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REVIEW OF CURRENT PRACTICES OF ISLAMIC MICROCREDIT AND MICROFINANCING IN SELECTED MUSLIM COUNTRIES

Norma Md Saad*, Dzuljastri Abdul Razak & Abdul Rahim Abdul Rahman***

ABSTRACT

Poverty is a major problem in most of the developing countries and majority of the governments of these countries have initiated some forms poverty alleviation programs to reduce poverty level in their respective countries. Studies have shown that microfinance is proven to be an effective tool to fight poverty in many developing countries, including Muslim countries. This study reviews the current practices of microcredit and microfinancing in several Muslim countries namely Malaysia, Bangladesh, Indonesia, and Sudan. The methodology used in this research is mainly literature survey. This study finds that Islamic microfinance industry is not yet well developed in Muslim countries. Indonesia, for example, has thousands of Islamic microfinance institutions operating in this country, however, many of those institutions have still not performed well and incurred losses in their operation. The study is only a preliminary research and the findings of this study will hopefully provide focal areas for further research in the near future.

1. INTRODUCTION

Poverty has become a serious problem for most of developing countries. According to Rural Poverty Report 2001 in Peck (2005), there are 1.2 billion people who are extremely poor surviving on less than $1 a day. Extremely poor people spend more than half of their income to obtain (or produce) staple foods. Most of these people suffer from nutritional deficiencies, and many suffer from hunger at certain times of the year. Within this community, one child in five will not live to see his or her fifth birthday (Barr, 2005). Considering the importance of resolving poverty problem, United Nations (UN) has announced the Millennium Development Goals which one of its aims is to cut the proportion of the poor to half by 2015.

According to Yunus and Abed in State of Microcredit Summit Campaign Report 2004, microfinance is an effective tool to alleviate poverty. This argument has been proven by many researches such as Khandker (2003), Gertler, *et al.* (2003), Park and Ren, (2001) through the success of several microfinance programs around the world, such as Grameen Bank in

* Associate Professor, Kulliyyah of Economics and Management Sciences, International Islamic University Malaysia, P. O. Box 10, 50728 Kuala Lumpur, Malaysia.

** Senior Academic Fellow, Kulliyyah of Economics and Management Sciences, International Islamic University Malaysia, P. O. Box 10, 50728 Kuala Lumpur, Malaysia.

Bangladesh, Bank Rakyat Indonesia in Indonesia, Amanah Ikhtiar Malaysia in Malaysia, CARD in the Philippines, FINCA and ACCION in Latin America, and other microfinance institutions all over the world. Considering the ability of microfinance in eradicating poverty, United Nation has decided to include it in the list of potential contributions to achieve the Millenium Development Goals set for 2015 to cut half the number of people living in poverty.

According to Dhumale and Sapcanin, (1999), there are many elements of microfinance that can be considered consistent with the broader goal of Islamic banking. At the very basic level, the disbursement of collateral-free loans in certain instances is an example how microfinance share common aims. This argument was strengthened by Sergado (2005). In his opinion, both Islamic finance and microfinance seem to be surrounded by a "fashionable aura" in Muslim developing countries where banks, financial institutions, microfinance institutions (MFIs), and non-governmental organizations (NGOs) are very interested in the issues of fighting poverty. He also notes that there is a considerable interest on Islamic microfinance because microfinance is a very flexible tool, whose models can be replicated but required to be tailored to the local socio-economic and cultural characteristics. The potential demand for tailored microfinance services is still largely unmet, especially in countries where the majority of the population is constituted by Muslims. However, the development of Islamic microfinance is far behind the development of Islamic bank. The development of Islamic microfinance should be supported because microfinance has dual functions; first, as financial institution and second, as development institution.

This study aims to review the current practices of microcredit and microfinancing in several Muslim countries namely Malaysia, Bangladesh, Indonesia, and Sudan. It reviews current existing literature on microfinance and Islamic microfinance.

2. MICROFINANCE AND POVERTY ALLEVIATION

Vento (2004) identifies microfinance as the supply of financial services which sometimes called microcredits to poor people in order to finance very small businesses that produce a return which can improve the life quality of the producer and of its family. Similar definition of microfinance comes from Barr (2005). He defines microfinance as a form of financial development that is primarily focused on alleviating poverty through providing financial services to the poor. However, Barr (2005) argues that microfinance is different with microcredit. In his opinion, microfinance has broader activities other than just lending money to the poor. Microfinance also provides other services including insurance, transactional services, and importantly, savings. This statement is supported by Ferro (2005). In his opinion, microfinance and microcredit is a different thing. While on the one hand microfinance stands for the provision of a broad range of products to small-sized enterprises, the term microcredit focuses more on small loans to low-income clients. However, Fernando *et al.* (2004) note that the term microcredit itself also has changed. Microcredit now encompasses not just small working capital loans for micro entrepreneurs and income-generating activities but also such purposes as consumption smoothening, housing improvements, and payment of school fees.

Regardless of various definitions of microfinance and microcredit, this system is important for financial development (Barr, 2005) and it will become the backbone of the financial system (CGAP, 2004). Microfinance Institutions (MFIs) are special financial institutions that have both social nature and for-profit nature (Vento, 2004). It can play the role as financial institutions as well as development institutions (Koveos, 2004). Therefore, it can be a powerful tool to fight poverty. Access to financial services such as savings, credit, transfers, payments, and insurance can help poor people take control of their financial lives. When good practice is applied, access may empower them to make critical choices about investing in businesses, sending their children to school, improving health care for their families, covering the cost of key social obligations such as marriages, and protecting themselves from crises like sickness, death, and natural disasters (CGAP, 2004).

Although partly ignored by conventional financial institutions, microfinance is currently showing its potentials and funding microfinance projects has become a priority for international donors as well as for national governments, private companies and philanthropic organizations (Ferro, 2005). There are several reasons why financial institutions are not interested with microfinance, such as the real profitability of microfinance, the high risk posed by small and short term lending operations and the widespread belief that the poor are poor because of their lack of skills. Further, it is very hard for financial institutions especially in less developed countries to overcome the social and cultural barriers in providing microfinance services (Ferro, 2005). Nevertheless, the development of microfinance institutions still gets strong support from many parties. Even, 28 members of Consultative Group to Assist the Poor (CGAP) have defined a vision for the future of microfinance: a world in which poor people everywhere enjoy permanent access to a wide range of financial services, delivered by different types of institutions through a variety of convenient mechanisms (CGAP, 2004).

Despite having unresolved problems, microfinance institutions worldwide have shown astonishing development (Microcredit Summit Campaign Report, 2004). This is possible because microfinance has received support at global, regional and country levels. Moreover, more active involvement of central banks in the industry has increased diversity of service providers and operational modalities, expanded the traditional, rigidly defined target group to include hitherto excluded segments, increased level of commercialization and greater polarization of service providers of microfinance industry (Fernando *et al.*, 2004). Lastly, although commercialization of microfinance service have been criticized by many parties, it allows microfinance institution to get greater opportunity to fulfill their social mission to serve the poor, and has encouraged some of the MFIs to adopt business-like approaches to their operations.

3. CHARACTERISTICS OF MICROFINANCE

Nowadays, microfinance institutions can be found in most countries in the world even in developed countries. Although microfinance products look different in every different region, there are some unifying characteristics that allow a program to be considered as microfinance program (Magiano, 2006). These characteristics are:

1. Lack of substantial amounts of collateral. Most programs use social collateral to recover loans. Pressure from within the group that has received the loan as well as the larger community to pay back the loan encourages repayment in the absence of physical collateral. Often this social collateral is reinforced with token amounts of compulsory savings and insurance.

2. Group lending. Most microfinance organizations have a group-lending component. Instead of a loan being distributed to an individual, a block of funds is distributed to a group of entrepreneurs who distribute the money and then the whole group pays the money back. In most cases each member is explicitly responsible for a certain amount of money, however, in the case of nonpayment the whole group is responsible for re-payment.
3. Small amounts of capital paid back within a short time frame. Microfinance organizations specialize in small loans that are paid back quickly and turned over.

According to Vento (2004), microfinance services usually consist of small loans with short term maturity, mostly oriented to finance working capital (but also longer term plants), repaid in very short-term installments (weekly, monthly, but also daily), to poor people with lack of collateral to offer. In many developing countries, microfinance usually charge higher repayment rate than the one in formal financial sector.

According to CGAP (2004), microfinance or financial services for the poor encompass savings, credit, payment and transfer services, and insurance. Providers of microfinance services can be nongovernmental microfinance institutions, savings and credit cooperatives, commercial banks, community-based organizations with bank linkages, insurance companies, state banks, and others. Vento (2004) provided the distinctive features of microfinance in Table 1.

Table 1
Distinctive Features of Microfinance

Microfinance Suppliers	*Source of Funds*	*Services Offered*	*Microfinance Demanders' Characteristics*
NGO Credit Unions Microfinance banks Commercial banks	Other people's money Member's Public Money	Microcredit Microleasing Microinsurance Deposits	Small "unbankable" producers lack of guarantees, low income

Source: Vento (2004)

Although products of microfinance look similar to those of conventional bank, in some parts of its operation, the operational of microfinance and conventional banks is definitely different. Unlike conventional banks that run with profit maximizing orientation, many microfinance institutions are more concerned with social orientation to alleviate poverty. Therefore, microfinance includes social educational programs in their activities and helps their clients increase their capacity. Ahmed (2002) described the differences between conventional banks and microfinance institutions as shown in Table 2.

Although a large numbers of microfinance institutions in the world have many problems, there are several microfinance institutions that have achieved significant success in assisting the poor people. For example, the Association for Social Advancement, BRAC (formerly known as the Bangladesh Rural Advancement Committee), the Grameen Bank, and Proshika, which together provide credit to 11.5 million households in Bangladesh. In Latin America, CrediAmigo, a microfinance program operated by Banco do Nordeste in Brazil, has provided 300,000 poor households with access to microfinance. In Kenya, the Equity Building Society has grown to 250,000 depositors over the last decade while Bank Rakyat Indonesia (BRI) serves over three

Table 2
Comparison Between Conventional Banks and Microfinance Institutions

Conventional Banks	*Microfinance Institutions*
A profit-maximizing firm	Non-profit government / non-governmental organization
Financial intermediary between savers and investors in the economy	Funds from external sources provided to the poor
Deposit forms the bulk of the liability	Saving (forced) of the client only deposits
Does not include social/educational programs	Include social/educational program
Physical collateral required to get funds	Social collateral through group and center information
Clients are relatively well off	Clients are poor
Clients come to the bank	MFI goes to people
Amount of loan is large	Amount of loan is small
Capital and interest usually paid at the maturity of the contract	Capital and interest paid in weekly/monthly installment during a year
Most clients are men	Most clients are women

Source: Ahmed (2002)

million poor borrowers with $1.7 billion in loans and provides bank accounts to some thirty million low income households, who have saved an aggregate of $3.1 billion (Barr, 2005).

Morduch (1999) highlighted several successful microfinance institutions. He compares the operation, characteristics and several financial indicators of those institutions as illustrated in Table 3. Although the figures shown are not up-to-date, it still can show how those successful microfinance institutions work to assist the poor.

4. MICROFINANCE INDUSTRY IN MUSLIM COUNTRIES

4.1. Bangladesh

Bangladesh is one of the most densely populated countries in the world. Almost half of the total population is still living below the poverty line - earning less than $1 a day. Microfinance institutions play a key role in alleviating poverty in Bangladesh. The microfinance industry in Bangladesh is one of the largest in the world. Bangladeshi MFIs are best known for their pioneering, large-scale provision of microfinance services, principally tiny collateral-free loans to poor women. The four largest MFIs, Grameen Bank, BRAC, ASA, Proshika account for 86 percent of the 14.3 million active borrowers.

The development of microfinance institutions took place in several distinct phases over the last two decades. Microcredit was first initiated by Grameen Bank and was developed by a team led by Professor Mohammad Yunus. In 1980, there was a long debate which opposed micro credit concept and commercialization among development practitioners although Grameen bank has show their success. The early 1990s was a period of rapid expansion of the Grameen-style micro credit approach. In recent years microfinance institutions in Bangladesh have moved from the margins of the financial system towards the mainstream. In 2006, there are more than 1200 microfinance NGOs in Bangladesh. The increasing number of microfinance institutions makes it easier for people to move from one institution to the other. Although the number of

Table 3
Characteristics of Selected Microfinance Program

Classification	*Grameen Bank Bangladesh*	*Banco Sol Bolivia*	*Bank Rakyat Indonesia Unit Desa*	*Badan Kredit Desa Indonesia*	*FINCA Village Banks*
Membership	2.4 Million	81,503	2 Million borrowers, 16 Million Depositors	765,586	89,986
Average Loan Balance	$ 134	$909	$1007	$71	$191
Typical Loan Term	1 Year	4-12 months	3-24 months	3 months	4 months
Percent Female Members	95%	61%	23%		95%
Mostly Rural? Urban?	Rural	Urban	Mostly Rural	Rural	Mostly Rural
Group-lending contracts?	Yes	Yes	No	No	No
Collateral Required	No	No	Yes	No	No
Voluntary Savings Emphasized	No	Yes	Yes	No	Yes
Progressive Lending	Yes	Yes	Yes	Yes	Yes
Regular Repayment Schedules	Weekly	Flexible	Flexible	Flexible	Weekly
Target Clients for Lending	Poor	Largely Non Poor	Non Poor	Poor	Poor
Currently Financial Sustainable	No	Yes	Yes	Yes	No
Nominal Interest Rate on Loans (per year)	20%	47.5-50.5 %	32-43%	55%	36-48%
Annual Consumer Price Inflation	2.7%	12.4%	8.0%	8.0%	-

Source: Morduch (1999)

microfinance program is increasing in nature, the scale and performance of the microfinance sector grow slowly compared to banking system.

Acording to Bangladesh microcredit Profile (*http://bwtp.org/arcm/Bangladesh*) there are two main challenges faced by microfinance in Bangladesh. First, although microfinance program has succeeded in assisting poor people, it has been estimated that certain groups of extreme poor households do not take part in microfinance program. As a proof there are poor districts where relatively few microfinance institutions operate in that area. Second, microfinance institutions in Bangladesh still have minimum coverage. More than 80% of microfinance-NGOs in Bangladesh have less than 5 branches. There are only two microfinance-NGOs in Bangladesh that have operation in more than 50 branches.

Even though microfinance programs in Bangladesh have shown significant impact on the country's economic development, there is lack of regulations that regulate these programs. NGOs offering microfinance in Bangladesh are not regulated or supervised either by the central bank (Bangladesh bank) or any regulatory agency, except in the case of Grameen Bank. Although microfinance institutions suffer from regulatory weaknesses, there have been few incidents of scandal or debacle in the microfinance-NGO sector. The government of Bangladesh is considering in designing an appropriate regulatory framework in view of financial condition and structure of local microfinance, the roles of microfinance within the financial services industry, and the capacity of the regulating entities to administer external regulation and supervision effectively.

As the basic principle of microfinance activity, microfinance in Bangladesh offers small amount of loans to their client. Loans are given around $15 to $160. However, members may take larger loans after repaying their first loan. Microfinance also offers saving opportunities for their borrowers. Thirty percent of microfinance source of funds comes from members savings. In BRAC, a member can save in three ways: own savings, compulsory savings and current account savings. Grameen bank even has many savings products that include personal savings, special savings, Grameen pension scheme, time deposits, savings scheme in which the amount deposited doubles in seven years, and fixed deposits with monthly income. On average, most microfinance NGO offer 5-6% interests on deposits from their members. Microfinance in Bangladesh are offering insurance products, especially life insurance to existing credit and savings clients. There are various kinds of products offered under life insurance and social services program by microfinance institutions such as health insurance, life insurance, credit insurance, property insurance, crop insurance, etc. Interestingly, some microfinance institutions offer services for business planning & management, entrepreneurship development, basic accounting and cash management, product diversification, innovation, and research. Some others offer services in the area of marketing outlay, production center, promotional activities, and infrastructure support, while some microfinance work in the areas of group formation, raising awareness, leadership development, linking/networking, and information sharing.

The major sources of funds for MFIs in Bangladesh are internal savings of members (micro saving, sponsor's equity), interest and service charge, loans from national agencies especially from The Palli Karma-Sahayak Foundation (Rural Employment Support Foundation) or PKSF, and external donor grants. A good trend showed by microfinance institutions in Bangladesh is that the external source of fund had decreased from 30.4 percent in 1997 to only 10.7 in 2004. This fact implies that MFIs are becoming more independent of donor compared to before.

In Bangladesh, there are four categories of service providers which provide microfinance services namely microfinance-NGOs, specialized institutions, banks or formal financial institution, and administrative ministries or divisions. Six national commercial banks which provide microfinance services under formal financial institutions category specialize in agriculture. In addition, some private commercial banks also provide similar kind of service. With enforcement from government, national commercial banks spread all over the country to expand economic activities targeting poverty alleviation. In 2005, these banks have provided credit to 2.25 million beneficiaries through direct programs. The cumulative disbursement of loans by these banks by December 2003 was about $150 million.

There are only two institutions in Bangladesh which can be considered as specialized institution that offer microfinance services, namely Grameen Bank and Bangladesh Rural Development Board (BRDB). Grameen Bank was established in 1983 by an ordinance but it started its activities in 1976 as an experimental project. It offers loan especially to women and works in more than 57,000 villages across the country with 1658 branches. Grameen Bank has been able to reach 5.3 million poor of whom 95 percent among them are women. The Grameen bank model has been replicated in several countries around the world. Bangladesh Rural

Development Board (BRDB) is the largest microcredit provider run by government. BDRB works through cooperatives and non-formal group network throughout the country with financial and technical support from the Government of Bangladesh and development partners. The target groups of the program include small farmers, women and men without assets. Family planning, health and education programs are also included in the credit and training activities. BRDB has disbursed $520 million to 102,342 cooperative societies/groups and about 3.6 million members in 2004.

There are several common microfinance-NGOs in Bangladesh: BRAC, ASA, Proshika, BURO Tangail, CHARITAS, and Society for Social Services. BRAC was established in 1972 as an NGO and started its microcredit program in 1990. BRAC has disbursed $2.28 billion to its clients which 98 percent of them are women. In 2004, total borrowers of BRAC were about 4.5 million. BRAC estimates that it contributes more than 1 percent to the GDP of Bangladesh. ASA was established in 1978 and started its microfinance activity in 1991. At the end of the year 2004, the number of members in ASA stood at nearly 3.0 million and it has disbursed $1,692.05 million. Proshika, was established in 1976 and matches member savings with credit and provides technical and marketing assistance whenever needed. It uses group formation and consciousness raising, rather than service provision. Currently, Proshika works with nearly 2.75 million men and women members, drawn from rural and urban poor households. BURO (Bangladesh Unemployment Rehabilitation Organization) Tangail has been involved with innovative microfinance programs since 1991. At the end of 2004, BURO, Tangail had disbursed loans of $74.70 million to 155,819 borrowers. During the same period, it has $11.54 million in outstanding loans and $13.50 million in revolving loans. CARITAS also started its operation in Bangladesh in 1976. Caritas is one of sixth largest microfinance-NGOs in Bangladesh in terms of cumulative disbursement, net savings, outstanding borrowers, active membership and revolving loan fund and seventh in terms of outstanding loan amount. In 2004, its cumulative microcredit disbursement, net savings, outstanding loan amount and revolving loan fund are $68.87 million, $390.14 million, $699.31 million and $919.878 million, respectively. Its total outstanding borrowers are 248,947 and active membership is 347,857 during the aforementioned period. Society for Social Service (SSS) was established in 1986 and has since been operating for rural microcredit, urban microcredit, credit for rural enterprise development, agriculture, rural house building etc. In 2004, its cumulative disbursement is $52.39 million with outstanding borrowers of 106,998 and active memberships of 133,404. Its outstanding loan amounts to $7.30 million and net savings of $3.74 million.

Government administrative units also play a role in development of microfinance sector in Bangladesh. There are thirteen ministries and fifteen divisions of the government of Bangladesh that have been carrying out microfinance activities. It is estimated that 15 percent of the clients of the microcredit program have benefited through programs of these units. The cumulative disbursement of loan by these units amounts to $933.4 million by December 2004. The recovery rate is about 83 percent. Ministry of Rural Development and Cooperative provides the highest amount of credit- the cumulative disbursement of the ministry was about $540 million in December 2004.

Although many literatures explore the success of microfinance system in Bangladesh, there are not many literatures which inform the existence of their Islamic counterpart. This research only found one literature written by Ahmed (2002) which analyzes the performance of three Islamic microfinance institutions in Bangladesh namely Al Fallah, Aan Unnayan Sangstha, Noble Educational and Literary Society, and Rescue. However, there are not many detail information about the activities of these institutions and other Islamic microfinance institutions especially in Bangladesh.

4.2. Pakistan

The development of microfinance in Pakistan is relatively new compare to other countries in South and South East Asia. Micro-finance has been an important aspect of poverty alleviation strategy of the NGO sector since the 1980s. Several institutions in Pakistan develop cooperation with international institutions to alleviate poverty in this country. For example, the Pakistan Poverty Alleviation Fund works with the World Bank and the Khushali Bank work with Asian Development Bank. The other institutions which offer microfinance service in Paksitan are Bank of Khyber, Tameer Microfinance Bank, National Rural Support Programme and Kashf Fondation (Oxford Management Policy, 2006). These institutions use public and private funds and operate regionally as well as nationally. Several institutions such as Tameer Microfinance Bank focus its operation initially in urban areas.

Since microfinance sector in Pakistan is relatively new, the client base of this industry is also relatively small which is about 0.5 million customers in 2005. The main services of microfinance industry in Pakistan are loan and saving. In the last few years, there has been a rapid growth of microfinance sector in Pakistan. The number of borrowers of microfinance institutions under the Pakistan microfinance networks is about 141,874. Although the accuracy is questionable, an earlier study (Hussein and Hussain, 2003) estimated that the main NGOs in the micro-finance sector had disbursed Rs 8.9 billion ($ 131.9 million) by the end of June 2002 to over 700,000 clients. The total number of microfinance borrowers in Pakistan as compiled by Hussein and Hussain is 381,874 (2003).

In order to enhance the development and performance of Pakistan microfinance sector, Oxford Management Policy (2006) has given several recommendations that the government should focus on. The recommendations cover the following issues: regulation of microfinance should be by function not institution, special tax structures for microfinance, evaluation of subsidies to microfinance, poverty monitoring and evaluation, evaluation of restrictions on loan size , the definition of eligible borrowers , interest rates, services to rotating savings and credit associations (ROSCAs), and broadening the policy dialog. The government of Pakistan through the Minister of Finance has also developed the Microfinance Sector Development Program (MSDP) with the objective to create a conducive policy environment allowing new players to emerge and to allow greater space to existing players, to develop appropriate financial infrastructure, promote and strengthen microfinance institutions, to develop linkages with NGOs and community organizations, to invest in building social capital, to mitigate the risks faced by poor households, and to develop institutions which would enhance the capacity and efficiency of those involved in the sector. By launching this program, the government hope that the performance of microfinance sector in Pakistan can be enhanced.

Compared to other countries in South Asia, several categories of microfinance sector in Pakistan is better than other countries. For example, in terms of productivity (measured by borrowers per staff member), the productivity of microfinance in Pakistan is better than in Afghanistan, Nepal and Bangladesh. However, the productivity of microfinance in Pakistan is still slightly behind those of India and Sri Lanka. In terms of efficiency (measured by cost per borrower), Pakistan perform significantly less well than any of its neighbors except Afghanistan. The write off ratio of microfinance in Pakistan is rather higher than its neighbors especially for the ratio of loans with more than 30 days over due where Pakistan's ratio is twice as high as any neighboring countries. In addition, in terms of financial performance measured by financial revenue, Pakistan is the worst performing country in South Asia.

4.3 Sudan

Sudan is the largest country in Africa. However, this country is included among 13th lowest countries in term of Human Development Index. The poverty level in Sudan is above 90%. This country suffers from political instability, bad governance, and fragile civil society structures. Women and children in this country are hit by conflict and they lack health and basic education, employment opportunities, sustainable livelihoods and food security.

Considering the high number of poverty in Sudan, people try to look up to the microfinance system which have been successful in alleviating poverty in other countries. Nowadays, the supply of microfinance in Sudan is extremely small compared to the demand for these services. Formal banking system is not design to serve the financial needs of the poor. Moreover, there are limited financial products that are available and appropriate to the needs of the poor. Although banking system in Sudan uses Islamic financial system as a single monetary system, the dominant products of banking industry are short term and sales based modes of finance (murabahah-purchase and resale plus profit margin) and salam (forward crop financing). These products have relatively higher cost of financing and are limited to production cycle. Therefore, it does not give much benefit to the poor.

There are several limitations to the current microfinance system in Sudan. For example, there is lack of strong institutions which are able to attract savings, recycle them into loans and provide other financial services needed by the economically active poor in a sustainable manner. There is no coordination between institutions offering microfinance services especially with other institutions which have different mandates (banks, NGOs, social funds, and rural development projects). Performance as microfinance providers is limited by the widespread perception that the loan is a gift and by the associated resistance to the shift from grants to a market oriented approach. Microfinance sector in Sudan also suffers from lack of exposure to worldwide microfinance good practices together with lack of training in microfinance facilitation and management. There are constraints in microfinance management service in managing and operating programs that effectively and efficiently providing microfinance services to the poor. Furthermore, the training and experience of commercial banks is unsuitable for servicing poor clients and there is lack of information on the credit history of the microfinance prospective clients.

To work out of the limitations above, El Mahdi, Managing Director of Unicons Consultancy ltd (2006), promotes major strategies to develop sustainable microfinance institutions in Sudan. That strategies consist of promoting efficiency and self sufficiency goal for microfinance by building both financial and managerial capacities, financial capacity building focusing on improving microfinance absorptive capacity and ability to attract greater funds, increase the number of loans disbursed and encourage savings, expand their clientele base etc, managerial capacity building focus on the institutional and human resources of the microfinance institutions, and promote efficient management that emphasizes the use of diagnostic and management tools for performance monitoring and transparent reporting while instilling a culture of accountability. EL Mahdi also suggests that the central bank of Sudan establish a supportive infrastructure for microfinance sector. For example, the central bank should develop the supportive information base, create a database on microfinance activities as a necessary requirement to inform policy makers, regulators and the donor community, establish an Information Credit Bureau (ICB), and support the establishment of an umbrella organization such as Apex Institution (Institutions that act as central bank for microfinance).

4.4. Malaysia

Microfinance is one of the strategies of the New Economic Policy (NEP) which was launched by the Malaysian government to reduce poverty and income disparities in Malaysia. Malaysia has several models of microfinance program. The biggest microfinance institution in Malaysia is Amanah Ikhtiar Malaysia (AIM) which is the replication of Grameen Bank model in South East Asia. Beside this institution, public institutions such as agriculture bank (Bank Pertanian), as well as the Credit Guarantee Corporation (CGC) also provide lending to small and medium enterprises (SMEs). However, the loan sizes of these institutions are somewhat above the conventional microfinance.

The banking sector in Malaysia does not put much interest on microfinance. According to McGuire, *et al.* (1998) the central bank, restricted the spread between the base and maximum lending rates in the commercial banking system to 4 percent, less than what would be required to cover the extra costs associated with microfinance lending. In the case of some loans guaranteed by CGC the permissible spread was only 2 per cent, reinforcing this effect. Therefore, getting involved in microfinance activity is difficult for commercial bank as well as other institutions. However, AIM, as the government link institution has been successful to help government in alleviating poverty in Malaysia. Grant received from the Malaysian government is one of the success factors that make AIM successful in assisting the poor people in Malaysia.

In 1998, AIM had given out 103,000 loans and disbursed a total of RM 328 million ($100.5 million). As of September 2006, AIM had 157,787 members and had disbursed a total of RM1.8 billion ($488.5 million) worth of loans. AIM's activities have been directed mainly, but not exclusively to the alleviation of poverty among poor Malays. In 1994, AIM had some 6,100 Grameen like groups in operation with a total membership approaching 30,000 borrowers. In Malaysia, because of the sensitivities of its Muslim clients and sponsors, AIM use 'service charges' on loans rather than interest expressed in percentage terms. For example, the average loan size for borrowers taking a third loan in 1994 was RM1,044 ($427) for which the service charge equated to around 4.7 percent flat over the usual one year loan term. For all classes of loans, service charges covered only a portion of AIM's lending costs (Conroy, *et al.*, 1995). About 60 per cent of AIM's operational costs between 1989 and 1995 were covered by Malaysian Government grant, while the state governments granted additional support of up to 40 per cent annually. In consequence, AIM had limited incentives to strive for self-sufficiency in its early years (McGuire, *et al.*, 1998).

In 1992, AIM had problem in expanding due to the decision of the Malaysian government to channel a grant of $7.3 million intended for loan capital over the period 1991 to 1995 through YPEIM, an Islamic foundation. YPEIM, however, decided to program the disbursement over a much longer period, and it caused a serious cash flow problem and undermined AIM's plans for expansion and the achievement of viability (Sukor Kasim 2000). AIM also experienced a loss of direction when they disbursed loan to the not so poor and non poor. AIM's decision to enlarge loans size and disbursement to better-off borrowers caught the attention of its evaluator which was concerned about the implications of this development for credit discipline and portfolio quality. By the end of 1998, portfolio at risk (PAR) had risen to 3 per cent (Sukor Kasim 2000) and by the end of 2000, the PAR of the whole AIM program with RM100 million outstanding had increased to 10 per cent. These are levels which indicate grave problems for the AIM program. In 1997 AIM decided to break with its early practice by raising the interest rate on loans to a uniform 19 per cent (Conroy, 1998). Not only was this a substantial increase, it also expressed borrowing cost as a percentage of principle for the first time. Although this decision is good for AIM in order to reach its sustainability, this policy did not put the poor as the beneficiary because the interest charge is unacceptable. AIM has however reduced the rates to 18% in 2000, 12% in 2002, and 4% in 2003 and 2004. Beginning the year 2005, AIM has fixed the interest rate charged to each loan at 10%.

4.5. Indonesia

Indonesia had been successful in reducing the size of its population living in poverty from 70 million in 1970 to 27 million in 1990 (from 60% to 15%). However, this progress in poverty alleviation slowed down in the early 1990s and it was destroyed by the currency crisis of 1997 and 1998. The microfinance sector in Indonesia is made up of a high variety of institutions, programs, services, and legal, regulatory and supervisory frameworks. Promotion of Small Financial Institutions (PROFI) divides the microfinance sector in Indonesia into three categories namely Institutional Microfinance, Program Microfinance, and Individual Microcredit. Table 4 show the list of institutions and programs which are actively involved in microfinance sector in Indonesia.

Microfinance institutions in Indonesia consist of commercial banks and people's credit banks (BPR) that are subject to the banking act and regulated by the Central Bank (Bank Indonesia), local non-bank financial institutions that are regulated by the Ministry of Home Affairs and provincial governments, cooperatives that are subject to the cooperative law, pawnshops that are regulated by the Ministry of Cooperative and Small Medium Enterprises, and non-regulated local organizations such as savings and credit associations. Microfinance program includes poverty alleviation projects that have established mechanisms of extending microcredit to poor target groups, social safety net programs that have been used for channeling funds to their target groups, subsidized credit schemes that target small farmers and entrepreneurs, and microfinance programs of non-governmental organizations.

Microfinance in Indonesia is defined as the provision of microfinance services by bank and non-bank institutions that fulfills financial intermediation functions with their own products and funds. This excludes institutions that were established for the sole purpose of channeling funds to target groups as well as commercial banks and other financial institutions of which the

Table 4
Participant of Microfinance Sector in Indonesia

Institutional Microfinance	*Program Microfinance*	*Individual Microcredit*
Commercial Banks (mainly BRI units) R&S: Bank Indonesia Level: District and sub-district **People's Credit Banks (BPR)** R&S: Bank Indonesia Level: Sub-district	**Microfinance System Building** -Linkage project (PHBK) -Microcredit project (PKM) Commercial relations between banks, LDKP, NGOs, self-help groups, and individual, customers. Strengthening small financial institutions.	
Rural Credit Fund Institutions (LDKP) R&S: Provincial governments Level: Sub-district and village **Village Credit Institutions (BKD)** R&S: BRI on behalf of Bank Indonesia* Level: Village **Village Savings & Credit Units (UED-SP)** R&S: Ministry of Home Affairs Level: Village **State-owned Pownshops** R&S: Ministry of Finance Level: District and sub-district	**Poverty Alleviation Programs** -Rural Income Generation Project (RIGP/P4K) : Commercial relations between BRI and small farmer groups -Family Welfare Income Generation Project (UPPKS): Subsidized credit to family welfare groups -Sub-district Development Project (PKK): grant-based revolving fund for sub-district financial management units -Urban Poverty Alleviation Project (P2KP): grant-based revolving fund for village-level financial management units -similar regional projects	Moneylenders Traders Shopkeepers Neighbors Family members
Microfinance Cooperatives -Savings & credit cooperatives (KSP)** -Savings & credit units (USP) of coop. R&S: Ministry of Cooperatives Level: District and sub-district -Savings & credit service points (TPSP) R&S: MoC and BRI (TPSP) Level: Village	**Crisis-related channeling of funds** -Social Safety Net, i.e., PDM-DKE: grants to villages and community groups -Community Recovery Program: grants channeled through NGOs -Fuel subsidies coverted to funds channeled through cooperatives and microfinaicla institutions	
Savings & Credit Associations*** R&S: Non-regulated, apex organizations Level: Village	**NGO microcredit programs**	

Source: Holloh (2001)

microfinance activities are limited to the implementation of government credit programs. Many commercial banks are involved in microfinance activities by acting as channeling institutions for government credit programs and by cooperating with small financial institutions and cooperatives. Only a few commercial banks, however, have their own microfinance windows or were established especially for providing microfinance services.

The only microfinance window of the commercial banking sector with national significance is the sub-district level unit system of *Bank Rakyat Indonesia* (BRI). The BRI unit system is the backbone of the rural financial system, which has gained international recognition for its outreach, profitability and soundness. The BRI units were transformed into viable profit centers through the introduction of market-oriented savings and credit products. The BRI unit system is a "strategic business unit" of BRI. The units operate at the sub district level under the supervision of BRI branches at the district level, but they are separate profit centers with their own financial statements. The units' financial operations are included in the financial statements of BRI. In 2000, the 3,694 units maintained 349 service posts and 266 service points.

A typical BRI unit has a staff consisting of four to six employees, while larger ones have up to 11 employees. The basic staff is made up of a unit manager, who approves loans and is responsible for the unit's performance, a teller, an accountant, and a loan officer. Growing units employ additional loan officers based on pre-defined standards. The unit's staff is often recruited from its area of operation in order to inspire confidence and maintain close customer contact. A striking feature of the unit system is its staff incentive system. Ten percent of each unit's annual profit is distributed to employees as bonuses based on individual performance. Features such as decentralized authority and responsibility as well as giving employees a stake in performance have to be regarded as a major factor predicting the units' success. Other success factors have been simplicity, standardization and transparency in organization and management. This is particularly true for the system's accounting, supervision and financial reporting, which are functioning effectively and efficiently.

People's Credit Banks or *Bank Perkreditan Rakyat* (BPR) are secondary banks, which are also subject to the banking law and are regulated and supervised by the central bank of Indonesia. The vast majority of these institutions were established after the banking reform in Indonesia in 1988 that introduced a new classification of primary and secondary banks. BPR usually operates at the sub-district level. In 2000, there were 2,427 BPR branches. Almost all of BPR operate in Java (86%) and Bali (10%). Around 59% of the BPR were registered as limited liability companies, 38% as regional government enterprises and 3% as cooperatives. In the early 1990s the Muslim mass organization, Nahdlatul Ulama, set up Syariah BPR in cooperation with Bank Summa, which later was liquidated as a result of one of the country's biggest bank scandals. Therefore, the objective of establishing 2,000 new Syariah BPR could not be achieved. As of September 2000, only 79 of the 2,426 BPR in Indonesia operated on the basis of Syariah principles. The number of Syariah BPR had increased by only 8 institutions since March 1997. Around 47% of the 79 Syariah BPR are concentrated in West Java (17) and the greater Jakarta area (20), and 28% are located in East Java (6), South Sulawesi (6), Aceh (5) and North Sumatra. According to Bank Indonesia reports (as cited in Holloh, 2001), 39 of the 79 Syariah BPR operated at a loss as of March 2000.

Rural Credit Fund Institutions or *Lembaga Dana Kredit Pedesaan* (LDKP) is a different type of non-bank microfinance institutions operating either at the sub-district or village level. They were established on initiative of provincial governments since the 1970s and are licensed, regulated and supervised by the provincial governments. Technical assistance and supervision is usually delegated to the Regional Development Banks (BPD), which are owned by the provincial governments. The first LDKP, *Badan Kredit Kecamatan* (BKK) in Central Java, *Lembaga Perkreditan Kecamatan* (LPK) in West Java, and *Lumbung Pitih Nagari* (LPN) in West Sumatra, were established in the early 1970s. The *Lembaga Kredit Usaha Rakyat Kecil*

(LKURK) in East Java were initiated in 1979/1980. The establishment of LDKP in other provinces was mainly a result of a seminar carried out by the Ministry of Home Affairs in February, 1984 in order to disseminate the existing LDKP models to attending governors and officials from various provinces. In the following, provincial governments initiated the establishment of *Lembaga Perkreditan Desa* (LPD) in Bali, *Badan Kredit Kecamatan* (BKK) and *Lembaga Pembiayaan Usaha Kecil* (LPUK) in South Kalimantan, *Badan Kredit Kecamatan* (BKK) in Bengkulu, *Badan Kredit Kecamatan* (BKK) in Riau, *Lembaga Kredit Pedesaan* (LKP) in West Nusa Tenggara, *Badan Usaha Kredit Pedesaan* (BUKP) in Yogyakarta, and *Lembaga Kredit Kecamatan* (LKK) in Aceh.

According to the monthly financial statistics of Bank Indonesia, the total number of LDKP almost did not change between the late 1980s (1,936) and the end of 1996 (1,978). The number decreased to 1,626 in 2000 because of the conversion of LDKP to People's Credit Banks (BPR). According to the reports of Bank Indonesia' BPR supervision department, this decrease does not correspond to the real number (630) of LDKP that were licensed as BPR until March 2000. Approximately 56% of the BPR-LDKP came from the BKK in Central Java and a further 32% from the LDKP in West Sumatra, West Java and East Java. Based on the number of presently active and converted LDKP, it can be estimated that only about one quarter of the LDKP have become banks. With the exception of West Sumatra and South Kalimantan, therefore, the present significance of the LDKP industry is greatly limited to Java and Bali. With an increasing number of LDKP converting to BPR, the LDKP in Java tend to become a phase-out model. The Balinese Government has resisted the pressure to convert LPD to BPR and demands a national regulatory framework that provides room to move for non-bank microfinance institutions. The LPD makes up 57% of the presently active LDKP, and they operate with 77% of the assets and 85% of the deposits of all LDKP, though the number of households in Bali contributes only 2.4% to the total number of households in all provinces with active LDKP.

Microfinance cooperatives are defined as cooperatives that provide financial services and are licensed, regulated and supervised by the Ministry of Home Affairs. Cooperatives specialized in financial services are known as *Koperasi Simpan Pinjam* (KSP) or savings and credit cooperatives. Multi-purpose cooperatives are allowed to provide financial services, if they operate an organizationally differentiated savings and credit unit or *Unit Simpan Pinjam* (USP). *Tempat Pelayanan Simpan Pinjam* (TPSP) or savings and credit service posts operate at the village level under the umbrella KSP or USP, but they are independent organizations that are additionally supervised by BRI. The cooperative sector in Indonesia has been characterized by the dualism of formal cooperatives and a variety of informal organizations that work according to cooperative principles but refrained from adopting the legal status of cooperatives.

There is a variety of poverty alleviation programs in Indonesia with microfinance components such as Rural Income Generation Project (RIGP/P4K), Family Welfare Genertion Projects or UPPKS, Sub-district Development Program (*Program Pengembangan Kecamatan* – PKK) Urban Poverty Alleviation Project, and *Inpres Desa Tertinggal* (IDT). On the other hand, Social Safety Net, Family Welfare Genertion Projects, and the Community Recovery Program are the examples of crisis development program with microfinance component. Furthermore, there are several NGOs that are concerned with the development of microfinance in Indonesia such as *Yayasan Bina Swadaya*, Altrabaku (*Asosiasi LPSM Mitra Lembaga Keuangan dan Pengembangan Usaha*