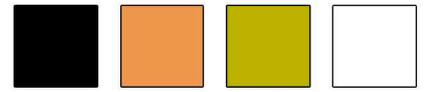


international
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Microfinance
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MÁSTER INTERNACIONAL EN MICROFINANZAS PARA EL EMPRENDIMIENTO

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Abstract

This paper is a research on the development of the Islamic microfinance sector in three countries: Yemen, Egypt and Indonesia.

The main purpose of this study is to find out which factors are essential for the expansion of the mentioned sector, and if they are comparable to other countries.

The research shows that the government's input is a crucial factor for the expansion of the Islamic microfinance sector. In the studied case of Yemen, the government's input has been led by a previous demand research addressed to the population.

However, due to the lack of surveys, statistics and, in general, of scientific researches, the confirmation of the last premise – if this demand of first importance is essential for the expansion of the Islamic microfinance- needs to be confirmed by a future specific research within the population/countries selected.

1. Introduction

This paper focuses on the impact of the Islamic microfinance in three representative countries -Yemen, Egypt and Indonesia- studying the most developed areas in this specific sector of MENA (Middle East and North Africa), and East Asia and Pacific regions.

The study of the three countries departs from a careful research of papers, recent studies, statistics, general information etc. Normally, this area is known by a lack of scientific literacy, and deep studies and researches.

The lack of information along with the curiosity that the Islamic financial system awakened has been crucial to select this kind of investigation whose main point is to establish a comparison between three representative countries in order to determine whether and why Yemen has a more developed financial sector rather than Egypt and Indonesia.

The research departs specifying the factors that are essential for the development of the sector. Specifically, it takes on the hypothesis that the Government's input is a key for the expansion of the sector. Starting from this point, the main objectives of this paper are to determine if after this government's input or the lack of it there is a population demand, and which are the strengths and weaknesses of the industry.

The methodology is based on the comparison of the Islamic indicators common to the three chosen countries in order to deduce relevant conclusions. The selection of the countries responds to their influence in the region where they

are located –in the case of Egypt-, to the importance to the microfinance sector –Indonesia- and to the development of the Islamic microfinance –Yemen-.

The suitable tools used for this purpose are published in the main and most reliable sources like World Bank Data, Gallup Poll¹, Mix Market², among others.

The majority of the selected tools are practical and objective in order to establish the most neutral indicators: percentage of religiousness, no account due to religious reasons, the number of Islamic clients and non-Islamic clients, credit preferences etc. Other tools are selected from scientific papers, as for instance, the government's input, or the legislation, among others.

The evidence proved by the methodology selected is that a government's input is crucial for the development of the sector.

To prove if this input should be carried out despite having a strong demand would need more research, information, and data of the specific preferences of the population and the characteristics of the referred country.

In the light of the above information, the investigation carried out in Yemen illustrates that there was a strong demand that directs the effort of the government in this direction.

Notwithstanding the above, in countries with no preferences between Islamic or conventional products or with preferences for the cheapest product, a government's input to introduce competitive Islamic microfinance products should be essential for the development of the sector.

Finally, the paper shows a general overview of the Islamic microfinancing sector in the world, and also the microfinancing sector and the Islamic microfinancing sector of the three chosen countries, Yemen, Egypt and Indonesia.

2. Islamic microfinance: definition, products and global impact

The principles of Islamic microfinance and finance are focused on Islamic law called “*Sharia*”. Islam emphasizes ethical, moral, social, and religious factors in order to promote equality and justice for the good of all Muslims (Nimrah et. al 2008).

The key Sharia principle that supports Islamic finance is the prohibition of imposing an interest rate to money lending practice, known as Riba (El-Zoghbi and Tarazi, 2013).

In addition, the following principles are applicable: money has no intrinsic value in itself, (El-Zoghbi and Tarazi, 2013); sharing risk between fund providers and

¹Market research and consulting services around the world: <http://www.gallup.com>

²MIX Market, financial data and social performance of Microfinance institutions: www.mixmarket.org

borrowers is mandatory (El-Zoghbi and Tarazi, 2013); all activities must be for permitted purposes, that means “Halal” (Ahmed et. al 2010); prohibition on realizing gains from speculation (Ahmed et. al 2010) and no uncertainty in commercial transactions (Ahmed et. al 2010).

The most common Islamic microfinance products respond to the following characteristics:

Table 1: financial, deposit and insurance products

Financial products					
Instrument	Suitable for	Capital cost	Borrower risk	Institution risk	Description
(a) Profit-sharing financing products					
Musharakah	Fixed assets, working capital	Very high	Low	Very high	Equity participation, investment and management from all partners; profits are shared according to a pre-agreed ratio, losses according to equity contributions.
Mudarabah	Fixed assets, working capital	Very high	Low	Very high	A profit-sharing partnership, to which one part provides the capital and the other the entrepreneurship. Profit is shared according to a pre-agreed ratio. Losses are born exclusively by the financier ³ .
Qard Hasan	All purposes	Very low	Very low	Moderate	Charitable loans free of interest and profit-sharing margins, repayment by installments. A modest service charge is permissible.
(b) Advance purchase financing products					
Murabahah	Fixed assets, working capital	Moderate	High	Moderate	A sales contract between a bank and its customers. The bank purchases goods ordered by the customer; the customer pays the original price plus a profit margin -markup- agreed upon by the two parties. Repayment by installments within a specified period.
Deposit Products					
Wadi'ah					Sight deposits, including current accounts (GiroWadi'ah).
Mudarabah	Fixed assets, Working capital	Very high	Low	Very high	Deposit products based on revenue-sharing between depositor and bank, including savings products that can be withdrawn at any time, and time deposit products.

³Karim, Tarazi and Reille, (2008): *Islamic Microfinance: An Emerging Market Niche*, Focus note N° 49, CGAP.

Qard Hasanah	al-	All-purpose	Very low	Very low	Moderate	Unremunerated deposit products for charitable purposes.
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Insurance products						
Tadamun, Takaful						Islamic insurance with joint risk-sharing.

Source: Division Economic Development and Employment sector of Islamic Microfinance in Indonesia (2005) and BMT (BaitulmaalwaTamwil) of the Islamic Microfinancial Services for the Poor, Indonesia (2010).

Among them the most common products in Islamic microfinance are Murabaha, Qard-Hassan, Musharaka and Mudaraba (El-Zoghbi and Tarazi, 2013).

In respect to the geographical distribution of Islamic microfinance, Indonesia, Sudan and Bangladesh gather approximately 82% of the total number of clients (El-Zoghbi and Tarazi, 2013).

Table 2: total volume Islamic microfinance clients and main countries

Total volume of Islamic microfinance clients	1,28 million
Indonesia	181,000
Sudan	426,000
Bangladesh	445,000

Source: EL-ZOGHBI, Mayada and TARAZI, Michael (2013): *Trends in Sharia-Compliant Financial Inclusion*, Focus Note, nº 84, CGAP.

There are approximately 255 providers of Islamic microfinance services worldwide and 92% of them are located in the East Asia and Pacific and MENA regions (El-Zoghbi and Tarazi, 2013).

77% of the institutions providing Islamic Microfinance are village/rural banks while 10% are NGOs (Non Gubernamental Organizations) and 3% commercial banks. On the contrary 60% of the total clients are served by commercial banks, 17% by NGOs and only 16% by village/rural banks. This is mainly due to the existence of a large number of Indonesian village/ rural banks with a very little client base (El-Zoghbi and Tarazi, 2013).

Table 3: percentage providers Islamic services and clients

Institutions	% of Islamic services offered	% Islamic clients
Village/rural banks	77%	16%
Commercial banks	3%	60%
NGOs	10%	17%

Source: EL-ZOGHBI, Mayada and TARAZI, Michael (2013): *Trends in Sharia-Compliant Financial Inclusion*, Focus Note, nº 84, CGAP.

The process of verifying the compliance with Sharia law of the products offered varies widely. The most common methodology is the approval of an internal Sharia board or adviser (54%) or of an external specialized advisor (45%). On the contrary 34% of the institutions polled, especially the ones operating in poorer Islamic communities, favor local religious councils or mosque committees (El-Zoghbi and Tarazi, 2013).

Table 4: preference of Sharia auditors

Institutions	% of preference
Internal Shariah board/adviser	54%
External Shariah board/adviser	45%
Local religious council or mosque committee	34%
Governmental supervision	34%

Source: EL-ZOGHBI, Mayada and TARAZI, Michael (2013): *Trends in Sharia-Compliant Financial Inclusion*, Focus Note, nº 84, CGAP.

3. General data of Yemen, Egypt and Indonesia

Table 5: Yemen, Egypt and Indonesia general data

Indicator	Yemen Republic		Egypt		Indonesia	
	Data	Year	Data	Year	Data	Year
Population	23.85 million	2012	80.72 million	2012	246.9 million	2012
GDP	\$35.65 billion	2012	\$262.8 billion	2012	\$878 billion	2012
GNI per capita, Atlas method	\$1.270	2012	\$2.980	2012	\$3.420	2012
Income level	Lower-middle income	2012	n/i ⁴	n/i	Lower-middle income	n/i
Poverty headcount ratio at national poverty line (% of population)	34.80%	2005	25.2%	2005	11.4%	2012
Improved water source, rural (% of rural population with access)	47%	2011	99%	2011	76%	2012
Life expectancy at birth, total	63 years	2011	71 years	2011	71 years	2012
School enrollment, primary (% gross)	97%	2012	113%	2012	109%	2011

Source: <http://data.worldbank.org/country/>

Table 6: bancarization data

	Yemen	Egypt	Indonesia
% Religiosity (muslims)	99,00%	90%	88,2% ⁵
% bancarization. Adults > 15 years old	3,70%	9,7%	20%
% no accounts due to religious reasons. Adults > 15 years old	8,90%	n/i	1,50%

Source: [http:// worldbank.org/financialdevelopment/](http://worldbank.org/financialdevelopment/) GFDR 2014: Report

⁴ No information

⁵ Miller, Tracy, ed. (2009): *Mapping the Global Muslim Population: A Report on the Size and Distribution of the World's Muslim Population*, Pew Research Center.

4. Microfinance sector in Yemen, Egypt and Indonesia

Table 7: Yemen, Egypt and Indonesia microfinance sector data

Element	Yemen		Egypt		Indonesia	
	Data	Year	Data	Year	Data	Data
Number of MFI	9	2013	400	2011	50.000 ⁶	2012
Loans	\$16.8 million	2010-2013	\$375.1 million	2011	\$11.2 billion	2012
Borrowers	75.460	2010-2013	1.400.000	2011	726.204	2012
% of women	69%	2011	66%	2009	86,8% ⁷	2011
Deposits	\$8.5 million	2010-2013	not allowed	-	\$13.1billion	2012
Depositors	58.496	2010-2013	-	-	1 million	2012
Average Loan Balance	\$263	2011	\$212	2011	\$289 ⁸	2011
Total clients	133.956	2010-2013	1.424.860	2011	>50 million ⁹	2011

Source: www.mixmarket.org/mfi/country/and and www.sanabelnetwork.org/

4.1 Microfinance sector overview in Yemen, Egypt and Indonesia

4.1.1 Yemen

Yemen has introduced microfinance in 1997 (Brandsma and Hart, 2004) mainly as a consequence of the establishment of the Social Fund for Development (SFD) established by Law Number 10 of 1997 to contribute to the social and economic development through the implementation of plans for poverty reduction (Social Fund for Development, Republic of Yemen¹⁰).

Since that date, the microfinance sector has experienced an important growth, from 250 active clients in 1997 (Brandsma and Hart, 2004) to more than 133.956 in 2012, according to MIX Market data of Yemen¹¹. This growth shows that Yemen is one of the poorest countries in MENA region (Brandsma and Hart, 2004).

Before the year 2000, the SFD was the main microfinance program (Pakdel and Rodríguez, 2010).

During the first phase of the SFD (1997 to 2000), the main lessons learned were the following: there is large demand for microcredit; borrowers are willing and able to repay; there is large demand for microsavings services, especially women; the poor need other financial services, credit for consumption and insurance; microfinance intermediaries with the potential to become sustainable require intensive support; Islamic finance principles can be applied to

⁶Global microscope on the microfinance business environment. Indonesia, 2013.

⁷Sustainable Microfinance in Asia: Landscapes, Challenges, and Strategies, 2014.

⁸ See reference 7.

⁹Leesa Shrader (2013): *Latest on Branchless Banking from Indonesia*.

¹⁰ See <http://www.sfd-yemen.org/>

¹¹ See <http://www.mixmarket.org/mfi/country/Yemen>

microfinance, but they may not be sustainable because the transactions costs may be too high (Brandsma and Hart, 2004).

In 2000 United Nations Capital Development Fund (UNCDF) Microstart program was presented by United Nations Development Program (UNDP) (Pakdel and Rodríguez, 2010).

In 2003 SFD and UNDP joined together and founded an emerging microfinance industry increasing the awareness of policy makers about interest rate and sustainability (Pakdel and Rodríguez, 2010).

Microstart was successful in targeting women. In general, they are poorer than men, they need lower loans and they need the agreement of their husbands in order to carry out economic activities (Pakdel and Rodríguez, 2010).

According to UNCDF, microfinance programs in Yemen are at a primitive phase and institutions are not sustainable since they do not have professional management and appropriate governance to ensure sustainability and growth (Pakdel and Rodríguez, 2010). The country is so far from reaching the potential demand because of the few microfinance programs in the country and the lack of specific microfinance policy by the government (Pakdel and Rodríguez, 2010).

According to Pakdel and Rodríguez (2010) *“the notable characteristic of microfinance in Yemen is diversification of programs”*.

4.1.2 Egypt

The microfinance sector started in Egypt in the 80ies, when the Association of Business of Alexandria (ABA) and the National Bank of Development (NBD) created small credit programs around the country with USAID support (Assaad, and Rouchdy, 1999). Other international organizations like UNDP, UNICEF, Kreditanstalt fuer Wiederaufbau, joined forces later with the Egyptian Banking Institute and the Social Fund for Development to provide funds and support to the sector, which grew progressively in size (USAID, 2004)¹¹.

In 2005 new legislation was passed within the National Strategy plan, pursuing the objective of providing the microfinance sector with a clear legal framework, a network organization called The Egyptian Microfinance Network (EMFN), the supervision of the Egyptian Financial Supervisory Authority (EFSA) and guidelines for operating and reporting to the Egyptian authorities (Waly, 2008).

This step accelerated the growth of the market, which has more than doubled between 2005 and 2010, reaching a size of more than \$375 million and about 1.4 million customers. Although only 14 IMFs report officially to EMFN, the

¹¹ See AviD, Final Report of Mid-Term Evaluation of USAID/Egypt Small and Emerging Business Program, 2004.

Egyptian Financial Supervisory Authority record 400 organizations, which provide some sort of microcredits to their clients under different schemes (EFSA¹²).

According to the 2008 Planet Finance national survey of the impact of microfinance in Egypt¹³, IMF can be regrouped as specialized NGOs, public and private banks, Community Development NGOs, Umbrella NGOs (often closely linked to the government), Community Development Associations (CDAs) and small, local, voluntary organizations.

4.1.3 Indonesia

Indonesia has a long history and experience of commercial microfinance, starting in 1892 (*Malcolm and Sukhwinder Singh, 2005*) with the creation of Badan Kredit Desa (BKD or Village Credit Organization), village-owed banks offering microcredit and saving service to the clients (*Anne, 2012*). A sustainable microfinance began in 1970 with the opening of Bank Dagang Bali (BDB), a microfinance private bank (*Robinson, 1992*), but was closed by Bank Indonesia in 2004 due to governance intervention (Mix market, 2005¹⁴).

In microfinance Sector, the policy environment and the regulation evolved rapidly during the decade of the 80ies due to the successive crisis, with the following five main developments (Sumantoro, 2007): liberalization of the interest rate and elimination of credit limit in 1983; the phasing out most of subsidized credit programs in 1990; a new banking law in 1992 and birth of two types of banks: commercial banks and rural banks; finally, in the period between 1997 and 2002, the crisis management of the financial sector geared to prudential regulation and effective supervision (Sumantoro, 2007).

After this financial crisis, the fight against the poverty became a priority of the government by means of starting a massive financial reform. In this scenario, microfinancial regulation was incorporated (*Yuri, 2004*). Two years after the crisis one of the pillars of the new poverty reduction strategy was facilitating the access to microcredit and the improvement of the environment for the expansion of MFIs (*Asep et. al 2010*).

The Central Bank of Indonesia (Bank Indonesia) defines a microcredit as loans of up to Rs50m (\$5,500) but there is not a legal definition of the microfinance in all the country (Sumantoro, 2007).

Within the formal microfinance market supervised by Bank of Indonesia there are three main players in the sector (BRI, BPRs, and Pegadaian –Indonesian corporation owned by the government with the monopoly of fiduciary services-) (Dian, 2013).

¹² See www.efsa.gov.eg/content/efsa_en/micro_pages_en/main_micro_page_en.htm

¹³ Planet Finance: *National survey of the impact of microfinance in Egypt*, 2008.

¹⁴ See www.mixmarket.org/es/mfi/bdb

The semi-formal financial sector has a smaller role in the provision of microfinance in Indonesia. NGOs did not play a significant role in financial intermediation but recently a few NGOs have ventured into commercial microfinance (Microfinance industry report: Indonesia, 2009¹⁵).

Finally, Informal credit and savings schemes, comprising Rotating Savings and Credit Associations (RoSCAs) and other forms of traditional finance with a limited outreach and sustainability prospects (Microfinance industry report: Indonesia, 2009). The main informal providers of microcredit are cooperatives (*Global microscope on the microfinance business environment, 2012*).

The microfinance industry in Indonesia is among the most important in the world, composed by more than 50,000 MFIs and characterized by the domination of the commercial Banks with 90% of total micro loans disbursed (*Global microscope on the microfinance business environment, 2013*).

Therefore the growth of the microfinance sector has been largely influenced by government policies on poverty alleviation as well as financial sector development (Seibel, 2011).

5. Islamic microfinance in Yemen, Egypt and Indonesia

5.1 Islamic microfinance overview

5.1.1 Yemen

Yemen adopted Islamic banking in 1996 (Al-ZamZami and Grace, 2001). Regarding microfinance, in 1997 the Hodeidah Microfinance Program (HMFP) was established by the Yemen government and the United Nations. The objective of the program was the application of the financial Islamic principles to the microfinance methodology (Al-ZamZami and Grace, 2001).

The program was established after a market study conducted in the city of Hodeidah (Al-ZamZami and Grace, 2001). Approximately 30% of its population were returnees from Saudi Arabia and Gulf States after the Gulf War, the initial target group for HMFP (Al-ZamZami and Grace, 2001). The market study showed that much of the population had conservative beliefs with clear preferences for Islamic banking methodologies (Al-ZamZami and Grace, 2001).

According to Sanabel, the Microfinance Network of Arab Countries¹⁶, in 2010 there were approximately 28,000 Islamic clients and 5 institutions offering Islamic products: 2 microfinance banks (AL AMAL and AL TADAMUN for small and microfinance), 2 NGOs and 1 commercial bank (ALKURAIMI). All of them were offering mainly Murabaha.

¹⁵ See www.bwtp.org/files/MF_Industry_Report_Indonesia_ELECTRONIC.pdf

¹⁶ Sanabel, the Microfinance Network of Arab Countries: *Islamic Micro and Small Medium Enterprise (MSME) Finance Survey, 2012*.

Notwithstanding the above, according to a new published by PlaNet Finance Group in 2013¹⁷, Najah Al-Mugahed, the managing director of Yemen Microfinance Network, estimates the size of the microfinance market in Yemen at about 1 million people, but within this number only 80,000 people (8% of the market) use Islamic services (Pierre-Charles, 2013). As explained by Najah Al-Mugahed, the main reasons of such percentage are, among others, the domination of the "Murabaha" in Islamic microfinance sector which implies a high cost due to the mark-up (Pierre-Charles, 2013).

5.1.2 Egypt

The first modern experiment with Islamic banking was undertaken in Egypt in 1963, in Mit Ghamr (Ready, 1967). This experiment finished in 1967 when the central government clamped down on the Muslim Brotherhood, because Islamic finance started to be perceived as linked to Islamic fundamentalism (Siddiqi, 1988).

In 2010 the Egyptian Islamic Finance Association's (EIFA) started a new push for Islamic finance and the Muslim Brotherhood government made Islamic finance and microfinance as one central point of its economic policy aiming at turning 35% of the total financial market into Islamic by 2017 (IFIS, 2012)¹⁸.

Expectations were really high on Egypt becoming the leader of Islamic finance development (Graiss, 2012). But with the sudden end of the Muslim Brotherhood government in June 2013, the development of the Islamic microfinance is now uncertain (Lotfy and Torchia, 2013).

Egypt does not have a special legislation for Islamic microfinance or a formal dual banking system (Wilson, 2011). Although there has been over three decades of Islamic banking experience, the present Banking Law (law number 88 of 2003) contains no provision for Islamic finance or microfinance and no clear indication about financial treatment of Islamic contracts (Wilson, 2011).

In practice the Central Bank of Egypt has adopted a flexible approach to the regulation of Islamic banking, providing Islamic Banking licenses to 14 banks. Some of them have downscaled and offer Islamic microcredits. Abu Dhabi Islamic Bank (formerly NBD), that was at the forefront of providing (non-Islamic) microcredit in Egypt, since 2007 has changed all its microfinance operations into Islamic compliant. Al Baraka Banking Group for example together with the Social Fund for Development and World Bank started in 2012 an Islamic microfinance program of half a billion Egyptian pounds (\$82.9 million) (Amwal Al Ghad, 2012).

Small institutions act in a limbo providing sharia compliant microfinance, but often without even publicizing the nature of their contract, demonstrating a need

¹⁷ See www.microworld.org; *What future for microfinance in Islamic countries like Yemen?* PlaNet Finance Group, 2013.

¹⁸ See IFIS: *Egypt Islamists draft code to boost Islamic banks*, 2012.

for regulation. Among the Islamic Finance Institutions there are formal, semiformal NGOs and informal institutions, like the gam'iyah (local association) (Abdul Rahman and Dean, 2012).

Two internet-based platforms, Shekra and Yomken, have recently been established as formal companies as the first Islamic finance and Islamic microfinance crowdfunding platforms of the region, respectively (Root, 2013).

Alashanek Ya Balady Association for Sustainable Development (AYB-SD) is a small NGO, which provides sharia compliant microcredits to poor women in Cairo suburbs. AYB-SD is also a good example of a way to empower women through Islamic Microfinance (Costa et al, 2010).

The most traditional way of performing sharia-compliant financing activities in Egypt, especially in the rural areas, are the gam'iyah plans. They are ROSCAs (Rotating Savings and Credit Associations) schemes and can be considered as a traditional form of Islamic Finance (El Gamal et. al, 2011).

It is a very under researched area but a Professor of The American University of Cairo, Mr. Mohammed El Komi, has dedicated to the subject, in the attempt to turn these schemes into full-fledged credit unions among villagers through the introduction of a bank or financial institution into the plan to guarantee accountability (El-Komi, 2013). These credits unions would keep acting in the respect of the Sharia Law and might become the embryo of a more formal Islamic Microfinance in rural Egypt (El-Komi, 2013).

5.1.3 Indonesia

Islamic finance began in 1990, mainly in response to political demands from Muslim scholars and organizations. Bank Indonesia permitted in the new banking act a dual banking system, conventional and Islamic one (Seibel, 2007).

In Indonesia, Islamic microfinance is referred to as sharia-finance and comprises two types of institutions, which are: banking institutions regulated under the banking law, and financial cooperatives supervised by the Ministry of cooperatives (Mulaya, Nasirwan, 2011).

There are three types of Islamic banking institutions work under the legal category of commercial banks: full-fledged Islamic commercial banks: Bank Umum Syariah (BUS); Islamic banking units of commercial banks: Unit Usaha Syariah (UUS); Islamic rural banks: Bank Perkreditan Rakyat Syariah (BPRS) (Rifki, 2011).

The Islamic financial or microfinancial cooperatives in Indonesia are not part of the formal financial sector. They may be placed into either the semiformal or the informal financial sector and has been grouped into two categories: BMT *BaitulMaalwatTamwil* created since 1992 and control about 95% of Islamic

cooperatives in the country, affiliated to the largest Islamic mass organization in Indonesia, Nadhatul Ulama (NU), with almost 40 million members (Ahmed et. al, 2010) and; BTM *Baitul Tamwil Muhammadiyah*, control about 5% of Islamic cooperatives, created since 1999 by the second-largest Islamic mass organization in Indonesia with some 25 million members, Muhammadiyah (Mila, 2007).

In the last decade, the evolution of Islamic banks in Indonesia has grown, but their part in the finance system was still small. In order to develop the sector, a development strategy has been started up in three phases: laying foundation for growth; Strengthening the industry; and Becoming a world class industry (Mulaya and Nasirwan, 2011). The process of evolution and development of Islamic microfinance is part of the Islamic Financial Services Industry as whole in Indonesia (*Ten Year Framework and Strategies Report, 2007*).

The Islamic microfinance, formal and informal categories, has grown slowly (Dian and Habib, 2013). Bank Rakyat Indonesia (BRI, village Bank), working like a commercial bank, is the first microfinance institution in all the sector with more than 3,5 million borrowers and \$7,4 billion total microloan in 2011 (Global Islamic microfinance landscape, 2012). BRI is also the most important actor who launches the government finance and microfinance strategies (Yuri, 2004).

In 2011, the Islamic rural banks had 8,4% of the rural banking sector and assets around the 6% of its conventional counterpart. Murabaha dominates as the preferred product of microfinance (79%) followed by musharaka (10%). Mudaraba and qard-hasan constitute only about 3% of the total financing in 2011 in all the country (Islamic banking Statistics, 2011¹⁹). Islamic MFI grew slowly in Indonesia compared to conventional MFIs in the last decade, (Dian and Habib, 2013).

5.2 Demand priority

5.2.1 Yemen

As stated previously, the first Islamic microfinance program (HMFP) was conducted after a market survey study in which the potential clients were interviewed to determine their preference for the type of credit (Al-ZamZami and Grace, 2001).

Even though traditional banking products have been marketed in Yemen, the poor have been unwilling to take credit due to religious beliefs (Al-ZamZami and Grace, 2001).

In addition, Islamic microfinance is used in this country because of the religious beliefs of the population despite of its higher cost of transaction (Pakdel and Rodriguez, 2010).

¹⁹ See <http://www.bi.go.id/en/statistik/perbankan/syariah/Default.aspx>

In the light of the above, when the microfinance programs in Yemen were designed, most borrowers rejected interest rates, because they considered them as haram (prohibited). The interest demand is not homogeneous, for instance people from the South had fewer problems with interest rates than people from the North (Bradsma and Hart, 2004).

Regarding Islamic products, the initial preferences of the clients were for Mudaraba because of its familiarity to the principles of Islam despite of the potential conflict between the borrower and the microfinance program in the application of the benefit (Bradsma and Hart 2004).

Concerning Murabaha initially many clients showed doubts about such Islamic product because it appeared too similar to the prohibited practice of the application of interests (Bradsma and Hart 2004). Later the clients asked for the Murabaha because its equal repayments allow clients to manage their business cash flow more easily than the Mudaraba which has unequal installments (Bradsma and Hart 2004).

In Yemen both products ended with the acquisition of the good for the borrower because the handling of money is considered haram (Bradsma and Hart 2004). This fact created high transactions cost for the borrowers and the programs. These costs are charged by a higher profit-sharing percentage or mark-up (Bradsma and Hart 2004).

Finally, in Yemen it is estimated that 40% of the poor people demand Islamic financial services regardless of a higher price (Mohieldin et. al, 2011).

In its turn, in 2013 Gallup Poll²⁰-based on data from Global Findex World Bank-shows that interviewees from Yemen if facing a hypothetical loan choice between conventional and islamic loan would offer the following preferences²¹:

Table 8: Yemen credit preferences

Prefers (more expensive) loan from Islamic bank	37%
Prefers (cheaper) loan from conventional bank	18%
Does not have a preference	22%
Don't know/refuse	17%

Source: www.gallup.com/poll/166583/islamic-banking-remains-niche-market-north-africa.aspx

5.2.2 Egypt

There is not precise information about how Egyptians perceive Islamic microfinance as opposed to traditional interest rate based microfinance. A recent randomized field experiment on the gam'iya, found that take-up and

²⁰ See Gallup Poll: *Islamic Banking Remains Niche Market in North Africa*, 2013.

²¹Please note that this survey is based on personal interviews carried out on 2012 to adults > 15 years self recognized as Muslims. This survey does not indicate the rent levels of the interviewed people.

repayment rates on them were higher than that of a conventional Grameen-style group (El Gamal et. al, 2011). The authors conclude that religion might be a reason for a stronger commitment of the public to the traditional Islamic microcredit, especially in the rural areas where the experiment was conducted, although this cannot be stated for sure, as the authors speak about intuition (El Gamal et. al, 2011).

In 2008, the NGO Planet Finance organized a national survey²² to study the impact of microfinance in Egypt, where it asked clients of traditional microfinance about their perception of Islamic microfinance. Being already customers of traditional microfinance this group is probably not representative of the society at large and nevertheless Planet Finance recorded a growing concern about the lack of compliance of microcredits received with Sharia law.

Probably sensitivity to Islamic principles in finance is slowly growing in the MENA region, as it shows the case of Jordan, where in 1999 most people were not aware of Islamic finance principles (Naser et. al, 1999) whereas in 2006 32% of people asked by a IFC study cite religious reasons for not seeking a conventional loan (IFC and FINCA, 2006).

A 2013 study of the United Nations takes into consideration data stemming from the Global Financial Inclusion survey, conducted worldwide by Gallup on behalf of the World Bank (Asli et. al, 2013). This research had a special focus on 5 MENA countries, among which there is Egypt. However, the due to survey execution errors, data from Egypt is not included in the loan comparison summary statistics (Gallup Poll, 2013²³).

5.2.3 Indonesia

In Indonesia, generally the clients of MFIs did not understand how Islamic banking or microfinance products function nor their characteristics (Seibel 2011). The Murabaha, the preferred product offered by MFIs, was only understood by 26.85% of the clients and just 14% of total clients understood the concept of Ijrah products (Dian, Habib, 2013).

54.4% of total clients of the most important islamic MFIs in Indonesia preferred an Islamic MFI to a conventional MFI in order to be in harmony with their belief and this gave them peace and confidence (Dian, Habib, 2013). In spite of this, many of them use conventional MFIs due to practicality and economic factors like the cost they are charged. Normally, the reasons to choose between conventional or islamic loans are: easiness, speed, profile of loan officers and payment method, low collateral, size of loan, and low interest/cost of fund (Dian, Habib, 2013).

Nevertheless, there are serious barriers to the expansion of Islamic Microfinance Institutions, because the lower volumes of their transactions does

²² See Planet Finance: *National Impact Survey of Microfinance in Egypt, 2008*

²³ See Gallup Poll: *Islamic Banking Remains Niche Market in North Africa, 2013.*

not allow economies of scale and make the Islamic products more expensive (Nur, 2013).

Literature on the demand for Islamic microfinance in Indonesia suggests that demand is not very significant. Seibel concluded in 2011 that “*there is no indication that the establishment of Islamic banks in Indonesia was preceded by broad popular demand for Sharia-based Islamic financial services.*”

The study of the Bank Indonesia on demand in Central and West Java has shown mixed results. The Central Java study found that consumers required more sensibilization and better knowledge about the Islamic products before it could actually draw conclusions regarding their actual preference. The Western Java study showed that consumers make choices based on proximity and convenience rather than religion (Seibel, 2011).

6. Research Result

Table 9: Islamic microfinance Indicators

Elements	Yemen		Egypt		Indonesia	
	Data	Year	Data	Year	Data	Year
% religiosity (Muslims)	99%	2011	90%	2011	88.2%	2009
% bancarization	3.7%	2011	9.7%	2012	20%	2012
% no accounts due to religious reasons	8.9%	2011	2.9%	2011	1.5%	2011
Government input	Yes		No		Yes	
Number Islamic IMF	5	2010	11	2010	7500 ²⁴	2013
Number Islamic microfinance clients	28.782	2010	8.577	2010	181.000	2010
% islamic clients/total clients	21,48%	2010	<1%	2010	<6%	2012
% priority Islamic demand regardless of a higher price	37%- 40%	2012	n/d	-	40%- 54%	2013
% priority conventional financial services	18%	2012	n/d		46%- 60%	2013
% with no preference	22%	2012	n/d		n/i	n/i

Source: MixMarket, Sanabel, Gallup Poll and others.

²⁴Siyasah Shar'iyah. Nur Jamaludin (2013): *The Role of Government of Indonesia in Improving Islamic Microfinance*, Viewpoint of Microfinance Consultant of Mutual Consulting, Bali.

Table 10: Comparative Indicators

	Yemen	Egypt	Indonesia
Date of beginning of the conventional microfinance (CMF) and Islamic microfinance (IMF)	Conventional and Islamic microfinance began in same year 1997.	The CMF initiated in 80ies. IMF started in 1963 but stopped officially in 1967. Sporadic but not official presence.	Conventional microfinance began in 1892, although the Islamic one started in 1990.
Drivers of Islamic microfinance	The Yemen government with the support of United Nation and others cooperation agencies.	Muslim Brotherhood party. The new government approach to IMF needs clarification	The Indonesian government and Muslims scholars developed the Islamic (micro) finance like other pillar of finance system.
Sector regulation	Central bank of Yemen applies Islamic banking regulation in Islamic microfinance system.	Does not have a special legislation for Islamic finance and IMF.	Banking regulation allows a dual (micro) finance system, conventional and Islamic, and let the Muslims scholars set the principles of IMF.
Demand priority	Islamic microfinance is used in this country because of the religious beliefs of the population despite of its higher cost of transaction.	Islamic microfinance penetration is very low, therefore the offer is not sufficient to meet the needs of such clients, who would prefer to take a credit from an Islamic bank even if more expensive.	Demand is not significant to assume of Islamic (micro) finance services. In spite of the religious criteria, the majority of clients use conventional microfinance due to practicality and economic factors like a capital cost.
Dominated product supplied and demanded in Islamic microfinance sector.	Generally the clients of MFIs did not understand characteristics of Islamic microfinance products and all of them demand MURABAHA.	Generally the clients of MFIs do not know very well the characteristics of Islamic microfinance products. Gam'yas are the only common Islamic financing form available	Generally the clients of MFIs did not understand characteristics of Islamic microfinance products and all of them demand MURABAHA, mainly offered by Islamic MFIs.
Evolution	slowly growing	slowly growing	slowly growing

Conclusion

As we have pointed out in the Introduction we have chosen 3 of the most important markets for microfinance in countries with major Islamic presence and we have taken into consideration the presence of Islamic microfinance and its share of the total market.

We have seen that Yemen, although being a relatively small market for microfinance, has an important presence of Islamic microfinance, its share of the market being about 38%. In Yemen the effort for promoting Islamic finance started in the early 90ies and the level of awareness of its principles are now consolidated, so that about 40% of the population prefer Islamic finance even when it is more expensive.

Indonesia on the contrary started incentivizing Islamic finance much more recently, in 2002, and with a more gradual attitude, so that there is not such a big demand for Islamic microcredits from formal institutions. Microfinance was already flourishing and there has not been a strong switch of clients to Islamic compliant loan schemes.

Similarly in Egypt, where the government has been constantly opposing the Islamic finance, only a very few organizations provide Sharia compliant loans. Even when a whole bank credit portfolio switches to Islamic rules, like is the case of ADIB, there seems to be no publicity at all of the nature of its new product design apart in the name of the bank.

They have very different characteristics, but we have also noticed similarities among the 3 markets. In all of them we have seen banks downscaling into the microfinance field to serve smaller clients, we have seen a large size of semi-formal credit institutions that act as ONG or cooperatives and an informal traditional lending system, which has been historically present both in Egypt and Indonesia through cooperatives and *gamiyas*, which complies with Sharia principles.

The main difference we have noticed among the 3 countries is in the attitude of credit takers towards Islamic finance. Whereas in Indonesia and Egypt there is a certain awareness of the existence of Islamic microfinance, the clients do not seem to ask for a credit compliant with Sharia law. In Yemen it is evident that many end users would only accept a microcredit which corresponds with their religious and spiritual beliefs.

This is possibly because Yemen is a poorer country, it belongs to the region where Islamic finance is most developed (Gulf and Arab peninsula) or it might well be because of the institutional push for the acceptance of Islamic principles.

In the light of the above, this is the result evidence of the study that we have conducted: the Government's input is a key for the expansion of the sector. If this input should be preceded by a population's demand or not to guarantee success, it will be the result of a future study in depth of the demand preferences of the specific population studied.

We have also realized during the research that Islamic Microfinance in its present form presents some weaknesses. The contract type, the timing of payments and installments, the lack of precise regulation and agreement on contract form allowed, sum up to complicate the success of Islamic microfinance.

The question that was posed by the Gallup Poll for example about the readiness of the public to take an Islamic microcredit even if more expensive, suggests that Islamic microfinance per se is more expensive for the borrower.

The difficulty of structuring Musharraka and Mudarraba contracts for example lays in the nature of the businesses financed and their lack of a formal and reliable accountancy, which would enable the calculation of a profitability rate of the business and as consequence the exact remuneration of the loan.

Until when there is no full agreement of regulators and supervisors on the types of contracts allowed, the Islamic microfinance might lack of a juridical base on which to evolve and thrive.

This effort of organization of the sector could have come from the Egyptian state, if the Muslim Brotherhood had had the opportunity of governing for a longer time. In the present situation it does not seem that Egypt will take the lead in developing Islamic finance, and the biggest effort will stay with the banks and foundations from the Gulf and Emirates attempting to expand their business model in the Mediterranean Arab world.

The whole area of Islamic microfinance looks like a very under researched one. We have not found any specific books on the issue, only quite a few paper of research for different international organizations but even then with little research in the field. Even looking for documentation in Arabic did not improve the quality or increase the number of useful documents for our study.

The collection of data is very limited or at least not public, starting from the number of MFIs that officially report to Microfinance networks as opposed to the number of MFI actually operating in the countries (Egypt 14 against 400, Yemen 5, Indonesia 64 against 7,500). This situation makes an intervention of the legislator very urgent, in the effort to create more order in the sector. It should not necessarily regulate and demand strict rules from the MFIs but approach the market with a more structured organization.

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