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Islamic Apex Institution for Microfinance and Sustainability

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Abstract
The purpose of this paper is to examine an apex institution of microfinance operating according to Sharia-compliant practices and its performance. After giving the background of the microfinance crisis, we provide evidence of the need for a more responsible microfinance industry. Thereafter, we examine the state of Islamic microfinance around the world and in the Arab world and focus on two existing apex institutions for microfinance: a conventional one – Social Fund for Development (SFD) in Yemen and an Islamic one – Sudan Microfinance Development Facility (SMDF). We conduct a comparison based on outreach to final beneficiaries and total outstanding loan portfolio. The outcome of our assessment, restricted to limited data, shows that SMDF performs better than SFD suggesting that Islamic microfinance apex institutions have potentially a greater impact. We conclude by saying that Islamic finance industry practitioners should make efforts towards developing the microfinance space, as microfinance clients, as they become bankable, will form the basis of loyal depositors to mainstream Islamic financial institutions.
Keywords: Microfinance, Islamic microfinance, responsible finance, apex funds

Introduction

Microfinance started with the Raiffeisen Bank in Germany and the Irish revolving loan funds following the famines in the 16th and 17th century Europe and took off in Bangladesh with the Grameen Bank in the 1970's. Microfinance is defined as the provision of a range of financial services to the poor and is also sometimes referred to as financial inclusion. The supply of small loans, savings and other basic financial products and services, coupled with education and social development programs, had a positive impact on the lives of many poor people over the years across the globe. In his 2005 paper, Hans Dieter Seibel gives an account of the early history of microfinance in Europe and in the developing world, namely India.

According to Seibel, the main lessons learnt from the early history of microfinance in Europe are as follows: (1) Interest ceilings imposed in Ireland in 1843 undermined the competitiveness of the Irish Funds and eventually led to their extinction. (2) Joint and several liability were an effective collateral substitute and risk management tool in early credit associations in Germany, but proved an impediment to the further growth of loan sizes and the spread of institutions until abolished by the Cooperative Act of 1889. Interest rates ceilings and joint liability until today are fueling the debate among practitioners: appropriate regulation and supervision of microfinance is critically important in bringing the poor and vulnerable communities the financial services they need (Anne Pouchous, 2012).

The most well-known successful experience of microfinance started in rural Bangladesh at the initiative of a group of students lead by Professor Muhammed Yunus from Chittagong University. The reason why earlier experiments of microfinance in rural India for instance came less to public attention is that, as Siebel argues, there is hardly a coordinated effort to assemble a history of microfinance, let alone an effort to combine lessons learnt from what worked well and what didn't in the provision of financial services to underserved populations.
Muhammed Yunus jointly with his Grameen Bank were awarded by the Nobel Prize for Peace in 2006 for "for their efforts to create economic and social development from below". These highly publicized efforts of development aid workers in promoting microfinance came under scrutiny in the aftermath of the global financial crisis in 2010, in a series of tragic events including the suicide of women microfinance borrowers in Andhra Pradesh (AP) India. Previously, the shift to commercialization of microfinance was severely criticized, not only by actors outside the sector but also by industry practitioners themselves, following the IPO of the Mexican MFI Compartamos in 2007.

Actually a closer look to early rural finance in India, gives a powerful illustration of the risks of unsound practices in the delivery of financial services to the rural poor. Siebel tells us that "rural finance, mostly in the form of abusive moneylending, spread under the Delhi sultanate with the introduction of a system of land revenue, housing tax and cattle tax to be paid in cash. Land was abundant; but the payment of taxes in cash was difficult, forcing the peasants to produce for the market. This resulted in the overall commercialization and monetization of the rural economy and the expansion of trade. At the same time it created a new market for the financial professions: rural moneylenders advanced land revenue payments to the peasantry; merchant bankers

financed trade. The urban population paid a mere 5% of their income in taxes, while land assessments in rural areas varied from one third to one half of the produce. Assessments of actual production were soon replaced by average pre-assessments, which caused severe hardship during bad years. This created a large class of rent-seekers, comprising tax collectors, moneylenders and a ruling class of landlords and officials without a salary but with rights to collect revenues; they kept about one quarter and transferred between one quarter and one third of the revenue to the government. Moneylending became part of everyday life in Indian villages. As rural indebtedness and the loss of land to moneylenders surged, microfinance turned into usurious moneylending of the worst kind. Peasants became serfs; they could not be displaced as long as the revenue was paid, but, if not, were punished by expropriation, bonded labor, enslavement and even death for what was considered an act of rebellion against the government. This led to a land revolution-in-reverse: dispossessing the peasants and converting their rights of occupancy into rights of tax collection: inheritable, alienable and mortgageable[1]".

These practices criticized for being usurious moneylending of the worst kind were also common practice under the Ottoman Empire with Khanjis. The Khanjis were brokers, merchants and money lenders all in one. They supplied the *muzari* (agricultural operator) with capital, with the conditionally implicit agreement that the *muzari* took his crop yields to the particular *khanji*. The khanjis did not charge their customers with outright interest on the loans they gave. Instead the particular *muzari* agreed to take his crops to be sold in the khan of his *khanji*. Sometimes, the *khanji* would charge a commission. Bedouin landlords would rent their land *to khanji* who would finance the irrigation equipment and would hire land workers. The profits would then be split between the land owner (10%), the khanji (60%) and land workers (30%)[2].

Modern microfinance in contrast was driven by a social goal and these usurious moneylending practices from the Delhi sultanate (13th to 16th century) allegedly disappeared. The industry was seeking to achieve the double bottom line, combining financial performance with positive social impact. This belief hold true until the microfinance crisis occurred, revealing irresponsible lending practices putting borrowers at risk. According to the Consultative Group to Assist the Poor (CGAP) "in a financial world characterized by responsible finance, clients' benefits would be balanced carefully with providers' long-term viability, and client protection is built into the design and business at every level". This definition of responsible finance resonates deeply with the goals of Islamic finance: "economic well-being with full employment and a high rate of economic growth, socioeconomic justice and an equitable distribution of income and wealth, stability in the value of money, and the mobilization and investment of savings for economic development in such a way that a just (profit-sharing) return is ensured to all parties involved"[3]. Islamic microfinance is at the confluence of responsible finance and Islamic finance and therefore could have the potential to shift out of poverty religious Muslims and at the same time ensuring that there is no mission drift. According to CGAP however, "despite a four-fold increase in recent years in the number of poor clients using Sharia-compliant products (estimated at 1.28 million) and a doubling in the number of providers, the nascent sector continues to struggle to find sustainable business models with a broad array of products that can meet the diverse financial needs of religiously observant poor Muslims". Needless to say, not all Muslims have the same degree of religiosity and not all Muslims are willing to go for Sharia-compliant products solely on the basis of their religious beliefs. Rather they would like to compare the pricing offered before choosing one product over another.

An important component of decentralization policy in rural financial markets is encouraging the apex organizations of MFIs. Apex mechanism refers to wholesale financial and non-financial services such as training and technical assistance. Apex institutions typically are funded by donor money, usually supported by the supported government money to ensure local buy-in. They operate at national level and support microfinance institutions. They can also support local consulting and training institutes to build capacity. The ultimate goal of apexes is financial sector development and expansion of sustainable outreach (Levy 2001).

Apex organizations provide valuable technical support in the form of accounting, auditing, training and a central liquidity facility. They assist in securing lines of credit from commercial or development banks and manage the liquidity requirements by transferring funds from member MFIs with surplus deposits to member MFIs with an excess of effective credit demand. Last but not least, they can join together with other apex organizations to lobby politicians and influence government policy. They are sometimes referred to as microfinance wholesale

[1] H. D. Seibel (2005). "Does History Matter? The Old and the New World of Microfinance in Europe and Asia", Working Paper, University of Cologne, Development Research Centre, No. 2005, 10.
[2] http://halshs.archives-ouvertes.fr/docs/00/33/90/53/PDF/A_Contrario-Ababsa.pdf
[3] M. Kabir Hassan, M.K. Lewis (2007). *Handbook of Islamic Banking*, Edward Elgar Publishing, UK.

funds or challenge funds and their characteristics and success factors are presented in more details hereinafter.

The purpose of this paper is to examine an apex institution of microfinance operating according to Sharia-compliant practices and its performance. We chose to focus on two apex institutions: Social Fund for Development in Yemen and Sudan Microfinance Development Facility. We investigate whether Islamic microfinance apex was more successful than conventional microfinance, based on the experiences of Yemen and Sudan. Our research is mainly based on desk review of literature, public World Bank project documents and interviews with industry practitioners.

1 Why is responsibility so thoroughly needed in the industry

Microfinance in its modern version is a relatively young and growing industry. As some regions offer mature markets, there are still untapped markets such as the Middle East and North Africa region. In the following section we present key figures on microfinance around the world and the microfinance crisis: we will start with an overview of the microfinance crisis in the world, with a focus on the case of AP India, and Morocco, two of the most mature markets for microfinance. Thereafter, we will present the principles of responsible finance adopted by the majority of the industry and embedded in the SMART campaign client protection principles. The Smart Campaign is a global effort to unite microfinance leaders around a common goal: to keep clients as the driving force of the industry. In this section, we consider the microfinance industry as a whole without differentiating between Islamic microfinance and conventional microfinance. For an introduction to the principles of Islamic finance and the state of the Islamic microfinance industry, please refer to section 3 hereinafter.

1.1 *What is microfinance?*

According to CGAP, "microfinance" is often defined as financial services for poor and low-income clients offered by different types of service providers. In practice, the term is often used more narrowly to refer to loans and other services from providers that identify themselves as "microfinance institutions" (MFIs). These institutions commonly tend to use new methods developed over the last 30 years to deliver very small loans to unsalaried borrowers, taking little or no collateral. These methods include group lending and liability, pre-loan savings requirements, gradually increasing loan sizes, and an implicit guarantee of ready access to future loans if present loans are repaid fully and promptly[1]. The term "microcredit" originated in Bangladesh and refers to the provision of small, one-year loans primarily to rural women organized in groups[2].

Microfinance is sometimes referred to as "financial inclusion" and aims at shifting out of poverty segments of population usually deprived from access to the financial sector by giving them access. A microfinance institution (MFI) is an organization, which can be a credit union, a non-governmental organization (NGO), a commercial bank or credit cooperative that provides microfinance services such as deposits, loans, payment services, remittances and sometimes insurance.

1.2 *State of the industry*

Since the establishment of the Grameen bank in Bangladesh in early 1970's, the industry came a long way. Today, over 200 million beneficiaries are clients of microfinance institutions – be it non-governmental organizations (NGOs), non-bank financial institutions (NBFI), commercial banks or for profit companies.

The bulk of microfinance clients can still be found in South East Asia today – where the demographics are comparatively advantageous – and the least penetrated market for microfinance is the Middle East and North Africa (MENA) region. In MENA, microfinance markets are in different stages of development with Morocco, Egypt and Jordan showing higher levels of maturity compared to younger markets in Syria, Tunisia and Algeria. The main source of funding for MFIs in MENA has been donated equity. Only Syria currently allows deposit taking by NGO-MFIs, while in all other countries restrictive regulations and current structure of the financial sectors hampers the growth of the microfinance sector. Recently MFIs enlarge the funding of their portfolios through debt financing. Among others because most MFI's are not regulated as financial intermediaries, the products they can offer is limited. Limited diversity of financial services and standardization is also a reflection of their limited internal management capacity.

MFIs in MENA are subject to very different monitoring, taxation, incentives and regulatory conditions. The enabling environment is best described as ambiguous and inadequate. Among the key policy-related issues and

[1] http://www.microfinancegateway.org/p/site/m/template.rc/1.26.12263/
[2] http://cgap.org/sites/default/files/Focus-Note-A-Microcredit-Crisis-Averted-July-2013.pdf

challenges that MFIs in the MENA region face are the need to introduce microfinance-specific laws and regulatory frameworks to support the commercialization of the sector.

There was a sharp decline in growth – in terms of assets volume – in the aftermath of the 2007 financial crisis. Some large MFIs in South-East Asia slowed down operations, whereas some MFIs in MENA faced growing non-performing loan (NPL) portfolios – in Morocco for instance, Zakoura Foundation for Microcredit had to close down. Many clients had multiple borrowings and this saturation of the market coupled with a severe shortage of skilled and qualified staff for effective NPL management lead to a major crisis.

Although this decline occurred during the global financial turmoil, a closer look at the industry reveals that the players themselves had rooted most of the problems triggering the operational deficiencies. As we will see in the following section, some practitioners pointed at the greed of unscrupulous investors pushing for lending in largely mature markets such as India and Morocco. Although Bangladesh was not hit as bad as India during 2010, a CGAP paper also examines how the crisis was averted in Bangladesh[1]: "in late 2007, MFIs began to worry that continued rapid growth could have negative consequences. "The country's big four MFIs—ASA, BRAC, Buro, and Grameen Bank, which constituted two-thirds of microfinance supply for the past decade—in aggregate stopped adding branches and staff around 2008. The change in course happened without notice or wider public discussion, and before microfinance crises in other countries, such as Nicaragua, Morocco, and India, came to light". It is also worth mentioning that most recently, there was a sharp increase in portfolio at risk (PAR) ratios in MFIs operating in the MENA region, following the Arab spring.

The decreasing growth figures in number of active borrowers are to be linked with the evolving lending methodology. It is believed that the smaller the loan size, the greater is the development impact of the micro-loan. In the original (Grameen) village banking version, microfinance clients are organized in groups, and a group can reach sometimes as many as 50 members. The evolving landscape of microfinance shows that more and more institutions tend to apply individual lending methodologies. Individual lending also allows for greater loan sizes. In some regions such as Latin America and Eastern Europe, individual lending has actually been the norm from the beginning. However, in other parts of the world like India, commercialization of microfinance usually goes hand in hand with a shift from group lending to individual lending. Most MFIs are supportive of their clients, which they encourage to graduate from micro to small business, a move that is accompanied by larger financial needs. As a result, 50% of microfinance is provided on an individual basis today.

In terms of loan sizes, unsurprisingly, the smallest loans are found in South East Asia. Loan sizes have increased sensibly since the early 2000's as commercialization of microfinance started to be the norm, a criticism widely voiced by opponents of microfinance as an effective development tool.

As a conclusion, microfinance has been rapidly expanding in all parts of the world, shifting slowly from rural areas to urban places and increasing outreach. Loan sizes have also been growing, with South East Asia (Bangladesh and India primarily, but also Indonesia and the Philippines) concentrating the largest portion of borrowers. MENA where populations are still mainly under-banked and underserved by microfinance, with its sizeable Muslim population has a strong potential for Islamic microfinance.

In the next section, we will touch upon the crisis that occurred in Andhra Pradesh, India, to understand the need for industry practitioners to give a solid framework to responsible finance and client protection principles. As reported by CGAP, "the crisis that erupted in the Indian State of Andhra Pradesh in early October 2010 hit at the epicenter of microfinance in India and has implications there, across the country, and globally".

1.3 *The crisis in AP and major debates in microfinance*

On October 29, 2010, the Wall Street Journal reported on women microfinance borrowers suicides in Andhra Pradesh in an article titled "India's Major Crisis in Microlending, Loans Involving Tiny Amounts of Money Were a Good Idea, but the Explosion of Interest Backfires". Similar articles were published in The Economist and The New York Times, shedding an unwanted light on client over indebtedness and non-ethical repayment collection methods of some MFIs[2].

[1] http://cgap.org/publications/microcredit-crisis-averted-case-bangladesh

[2] For a selection of articles, see http://www.economist.com/topics/microcredit and "*India's Major Crisis in Microlending—* Loans Involving Tiny Amounts of Money Were a Good Idea, but the Explosion of Interest Backfires," *Wall Street Journal* 29 October 2010. "Think Again: Microfinance," *Foreign Policy* 1 February 2012; "Microfinance under Fire," *New York Times* 21 March 2011; "Microfinance under Scrutiny," *Economist* 18 November 2010;

Andhra Pradesh with its 75 million inhabitants is the 5th most populous state of India and known as the state where microfinance has the largest outreach: Srinivasan (2010) estimates the total number of microfinance clients in Andhra Pradesh at 25.36 million (19.11 million SHG members and 6.25 million MFI customers), with a total debt of Rs. 165 billion. Five of the largest MFIs in India started operations in AP. By November 2010, MFIs were reaching 9.7 million borrowers with Rs. 72 billion outstanding, according to the government.

To make the situation worse, AP government published a list of 123 victims of private MFIs and investigated 76 cases where loan officers were blamed to have driven over indebted borrowers to suicide. In addition, AP's Chief Minister issued a call to microfinance beneficiaries not to repay their loans. An Ordinance was passed to "protect the women Self Help Groups from exploitation by the MFIs in the State of Andhra Pradesh". Interest rates were around 24.6%, and MFI managers argued that this rate "internalized many of the transaction costs borrowers would have to undertake if they borrowed from other sources and explained that this margin of expansion was crucial in achieving scale"[1].

The AP crisis triggered a discussion in the industry on increasing commercialization of microfinance and the rush for profit conducting to over indebtedness of vulnerable clients. On the funding side MFIs were criticized for receiving donor money to conduct increasingly commercial operations. More and more private players, such as microfinance investment vehicles and mainstream private equity providers were also attracted by the high returns offered by MFIs, which in turn pushed for more commercialization. All in all, the tragic events in AP started a discussion in the industry on the need for improved client protection and more responsible finance.

It is the author's opinion that the suicide cased of women borrowers in rural India was due to a variety of reasons, among them the aggressive recollection methods of lenders but also probably due to the patriarchal environment in which the women run their lives.

The industry showed mild signs of recovery during 2012. As per the data of 167 MFIs published by the Association of Community Development Associations (Sad-Dan), as of 31 March 2012, the total client outreach of MFIs was 26.6 million with a gross loan portfolio of Rs. 209 billion. The client outreach of MFIs came down by 16% and portfolio outstanding by 3% during 2011-2012 as compared to the previous year. Along with women Self Help Group (SHG) bank linkage program, the total outreach of clients under micro finance is 83.4 million clients as of 31 March 2012 (Sa-Dan, 2012).

The regulatory environment improved with Reserve Bank of India (RBI) issuing a set of guidelines to NBFC MFIs. Regulations now require banks and MFIs to adopt responsible finance practices. The issue of over indebtedness and coercion in recovery are addressed by the regulatory norms and fair practices code. MFIs now share their client data with credit information bureau. Another significant development has been the unification of code of conduct of both the industry associations, Sa-Dhan and Microfinance Institutions Network (MFIN) incorporating the key tenets of the Client Protection Principles of the SMART Campaign (see also section 2.4.), RBI's Fair Practices Code for NBFCs, and clauses from the RBI guidelines for MFIs. MFIs that are not members of the associations are also proactively adopting the code and ensuring compliance since banks are stipulating code of conduct adherence as a condition for bank loan.

Although the AP crisis is a powerful example, there are other just as striking examples around the world that illustrate the mission drift experienced by microfinance institutions. SKS in AP and Banco Compartamos in Mexico are often cited as excessive profit oriented institutions and their successful IPOs have attracted a lot of criticisms. The CGAP Focus Note n°61 "Growth and Vulnerabilities in Microfinance" (February 2010) nicely summarizes the lessons learnt from the crisis in Nicaragua, Morocco, Bosnia and Herzegovina. See also the microfinance in crisis working papers series for further discussions.

Therefore, it is believed now that the crisis in microfinance was inherent to the system rather than a conjectural consequence of the global financial turmoil. One major critic addressed to the industry are the aggressive pricing practices translating into usurious interest rates. There is a wide difference in microcredit rates between regions. The rates are likely to vary widely in Africa and Latin America more than in other regions. Interestingly, in South East Asia, interest rates for microfinance appear to be the lowest. As a side note, such data is to our knowledge unavailable for mark ups of Islamic microfinance products around the world.

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http://opinionator.blogs.nytimes.com/2011/03/21/microfinance-under-fire/?_r=0
[1] http://www.sirjournal.org/2013/01/10/microfinance-in-andhra-pradesh-india-in-the-wake-of-government-sanctions-a-look-at-institutions-and-borrowers-2/

As we have seen, in some countries like India, where the central bank regulates commercial MFIs went ahead and issued responsible finance guidelines for MFIs. Just as RBI issued a set of guidelines for Indian MFIs, industry practitioners turned to core values to draft universally applicable client protection principles embedded in the SMART campaign, which we will present hereinafter.

1.4 *SMART campaign client protection principles*

In the New Microfinance Handbook, the SMART campaign client protection principles under Chapter 3: The Role of Government and Industry in Financial Inclusion. In order to support build the industry's commitment to consumer protection, standards of practice and codes of conduct were recently introduced: the "United Nations Principles for Investors in Inclusive Finance," the "World Bank Draft Guidelines for Consumer Financial Protection," and the "Organisation for Economic Co-operation and Development (OECD) Principles and Good Practices for Financial Awareness and Education."

As many such codes of conduct, there is no legal consequence for non-compliance. However, commitment to one code of conduct usually entails that the institutions commits to regular peer review of compliance.

In addition, CGAP has developed guidelines for the industry based on consensus from various stakeholders, including, for example, "Good Practice Guidelines for Funders of Microfinance"; "Regulation and Supervision Consensus Guidelines"; "Disclosure Guidelines for Financial Reporting by Microfinance Institutions"; "The Role of Funders in Responsible Finance"; "Due Diligence Guidelines for the Review of Microcredit Loan Portfolios"; "Developing Deposit Services for the Poor"; and "Definitions of Selected Financial Terms, Ratios, and Adjustments for Microfinance."

Leading industry representative bodies such as the Social Performance Task Force (SPTF), the Smart Campaign on Client Protection Principles, and Microfinance Transparency have all launched initiatives and advocacy campaigns. In this paper, we chose to focus on the Smart Campaign, which offers a handy tool for monitoring social performance management. An exhaustive list of social performance internet resources is given for reference in annex 1.

The Smart Campaign was initiated in 2009 by the Center for Financial Inclusion at ACCION International, advocating consumer protection principles and has recruited hundreds of organizations and individuals to endorse them. The shift from assumed to explicit articulation of consumer protection measures followed debates about pricing and profits in microfinance, as well as the emerging crises related to over-indebtedness and abusive practices. The Smart Campaign has advanced seven consumer protection principles which are detailed on their website (Appropriate product design and delivery; Prevention of over-indebtedness; Transparency; Responsible pricing; Fair and respectful treatment of clients; Privacy of client data; Mechanisms for complaint resolution).

The uptake of the SMART campaign is a success with 3,3348 total endorsements, including 1,100 MFIs, 148 networks and associations, 210 investors and donors and 153 supporting organizations. The detailed information by country is available on SMART campaign's website (http://maps.smartcampaign.org).

Now we have seen that the industry has been through close scrutiny and consequently serious collective steps have been taken to ensure that the initial mission of microfinance, which is to promote financial inclusion to take people out of poverty, is respected. Microfinance was criticized for mission drift, for focusing more on urban areas, meaning better off people than underserved rural poor for the mean of commercialization. We have seen that there was an urge for more responsible practices. In addition, data showed that geographical outreach is limited in the MENA region where there is a sizeable Muslim population. In the next section we will examine the potential of Islamic microfinance, a sub-segment of responsible finance, for alleviating poverty. To do this, we will examine case studies from majority Muslim countries, namely Yemen and Sudan, where Islamic microfinance was investigated early on, through apex institutions for microfinance.

2 Islamic microfinance

This section is organized around an overview and landscape of Islamic microfinance around the world, with a focus on Arab countries. We start this introductory section with a presentation on the principles of Sharia-based Islamic finance. Table 1 is adapted from a World Bank handbook on Risk Analysis for Islamic Banks and gives in a synthetic overview of the basic principles of Islamic finance. The principles hold true for Islamic microfinance to the exception of *qard hassan*, which is, to put it simply, a loan without interest margin (more details on *qard hassan* are given in the following section).

Islamic microfinance first started with Mitghamir Bank in Egypt and Pilgrimage Fund in Malaysia in the 1950's-1960's. For a chronology of the development of Islamic economics and finance, please refer to the table taken from Iqbal and Mirakhor, 2007 (page 26).

Table 2 shows the main differences between conventional and Islamic microfinance that have been summarized by Ahmed in 2002 in a research paper.

Both conventional MFIs and Islamic MFIS rely on external funds and clients' savings on the liabilities side. In addition, Islamic MFIs can get funding from zakat or Islamic charitable sources. In some countries such as Sudan and Yemen, zakat is institutionalized, collected and disbursed by a legal authority on behalf of the state.
On the assets side, products offered by a conventional MFI are interest based, although some MFIs can have an Islamic window. FINCA Jordan for example is an affiliate of an international organization offering murahaba. An Islamic MFI's products range is limited to Islamic financial products (for details of Islamic products, please see hereinafter).

Microfinance practitioners are usually committed to the social mission of the institution they work for. On top of the monetary incentive, they are also rewarded by the positive social impact they can have on the beneficiaries' lives. In some cases, being part of an international network and having overseas training opportunities and the chance to interact with international consultants can also constitute a strong incentive. On top of all this, Islamic MFIs offer religious incentives.

On the non-financial services side, conventional MFIs provide financial literacy and health services – all secular – to their clients. BRAC in Bangladesh for instance offers economic development, education, public health and social development programs. Islamic MFIs can offer a more varied service range with faith-based social programs.

2.1 *Islamic microfinance around the world today*

According to a recent CGAP publication, there are today about 250 institutions offering Sharia compliant products in the world. Not surprisingly, these institutions are located mainly in South East Asia and Pacific (164 institutions) and the Middle East and North Africa (72 institutions). Commercial banks are leading providers of Islamic microfinance services (60% of institutions), followed by NGOs (17%). Of the 1.28 million customers of Islamic microfinance, the vast majority is located in Bangladesh (445,153 customers), followed by Sudan (426,694) and Indonesia (181,508). These three countries account for 82% of clients of Islamic microfinance.
If we consider the loan portfolio of microfinance institutions, Indonesia tops with an aggregate portfolio of USD 347 million in outstanding loans, followed by Lebanon with USD 132 million and Bangladesh with USD 92 million (2011 data).

2.2 *Islamic microfinance in the Arab world*

The microfinance network of Arab countries Sanabel, in collaboration with CGAP conducted a survey on Islamic microfinance in the Arab region beginning from Q4 2011 to Q2 2012 and with funding from Agence Francaise de Développement (AFD). The data was collected from 30 Arab MFIs (8 from Sudan, 7 from Palestine, 4 from Yemen, 3 from Iraq, 2 from Jordan, 2 from Lebanon, 1 from Syria, 1 from Egypt, 1 from Bahrain and 1 from Saudi Arabia), including both fully fledged Islamic microfinance and conventional MFIs operating Islamic windows.

The above figures should be read with the low access to finance figures in MENA in mind. Overall in the region, there is low financial literacy and banking sectors are underdeveloped compared to countries of similar income levels in other parts of the world. There is a shortage of finance for small and medium size enterprises, and the majority of entrepreneurs prefer to finance their start-up and growth with funding from informal sources such as family and friends. Insurance, private equity and leasing in particular are very little developed in MENA.

In 2010, Lebanon had the largest outreach in terms of clients served with 87,637 borrowers, followed by Sudan with 66,883 clients and Yemen with 28,782 clients. Lebanon had the largest Islamic microfinance loan portfolio (53%) followed by Sudan (20%) and Iraq (10%).

In Sudan and Yemen, all institutions responding to the CGAP/Sanabel survey were providing Islamic microfinance only. Average loan amounts given were substantially smaller in Sudan (USD 912) and Yemen (245) than in Bahrain (USD 3,842) and Jordan (USD 2,107) for instance. Most institutions in the region provide individual lending, with the notable exception of Jordan where group lending equals to providing a loan based on

a personal guarantee, as groups are composed of 2 people.

The top 5 institutions in the Arab world in terms of outreach are located in Morocco, Egypt and Tunisia: Al Amana (Morocco), Assiut Businessmen Association (ASBA in Egypt), Fondation Banque Populaire Micro-Crédit (BPMC in Morocco), ENDA (Tunisia) and Alexandria Business Association (ABA in Egypt).

In terms of products, MFIs offer essentially Islamic murabaha and qard hassan. Murabaha is an Islamic financing agreement whereby the MFI shall, at the request of the customer, acquire cash an asset and sale it to the ultimate purchaser with deferred payment of the purchase price which is composed of acquisition cost plus a profit margin for the MFI. Approximately 672,000 customers have received a murabaha for a total of USD 413 million. The *qard hassan* is an interest free loan used to fill funding gaps in the short term. The principal amount of the loan is repaid by the borrower without interest margin or participation in economic activity to be financed. No less than 191,000 customers have received a qard hassan for a total amount of approximately USD 156 million. For many observers, Islamic microfinance has the potential to include the poor segments of population not accessing conventional finance for ethical and religious reasons.

This path of thought is in line with the Global Financial Inclusion Database findings (table 3). While 50% of respondents (aged 15+) have an account at a formal financial institution, this figure drops to 18% in MENA. When asked why they do not have an account in a financial institution, 12% of respondents from the MENA region cite religious reasons, whereas only 4% of respondents in the rest of the world cite religious reasons.
Although it remains to be seen whether the respondents resided in countries where Islamic finance was readily available, it is worth observing that according to the 2011 Global Findex, around 19 million adults in MENA remained excluded from the formal financial sector for religious reasons.

Finally it should be noted that 1) countries across MENA do not have the same degree of religiosity and 2) when choosing between a conventional banking product and a Sharia-compliant banking product, individuals mainly prefer the product that is more attractive in terms of pricing.

2.3 *Apex institutions for microfinance*

The purpose of our paper is to assess the similarities and differences between the ways sustainable Islamic microfinance has been promoted and try to draw lessons learnt. Of particular focus will be apex institutions of MFIs as they play the role of industry promoters. The apex institutions of MFI usually are in charge of the monitoring of the sector, which will allow for comparisons.

Apex mechanism refers to wholesale financial and non-financial services such as training and technical assistance. Apex institutions typically are funded by donor money, usually supported by the supported government money to ensure local buy-in. They operate at national level and support microfinance institutions. They can also support local consulting and training institutes to build capacity. The ultimate goal of apexes is financial sector development and expansion of sustainable outreach (Levy 2001).

The body of literature on apex mechanisms is limited and there is hardly any research on apex institutions operating through Sharia-based rules. The question we would like to answer is whether an Islamic microfinance apex institution achieves a better impact than a conventional microfinance apex institution.

The success factors for microfinance apex institutions have been listed by C. Buchmann (2010) in his study on microfinance wholesale programs in China (table 4).

We adopt the criteria developed by M. Berger *et al.(*2003): a successful apex (or wholesale) scheme is one that contributes to the development of the microfinance industry through 1) entrance of lenders not previously serving the microfinance sector into this market or expansion of microfinance operations by these already serving micro entrepreneurs and 2) a broadening and deepening of the coverage of financial services to independent enterprises of progressively smaller scale and specifically to microenterprise owned and operated by low income people, women and other underserved people.

The authors list the following questions to assess whether the apex is successful or not: Did MFIs increase outreach by serving new clients and those who traditionally have had less access to credit such as women and micro enterprises? Did new lenders enter the market? Did existing specialized micro-lenders grow and develop new services? Did participating MFIs develop permanent institutional capacity for lending to micro-entrepreneurs in a sustainable and/or profitable way? Did the market develop by becoming more competitive

with lower rates and new products? Did policies favorable to sound microfinance develop with support from the apex programs?

We start our analysis by the case of Yemen, where the financial sector is mixed between conventional and Islamic finance and where the first experiments with an apex institution, the Social Fund for Development (SFD), started in 1997. We will then examine the case of Sudan Microfinance Development Facility (SMDF) a similar organization set up in 2008 following fully Sharia-compliant principles. We will then finally investigate whether Islamic microfinance apex was more successful than conventional microfinance, based on the experiences of Yemen and Sudan.

2.4 *The case of Yemen*

Yemen is one of the least developed countries in the world with an estimated population of 26.66 million in 2013, the second most populated country on the Arabian Peninsula. According to the United Nation Development Programme (UNDP), this figure is expected to reach around 40 million within the next 23 years, which will put enormous pressure on the delivery of basic services to the population (UN data). While drinking water and oil reserves are declining considerably, the demand for health and educational services as well as food security and employment opportunities is rising significantly. As reported by the United Nations, in 2012 Yemen ranked 160th out of 186 countries on the Human Development Index (HDI), a measure of life expectancy, education, and standard of living, which places Yemen at one of the lowest HDI ranking among the Arab states and worldwide.

According to the World Bank Database in 2012, more than 40% of the population was below the age of 15 years old and 67% of the Yemeni people lived in rural areas. The literacy rate for the total population aged 15 and above is comparatively low and was estimated at 64% in 2010. Only 47% of the women are able to read and write compared to 81% of men at that time. The life expectance at birth is assumed to be approximately 65 years for the total population. In 2009, 14.6% of the labour force was estimated to be unemployed. In Yemen, as in many other Arab countries, there is low labour force participation due to low female participation rates. In 2010, Yemen's male labour participation rate was about 80%, while the female labour participation rate was only 27% (ILO, 2012).

Although the political situation has stabilized to some extent since the political transition, the crisis of 2011 has contributed to the worsening of economic and social conditions in Yemen. Apart from the contracting GDP in 2011, the poverty increased from 42% in 2009 to a level of 54.5% in 2011. In 2012, 45% of the population was reported to suffer from food insecurity in comparison to 42% in 2009 (World Food Program data).

Yemen's financial sector is underdeveloped and dominated by the banking sector, whose involvement in the overall business activity is relatively limited. Financial services other than banking services – such as insurance, private equity or leasing – are almost inexistent. A stock exchange does not exist yet. Access to finance is very low with the informal sector playing a crucial role and most transactions are made in cash. According to the World Bank, only 3.7% of the population aged 15 and above had an account at a formal financial institution in 2012 (The Little Data Book on Financial Inclusion, 2012. as comparison, the overall indicator for the MENA region was 17.7% in the same year).

The consolidated balance sheet of commercial and Islamic banks in 2011 reached a total of YER 1,766 billion (USD 8.20 billion), a decrease by 9% compared to the previous year due to the instable political situation in 2011. The latest figures from February 2013, however, show a total of YER 2,375 billion (USD 11.02 billion), indicating a recovery of the sector. In total, 31% of all assets for both groups of banks were contributed by Islamic banks, which was 2% less compared to the year before.

With a very high rural population rate almost completely unreached by financial services and only limited access to finance for urban population, many Yemenis still lack awareness and, most of all, trust in the financial system.

2.4.1 Microfinance in Yemen

The microfinance industry in Yemen dates back to 1997, the year the Social Fund for Development (SFD) and its Small & Micro Enterprise Development (SMED) unit were established in order to support the development of the MSME sector. Since then, SFD has served as an apex organization to the great majority of microfinance institutions providing them with funds as well as various non-financial support services through SMED. As most Yemenis live in rural areas, in the beginning, various income generating programs were introduced in order to serve the needs of this part of the population. However, working in rural areas proved to be difficult and the

efforts were redirected towards establishing, developing and supporting initiatives in urban areas. Those were expected to expand their outreach to the rural areas in a more mature state of the industry. This strategy boosted the development of microfinance entities such as programs, foundations, SME banks and companies.

In 2002, the first microfinance bank Al-Amal was established based on a special law (No. 23) and in 2009 the Microfinance Banking law provided the legal framework for the further growth of the sector. Despite outside funding from foreign donor organizations, SFD remains still the primary founding sources for most of the MFIs.
Currently, there are 12 MFIs operating in Yemen including the Small Enterprise Development Fund (SEDF) of the Yemeni government and Tadhamon Islamic Bank's microfinance outlet. SEDF, formed in 2002 as an independent entity, provides various credit programs ranging from SME, women and youth loans to Islamic finance loans. Besides those institutions, there are several other entities including 1 microfinance company (Al-Awael Microfinance Company), 2 microfinance banks (Al-Amal Microfinance Bank and Al-Kuraimi Islamic Micro Finance Bank), 3 foundations (The National Microfinance Foundation, Aden Microfinance Foundation and Al-Mustadama Social Foundation for Development) and 5 programs (Sana'a Credit Program (Azal), Nama' Microfinance Program, Abyan Savings and Credit Program, Wadi Hadhramount Credit and Savings Program as well as the Tadhamon Small and Microfinance Program). Geographically, most institutions are concentrated in the western part of the country.
These MFIs have very limited outreach and serve approximately 63,000 clients. Since many MFIs were established to increase women's access to finance, women clients constitute a majority of client portfolio. Loans offered by these MFIs range from YER 5,000 (USD 23) to YER 250,000 (USD 1,163). As of December 2012, the total outstanding portfolio of MFIs stood at YER 3,853 million (USD 17 million) with an average loan size of YER 61,641 (USD 287).

The Microfinance Banks Law No. 15 of 2009 provides an adequate legal and regulatory framework for MFBs. Accordingly, microfinance banks shall be licensed, supervised and inspected by the Central Bank of Yemen (CBY). The minimum capital requirement is set at YER 0.5 billion compared to YER 6 billion for commercial banks. Moreover, microfinance banks are entitled to carry the same operations as commercial banks except for issuing checks, opening of letters of credit, financial agency, equity participations and trust activities. The law aims at enabling microfinance banks to reach sustainability more easily.

In Article 2 of the Microfinance Banks Law No. 15 of 2009, Microfinance is defined as "Banking transactions with families, small farmers, and small and micro enterprises in both urban and rural areas […]."However, the definition of the categories small and micro enterprises is not provided and varies considerably depending on other available sources. SMED defines enterprises as micro enterprises with an employee number between 1 and 5, while a small enterprise is considered to employ between 5 and 10 employees.

Even though the microfinance industry has grown considerably since 2003, the outreach remains very limited compared to its potential, especially outside urban areas. Besides, the political and economic crises in 2011 had a negative effect on the main performance indicators. The portfolio at risk rose significantly from 1.6% to 10.9% while the outstanding portfolio decreased by approximately 13% and the number of active borrowers dropped by 4.3% compared to 2010[1].

In December 2011, the above mentioned institutions served a total of 63,568 active borrowers and 87,615 savers, had distributed 445,843 loans adding up to YER 29,743 million and had maintained an outstanding loan portfolio of YER 3,853 million (USD 17.88m) while the average outstanding loan per borrower amounted to YER 61,641 (less than USD 300). The most recent data from March 2013, which is available for the institutions supported by SMED, indicates a positive trend in the microfinance industry. Excluding the Al-Mustadama Foundation and the Tadhamon Program, which are not supported by SFD/SMED and including the Social Institution for Sustainable Development, the overall number of active borrowers amounted to 83,680 and that of the active savers to 151,465 while the outstanding loan portfolio reached YER 6,642 million (USD 30.82m).

2.4.2 Islamic Microfinance in Yemen

Yemeni society is very conservative, and consequently, Islamic finance has found its way to become the predominant financial philosophy in the small and micro financial sector in the country. However, experience also has proven that the provision of both types of financial services (Islamic and non-Islamic) each including savings and loans, is needed to serve the largest possible number of clients. Lending in Islamic finance

[1] Social Fund for Development Yemen. 2011. Small and Micro Enterprises Development in Yemen and Future Prospects.

comprises three methodologies: Murabahah, Musharakah, and Mudarabah. In Murabahah, the lender purchases the needs of the borrower and resells them after adding a margin. In essence, the loan is in kind as no direct cash transactions must occur between the borrower and the lender when taking the loan, and the interest is actually the added margin. In Musharakah, the lender and borrower enter into some sort of partnership; profits (and losses) are shared later on according to a pre-determined ratio and arrangement. Mudarabah is a particular type of partnership, where one partner gives money to another for investing it in a commercial enterprise. The investment comes from the first partner who provides the capital, while the management and work is an exclusive responsibility of the other partner. Profits are distributed between them according to a pre-agreed proportion. Savings, in Islamic finance, is dealt with in a partnership fashion. Should the MFI lose money on savings, the depositor loses accordingly and in proportion to the amount saved. And vice versa, the same principle applies in the case of profits. All MFIs in Yemen offer Islamic finance, whether as the main service offered or as an option, and Murabahah remains the prevalent way of lending.

Anecdotal data suggests that there is potential for growth for Islamic finance in Yemen. Indeed, Yemeni entrepreneurs tend to be mistrustful of banks and could welcome ways of financing that promote partnership and are respectful of their beliefs.

2.5 *The Case of Sudan*

Islamic microfinance is potentially a powerful tool to promote financial inclusion, and has been actively promoted in Sudan. It is therefore particularly interesting to look more closely at the development of Islamic microfinance in Sudan.

Sudan is a lower middle income country with a long history of conflict. The country used to be the largest state in Africa, until South Sudan gained independence from Sudan on 11 July 2011. Two rounds of north-south civil war cost the lives of 1.5 million people, and a continuing conflict in the western region of Darfur has driven two million people from their homes and killed more than 200,000. Sudan ranked 170th in the United Nations' Human Development Index just before Zimbabwe, Ethiopia and war-torn Liberia and Afghanistan. This places Sudan at one of the lowest HDI ranking worldwide.

Sudan has a population of around 34 million people, 40% of which was below the age of 15 years old in 2012 (World Bank Database 2012). Literacy levels in Sudan are 71% for adults and 62% for adult women. Life expectancy at birth in 2012 was 60 years for men and 63 years for women. Sudan's population mainly lives in rural areas (67%). The most recent data available for labor force participation is from 2009: according to ILO estimations, total labor force participation was 48%, 73% for male and 23% for female population.

Sudan has experienced a substantial economic recovery since the mid-1990s, including rapid growth of manufacturing, construction, services, irrigated and rain fed agriculture, light manufacturing and more recently, energy exports. However, this growth has not been broad-based, and in fact has been accompanied by rising inequality and an increasing urban informal sector. According to the World Bank, about 60-75% of the population in the North and 90% of the South was estimated to be living below USD 1 a day in income in 2007.
Sudan banking system went fully Islamic in the 1980s. The International Monetary Fund (IMF) actively supported the Central Bank of Sudan in the process of converting the country's financial system to be fully compliant with Sharia. There are today 33 banks operating in Sudan (Central Bank of Sudan). Similar to Yemen, Sudan is under-banked. Outreach is limited to Khartoum and large cities such as Omdurman, Port Sudan and Kassala. Financial access is limited, only 7% of the population aged 15 years old or more had an account at a formal financial institution in 2011 (Global Findex).

According to the Making Finance Work for Africa website, authorities have recently embarked on a series of reforms in attempts to strengthen the financial system and improve the performance of the banking sector (http://www.mfw4a.org/sudan). Supervisory and legal and regulatory frameworks have been improved, particularly in the areas of corporate governance, risk management, and provisioning. Restructuring processes are also underway for two banks, including the Omdurman National Bank, to improve their financial position.

2.5.1 Microfinance in Sudan

In efforts to increase access to finance, the Central Bank of Sudan established a Microfinance unit in 2007 and, as of 2009, has required all commercial banks operating in the country to have established microfinance offices and allocate 12% of total loans to microfinance lending operations. There was a strong government push and willingness to position the ruling crew as one caring for the needs of the poor securing thereby political advantage.

In 2006, Central Bank of Sudan (CBOS) commissioned a situational analysis of microfinance in the country, upon which a National Vision for the Development and Expansion of the Microfinance Sector in Sudan was drafted, circulated for consultation and adopted. Thereafter, the First National Consultative Forum on Microfinance was conducted with donor support in November 2007. Following the Consultative Forum, the CBOS established a dedicated Microfinance Unit (MFU) in March 2007, fully responsible for executing the CBS strategy. The current regulatory framework for microfinance distinguishes between non-deposit taking microfinance providers and microfinance banks or non-bank institutions which have to be licensed by CBOS to mobilize public deposits.

Since most MFIs in the MENA region are not regulated as financial intermediaries, the products they can offer are limited. Consequently, most MFIs continue to offer small loans. In particular, micro-enterprise (business) loans have constituted the majority of loan portfolios (at least in theory, and according to the official statistics). Therefore the steps taken by the CBOS in regulating the sector were much welcome as they provided a healthy framework for the development of the sector.

In 2008, the (CBOS) and the World Bank through the Multi-Donor Trust Fund (MDTF) pooled their resources to establish a national facility, the Sudanese Microfinance Development Facility (SMDF) to act as a vehicle to help in developing the sector. The SMDF has been established to help in promoting the microfinance sector in Sudan. The SMDF provides technical support to the Microfinance Unit to strengthen its capacity to take part in the due diligence process of evaluating microfinance proposals and in the technical decision making process.

The total MDTF and Government of National Unity (GoNU) funds committed and disbursed as of 30 June 2011 was as follows: a total of USD 4,086,440 in TA had been committed and USD 1,486,168 had been disbursed. Moreover, a total of USD 7,970,000 in loans had been committed and USD 1,162,896 had been disbursed. Finally, a total of USD 820,000 in equity had been committed and USD 204,167 disbursed.

The data available on Central Bank of Sudan's website is very limited but World Bank's project progress documents give some indication on SMDF performance: overall, the project has achieved the number of beneficiaries envisaged under its development objective, with over 490,000 people with access to microfinance in Sudan. The outreach includes 302,000 clients served by commercial banks and 189,600 by MFIs. The Microfinance providers supported by SMDF have a total of 8,588 active loan accounts, with 47.2% reaching women. Lastly, the portfolio at risk (PAR) is 1.83%.

2.6 *Comparison and lessons learnt from Yemen and Sudan experiences*

Yemen and Sudan are hardly comparable in terms of size and population. However both countries have an underdeveloped banking sector and limited banks outreach. Financial inclusion indicators are extremely low: only 2% of population aged 15 years old and above took a bank loan in the 2011 in Sudan and only 1% in Yemen. The data indicates that there is much room for financial inclusion in both countries. Each arrives 167 on the "ease of getting credit" indicator. These figures also denote low financial literacy: only 7% of population aged 15 years and above had a bank account in Sudan and this figure dropped to 4% in Yemen, compared with 24% in countries with similar income levels. Needless to mention, one of the main reasons why poor people are excluded from the traditional financial sector is the limited availability of bank branches in rural areas. In addition, one of the potential reasons why people do not have access to banks could be for religious reasons. They would then stay away from the banking sector because banks charge interest rates, and this is against their religious beliefs.

In Sudan however, we have seen that the financial sector has been totally converted to Sharia based finance during the 1980's. Therefore, it remains to be seen whether microfinance has a greater impact on financial inclusion in Sudan than in Yemen, where the financial system is mixed. To do this, we suggest that we compare SFD and SMDF performances over the past two years. Performance will be assessed against the following criteria:

- Number of MFIs supported through equity, debt and technical assistance
- Total amount of funds disbursed
- Number of final beneficiaries
- Access to finance (savings, credit, other services) for beneficiaries

Table 6 is a compilation of the data provided above, obtained through Frankfurt School of Finance & Management and communication with SFD. There is a scarcity of data available for SMDF, as the institution

was established recently (in 2008 only) compared to SFD that goes back to 1997. Accordingly, we were not able to collect data on the number of active savers in Sudan. The difficulty for Yemen is to distinguish between Islamic microfinance and conventional microfinance as to date, there is no obligation for reporting on this criteria. The breakdown between rural versus urban outreach was not available neither.

Unsurprisingly Islamic microfinance has a greater outreach in Sudan compared to Yemen. The average loan amount is USD 254 in Yemen and USD 912 in Sudan, suggesting that the providers of microfinance reach poorer segments of the population in Yemen. The portfolio at risk jumped from 1.6% to 10.9% in Yemen between 2010 and 2011, as in the aftermath of the Arab spring, political turmoil also hit the Yemeni economy. In comparison, portfolio at risk seems to remain reasonable at 1.83% in Sudan. This is probably due to the fact that Sudan's economy is less contingent on global financial markets and the consequences of the Arab spring were felt less heavily in Khartoum than in Sana'a. Finally, 47.2% of borrowers in Sudan were women, compared with over 70% in Yemen. This is in line with the mission of microfinance that aims to serving poor women. In conclusion, preliminary evidence, based on desk research, shows that Islamic microfinance apex institution is more successful than conventional apex.

3 Suggestions for further research and conclusions

3.1 *Suggestions for further research*

Researchers in the field of apex institutions for microfinance are confronted with limited availability of data. Few institutions publish information on their operations and performance, therefore the existing literature is mainly limited to exemplary case studies or cross-sectional studies of different wholesale funds (C. Buchmann 2010).

As stated in numerous parts of this paper, although apex intuitions for microfinance seem to be the darling of development finance institutions in the past decade, until today, there is little research available on this topic. Furthermore, to the author's knowledge, there had been to date no research undertaken on Islamic apex institutions for microfinance.

An interesting topic for further research would be the social performance of an Islamic apex institution compared with a conventional apex institution for microfinance. SFD and SMDF could come in handy for the purposes of comparison. In addition, it is suggested that Palli Karma-Sahayak Foundation (PKSF) in Bangladesh and Pakistan Poverty Alleviation Fund (PPAF) would constitute favorable fields of study. Indeed, Yemen, Sudan, Bangladesh and Pakistan offer similarities in terms of development and cultural values. Whereas Bangladesh and Pakistan can be qualified as mature markets for microfinance, Yemen and Sudan are in the early beginnings of developing a microfinance industry. In addition, Sudan and Pakistan have taken voluntary steps to shift their financial systems from conventional to fully Islamic. Therefore, we believe that it would be interesting to assess whether they perform better financially but also in social impact terms. To undertake such research would require that the researcher travels to the field for data collection, including interviews with final beneficiaries.

3.2 *Conclusions*

The limited availability of data makes it difficult to compare the performance of SFD and SMDF. However, the evidence suggests that the very quick uptake of Islamic microfinance in Sudan has been favored by the government push and the 12% microfinance portfolio target put on all banks by the CBOS. It is safe to assume that more regulators developments are needed to include more diversified set of products, and not only microcredit. This assumption holds true for the whole of the Arab region, as Islamic microfinance is only in early stages of development. More market research is needed to develop products that meet clients' needs. In addition, there is potential for innovative products such as mobile banking and internet based banking, especially in those areas where outreach is difficult, such as the remote regions of Yemen or Sudan. As it is assumed that there is a high potential for the development of Islamic microfinance services in the region, it is as well safe to assume that there will be a greater need for client protection and that the lessons learnt from the experiences made in Bangladesh and India should be transposed to Yemen and Sudan in due time.

In addition, adequate risk management tools and procedures should be put in place to ensure good governance, sound policies and controls. The World Bank (WB) has recently entered into agreements with the Islamic Development Bank (IDB) and the International Centre for Education in Islamic Finance (INCEIF), and is well positioned to promote Islamic microfinance. We would recommend that the WB along with IDB and INCEIF engages in a market study exercise to assess the potential demand for Islamic microfinance products in their countries of operations. Finally, there is a trend in the Islamic finance industry to position the principles and practices of Islamic finance and banking as a sub-segment of responsible finance and to advocate for ethics and

social justice. As they go along the way, Islamic finance industry practitioners could take the opportunity offered to them by Islamic microfinance and make efforts towards the development of the microfinance space. Financial inclusion ultimately means that the poor clients of microfinance clients today are the clients of banks tomorrow. As traditionally unbanked populations enter the traditional financial system, they will also provide the basis for further markets for those in the Islamic finance industry.

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Notes

Table 1 Basic Principles of an Islamic Financial System (Source: H. van Greuning and Z. Iqbal (2008). Risk Analysis for Islamic Banks)

Prohibition of interest. Prohibition of riba – a term literally meaning "an excess" and interpreted as "any unjustifiable increase of capital whether in loans or sales" – is the central tenet of the system. More precisely, any positive, fixed, predetermined rate tied to the maturity and the amount of principal (that is, guaranteed regardless of the performance of the investment) is considered riba and is prohibited. The general consensus among Islamic scholars is that riba covers not only usury but also the charging of "interest" as widely practiced. This prohibition is based on arguments of social justice, equality, and property rights. Islamic law encourages the earning of profits but forbids the charging of interest because profits, determined ex post, symbolize successful entrepreneurship and creation of additional wealth, whereas interest, determined ex ante, is a cost that is accrued irrespective of the outcome of business operations and may not create wealth. Social justice demands that borrowers and lenders share rewards as well as losses in an equitable fashion and that the process of accumulating and distributing wealth in the economy be fair and representative of true productivity.

Money as "potential" capital. Money is treated as "potential" capital—that is, it becomes actual capital only when it joins hands with other resources to undertake a productive activity. Islam recognizes the time value of money, but only when it acts as capital, not when it is "potential" capital.

Risk sharing. Because interest is prohibited, suppliers of funds become investors instead of creditors. The provider of financial capital and the entrepreneur share business risks in return for a share of the profits. The terms of financial transactions need to reflect a symmetrical risk-return distribution that each party to the transaction may face. The relationship between the investors and the financial intermediary is based on profit- and loss-sharing principles, and the financial intermediary shares the risks with the investors.

Prohibition of speculative behavior. An Islamic financial system discourages hoarding and prohibits transactions featuring extreme uncertainties, gambling, and risks.

Sanctity of contracts. Islam upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard.

Sharia-approved activities. Only those business activities that do not violate the rules of Sharia qualify for investment. For example, any investment in business dealing with alcohol, gambling, or casinos is prohibited.

Social justice. In principle, any transaction leading to injustice and exploitation is prohibited. A financial transaction should not lead to the exploitation of any party to the transaction. Exploitation entails the absence of information symmetry between parties to a contract.

Table 2: Differences between conventional and Islamic microfinance (Source: Ahmed 2002)

Items	Conventional MFI	Islamic MFI
Liabilities (source of fund)	External funds, client savings	External funds, client savings, Islamic charitable sources
Assets (loans offered)	Interest based	Islamic financial products
Liability of the loan	Recipient	Recipient + spouse
Work incentive for employees	Monetary	Monetary and religious
Social development program	Secular (non Islamic)	Religious

Table 1: Reasons for not having an account at a formal financial institution (Source: Global Financial Inclusion Database)

	All (%)	MENA (%)	Rest of the world
Have an account at a formal financial institution	50	18	51
Do not have an account due to…			
Religious reasons	5	12	4
Distance	20	8	21
Account too expensive	25	21	26
Lack of documentation	18	10	19
Lack of trust	13	10	14
Lack of money	65	77	64
Family member already having one	23	9	24

Table 2: Success Factors for Microfinance Wholesale Funds (Source: C. Buchmann (2010). "Microfinance Wholesale Funds: The Case of China, November 2010, Centre for Microfinance at Zurich University)

Market criteria	Demand for wholesale funding	Sufficient number of MFIs requiring additional funding Sufficient underlying demand for microfinance services from retail clients
	Availability of eligible MFIs	Sufficient number of MFIs that are sustainable (or show clear potential to become sustainable) Sufficient number of MFIs that show satisfactory client and credit portfolio and social impact
	Comparative advantage	Direct funding relationships between funders and MFIs are inefficient Existing commercial institutions cannot provide similar services For technical assistance: no specialized provider or technical assistance available in the market
	Regulatory framework	Favorable policies for development of MFIs No interest cap No direct provision of government-subsidized loans to individual MFIs
Program design and execution	Executing agency	Transparent ownership of the apex institution Political independence Clear objectives Management and leadership skills Reliable funding Exist strategy
	Eligibility criteria and monitoring of partner MFIs	Institutional eligibility criteria Financial performance standards Social performance standards Close and strict monitoring after fund disbursement
	Terms and conditions of apex funding	Market-oriented interest rates on apex funds Inclusion and minimization of transaction costs No specific conditions for onlending of apex funds
	Technical assistance	Cooperation with specialized technical assistance providers Separation of banking and non-banking functions Partial subsidizing of costs for technical assistance Provision in the beginning of the program

Table 5: Financial Inclusion Indicators in Sudan and in Yemen (Source: Global Findex; Doing Business 2013. Worldwide Governance Indicators.)

Criteria	Yemen	Sudan	Low income group
Doing business (2013)	118	143	
Account at a formal financial institution (% age 15+)	4%	7%	24%
Loan from a financial institution in the past year (% age 15+)	1%	2%	11%
Getting credit	167	167	-
Control of corruption (2011)	0,25	0,20	-

Table 6: Success Indicators SMDF vs. SFD (Source: Sanabel, SFD, World Bank Project Documents, communication with SFD. (*) Dec. 2012)

Criteria	Yemen 2010	Yemen 2011	Sudan 2010	Sudan 2011
Number of MFIs supported		12*		10
Number of Islamic microfinance clients	28,782	n.a.	66,883	n.a.
Active microfinance borrowers	66,440	63,568	66,883	490,000
Active savers	59,000	87,600	n.a.	n.a.
Gross Islamic financing portfolio in USD	7,0411,943	n.a.	60,983,588	n.a.
Average outstanding loan Per borrower (Islamic products)	USD 254	n.a.	USD 912	n.a.
Portfolio at risk	1.6%	10.9%		1,83%
% of women clients		70%		47.2%

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