permodalan Nasional Madani (PNM), a commercially operating state-owned corporation, acting as a wholesale apex for financing small and medium enterprise programs or projects of commercial banks, rural banks (BPR) and cooperatives. While Bank Indonesia's functions have been concentrated on monetary policy, its various development banking functions have been divested in various other institutions including PNM. At the provincial level, BPDs (Regional Development Banks), one in each province, act as bankers to their governments. Some of them have responsibility for supervision of certain small formal financial institutions operating within their provinces.

Associations & Support Organizations:

At a meso level two organizations figure prominently. First, Asosiasi Bank Syariah Indonesia (ASBISINDO) established in 1992 is an association of rural Islamic banks (BPRS). Since 2002 its coverage also includes Islamic commercial banks. Its objective is the development of Islamic banking in Indonesia through human resource development, technical assistance, operational standardization and financial product development, facilitation of vertical and horizontal communication among Islamic financial institutions, advocacy and participation in policy dialogue.

Second, Pusat Inkubasi Bisnis Usaha Kecil (PINBUK) or the Center for Microenterprise Incubation, established in 1995, is the most important promoter of Islamic cooperatives. The objective of PINBUK is to develop the independent, sustained and healthy Syariah Microfinance Insitutions (SMFI) and their networks based on their community potentials, to create easier acces to information and resources for the poor community and microbusinesses through SMFIs and to advocate the public policies for the interest of the poor and microbusinesses. PINBUK has no legal status of its own, but is operationally autonomous. It acts as a facilitator of the establishment and licensing of new BMTs. PINBUK conducts training programs and undertakes a range of initiatives for capacity building of BMTs.

Micro-level players in microfinance in Indonesia include banks – commercial and rural – those are part of the Indonesian formal banking system and the savings-and-credit cooperatives that fall outside the purview of the central bank and the formal banking system.

Commercial Banks:

Indonesia follows a dual banking system that allows both conventional and Islamic banking to coexist. Commercial banks in Indonesia have generally evinced little interest in microfinance with the notable exception of Bank Rakyat Indonesia (BRI) and more recently, Bank Muamalat Indonesia (BMI) and Bank Syriah Mandiri (BSM). While the latter two are full-fledged Islamic banks, BRI follows dual banking – both conventional and Shariah-based. It is one of the largest commercial banks globally known for its "Units" that provide microfinance at a retail level in rural areas. Units offer restricted range of services tailored to the needs of small rural customers, that includes its highly successful Simpedes savings account and the Kupedes loan. BRI Unit Division's performance during the South East Asian financial crisis that badly affected the entire Indonesian banking system put the seal on its reputation as one of the most efficient rural financial institutions in the developing world. BRI's activities in Islamic banking is expected to increase substantially with acquisition of smaller bank recently with a view to transforming the same into a full-fledged Islamic subsidiary.

A number of commercial banks act as conduit for government microfinance programs, such as, the PHBK (Program linking Banks with Self-Help Groups).

Rural Banks or Bank Perkreditan Rakyat (BPR):

BPRs are generally much smaller than commercial banks and offer a more restricted range of services. BPRs that ensure Shariah compliance in their operations are known as Bank Perkreditan Rakyat Syriah (BPRS). The term

“BPR” translated as people’s credit bank is a small regulated financial institution. Recently a number of BPRs practicing Shariah-compliant banking have appeared on the scene. BPRs may accept time and savings deposits, and provide credit. Most are limited liability companies in private ownership, operating for profit. Some are part of a linkage with commercial banks or NPOs. Some are registered as cooperatives. There is no clearing system between rural banks.

Savings and Credit Cooperatives:

In contrast to independent initiatives, these cooperatives or mutuals have been a primary instrument of state policy for a long time. These are governed by a cooperative law. Islamic self-help savings and loan groups are usually called Baitul Maal wat Tamweel (BMT), also called Baitul Qirad in some regions.

Self-Help Groups (SHGs):

These are completely informal organizations. Hundreds of thousands of informal SHGs with savings and credit activities exist in Indonesia. Many are spontaneous groupings, based on traditional forms of association. Many other SHGs have been founded by government and community organizations in connection with government programs.

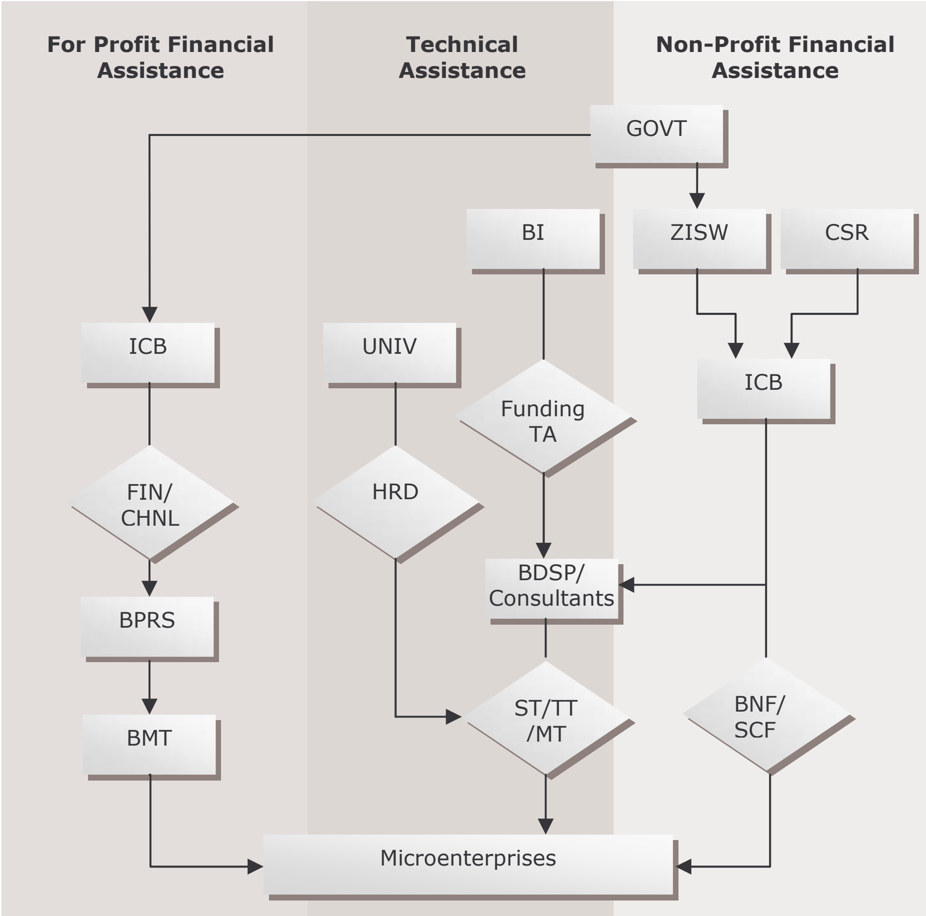
4.3.2. Microfinance Linkage Model of BI

Bank Indonesia has the following linkage model for the provision of microfinance – especially Shariah compliant microfinance. It envisages three kinds of intervention: for-profit financial assistance, not-for-profit financial assistance and technical assistance for developing microenterprises.

For-profit microfinance is undertaken by Islamic commercial banks either directly through their own "units" or jointly with BPRS - the rural banks and/or savings and credit cooperatives – the BMTs. Commercial banks also serve as channels for government microfinance schemes.

Technical assistance funds are provided by BI to various providers of business development services and consultants in association with universities who essentially provide for human resource development. This type of intervention would broadly involve managerial, technical and spiritual treatment of the microentrepreneurs.

Figure 4.1. Microfinance Linkage Model of Bank Islam



ICB: Islamic Commercial Banks; FIN/CHNL: Financing directly or jointly with BPRS and/or BMT or Channeling Government Microfinance Schemes
UNIV: University, HRD: Human Resource Development; TA: Technical Assistance; BDPS: Business Development Services Providers; ST/TT/MT: Spiritual and/or Technical and/or Managerial Treatment
GOVT: Government; ZISW: Institutions dealing with *Zakah*, Infaq, Sadaqa and Waqf; CSR: Corporate Social Responsibility; BNF/SCF: Basic Needs Fulfillment and/or Start-Up Capital Funding

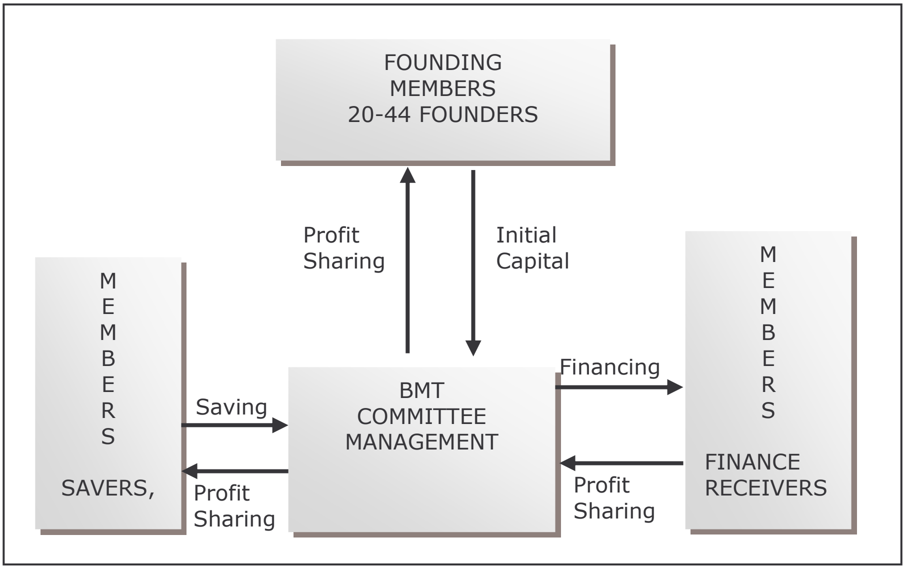
Non-profit financial assistance or what are known as non-commercial or social funds are provided by Islamic commercial banks in the form of *zakah* and non-*halal* funds; by private and government companies under corporate social responsibility and the specialized institutions dealing with *zakah*, *infaq, sadaqa* and *waqf* (ZISW). These funds are utilized to fulfill basic consumption needs of the deserving poor, to provide for technical assistance to the poor for their skill improvement, and also serve as start-up capital for the microentrepreneurs.

The model presented in Figure 3.1 seeks to present the above types of intervention that are interlinked and includes a wide range of institutions. It however, excludes the linkage envisaged between the BMTs and the poor before they are transformed into microentrepreneurs. The various self-help groups provide this linkage. This is presented in the following section.

4.3.3. Linkage between BMTs, SHGs and the Microentrepreneurs

As stated earlier the term BMT stands for Baitul Maal wat Tamweel. BMTs are savings and credit cooperatives that use Shariah-compliant modes in their operations. A BMT essentially has two components: Baitul Maal or the house of social assets (institution that pools *zakat, infaq*, and *sadaqah*) and Baitul Tamwil or the house of business development. A BMT generally goes through two important stages in its development. The first stage involves establishment of the BMT by 20-40 founding members. This is highlighted in figure 4.2.

Figure 4.2. BMT Establishment



In the second stage, BMT gets integrated with groups of microentrepreneurs, also known as Pokusma (*Kelompok Usaha Muamalat*) or KUBE *(Kelompok Usaha Bersama*). The latter term, which literally translates to "Cooperative Effort Groups" is used by the Ministry of Social Affairs. The formation of the groups and their integration with a BMT takes place in several steps. It begins with a feasibility test to identify and ensure that the community is poor and having potential microentrepreneurs. Then there is an interim stage called pre-group-training that involves explaining the program to the community, consolidation of intention and strong willingness, determination of the group member candidates, preparing grounds for their participation for compulsory group training (GCT). The GCT itself involves introduction to loan and saving procedure, POKUSMA/KUBE action plan formulation and follow up action. Regular group meetings (*RUMPUN, Rembmug Himpunan*) are then held that include, *inter alia*, saving and loan realization, sharing of experiences, environment concerns and spiritual strengthening. Capacity building organizations like PINBUK play an active role in KUBE formation. In 2004 and 2005, PINBUK in cooperation with the Ministry of Social Affairs developed 2,797 KUBEs owned by 26,726 poorest of the poor (*faqir miskin*), which were integrated with 87 KUBE BMTs in 19 provinces. It provided training for 87 KUBE Facilitators, 261 KUBE BMT Managers and staffs, 261 KUBE BMT Committee Members. In addition to the KUBE-BMTs, there are also masjid-based BMTs and village- based BMTs. A few are also based in schools and universities to cater to the students-staff-parents community. A selective list of BMTs is provided in Table 4.1.

The above process of BMT development provides for a linkage between groups of microentrepreneurs and the BMT. It is however a fact that the extremely poor and the destitute needs financial assistance to meet his/her basic consumption needs long before he/she may don the hat of a microentrepreneur and create wealth that could be shared with the BMT. Provision of finance at this stage has to be through *zakah* and/or *qard-hasan*. This is the objective of the KUM3 program of Bank Muamalat Indonesia (BMI) that is administered through *Baitul Maal Muamalat* (BMM), the social fund subsidiary of BMI.

BMI-KUM3 Program:

This is an economic empowerment program that aims to transform a deserving poor recipient of *zakah* (*mustahik*) to a payer of *zakah* (*muzakki*) in a time span of three years by turning him/her into a microentrepreneur. The program stresses on activities to build faith and piety among the microentrepreneurs and at the same time, provides support to them to increase income through provision of rolled capital and close guidance by its supervisors and consultants. There are currently 941 *mustahik* under the KUM3 program around 45 *masjids* served by 15 branches. An amount of IDR 957 million is provided as revolving financing in *qard hasan* mode so far.

Table 4.1. A Sample of BMTs

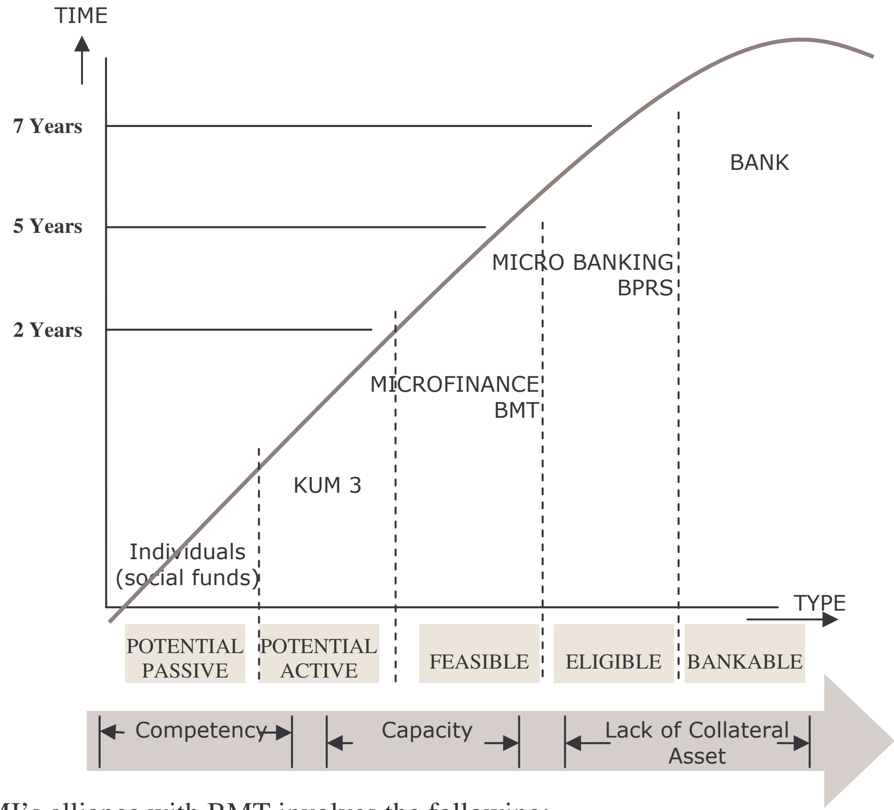
No	BMT Name	Location	Starting Members	Start Capital (Million IDR)	BMT Assets (Millions IDR)	Jumlah	
						Savers	Borrrowers
1	Tumang	Boyolali	60	7	4,000	1,800	1,200
2	Baiturrahma	Bontang	30	38,9	6000	3,789	2,359
3	Marhamah	Wonosobo	104	0,875	13,000	6,000	5,000
4	MMU	Pasuruan	20	15	17,000	8,000	6,500
5	BUS	Lasem	20	3	33,000	11,000	9,000
6	Dinar	K. Anyar	20	7	27,000	9,000	7,000
7	Al-Ikhlas	Lumajang	20	15	1,300	2,010	1,675
8	Arta B Umat	Sidoarjo	20	12	600	840	476
9	PSU	Malang	20	3	5,600	3,487	2654
10	Al-Furqon	Sumsel	20	17	1,000	1,803	887
11	Darut Tauhid	Bandung	20	25	17,000	4,876	4,108
12	Barrah	Bandung	20	10	3,505	2,200	1,786
13	Dana Ukhuwwah	Lembang	20	5	1,081	1,725	930
14	Al-Amanah	Sumedang	20	10	1,891	7,870	1,384

4.3.4. Linkage between Islamic Banks and BMTs/ BPRS

An important objective of establishing a well-linked integrated microfinance system is to ensure a long-term relationship between the various strata of the poor and the providers of microfinance. This implies that there is a systemic tracking and provision of "appropriate" financial services to the individual poor as he/she progresses towards higher levels of financial well-being and achieves higher levels of skill, experience and entrepreneurial acumen. An excellent example of such an integrated mechanism is the microenterprise development program of BMI. This is presented in Figure 4.3.

As indicated in the earlier section, provision of *zakah, infaq sadaqa and waqf (ZISW)* funds for consumption needs or for providing start-up capital in the form of *qard hasan* is undertaken under the KUM3 program. However, this constitutes Phase I of the program. In this phase, the objective is to transform the poorest of the poor from potentially passive to potentially active entrepreneurs. Every effort is made at this stage to proactively guide them on site with the help of university graduates working as consultants/ supervisors. As these entrepreneurs diligently repay their rolling *qard hasan* (the quantum is increased every time the earlier loan is repaid and the process is repeated over a two-three year period) and their microenterprises enter the "feasibility" domain, they are organized into BMTs. In this phase BMI enters into a partnership with these BMTs.

Figure 4.3. BMI Microenterprise Development Program



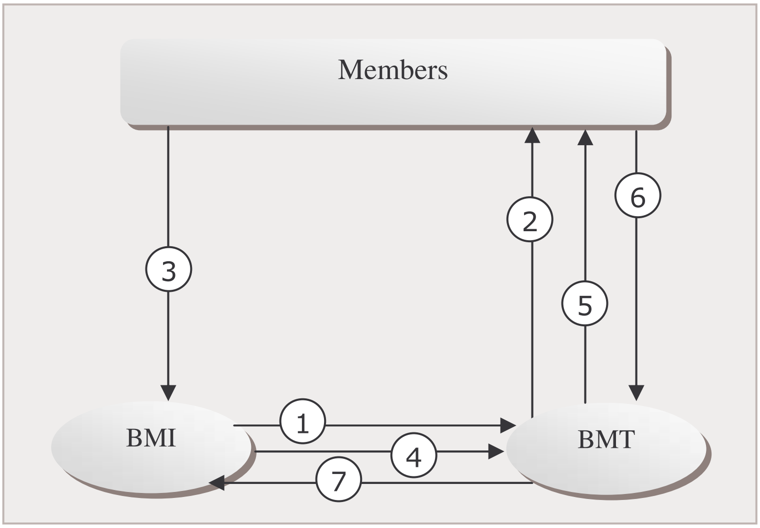
BMI's alliance with BMT involves the following:

1. Advancing the BMI service cycle through sale of its technology-based solutions, such as, Shar-E (an electronic banking solution), deposits, remittance and other banking transactions via its electronic data communication network on a revenue sharing basis;
2. Providing capital support for BMT establishment for onward financing to BMT members;
3. Building brand image of BMTs through standardization of facilities
4. Developing human resources through training programs on celestial management, basic operations of MFI, financing and investment, monitoring and control, leadership, marketing and sales;
5. Building system of information technology (on-project online system and Islamic accounting system);
6. Providing standard operating procedures (SOP); and financing procedures; and

7. Executing and channeling financing for government program (DBS, P3KUM, P2KER, PKPSBBM)

BMI has so far provided financing support of IDR 1207 billion to 2496 BMTs. in participatory modes. The financing structure is presented in Figure 4.4. The linkage is facilitated through Shar-E, an electronic banking solution.

Figure 4.4. BMI-BMT Linkage



1. BMT buys Shar-E (Shar-E Rabat) from BMI
2. BMT sells Shar-E to members and earns margin income
3. Shar-E funds are accumulated in BMI third party account
4. BMI provides financing to BMT usually on a revenue sharing basis (modeled on *jualah*)
5. BMT finances its members usually on *bai-bithaman-ajil* basis
6. Members pay installments to BMT
7. BMT pays installments to BMI

A similar structure is used for linkage between BMI and BPRS. So far, BMI has financed IDR 145 billion to 52 BPRS. Another dimension of the BMI-BMT linkage relates to channeling of government microfinance support funds through the BMTs. This is undertaken with BMTs on a revenue-sharing basis.

It is pertinent to note here the microfinance activities of other major players in the banking sector that promote linkages between various components of the rural financial system. Bank Syariah Mandiri (BSM) is a key player in channeling government support funds for microenterprise development through a network of BMTs on a revenue sharing basis.

Besides the BMI experiment, there are some excellent cases of establishment of such linkage between *zakah*, *awqaf* and microfinance. Under the umbrella of Dompet Dhuafa – perhaps the oldest Indonesian charity institution, *awqaf* and *zakah* institutions have been set up. Dompet Dhuafa is also the key promoter of BMT Center, a federation of BMTs providing an array of technical assistance, capacity building and information services to its member BMTs. More recently, Dompet Dhuafa along with BMT Center has promoted PT Permodalan BMT, a venture capital company that aims to provide micro-VC through their network of BMTs on a revenue-sharing basis.

4.4. Key Lessons and Areas of Concern

There are some excellent lessons to be learnt from the Indonesian model. The first and foremost lesson is that in the search for microfinance best practices, it is not a good idea to look for the "best" model that would work in all societies. As recent CGAP study emphasizes, "diverse approaches are needed—a one-size-fits-all solution will not work. Diverse channels are needed to get diverse financial services into the hands of a diverse range of people who are currently excluded." (Helms 2006, p02) For example, Grameen replications have not been particularly successful in Indonesia and the outreach of this category of NGO is insignificant. (Conroy 2003, p20).

The reputation of BRI as one of the most efficient rural financial institutions in the developing world has broken the myth that government-owned financial institutions are bound to be plagued by inefficiency. While pronouncing the success of BRI as "an anomaly" a CGAP paper nevertheless goes on to "identify key factors that led to the birth of a successful microfinance institution". It finds that two most critical factors responsible for the success of BRI are: strong political support and financial and human capital. (CGAP 1997, p04)

The Indonesian model has also shown the successful use of the contract of *jualah* resulting in revenue-sharing as a basis of linkage between higher-level organizations, such as, the commercial banks and rural banks or between commercial banks and cooperatives. This makes enormous sense given the difficulty with monitoring of costs if profit-sharing modes have to be used. The cooperatives of course, mostly use *bai-muajjal* while financing their members.

Chapter 5

LESSONS AND RECOMMENDATIONS

Poverty alleviation through microfinance requires a composite approach. Poverty levels vary across countries. So do cultures. Alleviating poverty through development of microenterprises therefore, requires different approaches and diverse models. This is the most fundamental lesson drawn from country experiences highlighted in the previous chapters. In this concluding chapter, an attempt is made to revisit the important lessons in the light of experiences of Islamic Development Bank as a key donor and catalyst for poverty alleviation and development in its member countries.

Programs for developing livelihood enterprises have poverty reduction as their main objective. These programs seek to upgrade productivity and increase the turnover of the multitude of livelihood enterprises and augment the income of the poor. They entail bringing about small improvements for many enterprises, often providing only credit, which is why they are sometimes characterized as being "minimalist." In contrast, growth-oriented microenterprise programs have enterprise development as their immediate objective and attempt to lift microenterprises to a qualitatively higher level of sustainability, setting them on the path to long-term growth, and seeking to provide a comprehensive range of services, including credit, training, technical assistance, skill improvement, product and market development and the like.

In countries like Bangladesh that are characterized by acute levels of poverty, development of livelihood enterprises has been under focus. The Grameen model of group-based and graduated financing has now become the "text-book" model of microfinance. Indeed Bangladesh is mentioned by many as the "university" of microfinance. The model of augmenting income of the poor via livelihood enterprises has been replicated not only in Bangladesh, but also in multiple countries across the globe. While a large number of studies have documented the positive impact of such programs, some have highlighted areas of concern.

Micro-credit programs of leading MFIs, such as Grameen and BRAC have been more successful in reaching the poor, but less successful in reaching the hardcore poor. These are households which are often severely undernourished, are marginalized in society and often ill or unable to work for various reasons. Proponents of microcredit highlight the need for enhancing skill levels through training and social mobilization activities in addition to provision of credit as a possible solution. The contrary view is that such people are not economically active and hence, may be pushed into penury that is more serious and perpetuating through availing credit that has a cost factor associated with it. Such people need to be supported with charity to take care of their immediate consumption needs; with an institutional mechanism to improve their skill level required to make them economically active and perhaps with a financing mechanism that does not penalize the new entrepreneurs with a cost, should there be an incidence of failure in their respective ventures. In Islamic societies, the institution of *zakah*, *awqaf* and *qard hasan* are supposed to perform the above three functions respectively. A model for this is provided in the Deprived Families Economic Empowerment Program (DEEP) of IsDB in Palestine. The project envisages three distinct types of intervention while ensuring a linkage between them (See Box 5.1).

Box 5.1. Linking Safety Nets with Microfinance: The DEEP Experiment

The Deprived Families Economic Empowerment Program (DEEP) of the Islamic Development Bank aims to develop a comprehensive package of financial and non-financial services to meet the needs of the poor and very poor families of Palestine, who are the target group. The program aims to transform the target beneficiaries from being recipients of humanitarian assistance to providers of income for their own families, thus enabling them to sustain their livelihoods. The program will provide financial and technical support to intermediaries, including microfinance institutions and Business Development Service (BDS) providers, who will in turn provide financial and promotional safety net services to the target group.

Financial services will be delivered by microfinance institutions. However, the DEEP funds will be used to finance loan products that target the poor and very poor clients, such as solidarity group lending. In the case of promotional safety net interventions, targeting and selection of beneficiaries will be done with utmost care and objectivity in order to ensure that the people benefiting from the program are only the poor and very poor. The package of interventions for the target group would include the following:

1. *Protective Social Safety Net Intervention*: Maintenance of current livelihood assistance; provision of health insurance and savings products;
2. *Promotional Social Safety Net Intervention*: Provision of a wide array of non-financial services critical to the entry, survival, productivity, competitiveness, and growth of micro and small scale enterprises run and owned by the poor and very poor;
3. *Financial Services Intervention*: Maximizing the outreach of the lending activities to the Palestinian poor and very poor people, contributing to the MFIs' capacity building; introducing Islamic lending Products; maximizing the outreach of savings activities to the poor; introducing micro insurance products.

Another major issue with conventional microfinance institutions is that the financing rates charged by them are “excessively high”. The case study of RDS clearly demonstrates that microfinance is both possible and feasible at a fraction of the financing rates charged by the flagship MFIs. Further, it provides collateral-free finance to the poor using the Grameen model of group and graduated financing with Shariah-compliant modes of financing that do not involve *riba*.

While there is a multitude of Shariah-compliant modes of microfinance, it is important to take note of their comparative features to identify the ones that are practically and operationally more suitable than others. While RDS uses *bai-muajjal* as the only mode of financing, this may not be the ideal one. It is observed that in the context of microfinance that involves small doses of financing in large frequencies, many of the checks and balances required for Shariah compliance tend to break down. Also *bai-muajjal* obviously is not suitable for financing all kinds of income-generating activities. Among alternative modes, *mudharabah* is fraught with practical problems arising out of reluctance and/or inability among informal livelihood enterprises for proper accounting of results. A more suitable mode suggested in this study for livelihood programs is *qard hasan*. This mode allows for recovering actual costs through levy of service charge. This would also better match the requirements of poor clients, make supervision easy and offer a workable and transparent model for replication elsewhere.

An important factor contributing to the general lack of interest among commercial banks in microfinance in Muslim countries is the absence of institutional credit guarantee systems in these countries. The study undertakes a case study of a specialized institution providing credit guarantee in Turkey and notes that such experiments could be replicated elsewhere and at the same time the process could be made Shariah-compliant in the framework of *al-kafala*.

Noncredit inputs such as design, product development, market information, marketing assistance in both domestic and export markets, appropriate technology development and the provision of common facility centers usually are particularly important for growth-oriented microenterprises. The study presents a case study of KOSGEB in Turkey, an organization highly successful in providing an array of non-financial business development services. Indeed, the highlight of the KOSGEB model is the comprehensive nature of support provided. The support is mostly in the nature of grants to cover a proportion of expenses incurred. The remaining part is borne by the entrepreneur. A source of discomfort in recommending the full-scale replication of the KOSGEB model is the fact that it is a government-operated agency. While organizations, such as, KOSGEB in Turkey or BRI in Indonesia are perhaps exceptions to the demonstrated inefficiencies in government-operated initiatives, a better alternative is to have several sub-sector-specific non-profit organizations that have the advantage of detailed local knowledge, better motivated staff, more flexible procedures, and a more focused commitment to the micro and small sector. Such a scheme could possibly be replicated with donor funds where the catalyst organization could be structured as a *waqf*. It is pertinent to note there that the most important initiative of IsDB in poverty alleviation so far – the Islamic Solidarity Fund – is structured as a *Waqf* (see Box 5.2).

Box 5.2. The Islamic Solidarity Fund: Microfinance through *Waqf*

IsDB has recently launched a Fund under the name "Islamic Solidarity Fund for Development (ISFD)" with an initial capital of US$ 10.00 billion in the form of a *Waqf*. The resources mobilized under the ISFD are to be seen as "seed money" and will be supplemented by additional resources, including co-financing, from all other partners (public and private) for funding poverty alleviation projects and programs.

As per the ISFD First Five-Year (2008-2012) Strategy, the selected programs to be implemented during the plan period involve thematic, country, multi-sector, and individual projects, which will be utilized to combat poverty in the member countries with priority accorded to Least Developed Member Countries (LDMCs) and poverty pockets in the non-LDMCs. The total cost of these programs is estimated at US$ 13.5 billion.

The thematic programs include (but not limited to) Vocational Literacy Program for Poverty Reduction (US$ 500.00 million), Microfinance (US$ 500.00 million), Communicable Diseases -Malaria and AIDS - (US$ 2.25 billion), and Water and Sanitation (US$ 1.0 billion).

Given the estimated cost of the above programs (US$13.50 billion), the Bank has launched a resource mobilization campaign and use all means to encourage partners and stakeholders to participate in the program. The IDB is committed to maintain the current level of annual concessionary resources of US$ 350-400 million to be available to the Fund for financing over the plan period. Besides utilizing the income which will be generated from the investment of its *Waqf* resources, the Fund will also invest its capital resources to support poverty reduction projects/programs, which can be financed on ordinary terms. The Fund will also attempt to market such projects/programs to the private sector and other stakeholders who could provide their services on market-based terms. Moreover, the IsDB will seek to establish a “Matching Fund” to attract contributions from private/philanthropic donors for specific poverty-reduction programs. Under this arrangement, the IDB will undertake any amounts that would be contributed to these programs by other donors.

While livelihood programs have a direct impact on poverty, they tend to leave out certain sections of the poor – the “poorest of the poor” and the destitute and the “graduate” poor. Programs to develop growth enterprises appear to target the “not-so-poor”. Notwithstanding the success achieved by the programs in their objective of serving the target population, they only partially address the issue of financial exclusion. What is needed is a systemic financial services approach to the issue of poverty alleviation under which, all sections of the society have access to appropriate, low-cost, fair and safe financial products and services from mainstream providers. This is the subject matter of Chapter Four.

A financial services approach to development of microenterprises would require taking into account both demand side and supply side considerations. On the demand side, the study highlights the need to design social safety-nets for the poorest of the poor. Further, it underscores the need to provide financing without restrictions on end-use and at the same time ensure compliance with the Shariah. On the supply side, the most important issue relates to establishment of linkage between various organizations that are part of the process of provision of financial and non-financial services. This study considers these organizations at three levels – micro, meso and macro levels in the context of the Indonesian microfinance system.

Bank Indonesia uses a comprehensive linkage model for the provision of microfinance – especially Shariah compliant microfinance. It envisages three kinds of intervention: for-profit financial assistance, not-for-profit financial assistance and technical assistance for developing microenterprises. For-profit microfinance is undertaken by Islamic commercial banks either directly through their own “units” or jointly with the rural banks (BPRS) and/or savings and credit cooperatives (BMTs). Commercial banks also serve as channels for government microfinance schemes. Technical assistance funds are provided by BI to various providers of business development services and consultants in association with universities who essentially provide for human resource development. This type of intervention broadly involves managerial, technical and spiritual treatment of the microentrepreneurs. Non-profit financial assistance or what are known as non-commercial or social funds are provided by Islamic commercial banks in the form of *zakah* and non-*halal* funds; by private and government companies under corporate social responsibility (CSR) funds; and by the specialized institutions dealing with *zakah, infaq, sadaqa* and *waqf*. These funds are utilized to fulfill basic consumption needs of the deserving poor, to provide for technical assistance to the poor for their skill improvement, and also serve as start-up capital for the microentrepreneurs.

An important objective of establishing a well-linked integrated microfinance system is to ensure a long-term relationship between the various strata of the poor and the providers of microfinance. This implies that there is a systemic tracking and provision of "appropriate" financial services to the individual poor as he/she progresses towards higher levels of financial well-being and achieves higher levels of skill, experience and entrepreneurial acumen. An excellent example of such an integrated mechanism is the microenterprise development program of BMI. Besides the BMI experiment, the study also highlights some cases of establishment of such linkage between *zakah, awqaf* and microfinance.

Box 5.3. Recommended IsDB Intervention in Promoting Islamic Microfinance

At a micro-level

- Participate in equity of Islamic financial institutions with a view to creating specialized MF Divisions;
- Create *Qard Hasan*-specific Funds to support various *qard-hasan* based microfinance institutions across the globe;
- Create refinance facility to act as a whole-seller of Islamic microfinance products for a chain of Islamic and conventional microfinance retailers;
- Participate in equity of commercial *takaful* companies with a view to developing micro-*takaful* products services; also of *retakaful* companies.
- Design a Credit Guarantee Scheme for Islamic microfinance providers;
- Promote dialogue among Shariah scholars for collective resolution of *fiqhi* issues related to microfinance

At a meso level

- Develop knowledge base through research in issues pertaining to building Islamic inclusive financial systems;
- Document, collate and translate best-practices from across the world of microfinance; Undertake training and education programs to impart microfinance related special skills to bankers;
- Undertake training of trainers to impart managerial and accounting skills to users of microfinance
- Encourage formation of apex and regional industry associations whose objective is the development of Islamic microfinance through human resource development, technical assistance, operational standardization and financial product development, facilitation of vertical and horizontal communication among Islamic financial institutions, advocacy and participation in policy dialogue;
- Create *Zakah* and *Awqaf* Funds at a global level dedicated exclusively for poverty alleviation and linked to microfinance institutions downstream; and
- Help create rating mechanism in member countries for Islamic microfinance institutions.

At a macro level

- Assist member countries to develop a regulatory framework for Islamic microfinance;
- Support policy makers to ensure an enabling policy framework conducive to the development of Islamic microfinance,
- Support and facilitate the integration of *zakah* and *awqaf* in financial sector reforms and
- Build an effective alliance and forum of Islamic microfinance providers and other stakeholders.

Source: Islamic Microfinance Development: Challenges and Initiatives, 2008, IRTI, IDB

The most important lesson to be learnt from the Indonesian model is that there is a need for diverse approaches to microenterprises development and poverty alleviation — a one-size-fits-all solution will not work. For example, Grameen replications have not been particularly successful in Indonesia and the outreach of this category of programs is insignificant. Further, BRI as one of the most efficient rural financial institutions in the developing world has broken a long held myth that government-owned financial institutions are bound to be plagued by inefficiency. Finally, it has demonstrated how the central bank can play a key role in enhancing financial inclusion by promoting Shariah-compliant microfinance.

It follows from the three country-specific case studies that they have succeeded in varying degrees in enhancing financial inclusion as a means to poverty alleviation. A multilateral development agency, like IsDB can act as a major catalyst to the process of development and poverty alleviation in its member countries by taking the diversity of their peoples and cultures into account. At the same time, a financial services approach to the issue is called for, under which, all sections of the society have access to appropriate, low-cost, fair and safe financial products and services from mainstream providers. This would require identifying and meeting the challenges at micro, meso and macro levels (see Box 5.3). The recommended interventions include, inter alia, use of *qard hasan* as the preferred mode, introduction of *microtakaful* (conspicuous by its near-total absence in case the three member countries) and credit guarantee systems, integration of *zakah* and *awqaf* with microfinance using the latter for provision of non-financial inputs, skills improvement and capacity building. It may be noted here that a recent Policy Paper on Poverty Reduction (Islamic Development Bank, 2007) argues for an innovative approach to integration of the institutions of *zakah* and *awqaf* with poverty alleviation[2]. It advocates creation of a *Zakah* Fund to:

1. Cover losses arising from the default of very small microenterprises;
2. Cover part of expenses incurred by commercial banks in evaluating and financing microenterprises by the very poor;
3. Provide *qard hasan* loans to reduce vulnerability of the non-poor from becoming poor due to external shocks through a system of micro-insurance; and
4. Build capacities to make households productive instead of focusing on income support.

The paper also advocates capacity building in existing *waqf* institutions through improving the quality of existing undeveloped and underdeveloped *awqaf* properties by investing in them and thereby increasing their returns. It underscores the need to develop alternative models of creating *waqf*, such as, cash *waqf* which can be given out as loans to the poor; development of *waqf* certificates to raise

[2] *See Annexure 4, Policy Paper on Poverty Reduction, Islamic Development Bank, 2007*

funds from the market and enable financing of *waqf* properties on a commercial basis; creation of mutual guarantee funds to pay for accidents, losses of property etc. as well as provision of microfinance on a concessional basis.

The present study suffers from a few limitations that are primarily due to time-related constraints. It makes no serious attempt to undertake quantitative analysis of some relevant hypotheses. For instance, the often-refuted-and-repeated "high financing costs" criticism against conventional MFIs may be investigated in a more scientific manner by analyzing financial data of a sample of MFIs and undertaking a cross-sectional comparison of costs of undertaking various operations. It would also be pertinent to get more systematic information for a number of countries on the size of Islamic microfinance relative to the overall microfinance industry, and additional information on how the Islamic microfinance component is performing in relation to conventional microfinance based on a set of benchmark indicators. The issue of sustainability is also an important one. A comparison between sustainability of Islamic and conventional microfinance may be undertaken on the basis of quantitative indicators of financial sustainability or self-sufficiency. Another limitation of this study is perhaps the sweeping nature of its assumption about behavior of Muslim poor clients of MFIs in the matter of abhorrence to *riba*-based borrowing as practiced by the major MFIs across the globe. A systematic survey needs to be undertaken urgently to throw more light on the demand side of microfinance services and relative importance of *riba*-free microfinance in enhancing financial inclusion.

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GLOSSARY OF ARABIC TERMS

Word	**Definition**
Awqaf	Plural of *waqf.* For meaning, see below.
Bait-ul-Maal	House of social and charity funds, an institution meant to help the poor and needy.
Bait-ul-Tamweel	House of financing
Bai Mu'ajjal	Sale on credit, i.e. a sale in which goods are delivered immediately but payment is deferred.
Bai Salam	A sale in which payment is made in advance by the buyer and the delivery of the goods is deferred by the seller.
Fiqh	Refers to the whole corpus of Islamic jurisprudence. In contrast with conventional law, *fiqh* covers all aspects of life, religious, political, social, commercial or economic. The whole corpus of *fiqh* is based primarily on interpretations of the Qur'an and the *sunnah* and secondarily on *ijma* (consensus) and *ijtihad* (individual judgement). While the Qur'an and the *sunnah* are immutable, *fiqhi* verdicts may change due to changing circumstances.
Faqir Miskin	Poorest of the poor
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.
Infaq	Spending. In the literature of Islamic economics, it usually refers to spending in the way of Allah.
Jualah	Performing a given task against a prescribed free in a given period.
Kafalah	A contract whereby a person accepts to guarantee or take responsibility for a liability or duty of another person.
Muamalat	Relationships/contracts among human beings as against *ibadat* which define relationship between God and His creatures.

Mudharabah	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.
Mudharib	An investment manager in a *mudarabah* contract.
Murabahah	Sale at a specified profit margin. The term, however, is now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed time frame, either in instalments or in a lump sum. The seller bears the risk for the goods until they have been delivered to the buyer. *Murabahah* is also referred to as *bay mu'ajjal.*
Musaqah	A contract in which the owner of a garden agrees to share its produce with someone in an agreed proportion in return for the latter's services in irrigating and looking after the garden.
Musharakah	Partnership. A *musharakah* contract is similar to a *mudarabah* contract, the difference being that in the former both the partners participate in the management and the provision of capital, 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 proportion to each one's share in the capital.
Mustahiq	A deserving recipient of *zakah*
Muzakki	A person liable to pay *zakah*
Qard Hasan	A loan extended without interest or any other compensation from the borrower. The lender expects a reward only from God.
Rabb al-Mal	Capital owner (financier) in a *mudarabah* contract.
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 a predominant majority of *fuqaha'* to be equivalent to *riba*.

Ribawi	Involving *Riba*
Sadaqah	An act of charity.
Shariah	Refers to the corpus of Islamic law based on Divine guidance as given by the Qur'an and the *sunnah* and embodies all aspects of the Islamic faith, including beliefs and practices.
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.
Wakalah	Contract of agency. In this contract, one person appoints someone else to perform a certain task on his behalf, usually against a fixed fee.
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.*
Zakah	The amount payable by a Muslim on his net worth as a part of his religious obligations, mainly for the benefit of the poor and the needy. It is an obligatory duty on every adult Muslim who owns more than a threshold wealth.

THE ISLAMIC DEVELOPMENT BANK (IDB)

Purpose

The purpose of the Bank is to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of *sharīʿah* (Islamic Law)

Functions

The functions of the Bank are to participate in equity capital and grant loans for productive projects and enterprises besides providing financial assistance to member countries in other forms of economic and social development. The Bank is required to establish and operate special funds for specific purposes including a fund for assistance to Muslim communities in nonmember countries, in addition to setting up trust funds.

The Bank is authorized to accept deposits and to raise funds in any other manner. It is also charged with the responsibility of assisting in the promotion of foreign trade, especially in capital goods, among member countries, in providing technical assistance to member countries, in extending training facilities for personnel engaged in development activities and in undertaking research for enabling economic, financial and banking activities in Muslim countries to conform to the *sharīʿah*.

Membership

The present membership of the Bank consists of 55 countries. The basic condition for membership is that the prospective member country should be a member of the Organization of the Islamic Conference (OIC) and be willing to accept such terms and conditions as may be decided upon by the Board of Governors.

Language

The official language of the Bank is Arabic, but English and French are additionally used as working languages.

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