

# **Frontiers of Islamic Banking: A Synthesis of Social Role and Micro finance**

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**Abstract:** Financing small and medium enterprises is viewed as a new paradigm to alleviate poverty and bring about development. Specialized poverty-focused microfinance institutions have evolved in last 25 years to finance microentrepreneurs. Problems facing these institutions are, among others, non-viability and dependence on subsidized funds for operations. Recently, a few Islamic microfinance institutions have also started operations in some countries. Operations of these institutions, however, have limited impact due to lack of funds and trained employees. Unlike conventional banks, Islamic banks' objectives should include social dimensions. Given this social role, Islamic banks can complement the efforts of Islamic microfinance institutions in providing the much-needed funds to the poor to facilitate their economic upliftment. The paper asserts that Islamic banks are predisposed to provide microfinance in a "win-win" situation. In other words, Islamic banks can finance the poor at no extra cost. Theoretical arguments presented show that Islamic banks can provide microfinance more efficiently benefiting from its scale of operations. To support some of the theoretical assertions, empirical evidence is given from the experience of Rural Development Scheme, a microfinance program of Islami Bank Bangladesh Limited.

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# **Frontiers of Islamic Banking: A Synthesis of Social Role and Microfinance**

## **1. Introduction**

The last quarter of the 20<sup>th</sup> century witnessed numerous financial innovations that catered to various needs of different segments of the society. While most of these innovations were concentrated in the countries with developed financial markets, couple of new ideas emerged from Muslim countries. The concepts of 'Islamic banking' and 'microfinance' surfaced almost concurrently, yet independently, in the mid-1970s. From its humble start, Islamic financial institutions have grown in size and scope rapidly. Given the large size of the potential market, non-Islamic financial institutions are also offering financial services that conform to Islamic principles. Currently, it is presumed to be one the fastest growing sectors in the banking industry worldwide. Similarly, microfinance institutions (MFIs), pioneered by Professor Muhammed Yunus of Grameen Bank in Bangladesh, have burgeoned in both developing and industrialized countries. After the failure of a few decades of top-down (trickle down) development policies to alleviate poverty in most developing countries, the innovative microfinance initiative is considered a "new paradigm" for bringing about development and eradicating absolute poverty.<sup>1</sup> "Microcredit Summit 1997" envisages 100 million poor would have access to microfinance by 2005. Multilateral financial institutions and international donors have adopted microfinance as a powerful tool for poverty alleviation and economic development.

Due to lack of collateral and asymmetric information problems, poor microentrepreneurs cannot obtain finance from conventional institutional sources. Before the advent of MFIs, most microenterprises were financed by non-institutional sources that charged exorbitant interest rate. In recent times, however, specialized

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<sup>1</sup>Growth in microenterprises or small enterprises can be important means of employment generation and development of poor countries. High population growth rate and limited employment opportunities in the agricultural sector and the modern manufacturing sectors leaves a vast majority of the labor force without productive employment. Microenterprises can play an important role in employing the surplus labor force productively (World Bank 1978). For an extensive study on microfinance, see, for example, Hulme and Mosley (1996a & b), *Journal of International Development* (Vol. 8, No. 2), Kimenyi, et.al. (1997), Otero and Rhyne (1994), and Schneider (1997).

poverty focussed MFIs are providing much-needed finance to a small segment of microentrepreneurs resulting in the increase in their income and wealth. MFIs innovative group-based format introduces a social collateral minimizing the asymmetric information problems and ensuring higher recovery rates. Most MFIs, however, are non-Islamic in character. Other than charging interest, the social agenda that is associated with these programs have secular features. A few MFIs with Islamic orientation have recently started operations in some countries. Their operations, however, are miniscule compared to the large number of the poor population that needs to be served.

Most of the Islamic banks, like their conventional counterparts, have not ventured into microfinancing. Whereas it is understandable why conventional banks are not involved in microfinancing, it is not befitting for Islamic banks to do the same. Islamic financial institutions have fundamentally different objectives compared to their conventional counterparts. Khan (1997) discusses this issue. He points out that the only difference between Islamic and conventional banking practices is whether the business is interest-based or not, then the non-Islamic financial institutions probably can deliver Islamic services in a better way than Islamic banks. He asserts that a distinct aspect of an Islamic enterprise is the social dimension in its operations.

One way of manifesting the social role of Islamic banks is to provide finance to the poor to increase their income and wealth. The innovative operational format used by the MFIs suits the poor and can be employed by the Islamic banks to provide such finance. This paper investigates if a marriage between Islamic banks and microfinancing is possible. The paper argues that there is a strong case for such a union as Islamic banks can deliver finance to the poor more efficiently and effectively. The theoretical arguments are supported by empirical evidence of Rural Development Scheme, a microfinance Program of Islami Bank Bangladesh Limited.

The paper is organized as follows. Section 2 discusses the need for social intermediation to finance microenterprises. The section then outlines the characteristics and operations of MFIs and points out some of the problems faced by them. In section 3, the scope and constraints of Islamic MFIs are discussed. Section 4 outlines the theoretical arguments for Islamic banks involvement in microfinancing

followed by a section of comparative analysis of Islamic banks and MFIs in financing microenterprises. In section 6, microfinance experience of Islami Bank Bangladesh limited is discussed in the light of the theoretical assertions made. Section 7 concludes the paper.

## **2. Financing Microenterprises: Need for Social Intermediation**

Smaller firms do not have any access to funds from traditional financial institutions. The underlying theoretical explanation for this phenomenon lies in the traditional problems of asymmetric information in financial intermediation. Bennett (1998) points out some barriers that accentuate the asymmetric information problems in case of smaller enterprises in developing countries. Physical barriers of poor infrastructure like lack of markets, roads, power, communications, etc., can worsen both the adverse selection and moral hazard problems. Physical constraints inhibit the financial institutions to gather information on their prospective clients and once credit is advanced it is difficult to monitor the use of the funds. Socioeconomic factors of clients like low numerical skills due to illiteracy, caste/ethnicity/gender aspects preventing interaction also add to the adverse selection problem. Microentrepreneur's lack of collateral due to poverty can increase the moral hazard problem. These barriers would make assessment of projects and monitoring the use of loans very costly. Furthermore, as the size of the loan for microenterprise is small, the administering cost of per-unit loans increases. These economic factors make it impossible for traditional financial institutions to offer credit to microenterprises.

Given the above problems in financing microenterprises and also the fact that these small-scale enterprises are important means to increase employment and reduce poverty, there is a need for a social financial intermediation of funds for the microentrepreneurs. Bennett (1998, pp. 106-7) points out two approaches of financing microenterprises. First, the linking approach under which conventional financial institutions are linked to the target group (i.e., the poor) through some intermediary. The other approach is to provide microcredit through specialized organizations, like NGOs, government agencies, cooperatives, and development finance institutions. Almost all of the financing for microenterprises in recent times has come from latter institutions that cater to the needs of the poor. This focus of this paper, however, is on the former linking approach. We argue that Islamic banks can finance

microenterprises more efficiently than MFIs. Before examining how this is done, the operations, prospects, and problems of conventional and Islamic MFIs are discussed.

### ***2.1. MFIs: Specialized Financial Institutions***

Though the importance of financing small-scale enterprises has been felt for a long time, the concept of group-based poverty focused microfinance is a relatively new concept with distinct characteristics.<sup>2</sup> Pioneered by the Grameen Bank in Bangladesh, group-based MFIs are banks for the poor and operate quite differently from the conventional commercial banks. Whereas commercial banks are profit maximizing firms, MFIs are either government or non-government organizations (NGOs) formed to provide the poor with their much needed finance. Given this nature, most MFIs have a social development program along with its credit facilities.

To get finance from these institutions, the client or beneficiary has to be poor.<sup>3</sup> A person must form a group of five like-minded people with similar socioeconomic status to get credit. Male and female groups are formed separately and relatives cannot be in the same group. A group is usually trained for couple of weeks to be familiar with the rules and procedures of the MFI. A number of groups are federated into a center with a center chief and deputy center chief elected from amongst them. Weekly meetings of the center are held at a convenient place in the locality. All members (i.e., beneficiaries) of the center are required to attend these meetings. An MFI official attends these weekly meetings to conduct the banking transactions and other business of the center.

MFIs extend credit of small amounts at a reasonable rate of interest. The loan is paid back in one year in (fifty) weekly installments. Credit is provided to the poor without any physical collateral. Instead, social collateral is introduced by forming groups. Loan repayment by an individual member of a group is the collective responsibility of all the members in the group and default by a member disqualifies all

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<sup>2</sup> Though different approaches to microfinance have evolved, the format discussed here is that of Grameen Bank, which serves as the dominant model for most group-based microfinance institutions (Morduch 1999).

<sup>3</sup> Different MFIs define their target group in different ways. For example, to be eligible to get credit from Grameen Bank a household must own less than 0.4 acres of land and must not have assets exceeding the market value of one acre of cultivable land.

members to get new loans. As a result, members in the group monitor the activities of each other and peer pressure induces the repayment of the loan. This format of peer monitoring mitigates the problem of asymmetric information and reduces transaction costs (Huppi and Feder 1990, Morduch 1999, Stiglitz 1990). Most MFIs have various (forced) savings programs. Sometimes, MFIs also extend credit to individuals for building houses and to a group or center for collective enterprise.

Most MFIs have a social development program associated with financing. The objective of this program is to generate personal and social consciousness among the members. These programs include aspects that affect behavioral changes (such as personal hygiene, sanitation, drinking clean water, etc.), moral teachings (like teaching to be honest, disciplined, and cooperate among themselves), and social customs (like accepting family planning, not practicing the dowry system, etc.). Knowing these principles and norms are prerequisites to obtain loans from the MFI and are continuously inducted in the members during the weekly meetings. At times, necessary inputs to implement these social programs (like tube wells for water, oral re-hydration salt, etc.) are provided by the MFI on subsidized basis.

## ***2.2. MFIs: Problems and Constraints***

While a large literature exists that shows the success of MFIs, some recent studies show failure of these institutions in reaching some of their objectives.<sup>4</sup> The problems relevant to this paper are given below.

*a) Asymmetric Information Problems:* The bulk of the loan by microfinance institutions is targeted towards women. In reality, however, the male members of the household initiate taking loans and control the funds received by the female members. Furthermore, loans taken from the bank are often used for purposes other than those the loan is sanctioned for (Rahman 1999, p. 75). When loans are used for non-productive purposes, the chances of default increase. Buckley (1996, p. 390) reports that in 1993, 46 percent of the Malawi Mudzi Fund's (a MFI in Malawi) borrowers were in arrears (did not pay installments between 1 to 4 times) because they diverted the funds for consumption purposes. Among the defaulters

(those who did not pay more than 4 installments), the corresponding number was 33 percent.

*b) Economic Viability of Microfinance Institutions:* Ideally microfinancing would be a "win-win" situation, where the MFI operates at a profit and the poor benefit from the credit program. This, however, is not the case for most MFIs (Morduch 1999). Due to lack of fund mobilization and the high administrative cost most MFIs are not economically viable.<sup>5</sup>

*c) High Drop-out Rate and Non Graduation from Poverty:* Ditcher (1996), Hulme and Mosley (1996a), and Montgomery (1996) report that microfinance institutions do not serve the poorest who are either not given loans or drop out of the credit schemes.<sup>6</sup> Karim and Osada (1998) observe that there is a steady increase in dropout rate from Grameen Bank (15 percent in 1994) and that 88 percent of the total dropouts did not graduate to the status of non-poor. Assaduzzaman (1997) finds that whereas microfinance does increase the income level of the poor, the current operations of MFIs are not very effective in improving the lives of the extreme poor.

### **3. Islamic MFIs: Prospects and Problems**

Given the important role of financing microenterprises in alleviating poverty, several Islamic MFIs have been initiated in some countries. Islamic MFIs retain the innovative operational format of conventional MFIs and orient the program towards Islamic principles and values.<sup>7</sup> Islamic MFIs, however, can have potentially more varied liabilities and assets. For example, on the asset side various modes of financing

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<sup>4</sup>For accomplishments of MFIs see Bornstein (1996), Fuglesang and Chandler (1993), Goetz and Gupta (1996), Hashemi, et. (1996), and Hossain (1983, 1987).

<sup>5</sup> For example, Bennett (1998, p. 116) report that administrative cost of five MFIs in South Asia is in the range of 24 percent to more than 400 percent of per dollar lent. Reed and Befus (1994, p. 190) study five MFIs and find average return on assets for three of these below 2 percent, one at 3.5 percent and the other at 14.6 percent. Hashemi (1997) and Khandker, et.al. (1995) point out that Grameen Bank would operate at a loss without grants. A Subsidy Dependence Index (SDI) developed by Yaron (1997) indicate that in 1996 Grameen Bank would have to increase its lending interest rate by an additional 21 percent in order to breakeven without subsidies (Hashemi 1997). Similarly, Hulme and Mosley (1996a, p. 52) find that 12 out of 13 MFIs from six countries have positive SDI ranging from 32 percent to 1884 percent.

<sup>6</sup> For example, dropout rates for the Grameen Bank and BRAC are 15 percent and 10-15 percent per annum, respectively (Hulme and Mosley 1996a, p. 122).

used and on the liability side sources of income can also include *zakat*, *waqf*, etc. Furthermore, the Islamic content of the Social Development Program can build the social capital that is needed for successful functioning of MFIs.

Islamic MFIs have some inherent characteristics that can mitigate some of the problems faced by conventional MFIs pointed out in Section 3. By targeting the family unit instead of women members in the household, the adverse selection and moral hazard problems of the recipients not using the funds may be minimized. Furthermore, as Islamic finance involves real transaction instead of cash being given out, the opportunity of diverting funds for uses other than that requested for is eliminated. The nature of the social capital intrinsic in the Islamic social development program can potentially decrease the default rate as solidarity among the group members increases and beneficiaries take it as an religious obligation to repay their debt. All these factors improve the profitability/viability of Islamic MFIs.

The institutions of *zakat*, charity, and *waqf* can be integrated into microfinancing program to effectively alleviate absolute poverty. *Zakat*<sup>8</sup> and *sadaqat* in Islam are important tools for the redistribution of income and growth. *Zakat* is one of the five pillars of Islam binding on every wealthy Muslim and can be used to increase the participation in production of the poor (El-Ghazali, 1994, p. 48). *Zakat* and income from *waqf* can be integrated into the microfinancing system to benefit the poorest beneficiaries. *Zakat* given to the poor can be used for consumption, asset building, and production purposes to complement funds of Islamic MFIs. These complementary funds can either be given as grants or interest free loans (*qard-hasan*) according to the needs of the beneficiary. As these complementary funds will reduce the need for diverting money to consumption and purchase of assets, it is expected the funds taken for productive activities will be invested accordingly. As a result, the overall return on invested funds is expected to be higher and the probability of default lower. Thus, integrating Islamic institutions of *zakat*, charities and *waqf* with microfinancing will not only include the core poor in the program, but also ensure the repayment of the funds to the Islamic MFI. A survey of Islamic MFIs, however, reveals that they are not employing their full

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<sup>7</sup>For a discussion on Islamic MFIs in Bangladesh see Ahmed (2002).

<sup>8</sup>For detailed discussions see El Asker and Haq (1995) for *zakat* and Basar (1987) and Cizaka (1996, 1998) for *waqf*.

usable potentials (Ahmed 2002). The same survey shows that Islamic MFIs face the following problems that hinder their growth.

***i) Lack of Funds***

Officials of the surveyed Islamic MFIs contend that expansion of their activities is hampered by lack of funds. MFIs cannot attract deposits as commercial banks do. Other than the initial start-up capital provided by a few volunteers, most of the funds for conventional MFIs come from external sources and beneficiary savings. Need for funds is the greatest during the initial stages of operations of MFIs when the beneficiaries savings are nil or small. As the MFIs grow, the savings of beneficiaries accumulate which can then be recycled in financing microenterprises. The time needed for an MFI to operate its activities based solely on beneficiaries' savings, however, may be very long.<sup>9</sup> As pointed out above, Islamic MFIs have not yet tapped the funds from Islamic institutional sources of *zakat*, charity, and *waqf*.

Officials of Islamic MFIs point out that there are certain problems in obtaining funds from external sources. First, the Islamic educational content of Islamic MFIs deters some external sources from funding these institutions. Second, though some funds are available from government agencies, they impose certain terms and conditions. Some of these terms and conditions are contrary to Islamic principles and limit the flexibility in the operations of Islamic MFIs. For example, the funds are given on interest and the MFIs are required to recover a certain fixed rate of return on their investments. As a result, funds from these sources cannot be employed in microfinancing using certain Islamic modes of financing (like *mudarabah* and *musharakah*). Another, implication of lack of funds is, as the officials of Islamic MFIs indicate, that the benefits package given to employees is not as good as the established MFIs operating in the neighborhood. This sometimes induces employees with experience to move on to other MFIs paying better pay and benefits.

***ii) Training***

Training employees regularly on different aspects of MFIs' operations can enhance efficiency. Training in case of Islamic MFIs would also cover knowledge on different

Islamic modes of financing and appropriate Islamic orientation of Social Development Program. While some training on conventional topics (like accounting and administrative aspects) are offered from time to time by the governmental agencies, Islamic oriented training sessions are lacking or too expensive when available.

The above discussion shows that while Islamic orientation in Islamic MFIs can mitigate some problems faced by conventional MFIs (like asymmetric information problems), they face couple of constraints that limit their expansion. Given these limitations of Islamic MFIs, we examine the prospects of Islamic banks to provide the much needed funds to the poor microentrepreneurs next.

#### **4. Financing Microenterprises by Islamic Banks: Rationale**

The role of Islamic banks in financing microenterprises can be studied from two perspectives. First, the social dimension of Islamic institutions and second, the economic rationale for such financing. These are discussed below.

##### ***4.1 Social Role of Islamic Banks and Microfinancing***

Though there have been discussions on the nature of an Islamic enterprise in general (for example see Siddiqi 1988), Khan (1997) focuses on the objectives of Islamic banks. He points out that operations of Islamic banks have two aspects, viz. the 'mechanics of it' and the 'spirit of it'. While mechanics relates to fulfilling the Islamic legal requirements in its operations, the latter relates to faith. Any institution (including non-Islamic ones) can fulfill the mechanics of Islamic by providing Islamic compatible financial contracts and transactions. The spirit of an Islamic enterprise, however, distinguishes an Islamic bank from a conventional bank. Khan (1997) points out that different variants of conventional financial institutions (like mutual funds, Rental Equity participation Trusts, etc.) appear very close to Islamic modes of financing, but this doesn't make these institutions Islamic. He asserts that Islamic banking has to relate its activities to faith if it has to distinguish itself from conventional financial institutions.

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<sup>9</sup>Majority of the funds of large well-established conventional MFIs (e.g. Grameen Bank) still comes

Khan (1997) maintains that the philosophical basis of the faith component of Islamic banks lies in *adl* (social justice) and *ahsan* (benevolence). The implication of these concepts is "taking care of those who cannot be taken care of by the market, who cannot play with economic forces or do not have access to economic means to enable them to exploit the economic opportunities around them" (Khan 1997, pp. 12-13). Given this characteristic, it is imperative on Islamic banks to include social dimensions in their operations along with the normal banking practices.

The question is how the social role of Islamic banks can be best exemplified. Khan (1997) suggests a variety of activities like *qard-hasan*, financing housing, meeting basic needs, and promoting and financing small entrepreneurs. All these aspects, however, can be covered in a comprehensive integrated program with focus of microfinancing. As mentioned above, most microfinance schemes have an integrated social development program. Islamic banks by adopting this approach of microfinancing can engage in a much broader program of wealth creation for the poor and bring about development. As the next section reveals, they can fulfill this social role at no extra financial cost.

#### ***4.2 Islamic Banks and Microfinance***

Other than the social dimension, there are several other arguments in favor of Islamic banks' involvement in microfinancing. Financing productive activities is the specialization of banks. Financing microentrepreneurs will be an extension of their client base. They already have the skilled manpower that has the know-how on which they can expand their microfinance operations. Islamic banks have certain other advantages over MFIs in providing such finance. By using the Islamic modes and financing and orientation, Islamic banks can mitigate the asymmetric problems faced by conventional MFIs (as discussed in section 4). Furthermore, the lack of funds and trained personnel constraining the operations on Islamic MFIs is eliminated in Islamic banks. With its established network of branches, Islamic banks will be able to deliver services at a lower cost than MFIs. This vantage point of Islamic banks along with the fact that the provision of microfinance can be done at no extra cost further reinforces the argument for the involvement of Islamic banks in microfinancing. Some of the

economic advantages of Islamic banks in providing finance to the poor are evident when we examine the economics of microfinancing below.

#### **4.2.1. Economics of Microfinancing**

Profit ( $\pi$ ) of a conventional MFI is defined as difference between its total income or revenue ( $TR$ ) and total costs ( $TC$ ). That is,

$$\pi = TR - TC \quad (1)$$

Total costs of a MFI will include borrowing costs ( $BC$ ) and operating costs ( $OC$ ). Other than borrowing funds ( $F$ ) from external sources, MFIs build up savings of members ( $S$ ). If  $i_f$  and  $i_s$  are the interest rates paid on funds provided by external sources and savers respectively, then borrowing costs equals,

$$BC = i_f F + i_s S.$$

Operating costs ( $OC$ ) includes variable costs (wages), fixed costs  $O$  (i.e, rent, utilities, etc.). Note that these costs can be further divided as those incurred at the field level and those that are incurred away from the field (costs at head office and regional offices). For our analysis we breakdown the total number of employees of the MFI,  $m$ , into those working at the field level,  $m_f < m$ , and those who are not working there ( $m_h = m - m_f$ ). Thus, operating costs can be written as,

$$OC = w_f m_f + w_h m_h + O, \quad (2)$$

where  $w_j$  is the average wage rate for employee type  $j$  ( $j = f, h$ ). Thus, total costs of an MFI equals,

$$TC = (w_f m_f + w_h m_h) + O + i_f F + i_s S. \quad (3)$$

From an accounting point of view, income of MFI is derived from the interest earned from loans to the beneficiaries ( $L$ ) and interest earned on deposits with other financial institutions ( $D$ ). The amount of loan given out by the MFI equals the average loan amount given ( $l$ ) times the number of beneficiaries ( $n$ ). The repayment (or recovery)

rate of loans ( $\pi$ ) depends on, among others, the actual use of borrowed funds in the economic activity. Diversion of funds (to non-productive activities) increases the probability of default. Diversion of funds can be minimized and repayment-rate improved with better overall supervision and monitoring of the loan. For a given number of clients, supervision, and monitoring improve with more employees at the field level. In other words, as field level employees increase, the repayment rate ( $\pi$ ) is expected to rise. Wages paid to field level employees ( $w_f$ ) can affect their incentive to work and affect recovery rates. Furthermore, higher interest rate charged for credit ( $i_l$ ) increases the probability of default. The repayment rate function can be given as,

$$\pi = \pi(m_f/n, w_f, i_l), \quad \pi'_1 > 0, \pi'_2 > 0, \pi'_3 < 0; \quad (4)$$

where  $\pi'_j$  ( $j=1,2,3$ ) is the first derivative with respect to the  $j$ th argument. The total income of the MFI can be written as:

$$TR = \pi(m_f/n, w_f, i_l) i_l nl + i_d D, \quad (5)$$

where  $i_l$  and  $i_d$  are interest rates on loans and deposits respectively. Using the definitions of costs and income from equations (3) and (5) in equation (1), we can write the profit of a MFI as,

$$\pi = \pi(m_f/n, w_f, i_l) i_l nl + i_d D - (w_f m_f + w_h m_h) - O - i_f F - i_s S, \quad (6)$$

Note that  $D, F, S, i_d, i_f$  are exogenous to the system. The effects of variables that are of interest on the profit is given below;

- i).  $d\pi/di_l > 0$ , if  $\pi nl > \pi'_3 i_l nl$ ;
- ii).  $d\pi/dm_f > 0$ , if  $\pi'_1 i_l nl > w_f$ ;
- iii).  $d\pi/dw_f > 0$ , if  $\pi'_2 i_l nl > m_f$ ;
- iv).  $d\pi/dn > 0$ , if  $\pi i_l l > (m_f/n^2)\pi'_1 i_l nl$ ;
- v).  $d\pi/dl > 0$ ;  $d\pi/dm_h < 0$ ;  $d\pi/di_s < 0$ ;  $d\pi/dO < 0$ .

The effect of an increase in the interest rate on loans ( $i_l$ ) on the profit will be positive if the resulting increase in income offsets the decrease in income due to lower

repayment rate. The effect of an increase in the employees in the field ( $n_f$ ) improves the supervision and monitoring of the use of credit and hence increases the income by raising the recovery of loans. The profit of the MFI will increase if this increase in income is greater than the wages paid to the marginal employee. Similarly, an increase in the wages paid to employees ( $w_f$ ) will increase profit if the improvement in the recovery rate (due to improved supervision) exceeds that increased wages paid. An increase in the beneficiaries ( $n$ ) will affect profit positively if the returns from them are greater than the decrease in recovery rate (due to increased difficulty in supervision). Finally, larger average loan size ( $l$ ), fewer non-field workers ( $m_h$ ), lower interest paid to savers ( $i_s$ ) and lower overhead costs ( $O$ ) will increase the profitability of the MFI.

### **5. Financing Microenterprises: MFIs versus Islamic Banks**

In this section we compare the relative economic performance of MFIs and Islamic banks in delivering microfinance. Note that Islamic banks will use the same format as the MFIs in microfinancing as this format suits the poor. Specifically, small amount of credit is given to the poor without any physical collateral. In order to qualify for funds, beneficiaries have to be poor and form groups. Funds are provided under some Islamic mode of financing for three months to a year and repaid in weekly/monthly installments. An official from the Islamic bank conducts the microfinancing activities and collects installments at the weekly meetings at the center. Though the bank deals primarily with women, the overall target is the family. As a result, the bank encourages the active participation of the spouse in the funded activity.

As regards to the *modus operandi* of microfinance operations by an Islamic bank, the field level operations can be conducted from its branches and a small department can coordinate these operations at the head-office (national) level. At each branch, field workers will do the business under the supervision of field supervisors. An officer of the bank will oversee the microfinance operations of the branch. Microfinance operations will be focussed among the poor in the vicinity of the branch. Given the above, we can compare the relative effectiveness of providing such finance by MFIs and by Islamic banks. The results are summarized in Table 1.

***Table 1: Comparison between MFIs and Islamic Banks in Providing Microfinance***

<b>MFI</b>	<b>Islamic Banks</b>
<u>Operating Costs</u> $OC^M = w^M_f m^M_f + w^M_h m^M_h + O^M$	$OC^I = w^I_f m^I_f + w^I_h m^I_h$
<u>Borrowing Costs</u> $BC^M = i^M_f F + i^M_s S$	$BC^I = r^I_d D + r^I_s S$
<u>Implications of Lack of Funds (1)</u> $m^M_{f/n} \downarrow \rightarrow ?^M \downarrow \rightarrow TR^M \downarrow$	$m^I_{f/n} \uparrow \rightarrow ?^I \uparrow \rightarrow TR^I \uparrow$
<u>Implications of Lack of Funds (2)</u> $w^M_f \downarrow \rightarrow ?^M \downarrow \rightarrow TR^M \downarrow$	$w^I_f \uparrow \rightarrow ?^I \uparrow \rightarrow TR^I \uparrow$
Lack of Supporting Program for poor => Fund diversion	Supporting Program for poor => No Fund diversion
Costly Training	In-house Training

#### ***a) Profitability/viability***

Profitability/viability can be discussed from the revenue and cost sides. As before, total costs of providing microfinance can be viewed as operating and borrowing costs. The operating costs of an MFI ( $OC^M$ , superscript M indicating MFI) will include costs at the head office, the regional offices, and branches that cover the field-level work. The costs comprise a variable component (wages to employees at the field and head-office levels =  $w^M_f m^M_f + w^M_h m^M_h$ ) and a fixed component (rent, utilities, etc. =  $O^M$ ). The total operating costs of an MFI is  $OC^M = w^M_f m^M_f + w^M_h m^M_h + O^M$ .

In contrast, operating costs of providing microfinance in case of an Islamic bank ( $OC^I$ , superscript I indicating Islamic bank) will be much smaller. As Islamic banks will provide microfinance from existing branches, it will not incur any extra fixed costs (rent, utilities, etc., i.e.,  $C^I = 0$ ). Furthermore, it will not require a whole range of professionals/employees, particularly at the top management level at the head office and regional offices. This will reduce the cost of operations at the head-office level (i.e.,  $w^M_h m^M_h > w^I_h m^I_h$ ). Note that the wages paid to the field workers and supervisors in case of Islamic banks is expected to be higher than their MFI counterparts (i.e.,  $w^M_h < w^I_h$ ). As discussed above, this will have two offsetting effects. On the one hand, higher wages will attract more productive field-level workers and on the other hand it will increase the wage bill. As the field level workers are paid

relatively lower salaries than professionals at the management level, the total wage bill for microfinance operations in an Islamic bank is expected to be much lower than that of MFI. We can conclude that the total operating costs of providing a certain amount of microfinance to a given number of beneficiaries will lower in case of Islamic banks than MFIs. That is,

$$OC^M (= w_f^M m_f^M + w_h^M m_h^M + O^M) > OC^I (= w_f^I m_f^I + w_h^I m_h^I);$$

$$m_h^M > m_h^I, w_f^M < w_h^M.$$

To discuss the borrowing costs, we need to examine the sources of funds for these institutions. In the absence of deposits (other than savings of beneficiaries), bulk of the funds of the MFIs is from external sources. Though sometimes the external funds are provided at subsidized rates, certain conditionalities are attached to it. In contrast, Islamic banks main sources of funds are deposits. The opportunity cost of using these funds is investment in alternative investments. Most Islamic banks, however, have excess liquidity given the lack of Islamic compatible money-market instruments to park funds for shorter periods of time. Given this excess liquidity, the opportunity cost of using these funds is zero ( $r_d^I=0$ ). Assuming that the Islamic banks offer its beneficiaries the same rate of return as MFIs (i.e.,  $i_s^M = r_s^I$ ) on their savings, then we can conclude that the borrowing costs of funds will be lower in case of Islamic banks ( $BC^I$ ) than MFIs ( $BC^M$ ), as indicated below.

$$BC^M (= i_f^M F + i_s^M S) > BC^I (= D + r_s^I S).$$

The above discussion shows that Islamic banks can finance microenterprises more efficiently (at a lower cost) than MFIs.

### ***b) Quality of Service***

An implication of dependence on external funds is that MFIs have to abide by some conditions. While some conditions are value neutral, others are not compatible with Islamic principles. For example, the funds from external sources are given on interest and the MFIs are required to collect a fixed return from the beneficiaries. The implication of this is that Islamic MFIs lose their independence to use certain profit-

sharing modes of financing and frame procedures that may be more appropriate for financing certain activities.

In contrast, Islamic banks use their own funds and are independent to frame programs that suit the beneficiaries. For example, the revenue generated from certain activities like agricultural production and cow-fattening have a gestation period. Thus, it becomes difficult for beneficiaries of MFI to pay installments as the return from investment flows in at a later date. An Islamic bank can frame a repayment schedule where the beneficiary pays a token (small) amount of money at the weekly meetings, and pays the bulk of the debt when the asset or produce is sold.<sup>10</sup>

As pointed out earlier, Islamic MFIs in Bangladesh identify lack of funds as one of the major constraints to growth and efficient operations. Other than limiting the expansion of operations of MFIs, lack of funds also have other detrimental implications. They cannot hire sufficient workers at competitive wages. Paying lower wages implies that they employ relatively low productivity workers. Lack of funds also means employing fewer field level workers lowering the employee-beneficiary ratio adversely affecting supervision and monitoring. Both factors increase the probability of default,  $\rho^M$ , and lowering the expected income of MFIs. Islamic banks, however, can employ adequate workers at competitive wages along with other benefits. This allows them to employ productive workers and maintain an appropriate employee-beneficiary ratio. These have a positive impact on the repayment rate and income of the bank. The comparative effects of lack of funds on the revenue of MFIs and Islamic banks are shown in Table 1.

Another factor that can improve the efficiency of the operations of MFIs is periodic training and workshops to upgrade their skills of employees. Islamic MFIs contend that they cannot benefit from these costly training sessions due to lack of funds. Islamic banks being relatively larger institutions can organize training courses for their employees. Larger Islamic banks have their own in-house training

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<sup>10</sup>This cannot be done by those MFIs in Bangladesh that take funds from government funding agency (PKSF), as a condition attached for funding is that the beneficiaries should start paying installments of equal amounts within two weeks of the disbursement of funds.

departments and the employees involved in microfinancing can benefit from these in-house training programs at little extra cost.

### ***c) Complementary Poverty Reduction Program***

It has been pointed out above that the poorest sections of the population are left out by conventional MFIs. One reason is that extreme poverty leads to the diversion of funds from productive activities to consumption and asset purchases. This lowers the overall return on investment and makes it difficult for the poor to repay the loans. It is pointed out above that some charitable institutions (like *zakat*, *sadaqaat*, and *waqf*) can be integrated with microfinancing to reach the core poor. The Islamic MFIs, however, have not tapped into these sources to complement financing to the poor. One reason may be the Islamic MFIs find it difficult to mobilize *zakat* proceedings from the community.

Islamic banks can devise a complementary program to finance the core poor. Most Islamic banks have a fund created from collections of penalties for late payments from overdue accounts. These funds, on principle, can only be spent on charitable activities. These funds can be integrated with the microfinancing either as outright grants or *qard-hassan*. This will not only prevent diversion of funds from investment to consumption by the poor, but act as an added financial incentive to repay the funds taken for microentrepreneurs.

## **6. An Example of Microfinancing by Islamic Bank: Rural Development Scheme of Islami Bank Bangladesh Limited<sup>11</sup>**

Rural Development Scheme (RDS) of Islami Bank Bangladesh Limited (IBBL) was initiated in 1995 and started operations in 1996 to cater to the investment needs of poor microentrepreneurs, particularly in the rural areas. RDS is funded from IBBL's general investment fund. As of September 1999, RDS has provided microfinance services in 812 villages from 52 branches of IBBL. A total of Tk.<sup>12</sup> 243.58 million was disbursed at 12 percent rate of return<sup>13</sup> to 23,184 clients (organized in 7,012 groups and 1,733 centers) with a recovery rate of 99 percent. IBBL also manages the

<sup>11</sup>The information provided in this section is based on a field survey on Rural Development Scheme and interviews with officials of Islami Bank Bangladesh Limited.

<sup>12</sup>Taka (abbreviated Tk.) is the currency of Bangladesh (1US\$ =51Tk. in 1999).

<sup>13</sup>The 12 percent rate of return is broken down as bank profit (6 percent), supervision charge (4 percent) and risk fund (2 percent).

Islamic Bank Foundation (IBF), a fund created from *zakat*, charity donations, and income of the bank that cannot be included in profit of the bank.

In line with the social dimension of its operations, the objective of RDS is to eliminate rural poverty through community development approach. The target group of RDS is the rural poor, defined as the landless or those households having less than 0.5 acres of cultivable land. Other than providing finance for microenterprises to generate income, RDS also focuses on health, sanitation, and education of its beneficiaries. The dominant mode of financing used by RDS is *bai-muajjal* (deferred-price sale). The scheme uses the group-based format of the MFIs outlined above. Small amounts (ranging from Tk. 3,000 to Tk. 25,000) are given to individuals and repaid back in small weekly installments. No physical collateral is required for obtaining funds. Instead, social collateral is introduced by forming groups and centers. The clients save Tk. 5 per week as personal savings and have to give Tk. 1 per week for the center fund. Note that 2 percent of the 12 percent rate of return charged goes to a risk fund that is used repay installments of beneficiaries facing unusual problems and in case of emergencies.

Like Islamic MFIs, RDS deals with the family via the women. The Islamic approach of targeting the family and using Islamic modes of financing eliminates to a large extent asymmetric information problems arising in conventional microfinancing. As mentioned earlier, this approach mitigates the adverse selection and moral hazard problems resulting from the fact that the intended use and user are different from the actual use and user of funds. As Islamic modes of financing involve a real transaction, the moral hazard problem arising from the use of funds for purposes other than those intended is also eliminated. The other elements of the operations of RDS are discussed below.

#### ***a) Profitability/viability***

Figures in Table 3 below, shows the cumulative accounts of RDS up to December 31, 1998 will form the basis for discussion on RDS profitability. Note that only variable costs, that is expenditure by the field supervisors and their expenses (including depreciation of motor cycles, fuel costs, and other related expenditures) are incurred by RDS. The fixed costs of rent and utilities and other fixed costs like furniture do not

appear as RDS operate from the bank branch premises and do not have to pay for these.

**Table 2: Income and Expenditure of RDS up to December 31, 1998**

<b>Income</b>	<b>Amount (in millions)</b>
Income from Investment (at 6% RR)	Tk. 7.377
Income from Supervision Fund (at 4%)	Tk. 5.037
Amount of Risk Fund (at 2%)	Tk. 2.508
<b>Expenditure</b>	
Salary of Field Supervisors	Tk. 6.558
Other Operational Costs (Depreciation of Motor cycles, fuel costs, etc.)	Tk. 1.422
Salary of Project Officer	Tk. 3.876
(Opportunity) Cost of Funds (Tk. 64.4 million at 7.07 at percent)	Tk. 4.553

If all the items of income and expenditure in Table 2 are used to calculate the profit of RDS, it appears to be operating at a loss. This figure, however, may be misleading due to the following factors.

i) The rate of return charged by RDS (i.e. 12 percent) is lower than most MFIs that have rates of return/interest rate in the range of 16-55 percent.<sup>14</sup> By charging a lower rate of return than the market rate, RDS is essentially subsidizing the microentrepreneurs. As a result, the income from investments is relatively lower than that of MFIs.

ii) A major part of the expenditure is due to salary of the project officer. The project officer, however, devotes only a part of the time for RDS activities as he is an officer of the bank overlooking the activities of RDS. Payment of full salaries to the project officer is an over-estimation of the expenditures for RDS.

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<sup>14</sup>For example Grameen Bank charges an interest rate of 20 percent. Al-Fallah, Noble, and Reescue three Islamic MFIs operating in Bangladesh charge a rate of return of 16 percent. Morduch (1999) reports that Badan Kredit Desa, Indonesia and BancoSol, Bolivia charge nominal interest rate of 55 percent and up to 50.5 percent respectively.

iii) The opportunity cost of funds used in microfinancing is calculated at an average of 7.07 percent given to depositors of IBBL. This may, however, be misleading due to the following reasons. First, IBBL, like other Islamic banks, has a large amount of liquid funds due to the lack of Islamic money market instruments. In 1998, cash held by IBBL was Tk. 8,247.8 million making the RDS disbursements only 0.47 percent of it. Second, the amount needed for microfinance is miniscule compared to the total assets of IBBL. In 1998, disbursement of Tk. 39.1 million to the rural poor under RDS is only 0.13 percent of the IBBL's assets (of Tk. 30843.9 million). Given these facts, the opportunity cost of using the funds for microfinancing is close to nil.

Given the above qualifications, different scenarios regarding the profitability/viability of RDS can be arrived at. These are summarized in Table 3.

**Table 3: Profit/Loss of RDS under different Assumptions (in millions of takas)**

	<b>Income</b>	<b>Expenditure</b>	<b>Profit</b>
<b>Case 1:</b> Total income - total expenditure	14.922	16.409	-1.487
<b>Case 2:</b> Adjusted Exp. (less opportunity costs of funds)	14.922	11.856	3.066
<b>Case 3:</b> Adjusted Exp. (less Project officers salary)	14.922	12.533	2.389
<b>Case 4:</b> Adjusted income (16 percent rate of return)	19.896	16.409	3.487
<b>Case 5:</b> Adjusted income & expenditure (Cases 2 & 4)	19.896	11.856	8.04
<b>Case 6:</b> Adjusted income & expenditure (Cases 3 & 4)	19.896	12.533	7.363
<b>Case 7:</b> Adjusted income & expenditure (Cases 2, 3, & 4)	19.896	7.98	11.916

When expenditures on all heads are included (salaries of project officer and opportunity cost of funds) then RDS incurs a loss of Tk. 1.487 million. As mentioned above, however, the funds are provided to beneficiaries at below the market rates and couple of expenditure heads cannot be directly charged to RDS. When these adjustments are made, RDS operates at positive levels of profit. Different cases involving these adjustments are possible. If the cost of fund is excluded (as the

opportunity cost of these funds are close to zero), then RDS operates at a profit of Tk. 3.066 million (Case 2 in Table 3). Similarly, when salaries of project officers are excluded (as they work only part-time for RDS) the scheme earns a profit of Tk. 2.389 million (Case 3).

On the income side, note that the income figure is based on a rate of return of 12 percent. To cover all the expenditures during the period (including cost of capital and project officers' salaries), the breakeven rate of return is estimated at 13.2 percent. The rate of return charged by RDS is much lower than that charged by other MFIs. If the income of RDS is calculated at a lowest rate of return of 16 percent charged by other Islamic MFIs, then the profit with this rate of return under different assumptions of expenditures are shown in Cases 47. Note that RDS would operate on profit in at 16 percent rate of return that even when the cost of funds and salaries of project officers are included (case 4). The largest profit is derived when all the adjustments in costs and income heads are made (Case 7).

#### ***b) Quality of Service***

Quality of service provided by RDS will be much better than Islamic MFIs due to several reasons. First, the IBBL can attract better employees as they offer a better benefit package. Not only do field supervisors get better pay, but they also get other benefits associated with working in an established financial institution. Second, all employees in the RDS are trained at the Islami Bank Training Academy at no extra cost to them. The high quality in-house training provided by professionals in the training Academy improves the skills of the workers increasing their productivity. Third, the field level workers can perform their banking services more efficiently due to better logistics support. For example, whereas field workers of most Islamic MFIs use bicycles to go to the weekly meetings and visit beneficiaries, those of RDS use motorcycles. Forth, RDS employs sufficient workers to keep an ideal employee/beneficiary ratio. This helps them to monitor clients and supervise the funds more efficiently. Fifth, as RDS is not dependent on external sources for funds, it can frame its program in a manner that is suitable to the beneficiaries. For certain activities, an installment repayment scheme that correspond to the income stream of the funded activity can be arranged. This practice does not burden the beneficiaries when there is no income generated from the investment.

### ***c) Complementary Poverty Reduction Program***

RDS has been successful in integrating other support programs along with the microfinance scheme. As mentioned earlier, poverty induces people to divert funds to consumption and purchase of other assets. RDS uses funds from Islami Bank Foundation for a complementary program for asset building. The clients can obtain interest-free loans (*qard-hassan*) from this fund to buy assets (like tube wells) and housing. This not only builds the asset base of the beneficiaries but also affects the repayment rate positively as funds are not diverted for non-productive purposes. Furthermore, as default and arrears disqualify beneficiaries to avail of interest-free loans, this facility acts an incentive for them to repay the installments on time.

## **7. Conclusion**

A distinguishing feature of Islamic banks is the social role in its operations. As microfinancing enables the increase in income and wealth of the poor, it is considered a new paradigm to poverty alleviation and bring about development. The paper argues that the social aspect of Islamic banks can be best realized by financing the poor microentrepreneur. The paper contends that Islamic banks can provide microfinancing by avoiding some problems faced by conventional and Islamic MFIs. Theoretical arguments are given to show that microfinance can be provided to the poor more efficiently and effectively by Islamic banks than MFIs. Well-established Islamic banks can benefit from their scales of operations. As Islamic banks do not depend on external sources, their microfinance scheme can adapt to cater some special needs of the beneficiaries. Islamic banks can also operate a complementary support program along with microfinancing to target the core poor.

The paper presents a strong case for Islamic banks to facilitate wealth creation of the poor through involvement in microfinancing. As more and more conventional banks begin to provide Islamic financial services, the 'spirit' of Islamic banks reflected by its social role will distinguish Islamic institutions from non-Islamic one. Contrary to what one would believe, the paper shows that implementing the social function by financing the poor will not be a burden to Islamic banks financially. Instead, Islamic banks are predisposed to provide microfinance in a "win-win" situation. That is, Islamic banks can operate microfinance programs at no extra cost and improve the

economic conditions of the poor. Experience from RDS of Islamic Bank Bangladesh Limited supports this assertion.

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