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Al-Tawhid in relation to the economic order of microfinance institutions

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Abstract

Purpose – This paper aims to study the problems faced by microfinance institutions (MFIs) and relates it with *Al-Tawhid* to see the solutions.

Design/methodology/approach – An exploratory method was used to examine various literature that discuss MFIs, the challenge issues growing in tandem with the growth of the microfinance sector and the economic order of MFIs and tries to link it to *Al-Tawhid*.

Findings – The absence of *Al-Tawhid* concept in the practice of conventional MFIs caused the practices are not acceptable to Muslim micro entrepreneurs. Hence, the use of *Al-Tawhid* principles of contract suggested practices that are fair and free from elements of riba and gharar. It relates to the economics order by looking into the aims of providing finance up to reaching the consensus process or shuratic. Cash waqf is suggested as a source of fund for Islamic MFI for sustainability.

Research limitations/implications – The findings need to be supported with empirical study to come up with suitable models.

Practical implications – Alternative sustainable source of funds for the Islamic MFI is suggested.

Social implications – Activating the cash waqf will involve the society in large to contribute to the economic development. The beneficiaries, such as the poor and needy, will be able to find a source of living and be actively involved in generating income activities.

Originality/value – This paper highlights the cause of problems faced by conventional microfinance and relats the *Al-Tawhid* to overcome those problem conceptually.

Keywords Enterprise, Islamic finance, *Al-Tawhid*, Economic order, Islamic microfinance institutions, Maqasid shari'ah

Paper type General review

1. Introduction

Al-Tawhid affirms that the unique God created man in the best of forms to the end of worshipping and serving Him[1]. Therefore, obedience to God and fulfillment of His command are man's *raison d'être*. *Al-Tawhid* also affirms that this purpose consists of man's vicegerency for God on Earth[2]. According to the Quran, God has invested man with His trust, a trust which heaven and earth were incapable of carrying and from which for they shied away with terror[3]. Here, the divine trust is the fulfillment of the ethical part of the divine will, whose very nature requires that it will be realized in freedom, and man is the only creation capable of doing so. It is this exercise of human freedom regarding obedience to God's commandment that makes fulfillment of the command moral.

Humanomics
Vol. 30 No. 4, 2014
pp. 325-348
© Emerald Group Publishing Limited
0828-8666
DOI 10.1108/H-01-2014-0006

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It shows that *Al-Tawhid* tells us that God, being beneficent and purposive, did not create man in sport or in vain[4]. He has endowed him with the senses, with reason and understanding, made him perfect – indeed, breathed into him of His spirit – to the end of preparing him to perform this great duty. In performing his duty, his ethical striving and action will enter the realm of space-time. Therefore, the earth (via the economic action) is the object of the human's endeavor, and all humankind is to be involved in its and their own transformation. In this perspective, how should the economy via the business enterprises be transformed? In particular, in this paper, we want to clarify the essential relation of *Al-Tawhid* to the economic order of microfinance institutions (MFIs).

Studies done by many researchers, such as Park and Ren (2001), Centeno (2010), IFAD (2007), Srnec and Havrland (2006), the founder of Grameen Bank Yunus (1998) and many more others, have been examined to find the economic order and the challenge issues grow together with the growth of the microfinance (MF). The Muslim micro-entrepreneurs need shari'ah-compliant models of microfinance which is based on the *Al-Tawhid* perspective. So far, the studies on Islamic microfinance by others focused on the proposal of instruments to be used by Islamic MFIs in providing financing and the modus operandi. Our article looks into the economics order by looking into the aims of providing financing up to reaching the consensus process or *shuratic*. The Muslim micro-entrepreneurs cannot accept the practice of *riba* (as a proof in accepting *Al-Tawhid*) with high interest rates charged on the loan provided by the conventional MFIs.

Islamic MFI should maintain to observe the aims (*maqasid shari'ah*) of providing finance to the poor and needy. The findings show that the poor entrepreneurs are trustworthy people. The low profit charge or even benevolent loan should be used to replace high interest rates charged by conventional MFI. The *shuratic*/consultation process will help the Islamic MFIs to understand the poor micro-entrepreneurs.

The remaining discussion of this paper will be divided into four sections. Section 2 will highlight the challenges in developing MFIs. Section 3 presents the economic orders of MFI as understood by many researchers. Section 4 is linking *Al-Tawhid* to economic order of MFIs which differentiate the Islamic MFIs from conventional MFIs. The paper will be ended with conclusion and recommendations.

2. The challenges in developing MFIs

In general, small entrepreneurs (including the poor) are excluded from the banking system due to many reasons. Among the reasons are as follows. *First*, the lack of collateral which is required by banks. *Second*, banks are also reluctant to lend to the poor due to high administrative costs; processing and supervision costs of small loans which are disproportionate to the amount of lending (Islam *et al.*, 2002, Peque, 2005; The United Nation Report, 2006; Nuwire, 2008; Raiyani, 2009; Centeno, 2010; The World Bank 2011). Therefore, bankers prefer to deal with large-scale enterprises. *Third*, the poor have unstable income for repayment of loans, high costs of transaction that are unattractive to the banks, lack of necessary documents and the location of banks. The banks are usually only located in commercially profitable areas which are difficult to reach for those who live in underdeveloped areas. *Fourth*, the poor, as reported in International Fund for Agricultural Development [IFAD] (nd), Kendall (2009), Tiwari and Fahad (2014) have limited access to formal sources of credit due to complicated loan procedures and paperwork, combined with a lack of accounting experience. This exclusion

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motivates researchers, for example Park and Ren (2001), Centeno (2010), IFAD (2007), Srnec and Havrland (2006), Ahmed (2007) and Kahf (2011), to suggest MFIs as alternative avenues for the poor and small entrepreneurs to get financing.

As MF evolves, it faces critical challenges in terms of sustainable and universal methodology, commercialization, mission drift and corporate governance as discussed below.

2.1 Sustainability

In the 1990s, the issue of financial sustainability of MFIs gave rise to an important debate between the *financial systems* approach and the *poverty lending* approach (Robinson, 2001 as cited in Hermes and Lensink, 2011). The *financial systems* approach stresses the importance of being able to cover the cost of lending money out of the income generated from the outstanding loan portfolio to reduce operational costs as much as possible. The *poverty lending* approach, however, aims to overcome poverty, primarily by providing credit with subsidized interest rates. The argument is that the poor cannot afford higher interest rates. However, empirical evidence neither shows that the poor cannot afford higher interest rates, nor that there is a negative correlation between the financial sustainability of the institution and the poverty level of the clients. The main argument is that large-scale outreach to the poor on a long-term basis cannot be guaranteed if MFIs are not financially sustainable. As time goes on, according to Hermes and Lensink (2011), most parties emphasize the importance of striving for financial sustainability. Therefore, donors, policymakers and other financers of MF have shifted from subsidizing MFI institutions toward a concern for improving the financial sustainability and efficiency of MFIs.

The Deutsche Bank (2007), as cited by Hermes and Lensink (2011), reported that only about 1-2 per cent of all MFIs in the world (about 150 organizations) were financially sustainable, and 8 per cent were close to being profitable. In most cases, these were larger, mature, regulated and relatively well-known and commercialized MFIs, focusing on profitability and/or sustainability. Twenty per cent of MFIs, consisting of mostly non-governmental organizations (NGOs), were not yet financially sustainable, but might become sustainable in the near future. The remaining 70 per cent consisting of smaller, start-up organizations, were still far from being financially sustainable and were, therefore, (heavily) dependent on subsidies.

However, in another study, Rosenberg (2008) reported that 565 out of about 1,300 MFIs were financially sustainable in 2006. Comparing government-based MFIs with private MFIs, government MFIs tended to be more unsustainable. This was due to the fact that, with a few large exceptions, they were not trying to be sustainable. However, surprisingly, it was reported that in 2006 not-for-profit MFIs were more profitable than for-profit MFIs. This was because the not-for-profit MFIs did not pay taxes and operated in less competitive markets.

Recent research on the performance of MFIs conducted by Hudon and Traca (2011) studied the relationship between subsidies and the efficiency of MFIs. Many MFIs still receive subsidies from governments, donors, NGOs and so on. The providers of subsidies increasingly demand transparency related to the effects of their subsidies on the performance of MFIs. An issue raised was that subsidies may keep inefficient institutions alive. There was evidence that subsidy intensity has a positive relationship with the efficiency of MFIs. There was also a threshold effect, meaning that if the

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subsidy intensity went beyond a certain level, efficiency was compromised. A clear policy-relevant message was that subsidizing MFIs may contribute positively to efficiency, but only up to a certain maximum level.

Then, Hermes *et al.* (2011) provided new evidence on the existence of the trade-off between sustainability (cost efficiency as a measure of sustainability) and outreach (the depth of outreach measured by the average loan balance and percentage of women borrowers). They found strong evidence that outreach is negatively related to the efficiency of MFIs.

An empirical study done by Cull *et al.* (2007) showed that MFIs that mainly provide individual loans perform better in terms of profitability, but the percentage of poor borrowers and female borrowers in the loan portfolio is lower than for institutions that mainly provide group loans. The study also suggested that individual-based MFIs increasingly focus on wealthier clients. This proves that mission drift occurs less in group loans. Another finding was that prudential regulation and supervision raise the costs of lending for MFIs. Supervision has a negative effect on outreach, as supervision is positively associated with the average loan balance, whereas it is negatively associated with the percentage of women borrowers.

Evidence from the studies of Cull *et al.* (2007) and Hermes *et al.* (2011) showed that when the MFIs reach efficiency, which is an important criterion for sustainability, their outreach gets lower. This defeats the purpose of subsidies – which is to enable MFIs to give more outreach and higher average loans. This is because the foci of MFIs change from providing loans to as many as possible poor and vulnerable people toward giving loans to wealthier clients (a mission drift) to be profitable and be sustainable. The need to be profitable makes MFIs more conscious of supervision which increases the costs of lending and lowers the rate of outreach.

Srnec and Havrland (2006) highlighted that sustaining the provision of MF services is an important goal of any MF operation. This is because they provide financial services to un-bankable people. The issue now is how to make MFIs sustainable. Subsidies are important, but do not lead to financial sustainability. To be financially sustainable, according to Srnec and Harvland (2006), the MFIs need to aim for profitability as in commercial operations. There are some strategies that formal MFIs can take to manage risks such as avoidance risk, diversification of the international currency, use of local currency and use of other financial instruments (insurance and security system). Off-setting risk is another strategy – having long hedging of potential risk results from currency devaluation and higher fees. Risk diversification is important and can be achieved by diversifying the allocation of resources.

2.2 Commercialization

All the above strategies can be used by commercializing MFIs. Commercialization is a practical solution to the problem of limited sustainability and outreach. The commercial principle in MF can also help to overcome the issues of lack of accountability and transparency through corporate governance procedures (which will be touched in Section 2.3 and performance monitoring activities. The issues of lack of accountability and transparency in MFIs have often been criticized. These issues are partly due to the fact that MFIs often have no owners whose capital is at risk. Commercialization requires the establishment of performance standards relating to the portfolio quality, efficiency, sustainability and outreach.

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Both Charitonenko (2003) and Srnec and Havrland (2006) outlined the process for commercialization. It should abolish subsidized, directed credit program and transfer the remaining credit program to financial institutions. The regulation and supervision of the institutions must be strengthened, and MF performance standards must be developed which cut across institutional types. Wholesale lending interest rates should be allowed to vary according to the market. There are several arguments on the advantages and disadvantages of commercialization of MF.

Fehmeen (2003) mentioned that central banks in many countries forbid non-bank MFIs (such as NGOs and cooperatives) from offering micro-savings to the poor. Grants, loans and Initial Public Offerings (IPOs) are the only other traditional alternatives sources of fund for the MFIs. Commercialization will help MFIs to raise funds, as MFIs generally lack low-cost funds to support the growth and sustainability of their operations. The success of two MFIs in the capital markets (Bank Compartamos of Mexico and SKS of India) improved the "credibility of MF in capital markets" and helped to attract funds from social and commercial investors. The additional funds (profits and other equity generated through an IPO) can be invested in the MFI to expand market outreach and achieve operational efficiencies (economies of scale) which will, in the long run, lower interest rates while increasing the range of customer-centric products. Bank Compartamos, for example, drew plenty of attention and criticism because of its high interest rates (85 per cent per annum) at the time of its IPO in 2007. However, the MFI has not become less customer-centric or more commercial since the IPO, and their interest rate actually fell by to 71 per cent in the subsequent year, and this rate is amongst the lowest in the market. However, he mentions that the long-term risk still remains.

Fehmeen (2003) also highlighted a worry about commercialization (especially to the extent of tapping into capital markets) – that it is contrary to the mission of MF, which calls for the protection and empowerment of the poor. The pressure to deliver high returns to investors may drive MFI managers to rely on exploitative practices, such as increasing interest rates, avoiding investing in "bad" businesses/projects or following aggressive credit collection methods. The willingness to forego profits for the sake of social returns may hold true for individual investors. However, majority of shares in MFIs are purchased by commercial investors because MF has been established as a rewarding financial investment.

Some arguments look at the issue of the commercialization of MFIs from a moral point of view. It is morally questionable to make money off the poor, even if the organization's mission remains intact. While the poor are made to pay above-market rates (on the basis of high operating costs and other factors), company executives walk away with millions of dollars. If social and financial objectives are combined, the former should be the MFI's first priority, and investors must be "socially oriented investors". This is to prevent MF mission drift (Davis and Fehmeen, 2003). A variety of social performance metrics should be used to ensure that for-profit MFIs deliver promised social returns. The MF model should be such that any profits directly help the clients (similar to cooperatives). IPOs should preferably be the last resort for MFIs seeking to raise funds (Fehmeen, 2003). It should be remembered that Grameen Bank, one of the largest MFIs in the world, grew purely based on its social performance – grants, donations, voluntary savings from borrowers and deposits from the general public are major sources of funds. World of Vision, another giant NGO, falls in the same category because its ideas of sustainability are far from commercial.

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Arena (2008) expressed that MF has flourished into a full-blown anti-poverty movement nearly universally across the political spectrum. The United Nations declared 2005 as the International Year of Microfinance. Furthermore, Mohammed Yunus received the Nobel Peace Prize in 2006 for his pioneering work in MF in Bangladesh. This increased attention and the promises of profitability made by the movement's leaders have attracted the capital of both commercial investors and large donors. The MF movement has also gained a number of critics. The political right urges MFIs to transition from subsidy-dependency to commercial profitability to be sustainable.

Both commercialization and subsidy-oriented MFIs are facing possible ethical issues. Thus, there is a need for corporate governance to be made available. Corporate governance now becomes one of the foci of the relevant agencies.

For example, it was reported that in Benin, local NGOs were subcontracted by a multi-million-dollar MF program. Banks subcontract up to 20 NGO MFIs. The maximum loan amount is USD60. Borrowers have six months to repay the government-backed loans with a five-per cent interest rate (IRIN, 2009). IRIN (2009) studies revealed that loan intermediaries are taking bribes from borrowers by charging up to USD7 instead of USD2. Furthermore, many cases have been reported in which repayment received from borrowers is not remitted to the fund's partners (banks). This happens due to lack of supervision and the program's rapid growth has left it open to "unscrupulous intermediaries" hired to process loans. Without concrete criteria, the program is open to favoritism and corruption.

2.3 Corporate governance

Basically, the principles of governance, as discussed in Fundacion Microfinanzas BBVA (2011), should include the protection of shareholder rights; guarantee the fairness of decision-making at governance levels; limit the abuse of power; establish a framework of responsibility for administrators and senior executives; have respect for human dignity and rights (such as equal opportunities and respect for diversity); and promote integrity, loyalty and honesty, as well as comply with laws and regulations to prevent unlawful activities and conflicts of interest. To ensure good governance in administration, there must be an annual general meeting that functions as the institution's highest governing body where shareholders can exercise their vote and communicate with each other. The organization must establish internal regulations that set the criteria for organizing and running the annual general meeting. Good governance should emphasize the importance of the Board of Directors as a governing body. The Board of Directors can set up committees to help it to perform its duties such as audit committees, investment and risks committee, appointments and remuneration committees, corporate governance committees and other special committees. Good governance in management must have a full separation between administration and management duties so that each body carries out its duties with the highest efficiency. Therefore, the organization must have a general manager as the institution's legal representative, appointed by the Board of Directors, who reports to the Board Chairman. The Board of Directors should be responsible for general strategy, control and supervision and must not interfere in general management activities. However, important decisions or measures taken by the management body must be approved by the Board of Directors.

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Fundacion Microfinanzas BBVA (2011) also suggested general acting principles to guide MFIs in improving their performance. These are simple, flexible, generic and feasible criteria. In terms of streamlining the process of approval or denial, well-defined procedures need to be established to assess the customers' application. MFIs must have a manual that explains those procedures. The procedures must be aimed at mitigating transaction risks and streamline product approval and payment times. The contract conditions must be explained as clearly and simply as possible; spell out the product cost, expiry period, repayment conditions, terms and amount of possible penalties in the event of breach of contract, etc. The institutions must also establish internal and external control mechanisms to guarantee in-depth knowledge of the institution's activities through an efficient reporting system. Risk control, financial profitability and self-sustainability are very important. Therefore, management is responsible for directly supervising the organization's liquidity, solvency and performance. Performance must be measured, and impact must be studied from time to time.

The growing importance of MF corporate governance led to the 4th annual Convergences 2015 Forum in May 2011, which has launched the "Paris Appeal for Responsible Microfinance". To address the excessive commercialization of MF and other issues, the Paris Appeal reaffirms the role of MF as a tool in the service of development and inclusive finance. It aims at bringing back ethical values and a social orientation as sub-topics that should inspire all stakeholders in the sector and offer to ensure self-regulation initiatives and rules that converge toward a solid foundation of principles. These rules will help to define responsible MF and restore confidence among the public.

The content of the appeal is as follows: When we want to consider the CG framework:

> Consider that microfinance institutions must pursue a long-term double objective of financial viability and social impact, by offering products and services adapted to the poor, by leading a policy of moderate interest rates, and by complying to the highest standards of information and client protection. The compliance of policies and practices must be certified by recognized social performance indicators.
>
> Remind of the importance of solid governance of adapted prudential rules and efficient reporting and control systems. Such rules and practices must be given an efficient and objective supervision and notation system.
>
> Call on to microfinance institutions, their national and regional associations and regulation authorities, to systematically apply the principles and rules established by the industry to adjust and prevent the sector's mission drifts, and to prevent and complete them with regulations adapted to the context in each country.
>
> Encourage investors specialized in microfinance to subscribe to a Code of conduct serving the long-term interests of the MFIs they support, allowing them to strengthen financial viability and to reach their social objectives.
>
> Encourage researchers and universities to scale up cooperation with MFIs to conduct impact studies and disseminate best practices.
>
> Call on to donors and private foundations to uphold their microfinance commitments, to encourage innovation and diversification, to support and train clients and to focus programs

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on geographical regions, particularly Africa, sectors such as agriculture and products and services such as micro-insurance and credit for the poorest, where the needs are manifest.

2.4 Targeting the poor

The success of MFIs can be based on their achievement in providing MF, saving and insurance services to poor and vulnerable groups of people such as women, youth and the disadvantaged. Park and Ren (2001), in their research, highlighted that the ability of MF programs to help the poor rests on a set of propositions. First, the program must reach the poor who request loans at the program interest rate and they are having projects with expected returns that exceed the cost of participation (the interest rate). They are those who cannot be financed more cheaply by other institutions. It is important to observe that the eligibility rule must exclude the rich to ensure the reach of the program to the poor. The second is that the program must achieve high rates of repayment. This can be achieved through group liability, dynamic incentives and regular repayments. Third, the loans must bring net benefits to the poor and not simply give out the credit.

The Grameen Bank of Bangladesh, the most individual prominent of the successes now reaches over 2 million people, with cumulative lending of about USD2.1 billion. Similar successful examples are known in Latin America (e.g. Banco Solidario in Bolivia) and in Africa (the Kenya Rural Enterprise Program). Such institutions have not only achieved a degree of success but they have also managed to attract donor support and press attention (UN, 2006).

A further key factor for measuring success is the recruitment policy of the MFI, which should select people who care about the broader goal of the organization, who are willing to constantly upgrade their technical and relational competences and are honest. A special monitoring system should be in place to check for dishonest appropriation, which is relatively easy in the business. For example, technology should be applied to record transactions, and it is crucial to have systems that can double check clients and employees (Piana, 2008).

It was mentioned in an article by UNEP IETC (2003) that a factor that contributed to the success of MF was the "credit-plus" approach. A focus of MF has been not only to provide credit to the no or low income community but to integrate with other services such as community organizing and development program, leadership training, skills and entrepreneurship management, financial management and so on.

There have been many studies done which show some elements of failure of MF. MF programs must have an efficient control and monitoring system. Karnani (2007) quoted the Boston Globe in pointing out that micro-lenders regularly fail to achieve their objective to help people attain permanent self-employment. This is often because they fail to ensure that the loans are actually used by their borrowers to start small businesses. Some studies on Grameen's loan revealed that the repayment rate does not match what the bank claims, that at least one quarter of its loans were being used for household consumption and there is no serious supervision from the bank. The fact that the loans were used for household consumption suggests that poor families need welfare assistance besides MF for their microenterprises. He mentioned that the poorest of the poor need more than MF. They need grants, as their income is inconsistent, and even micro loans will make the situation worse, especially with high interest rates that range from 25 to 60 per cent annually (between 2 to 4.5 per cent each month), although this is

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still lower than informal money lenders. In Sri Lanka, Judith (2004) reported that microenterprises account, on average, for only 56 per cent of a household's income. The other sources of a household's income are from additional self-employment activities, local wage employment, remittance from family members working in other provinces and overseas and transfer payment from the government. The issues faced by MFIs, as discussed above, are based on the economic order of MFI that will be highlighted in the following section.

3. The economic order of MFIs as understood by many researchers

The term economic order refers to the set of prescribed norms, rules and procedures that regulate the exchange of goods, services and capital[5]. These economic orders can be seen from various aspects, the establishment and the rules and procedures.

3.1 Establishment

MFIs have been established as formal, semiformal and informal. Informal MFIs give assistance to the very poor in solitary regions. It consists of non-formal initiatives and non-formal NGOs. These informal institutions are motivated by the sense of responsibility of the society. Ledgerwood (1998) characterized informal financial intermediaries as those which operate outside the structure of government regulations and supervision. They include moneylenders, pawnbrokers, self-help groups and NGOs, as well as the savings of family members who contribute to microenterprises. These initiatives become formal when they are transformed into an integral part of the financial system. The trend is to transform the informal into formal institutions, as reported by Srnec and Havrland (2006).

Most MFIs started as not-for-profit organizations like NGOs, credit unions and other financial cooperatives, as well as state-owned development and postal savings banks. An increasing number of MFIs are now organized as for-profit entities, often because it is a requirement to obtain a license from banking authorities to offer saving services. For-profit MFIs may be organized as non-bank financial institutions, commercial banks that specialize in MF or MF departments of full-service banks (CGAP, 2012).

Hubka and Zaidi (2005) mentioned that MF was initially developed by NGOs. Today it is still primarily deployed by NGOs who receive donor funds and/or- lend to MF clients (often at subsidized interest rates). In many cases, governments also play a critical role: setting policies for the MF industry (most frequently interest rates), providing lump sum grants to NGOs or other MFIs or lending directly to the poor. Other important players in microfinance are credit unions, cooperatives, commercial banks and small informal groups (self-help groups).

Formal MFIs offer competitive financing alternatives to informal lenders in rural areas. MFIs are able to service borrowers that are ignored by traditional lenders. MFIs can offer lower interest rates due to connections to formal financial markets, portfolio diversification and economies of scale (Coke, 2002).

In Nigeria, informal MF activities flourished all over the country, before the emergence of formal MFIs. Informal MF is provided by traditional groups that work together for the mutual benefit of their members. The key features of these informal schemes are savings and credit, informal operations and higher interest rates compared to the formal banking sector. Now the formal MFIs are operating side by side with the

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informal services, providing services which include savings, credit and insurance facilities (Mejeha and Nwachukwu, 2008).

Piana (2008) compared the practices of informal money lenders with MFIs. Money lenders offer extremely high rates of interest to borrowers, exploiting the emergency need for hot money, leaving the poor in worse condition after paying back. The immediate necessity for money is sometimes due to having to repay a previous debt gone overdue, a funeral, a marriage ceremony, a lost gamble, etc. The difference with MF is the use of the loan, the dynamics of in-debtness, a higher interest rate and the way default and delayed payments are handled.

However, Tiwari and Fahad (2014) discovered how formal MFIs can work together with informal MFIs. Informal institutions have comparative advantage in terms of small transaction costs achieved through flexible operational processes. For example, informal institutions are better equipped to deal with credit assessment of the urban poor, making loan processing costs cheaper. On the other hand, formal institutions have the advantage in terms of access to a broader resource base. Therefore, Tiwari and Fahad (2014) suggested a joint venture between informal and formal institutions. The formal institutions can provide funds in the form of equity and the informal institution can extend savings and loan facilities to the urban poor. Another form of relationship suggested was for formal institutions to re-finance loans made by informal institutions. So, informal institutions are able to tap additional resources.

Formal MFIs consist of government-based and non-government organizations. In the USA, government-based MFIs become competitors to private MFIs who have served society for a longer time. The private MFIs wanted the government to support MF development to ensure macroeconomic stability and legislative clarity, as well as promote specific activities such as training for MFIs' staff, supporting access to cost-cutting technologies and setting rules on flexible banking hours (Bate, 2007).

Research conducted by Park and Ren (2001) on the performance of Chinese MF programs which adopted the Grameen model, carried out a comparative study on NGO programs, NGO–government (mixed programs) and government programs. The NGO program was located on a flood plain area, while the other two were conducted in mountainous regions. The evaluation of financial and operational performance showed that the NGO performed better in terms of operational and financial sustainability, peer selection and monitoring, repayment and dynamic incentive response. The government with subsidized interest rates as low as 2.88 per cent performed less successfully than the NGO and mixed programs in China. The government MF programs with subsidized interest rates failed to reach the poor because the rates became attractive to rich households. The repayment performance of NGOs was better than that of mixed programs and government-based MF programs. Weekly repayment in the NGO programs was 95 per cent (never delayed), while mixed programs showed a rate of only 67 per cent, and government programs showed a rate of 24 per cent.

The report did not mention specifically the reason for low repayment rates on the government MF program. However, it explained that the government officers were very excited with the program and wanted to implement it as soon as possible. Therefore, the mechanisms and some procedures were not really observed. They commented further that the high on-time repayment and nearly 0 per cent default repayment on the NGO program indicated that the poor are creditworthy people. In their paper, Park and Ren

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(2001) underlined the factors that determined high on-time repayment included being female, having more or better quality land, not having health scares, less geographic distance among group members and dynamic incentives (expecting new loans if the current loan is repaid).

3.2 Rules and procedures

There are several rules and procedures that have been introduced to regulate the MFIs. Among them are:

3.2.1 Loans size. The small size of loans becomes the typical size of MF. It can be discussed in three dimensions (as reported in Piana, 2008):

(1) in absolute monetary values, as compared to a typical business loan;

(2) in relation to the borrower's income, so that payback is easier; and

(3) in respect to the lender's portfolio, so that the single default borrower has no impact on the MF institution's financial position.

The small-sized loans can give more opportunities to a larger number of recipients; a wider outreach over the target population. The small sized loan can also attract poor people and make it unattractive for the affluent.

In addition, small-scale loans are needed by those who want to start up a small business such as a small eatery or a simple cottage industry. Some of those people strategize by pooling their loans together and starting a cooperative. Earnings from these activities can help pay up their loan, and they can divide their profit amongst themselves or roll it over to make the business grow (Centeno, 2010).

However, MFIs provide small loans but allow repetitive loans. Game theory has widely shown that repetitive loans generate a setting where it is better for the borrower to pay back than cheat to obtain trust for the next loans (Piana, 2008). The advantage of small loans according to Centeno (2010) is that a small loan offers less risk for MFIs and makes it easier for the borrower to pay back the amount.

3.2.2 Repayment period. The shorter period of repayment, as argued by many researchers like Piana (2008), Centeno (2010) and Fischer and Ghatak (2011), forces the borrower to concentrate on low-risk improvements of his activity, and it is coherent with the short-time planning horizon typical of the poor. High frequency of repayment reduces the value of each installment, easing the task of honoring it, and offers more opportunities to monitor how the business is going. This is particularly important, as MF is not backed by collateral.

However, the FAO Corporate Document Repository (2014) mentioned that the loan term and frequency of loan repayments should ideally be based on the borrower's cash patterns. MF loans are generally short-term, ranging from less than a year to two years, as most loans are small and are used for working capital purposes. For most MFIs, repayments are made on an installment basis (weekly, biweekly and monthly) for activities that generate ongoing revenues. There can also be variations where a combination of installment and lump sum payments are made so that borrowers are not unduly burdened. The design of repayment periods also depends on the ability of the MFI to collect and ensure repayments. The location and proximity of the MFI to the borrowers so that credit officers are able to make frequent visits to the clients and vice versa are also critical considerations. Whatever the design of the repayment schedule, the basic rule is that it should correspond to the income derived from the activity

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financed by the loan and therefore loan terms and repayment periods must be flexible enough to meet the client's needs.

Piana (2008) commented that a high repayment ratio, with 98 per cent up to 100 per cent loans paid back on time, was the single strongest reason exhibited by most MFIs to the skeptical financial and political community. The neglected poor, the illiterate and those lacking formal training, living in doubtful hygienic conditions, after a life of oppression, can be good and remunerative clients of financial products, keeping their promises and activating all their entrepreneurial and personal energies.

3.2.3 Interest rates. According to the FAO Corporate Document Repository, global experience has demonstrated that subsidized interest rates are not financially sustainable. On the other hand, borrowers have been found to be more concerned with access to credit issues than the cost of the service; thus, they are generally not sensitive to interest rates. They are more concerned with MFIs that can offer efficient, flexible and convenient credit services. Piana (2008) emphasized that a high interest rate on a loan is acceptable to the borrowers if the economic activities can generate high returns and is profitable. The poor can afford to pay a high interest if the loan immediately increases income and the repayment is just in a few weeks.

As a rule of thumb for the adequate remuneration of the loan, Yunus (2007) has proposed a Green Zone of interest at the market rate plus up to 10 per cent; a Yellow Zone which equals the cost of funds at the market rate plus 10 to 15 per cent; and a Red Zone, where the rate is higher than in the Yellow one and which is the moneylenders' territory.

There are several reasons for the high interest rate charged by MFIs. First is to cover the high costs of administration. The Carleton Microfinance Club (2011) highlighted that one of the significant reasons for the high interest rates charged by MFIs is high administration costs due to small loan sizes. By offering very small loans, the overhead incurred by MFIs per dollar is very high. For example, USD20,000 could easily be a single loan in a traditional bank, but the same USD20,000 at MFIs may serve as many as 800 clients. The costs of processing a new loan application, collecting weekly payment and monitoring the borrowers are similar per loan whether it is extended by MFIs or by traditional financial institutions (such as banks). Therefore, the cost per USD is higher for MFIs compared to traditional banks (Coke, 2002).

The second reason is that too low interest rate always become more attractive to the rich. High interest rates will exclude the rich from taking advantage of the MF scheme (Park and Ren, 2001). The third reason concerns sustainability. In addition to high per unit administrative costs, MFI loans are not secured with any collateral. This implies that in the event of default, lenders are particularly vulnerable to capital losses. Several MFIs have, in fact, achieved solvency without external subsidies. Examples include BancoSol in Bolivia and Bank Dagang Bali in Indonesia (Robinson, 1996 as cited by Coke, 2002). Therefore, high interest rates are used to cover some of the losses from defaulted repayments.

In addition, the processing and monitoring costs should be kept low. Many MFIs require the borrower to set up a group of peers involved in a cycle of conditional loans. For one member to obtain the loan, the previous borrower has to pay back regularly. The group exerts surveillance on each member, helps in coping with difficulties and reduces "idle" time, when the money paid back remains in the institution before being given to a new borrower (Piana, 2008; Park and Ren, 2001). The monitoring process happens via

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group-lending contract and incentive is given by increasing loan sizes over time based on the repayment histories of previous loans (Park and Ren, 2001).

3.2.4 Clients. From the definitions given by various reports, authors and researchers, the target group of MFIs are the poor, women, youths, landless, those who have no assets for collateral, and those who are "otherwise unbankable" (Park and Ren, 2001; Coke, 2002; UN Report, 2006). Park and Ren (2001) summarized that the MF programs are united in aiming to provide financial services to individuals who are traditionally excluded from the banking system, especially women. Most MF initiatives and programs explicitly target the poor and those without collateral by reducing the costs through peer screening and monitoring efforts.

The FAO Corporate Document Repository reported that globally, women constitute the majority of MF clients, primarily because of their better repayment records. Women's involvement in MF has been shown not only to benefit them personally but their households and the community as well. Because they spend more of their income on their households, the welfare of their families is enhanced, thus generating a multiplier effect.

Coke (2002) criticized that the theoretical models of group lending do not address the gender dimension that is crucial for understanding MFI performance. MF programs in general target women based on the assumption that female borrowers will use the loan funds to increase business profits and thereby improve household welfare. This idea is supported by general research on the impact of female income and male income on the level and type of household expenditures. Coke (2002) further highlighted that loan repayment is not a gender neutral decision. Women's and men's repayment behavior may differ because of differences in gender roles, norms and perceived interest. MFI borrowers decide to repay the loan or default within the context of other household decisions. For example, female borrowers may choose to forego the loan payment to pay her child's education. This will lead to loan default.

The World Summit for social Development, Copenhagen, 1995, listed the target groups that MFIs should pay attention to: small rural or urban producers; landless farmers; and other people with low or no income, women and disadvantaged groups (Report of the Secretary General, 2006). The report estimated the poor at 1.3 billion people all over the world. Access to finance through MF is one of the factors to help poverty eradication.

In Bangladesh, 94 per cent of the Grameen Bank's loans go to women. This was explained by the founder Muhammad Yunus by the fact that women have plans for themselves, their children, their home, meals and so on. The resources and profit generated as a result of the MF will be ploughed back into the development of the immediate household and family (UNEP IETC, 2003).

3.2.5 Services offered. MFI offers a wider scope of services which includes MF facilities, saving facilities, remittance facilities and insurance and other financial services. MF also means building a financial system that serves the poor. It is obvious that MF matches the needs of micro and small enterprises. Micro businesses need small amount of loan and to be repaid in short term. A successful micro business will find itself needs larger size of loan for expansion. MFIs should fulfill this need by providing larger maximum amount of loan.

3.2.6 Group lending. Group lending is known as a "solidarity group lending scheme". Loans are given to a group of individuals. If one of the group members is unable to repay

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his/her portion of the loan, then the group members are subsequently responsible for the default. This contractual institution is designed to use social norms and group peer pressure to ensure that group members will fulfill the responsibility of repayment. As the groups are self-formed, the group members effectively bear most of the screening costs associated with new loans. People with poor character and low business prospects are not accepted into the group (Coke, 2002).

The FAO Corporate Document Repository stressed that group formation is an essential component of group-based lending, and the use of peer pressure from other group members acts as a collateral substitute as well as a repayment incentive. Group lending may also reduce transaction costs and risks because of internal group monitoring and screening.

The literature on MFI loan repayment decision often focuses on the role of group sanctions in discouraging defaults (Park and Ren, 2001; Coke, 2002; Habteabt 2005; HOPE website, 2011). It was observed that MFIs practice different methodologies to ensure repayment, such as using co-signers or social collateral (community banking). The borrowers approach the MFIs not as individuals but as a group. Within the group, members will decide how much would be appropriate for each of them to receive. Agreement among them is important as each of them is not only responsible for repaying their loan but also the repayment of other members loans if they default. Group lending creates incentives for individual group members to screen and monitor the other members of the group and to enforce repayment. Thus, the lender no longer has to invest in screening, monitoring and enforcement activities. One of the expected advantages of group lending programs is that it reduces the moral hazard behavior of the participants (Coke, 2002).

3.3 Islamic MFIs

The development of MFIs move from informal MFI to formal MFI and now many MFI become commercialize as discussed above. MFIs with profit-making objective have to charge high interest rate to sustain. The existence of Islamic MFIs also follows more or less the same sentiment, although they are bringing the shari'ah contracts in the operation.

Islamic MF is basically an extension of the Islamic banking and finance concept, which is free of *riba* (non-interest based) financing arrangements (Nazirwan, 2009). Instead of charging interest, the transaction is in the form of profit-and-loss-sharing contract and mutual partnership, where its practices should be tied to tangible goods and real economic activities, prohibit speculative transactions, illicit business and cheating and deception, as well as unjust practices.

However, according to CGAP (2013), the supply of Islamic financing products for the poor is largely limited to *Murabaha* and *Qard Hassan* loans, whereas the minority includes *Salam, Musharaka/Mudaraba* and other. *Murabaha* is a "cost plus mark-up" sale contract often used as working capital to finance goods needed. The client typically requests a specific commodity for purchase which the financier procures directly from the market and, subsequently, resells to the client after adding a fixed "mark-up" for the service provided. *Qard Hasan* is a benevolent loan. In Bangladesh, Qard Hasan was the second highest number of clients after Murabaha (Haque and Yamao, 2011). While, *Salam* was the third. The profit-and-loss-sharing schemes of *Musharakah* and *Mudarabah* are not widely offered by Islamic MF providers, although both are most

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encouraged by *Shari'ah* scholars, as they are the Islamic financial contracts that are best reflecting *Shari'a*h principles. *Musharakah* is partnership financing in which the parties share the profits or losses according to a predetermined ratio. *Mudarabah* is capital or trustee financing, in which one party acts as financier by providing the funds, while the other party provides the managerial expertise in executing the project (or provides some other form of nonfinancial contribution). In *Mudarabah*, profits are shared according to a predetermined ratio, but any financial losses are borne entirely by the financier, while the manager loses time and effort (or other nonfinancial contribution). Both *Musharakah* and *Mudarabah* require true reporting and a high level of transparency for profits and losses to be distribute fairly. Although promoted strongly by Shari'ah, they often result in substantial operating costs, particularly for micro and small enterprises that are not accustomed to formal accounting. As a result, overall outreach of both products remains low, with only 9,300 clients in total (CGAP, 2013).

UNDP (2012) highlighted several challenges that are currently hindering the scaling up of Islamic MF in many Muslim-majority countries. The challenges are lack of resources, particularly funding- and Islamic finance-related knowledge, lack of capacity building, lack in operational efficiency and risk management and, finally, unfavorable rules and regulations. For example, the funds are given on interest, and the MFIs may be required to recover a certain fixed rate of return on their investments. As a result, funds from these sources cannot be used in microfinancing with certain Islamic modes of financing like *mudarabah* and *musharakah*.

Obaidullah (2008) stated that there are only a few cases of successful Islamic MF experiments in Muslim societies. These institutions are not integrated into the formal financial systems, and, in most cases, these are in the nature of experimental projects initiated by international donor agencies, religious or political groups. Cases of Islamic banks practicing MF are even fewer.

Brandsma and Bujorjee (2004) reported that in Syria, the MF original funds were contributed by shareholders for profit based. In Yemen, it is based on group lending approach by using *Murabaha* contract. In Pakistan, the financing of their MF is in the nature of small interest-free loans (*Qard Hasan)*. Most of its activities are carried out by volunteers, and there is no funding from international donors or financial institutions.

From the discussion above, it is obvious that IMFIs are still lacking of source of fund. IMFIs were also funding the poor micro entrepreneurs with profit-making motives. The IMFIs have to charge the clients with certain rate of profit so that the IMFIs can be sustained. IMFIs are still unable to widely practice *mudarabah* abd *musharakah* which are seen as more fair and just for the poor. *Mudarabah* and *musharakah* will be able to distribute the profits and losses fairly to the poor entrepreneurs. Hence, it will be in-line with the *maqasid*/objective of shari'ah in relation to *Al-Tawhid.*

4. The relation of *Al-Tawhid* to economic order of MFIs

It is clear that there is still a lack in constructing the *Tawhidy* worldview of the Islamic MF system. Choudhury (2010, 2011) argued that the failure to comprehend this essential and indispensable foundation of the *Tawhidy* epistemology has been the root cause of the predicaments of any program of finance including MF for the poor micro businesses. Any programs should be aimed to achieve the *maqasid* as-shari'ah principles. If the conventional MFI approaches being adopted by Islamic MFI without the concept of *Al-Tawhid*, the result will be to the sole benefit of the rich man and the principal

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shareholders' interests served by Islamic financial institutions. The participatory real-economy and well-being/*maslahah* development financing instruments have been increasingly abandoned by Islamic financial institutions.

The emergence of *Al-Tawhid* worldview with the epistemology of unity of knowledge and the financial system induced by such knowledge-flows is the way to substantially understand the logical negation of many of the postulates of mainstream economics and finance theory and practice. Therefore, we want to establish this relationship.

Hence, *Al-Tawhid* will be linked to the economic order of MFI as per the missing link that we found out from previous discussion as follows:

- *maqasid* shariah;
- trust;
- *qard-hasan* and cooperative;
- war against interest; and
- learning/*shuratic* process.

4.1 Maqasid *shariah*

Maqasid as-shari'ah principles should be understood by all parties involved, including the MFIs, donors or investors, the government and the clients who benefit from the programs or the schemes. New trends in MF services tend toward commercialization, accessing sources of fund through issuing shares to the investors. The main criticism levied against this is that the rich should not be profiting from the poor but helping them instead.

Although the literature indicates that MF is still in demand by the poor despite the high interest rates charged by MFIs, it does not mean that it is an ideal solution. The poor still have no choice but to pay, and it has been proven to be a high repayment rate. There are critiques that the poor may be trapped in continuous debts. The most important is the absence of *Al-Tawhidi* principles in the practice of the transactions in terms of the contracts, processes, procedures, participants and so on.

Islamic *shari'ah* emphasizes distributive justice. Distribution ranks quite high in the *shari'ah* hierarchy of values, and is an explicit Qur'anic criterion for evaluating a society. Refusal to share with the needy is considered transgression as mentioned in *Surah al-Haqqah* 69:Verse 34 and *Surah al-Fajr* 89:Verse18. Combating poverty, or need fulfillment, is the primary goal of re-distribution in Islam and is one expression of the Divine verdict to honor the children of Adam. *Shari'ah* has also made it mandatory on each individual to earn a living for himself and his dependents (Zarka, 2007).

4.2 Trust

Our findings show that traditional banks do not trust the poor. Islamic finance industry should not be following the same sentiment of conventional bank that traditionally prefer not to provide small loan in the short term to the poor and needy without collateral. Only lately in 1990s, banks started paying attention to the MF with focus shifting to achieving good returns. Unremarkably, the industry gave clients what they want, and did not bind itself to the lofty goals advocated earlier by pioneers of Islamic finance. The tendency now is not to depend on bank in catering the micro businesses but

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MFIs. The Islamic MFIs should be clear with the *maqasid shari'ah* of providing microcredit to the poor and vulnerable low-income people.

Finding from literatures showed that many MFIs are successful in collecting high repayment and experience low default rate despite of high interest rate charged to the clients. This proved that the poor and low-income people are credit trustworthy. In fact MFIs are expending globally and have moved toward commercialization. It is acceptable that micro entrepreneurs may fail in their enterprises due to genuine economic reasons. Islam has the supporting system known as *zakat* system which can be utilized collaboratively in the case of failure. *Zakat* can be used to guarantee the debts of the poor and needy.

4.3 Benevolent loan – qard and cooperation

MFIs may find it difficult to attract deposits as commercial banks do. Bulk of the funds of the MFIs is from external sources. Although sometimes external funds are provided at subsidized rates, certain conditionalities are attached to it (Ahmed, 2011).

The current practice of MFIs more toward providing loans with high interest rate due to several reasons is as discussed above. The *maqasid as-shari'ah* principles of providing MF have to be the main aim of the fund providers or donors. We would like to suggest the use of *waqf* donations as a source of funds for MF providers. Most humans have a great reserve of goodwill toward the poor and needy, and would like to help them to varying extents. Islam and all known religions nurture this moral sentiment and strengthen it. Financing is one form of help that many would love to do, but for two hurdles: the cost of administering and collecting the funds and the risk of loss (default by recipients for any reason).

The goal is to provide MF to the productive poor in various *shari'ah*-compliant modes, in a sustainable modern institutional setting. The terms of financing must sustain the *waqf* but should otherwise be most favorable to recipients. *Qard hasan* cannot be the only mode because survival of the monetary *waqf* requires generation of some income. Permanence is a prime requirement of *waqf* to most jurists. Therefore, there are several reasons why MFIs would be efficient in managing the fund. However, *waqf*-based MFIs can offer financing to the poor and needy at lower costs for two reasons. First, *waqf* institution as non-profit institutions will be exempt from taxation and, second, shareholders do not expect to receive profits or dividend.

Note that MF cannot be funded directly from *zakat* collections, as *zakat* must be given to the poor and not loaned to them. However, under the terms of the *murabahah* contract, *zakat* can be used to help the poor and needy to repay their loans in the case that they are unable to do so due to business failure. In many cases, a beneficiary who becomes unable to pay back the MF he had received also becomes *ghaarim* (one burdened with debt) according to *zakat* rules in the Qur'an *surah Taubah 9:Verse 60*. He thus becomes a legitimate recipient of *zakat* to pay back what he owes the *waqf*. Permanent donations of money and real resources may be accepted for *waqf*, no matter how small. This opens the door for wide public participation. Loan withdrawals will not happen, as one of the principles of *waqf* is that it is perpetual, that is once property has been endowed, it has been transferred to Allah and cannot be taken back.

On the other hand, the clients must understand the concept of trustee in repaying the loan and the responsibility to work hard for themselves and their families. Eligible recipients of micro-finance are the needy who can be expected to pay back from future

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income what they receive now. No collateral should be required, as it would exclude the weakest and very needy, which have little or no collateral to offer. They are the under privilege people who are denied finance under the traditional financial system. We must substitute by using group social and moral collateral, and benefit from earlier experiences in this regard by Grameen Bank and others.

In managing the risk of assets management, *waqf* property must be managed according to modern management methods, more efficient and more effective when it is used to provide low cost facilities and financing micro and small businesses for poor and needy. This is due to high risk of default if the business is not success. Ahmed (2011) proposed different kinds of reserves to be observed by *waqf* property management such as *takaful*, profit equalization and capital reserves.

The *waqf*-based MF is to enable the Islamic MFIs charge low profit rate to the micro and small entrepreneurs. This is possible because the fund providers (*waqf* donors) are not expecting any return other than rewards from Allah SWT.

4.4 War against interest

The principle of *riba* provides a guarantee of fixed return to the owner of capital. On the other hand, the entrepreneur who are taking the risk of managing the business; spend time, energy, capacity and resources and whose efforts and skills to make the business thrive, are not guaranteed any return. The entrepreneur, in fact, has to pay a fixed payment as price for the capital they loan. Which logic and cannon of justice can justify this economic principle?

Islamic economic principles emphasize justice to all parties involved in the economy. It does not allow the players to earn with sense of greediness. The capital owner shares both profits and losses. While, on the other hand, the entrepreneur also willing to share bigger portion of profits with the money providers.

The practices of Islamic finance contracts are suggested in lending fund to the microbusinesses such as *mudharabah*, *musharakah* and *murabahah* to lower the risk of loans. Under *mudharabah* and *musharakah*, the money providers will share profits or the profits and losses of the businesses. In this way, the burden on the businesses will be borne together with the money providers and offering a fairer rate of charges. The profit gained by the MFIs will be used for maintenance, to cover the administrative costs, and to cover the risks and growth of the scheme. This form of contract will encourage the sense of cooperation relationship.

4.5 Learning process/shuratic process

Islamic MFI needs information and feedback from clients to become client-led MFI. The clients will get benefit from the facilities if they can get what they really need. Understanding the needs and problems of the clients can help the Islamic MFI to improve the delivery of products and services. Knowledge and information about the needs and problem of client are not a one-go activity. Therefore, Islamic MFIs need to go through a continuous learning process by getting feedback through various ways of information collection. The learning process is continuous and repeated. Choudhury (2010) stressed that knowledge is never complete in the human domain. Therefore, the worldview underlying theory and model in the absence of such an over-encompassing epistemology cannot be complete, absolute and perfect. The quest for knowledge in this regard remains open-ended.

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The Islamic MFIs are suggested to not only provide financing for the micro and small enterprises but also consultation services to guide and help the entrepreneurs. *Shuratic* (consultation) become learning process for both Islamic MFI and the participants. Islamic MFI can collect information and use it in decision–making, while the participant can share problems, experience, and may cooperate among participants. The courage to be persistent in running the business would be come from peer pressure, peer support, monitoring system and support from the MFI management. It also can be used as media to get the genuine information regarding the micro businesses of the clients and to practice the transparency.

In the learning process, the clients or entrepreneurs would gain knowledge and improve their businesses gradually. Cohen and Wright (2003) suggested various ways of information collection that MFI can apply such as interview, reporting, workshop for stakeholders, etc. They also suggested institutional capacity building of MFI through participation of loan managers in interviewing the clients (data collection), data analysis and involve in decision-making process. Identification of obstacles should be quick action. Loan officers had to be trained to use client information and management had to be proactive in this process. Operations people, especially those on the front line, had to be part of the team. Cohen and Wright (2003) suggested setting up routine focus groups for loan officers so that their voices could be heard by management.

Consultation, especially in focus group can help to get large information at one time. Well-facilitated focus groups proved to be a very effective mechanism for gathering a large volume of information quickly. The groups of loan officers particularly welcomed the opportunity to have their voices heard, something that is frequently lacking in the many top-down institutions that dominate the MF industry.

The results revealed that MFIs become more client-responsive when they commit to developing systems of data collection and analysis to ensure that client voices can be heard. The results also validate the capacity of front-line staff to take responsibility for collecting and analyzing credible client information, as well as benefits that result from giving staff a "voice" in decision-making processes.

5. Conclusion

The Islamic MFIs can play important role in reducing poverty problem in Muslim society. The Islamic MFIs are growing all over the globe. At the same time, most MF funding is still provided by government, development-oriented international financial institutions and NGOs. It is clear that MF can only be extended to meet the enormous demand by finding more sources of funding. On the other hand, waqf, as an economic development institution, has not been fully utilized to the optimum. The increasing investment in MF is a reflection of an increasing number of sustainable MFIs worldwide. The issues in the development of MFIs range from providing small short-term loans without collateral, to other issues such as sustainability due to defaulted payments, high interest rates, outreach and coverage of clients, sources of funding and commercialization. The most recent issue highlighted in the literature review shows the importance of corporate governance in monitoring MFIs. MFIs may find it difficult to attract deposits as commercial banks do. To develop further, MF will require increasing the scope or outreach (number of individuals reached), impact (effect on the well-being of borrowers) and depth (ability to reach the poorest of the poor) of MF. The aim is to make MF available not just to the moderate poor but also to the extreme

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poor and the vulnerable non-poor, and to expand the set of microfinancial products offered. To achieve this increase in the scale of MF will require deposit mobilization. Continued reliance on donor or government funds is unrealistic. Deposit mobilization can be eased by the commercialization of MF. Hence, many MFI are transforming themselves into formal financial institutions, and commercial banks, which offer MF products.

The movement from informal MF to formal microfinance and commercialization of MFI bring some advantages to the poor and needy. However, the interest rates charge to the poor entrepreneurs are still very high compared to traditional banks' interest rates charge to the rich entrepreneurs. This is due to high operational costs of MFI and need for sustainability. Hence, this paper suggests Islamic MFIs move from informal to formal MFI in commercial form but maintain the aims of provision of finance to the poor entrepreneurs. The main purpose is to help the poor lifting themselves from poverty. This can be done by using cash *waqf* as a source of funds for Islamic MFIs and using *Al-Tawhidi* principles of contract which are fair and free from elements of *riba* and *gharar*. It is also suggested to incorporate *zakat* fund to help the micro businesses run by the poor and needy in facing genuine economic problems. The emergence of an *Al-Tawhid* worldview based on the epistemology of unity of knowledge and the financial system has the possibility of helping to settle many of the postulates of mainstream economics and finance theory and practice.

Notes

1. Refer to Adz Dzaariyat 51:56, At-Tiin 95:4, As-Sajdah 32:9.
2. Refer to Al-Baqarah 2:30.
3. Refer to Al-Ahzab 33:72.
4. Refer to: Al-Qiyaamah 75:3, 36, Al-Mu'minuun 23:115 and Al-Anbiyaa' 21:16. Produce the meaning.
5. http://what-when-how.com/social-sciences/international-economic-order-social-science/

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