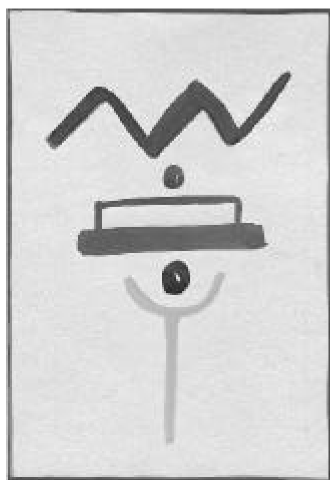

APPROACH OF MICRO-CREDIT AND INCOME-GENERATING PROJECTS FINANCED BY THE SOCIAL FUND FOR DEVELOPMENT IN YEMEN

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ECONOMIC DEVELOPMENT AND POVERTY REDUCTION WORKSHOP

Mediterranean Development Forum
September 3 - 6, 1998
Marrakech, Morocco

Approach of Micro Credit and Income-Generating Projects
Financed by the Social Fund for Development in Yemen

The Social Fund for Development (SFD) in Yemen was established in February 1997. The Fund has three components (i) Institutional Capacity Building, (ii) Community Development and (iii) Small and Micro Enterprise Development. This last unit tries to bring both non-financial and financial services -especially credit- to low income groups in Yemen. The SME wants to be a coordinating, supporting and supervisory body that is not involved in implementation of loan programs. It responds to credit proposals, appraises these requests, provides where necessary advisory, training and managerial support to the financial intermediary and monitors the technical and financial progress of the program.

Lending takes place through grassroots level organizations such as cooperatives, local and international NGOs, while the SFD provides the seed capital. It is believed that these organizations are in a much better position to assess the borrower's character and have a better understanding of the credit risk in the area. Local organizations that are interested to launch a credit scheme and to receive technical and financial support from the SFD should:

1. Be registered under Yemeni law and assume a legal entity;
2. And:
   - For income generating projects: the organization must have a financial administration or undergo a training that allows the introduction of an adequate bookkeeping system.
   - For micro finance projects: a unit is established within the organization and qualified staff is recruited to manage the projects.

The lending scheme of the SFD can be characterized as a demand led program. Any organization that meets the previous eligibility criteria can forward loan requests. After a favorable recommendation based upon an appraisal by the SME, the Social Fund and the financial intermediary sign a contract stipulating the responsibilities and duties of both parties. On the side of the financial intermediary, the NGO or cooperative will:

- ✓ Appraise the individual borrower's eligibility, character and business proposal
- ✓ Sign a loan contract with the individual members
- ✓ Disburse the loans
- ✓ Monitor and collect the loans following the details of the loan contracts
- ✓ Provide the SFD with reports about project progress and any event, which may prevent the full repayment of the loan assets to the lender.

The contract may include a grant element to subsidize overhead costs and further determines the loan amount. Responsibility of repayment of the assets rests with the financial intermediary.

The SFD credit program wants to target poor people in the local communities who have managerial capacities to implement income generating activities but lack financial resources to fully realize the proceeds of their small businesses. To become eligible to participate in the credit scheme, final borrowers:

- ✓ Have to of legal age
- ✓ Preferably have access to existing income generating activities (farming, trading, processing, etc.)
- ✓ should not be bankrupt
- ✓ has to have a good reputation
- ✓ If previously borrowed, should show a good credit history
- ✓ Should not have other debts from formal or informal credit sources.

The credit program of the SFD has the following approach:

- ✓ Free use of individual loans as long as investments are viable, character references are positive and borrowers are able to repay the loan
- ✓ Individual loan amounts are based on projects, financial situation as well as the reputation of the borrower
- ✓ There is no grace period and the lending program should yield a cost recovery income level
- ✓ Individual loans are covered by a combination of promissory notes and the joint and several liability declaration

of the borrowers

- ✓ Whenever possible, loans are released in installments and monthly repayment of the loan is recommended
- ✓ Savings generation by the members can be a part of the lending program.
- ✓ Initially only short term loans and loans to individual projects are allowed

Approaches to bring financial services within reach of the poor in Yemen.

(The first experiences of the Social Fund for Development.)

Introduction

The Social Fund for Development (SFD) in Yemen was established in February 1997. The Fund has three main components to wit Institution Building, Community Development and Small and Micro Enterprise Development. This last unit tries to bring financial -especially credit- and non-financial services to low income groups in Yemen.

Yemen is situated at the edge of the Arabian Peninsula bordering Saudi Arabia in the north, Oman in the east, the Gulf of Aden in the south and the Red Sea in the west. The republic is one of the poorest countries in the World. It has a per capita income of 306 US$.

The civil war in 1994 and the Gulf crisis have greatly affected the economy. Registered unemployment rate is 9.1%. The employment situation is further compounded by widespread underemployment. The official inflation figures for 1998 is 5%. The number of people living below the poverty line is staggering and still increasing.

The economy is being restructured under the stewardship of the Ministries of Planning, Treasury and Local Administration and supported by the International Monetary Fund and the World Bank. The Government policy promotes the creation of a favorable environment for domestic and foreign investment, believing that the private sector will become the engine for economic growth. The creation of a market-oriented economy necessitates the government to abolish subsidies, which are particularly felt by the poorer and more vulnerable segments of the society. This path of transformation is far from being smooth. Riots in June 1998 after the Government increased the prices for oil, killed more than 50 people nation wide.

It is within this environment that the SFD tries to bring credit services to the poorer segments of the population. The first credit program under the SFD was launched in February 1997 and loans were disbursed in March 1997. Other programs soon followed. As of August 1998, the Social Fund has approved 10 projects of which 5 are ongoing. The total amount approved is 1.5 million US$ and the total accumulative amount disbursed is about 700,000 US$.

Yemen has no experiences in micro finance programs. The banking industry is geared towards financing the government (bonds), large industrial enterprises and medium size trading societies in urban areas (usually short-term trading capital, and liquidity financing). Also the lending experiences of (international and local) NGOs in Yemen is in an embryonic stage. In other words, the Social Fund is entering virgin grounds in its attempt to give credit to poor people in Yemen. This paper tries to capture this first experience and wants to conclude to address some of the issues the program is facing to keep the space of growth of its lending program.

Approaches and Experiences

The micro credit program follows a demand led approach. The SME unit of the SFD usually responds to loan proposals coming from the field. By far most project requests received by the unit include the provision of loans to finance one particular income generating activity. Examples include the financing of goat and sheep rearing and cattle fattening. Sometimes the SME unit is pro-active and initiates loan programs. This is the case for instance of a micro finance program in an urban area (Hodeidah). Although the initiative came from the Social Fund, the growth and development that followed was the result of the response in the field. After a little more than 16 months of operation, the loan portfolio of the Fund can be characterized by projects that finance one particular type of activity and programs that finance multiple types of economic activities. While rural based credit programs include both types of projects, the urban-based program includes the financing of a micro credit scheme only.

All micro credit programs and income generating projects focus on individual borrowers. Initiatives to finance community or jointly implemented projects are not eligible. Experiences elsewhere have shown that such projects are very risky and arbetter assisted by co-financing arrangements (subsidies, grants). All individual projects generate

income. Providential use or liquidity financing is not permitted.

The eligible borrowers belong to the poorer segments of the Yemeni society. They can include urban slum dwellers who already have their own economic activity such as petty trading, commuting services, production related activities, personal services, etc. Sometimes also new activities are eligible for foreign financing. In the rural areas, small farmers, landless laborers and other rural poor are target borrowers. Except for one rural based micro lending program where 100% of the borrowers are female, the great majority of the borrowers are men. This percentage ranges from 85% in the urban-based Hodeidah program to almost 100% in other rural income generating programs. A noticeable difference between the urban micro finance program and the income generating rural projects is that the borrower in the first program is at the same time the entrepreneur or implementer of the project being financed with foreign capital. The borrowers of cattle fattening and sheep raising are often the men as head of the households, while the children and women do the rearing. Thus projects in the countryside can be considered much more as household projects with the entire family members being involved, while urban projects are much more individual economic activities that add household income.

The information available about the potential borrowers is very limited in the urban areas but is widely available in the micro lending schemes in the countryside. The urban lending program tries to overcome this information gab through the formation of small groups of 5 people who know and trust each other and mutually pledge to guarantee the repayment. These groups do not increase the actual knowledge of the individual borrowers but it is expected to reduce the risk of the portfolio. Social network is much more developed in the countryside where information is available about each potential borrower. The information network is thought to be that well developed that borrowers do not necessarily have to be a member of the (cooperative) lender.

The urban credit program limits the services to providing credit to the borrowers. In all other credit programs credit is flanked by other supportive activities. In programs that finance sheep, goats and cattle, veterinarian services form part of the loan package. In the rural micro credit program for women, the borrowers participate in literacy classes; health programs and all members are compelled to participate in the savings program.

Also the role of the Social Fund in the programs differs. In the urban-based micro credit program, the Social Fund provides seed capital and intensive institution capacity building and technical assistance. The complexity and innovative approaches of the lending program and the weak institutional landscape justify this. The capacity of local organizations in the countryside is limited too, but financing income-generating activities is less complex. It has proven to be feasible therefore to recruit locally a manager for the loan programs and often these managers are employees of the grassroots level organization that implement the scheme. The rural micro credit scheme in Hais is supported by an international NGO that supervises and manages the scheme.

Although the involvement of the Social Fund differs per program, all micro credit schemes aim at institutional and financial sustainability. After the support of the Social Fund ends, local institutions (NGOs, cooperatives, and people’s organizations) are expected to continue this financial service to the poor. Income generating projects are not expected to be institutional viable, but should meet the financial sustainability criteria.

Different persons should do identification and appraisal of individual projects. In the micro schemes, individual borrowers do the identification. The proposals are discussed in the groups and members should mutually guarantee the repayments of all loans. The management of the credit program is Hodeihdah approves the loans, while this approval authority is delegated to the group in Hais, albeit closely monitored by the international NGO (that has a veto). Local NGOs identify income-generating projects after discussion with groups of people. Any household who is interested in cattle fattening, goat and sheep raising can apply for this loan product. The Social Fund appraises the feasibility of the entire scheme.

Formal contracts are signed between the Social Fund for Development and the local financial intermediaries (NGOs, cooperatives). Individual borrowers sign a promissory note that at most details the use of the loan, loan amount (usually between 20,000 and 100,000 YR for the urban based credit scheme and IGPs and up to 20,000 YR for the women’s program), repayment schedule (in installments or in lump sum) and repayment date (short term from one week to 10 months).

The quality of the financial service in terms of flexible loan products differs per program. Loan products vary most in the Hodeihdah program that allow different loan use, different maturity dates and different loan amounts. The rural credit scheme in Hais has only one amortization scheme (10 months). The income generating schemes are the least flexible. There is a trade-off between the quality of the schemes and management required. All projects would like to improve their lending products, but available management so far has prevented this realization. The approaches to improve the quality of the loan program differ per program and each implies a different trade-off. An external manager is employed in the Hodeidah program which has allowed a more sophisticated lending scheme, however much needs to be done to quickly institutionalize these services. In Hais the quality of the lending services is curtailed but within the handling capacity of the groups. This project opted to keep the management of the scheme within the groups, which has affected the variety of the loan products. Hodeihdah has chosen to give higher quality of lending products, yet at the expense that at present it is beyond the local capacity of the NGO to continue such a scheme. Both schemes have in common that much training is needed as part of institution building to prepare local organizations to fully take over the credit scheme.

A salient feature of the lending schemes is the application of Islamic banking principles. Under the Islamic-banking law, capital is not allowed to receive interest. Instead two loan models have emerged the so-called Mudaraba and Murabaha schemes. Under the Mudaraba model, the lender buys equity in the business and the borrowers provide the labor. As a result, the business is not owned by the borrower but by the lender. With each installment however the borrower buys equity or shares back from the lender. Under this scheme borrower and lender agree in advance how much the former will be compensated for the labor provided. This amount will be deducted from the proceeds of the business. The net profits (so after deduction of labor costs) will be paid as dividends to the owner of the business. The ownership of the business however is gradually shifting from the lender to the borrower.

The Murabaha is a much more simple. Under this scheme, the lender buys the items on the market and resells it to the borrower at a higher price. The margin is determined in advance and can be considered as interest in the conventional way. In sum, under the Mudaraba scheme, the risk is much more with the lender, while with the Murabaha the risk lies more with the borrower. It should come as no surprise that the borrowers prefer the Mudaraba scheme while the Murabaha is opted by the lenders. Most projects apply the Murabaha because this scheme requires much less administration, needs lesser monitoring to curtail cheating and in the final analysis is easier understood by both lender and borrower. Lesser administration and monitoring make the scheme less costly too.

Emerging Issues

The lending program undethe SFD is expanding very fast and some issues have surfaced which needs special attention of the management. One of these issues concerns the risk profile in the credit program. This risk profile is very high due to loan use and coverage of the loans. In the countryside, nearly all loans are in sheep and goat raising. Such loans are risky because of market situation (increase on the supply side can depress marketing prices) and the one-sided use of such loans implies putting all the eggs in one basket. An infectious disease can wipe out the entire fund. The project is aware of this risk and is looking at ways and means to diversify the loan portfolio to spread the risks. One handicap however is the limited investment opportunities available to the target groups. These groups have only limited access to the production factors (including land) and face constraints in the marketing.

A second factor that increases the risk profile of the fund is that borrowers do not offer hard collateral or even chattel mortgage. The only "collateral" provided are either joint liability groups (solidarity groups) in which a member guarantees the repayment of his or her loan and that of the group or the personal guarantee of a more wealthy person in the community. This co-makership is applied in nearly all the income generating projects. The first experience of the project is that the mechanism of mutual liabilities does not work satisfactory. In the case of Hodeihdah, the group brings a defaulting member to the project or the police station, but the other members refuse to guarantee the payment of the defaulting amount. It is believed that this several and mutual guarantee mechanism is not working because members see the group formation as a condition to receive a loan for individual projects. The project still believes in the concept of joint and several liabilities but there is clearly a need to re-enforce the group formation. A group formed today should not become eligible to receive credit tomorrow. Also repayment incentives could be introduced. In Hodeihdah individual borrowers pay a high insurance premium and a rebate could be proposed to

those groups of which all the members repay the loans in time. In the rural based micro program, individual and group savings of the group could be taken as partial collateral. Individual members can lose part of their savings when any borrower of the group does not repay the loan. Policies and procedures should be worked out before such a scheme could be introduced.

Credit unlike grants and subsidies have to be repaid. Credit programs need therefore a strong local organization that can retrieve borrowed financial resources. This local organization has to have a clear policy direction and should posses a strong management structure. The institutional landscape in Yemen however is poorly developed. There are only a few local organizations that can show a track record. Most local organizations are of a recent origin and have not developed a long-term vision. Also the management of most local organizations is still poorly developed. Moreover the law allows the registration of very different organizations under one NGO law. As a result NGOs in Yemen includes very different institutions which differ in philosophy, organization and management. A local NGO can be a relief agency or an agency that provides technical support to the poor(er) segments of the society and sources and channels capital, goods and services from donors to the beneficiaries). NGO organizations can also have characteristics of a cooperative organization (service oriented to members) and can even perform as corporations (i.e. have economic activities aimed to make profit).

Grassroots level organizations in Yemen accept share capital from members just as cooperatives. At the same time they provide services to members and non-members as long as they meet certain poverty yardstick criteria. Just as NGOs they attract grants and subsidies from donors. In theory most of the associations are democratic and have a General Assembly, yet this Assembly is never convened. Experiences also show that one to three people control the entire operation and manage the grassroots level associations. The SFD therefore is often dealing with personalities rather than institutions.

The institutional appraisal of the Social Fund encourages the participation of People's Organization (cooperatives) because of their vision of self-reliance. It is believed that developing sustainable credit schemes are better placed in organizations that promote the philosophy self-reliance as well. However if self-reliance and track record of the local organizations were strictly applied, many organizations would not pass the eligibility criteria. Therefore the Social Fund is heavily involved in the management of certain credit schemes and emphasizes the institutional development of other grassroots organization. The training and management support given by the Social Fund should ensure that these organizations will soon meet the minimum eligibility criteria required to manage foreign financial resources.

The Social Fund has limited institutional strengthening capacity and wants to be a coordinating and managing agency only. This is why it collaborates with international and local NGOs as cooperating technical and financial intermediaries to channel technical and financial services to grassroots level institutions. Strong international and local NGOs are selected among others on their track record that they promote self-reliance in the villages and among the target groups. One indicator for such self-reliance promotion is their active support to grassroots level groups and their ability to strengthen self-help associations.

Main Characteristics	Urban Based Credit Program	Rural Based Credit Program	
	Micro Credit	Income Generating Projects	Micro Credit
Target groups	Urban slum dwellers, men and women, but mostly male borrowers	Farmers, members and non-members of cooperatives, NGOs, mostly male	Only women from different villages, supported by a NGO
Program services	Credit and financial advisory to borrowers	Credit and veterinarian services to borrowers	Credit, savings, literacy classes, health and veterinarian services
Role of Social Fund	Provider of seed capital, financing of initial costs, recruitment and payment of manager scheme	Provider of seed capital, financing of initial setting up cost. No managerial role for SFD	Provider of seed capital, financing of initial setting up cost. No managerial role for SFD
Target and policy	5000 active borrowers, organizational and financial sustainability	Financial sustainability	2000 savers and borrowers, financial and organizational sustainability
Identification credit proposal	By individual	By NGO	By groups in villages
Appraisal and approval	By credit program	By SFD	By group in village but with veto of NGO
Loan contract	Promissory notes, details loan use, loan amount and repayment date	Promissory notes, details repayment amount or condition and repayment date	Promissory notes, details loan use, loan amount and repayment date
Use of loan	Free use, as long as it is productive (no providential use permitted)	For one type of income generating activity only such as goat or sheep raising, cattle fattening	Free use of loan, but use should be productive.
Duration	Short-term from one week to maximum one year	Equal for all loans usually 10 to 12 months	Equal for all loans, up to one year
Loan size	First time borrowers up to 20,000YR Frequent borrowers up to 100,000 YR	Depends on use loan and market prices of cattle. Ranges from 20,000 to 100,000 YR	Same for all first time borrowers (9,000 YR), increases for frequent borrowers up to 20,000 YR per borrower
Security	Joint liability, no hard collateral	Joint liability, no hard collateral	Joint liability, no hard collateral or savings
Repayment schedule	In installments	In lump sum	In lump sum
Repayment incentives[1]	New loans in higher amounts become available	None	None
Repayment sanctions	Fees, imprisonment	None	Fees
Islamic Banking[2]***/ Interest rate***	Murabaha/2% per month	Mudaraba	Murabaha

[1] Incentives could include discount on interest payment, fees, etc.

[2] Mudaraba is partner financing in which lender and borrower share in profit after borrower's deduction of cost. "Interest" is not known in advance. Marabaha includes buy and sell of the inputs by the lender, difference in price is actual interest payment and known in advance

Savingcomponent	Not included	Not included	Compulsory part of loan program
Insurance scheme	Covers payment of future installments	Not included	Not included
Management	Independent from NGO	Independent from NGO	Integrated in the group, supervised by NGO

Hodeidah Micro Finance Project

Introduction:

The Social Fund for Development (SFD) was established in February 1997. The Small and Micro Enterprise Development program as part of the SFD put a plan to develop two Micro Finance pilot projects, one in Hodeidah city and a rural project in Dhamar. A regional consultant with the assistance of the World Bank SMEs specialist conducted several missions to Hodeidah to assess its economic and social environment, and the credit needs of the informal sector in the city. The mission also conducted a survey to select a convenient partner organization to implement the project.

The mission identified Hodeidah Women Union as a partner organization for the Micro Finance Project. The mission indicated that most of the potential borrowers require financing using the Islamic financial rules (Murabaha, Mudaraba and Musharaka). This is due to the religious belief of the people, which prohibits taking loans with interest (Riba.)

The mission designed the project based on the potential clients' preference and applied the Islamic financial tools as a mean for financing micro enterprises in Hodeidah. The Dhamar rural micro finance project was delayed due to some unpredicted circumstances.

In Hodeidah the SFD and Hodeidah Women Union signed the pilot project agreement in July 1997. Based on the agreement, the SFD provides the project with the technical assistance required to set its structure, train the staff and set the different financial, administrative, and lending systems.

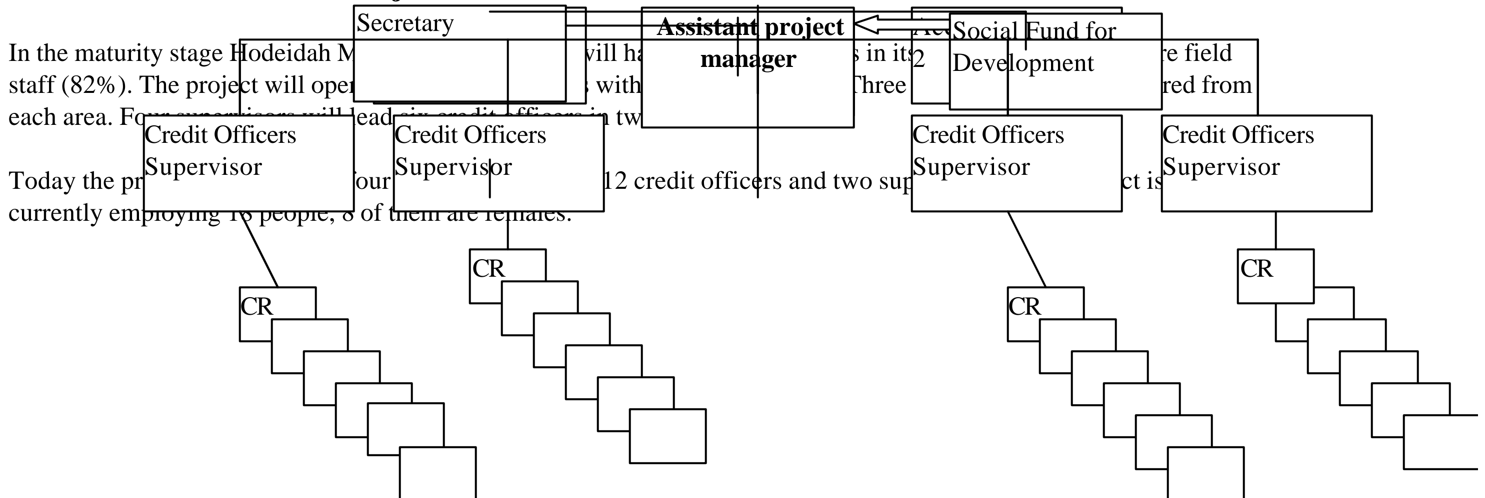
Objectives of the HMFP:

1. To assist the partner NGO to develop an institution that provides financial services to the poor.
2. To build the institutional capacity to provide the targeted groups with sustainable financial services.
3. To reach 5,000 active borrowers by the end of the third year of operation.
4. To document the experience of the project and to elicit lessons for future implementation of similar projects.
5. To use the project as an educational tool for the Social Fund staff to build their capacity in managing and monitoring Micro Finance projects.

Hodeidah Micro Finance Project Structure:

In the maturity stage Hodeidah M… will ha… s in its … e field staff (82%). The project will oper… with … Three … red from each area. Fo… ead… tw…

Today the pr… four … 12 credit officers and two sup… ct is currently employing 18 people, 8 of them are females.



Project Progress:

The project started the lending process in January 98 in two districts of Hodiedah City. In July lending started in two new districts. The total number of loans distributed by the project as of July 30,1998 is 1096 loans **with a total amount of** YR 23,194,500**. About 15.4 % of the borrowers are women. The repayment rate of the loans is above 90%. The attached progress report indicates the characteristics of loans distributed during the period from January up to July1998 (see annex 1 for details.)**

The administrative steps required for issuing loans from Hodeidah micro finance project:

1. Any existing or start -up micro business owner who likes to be financed should:
   1-form a group of five people who have the same desire and
   2- approach a credit officer in their district.
2. The credit officer will assist each group member to fill a loan application form, which indicates the basic business data, information about the applicant and the proposed loan size.
3. The district supervisor and the district loan committee review each loan application.
4. Each group member signs a guarantee form indicating that the group members agree to guarantee each other and are willing to pay for each other in case of arrears or delinquency.
5. The credit officer conducts a business appraisal for each member of the group using a simple feasibility study form. The form indicates the usage of the loan and the expected income and expenses of the business.
6. The credit officer forwards the group applications, the feasibility studies and the guarantee form to the manager or his/her assistant for further review and approval.
7. The credit officer gets cash advance equals to the loan size approved for each group member.
8. The credit officer sets a schedule in cooperation with the borrowers to buy the business needs for each borrower.
9. The credit officer goes to the market area with each borrower and gives him complete freedom to choose his business needs as indicated in the business study.
10. In the market area, the credit officer pays for the bought items and signs an agreement reselling the items to the borrower after adding a specific margin to the actual amount. The agreement specifies the repayment schedule and amounts.
11. The credit officer settles his/her advance with the financial department and reports the actual amounts of the loans.
12. The credit officer hands the signed contracts to the assistant project manager for filling and a copy to the financial department to follow up on repayments.
13. The financial department opens an account for each borrower indicating the number of installments, the installment size and the due date.
14. The credit officer receives a receipt book to be used during the collection of the loan installments.
15. The credit officer collects a weekly fee of YR 30 for the insurance fund from each group member.
16. The insurance fund has a separate account, which indicates the fund income and expenses.
17. The insurance fund compensates the borrowers who may face emergencies that affect their businesses such as fire, flood or death.
18. The borrower is compensated only after the approval of the rest of the group members and the credit officer.

19. The supervisor, the assistant project manager and the project manager conduct field visits on a random basis to follow up on the project clients.

20. The management prepares monthly progress reports based on the prepared forms, indicating the number of loans distributed, type of businesses, gender distribution, case load per credit officer, repayment rate, overdue rate, delinquency rate, aging of arrears….etc.

21. For the calculation of repayment rate, advances received from borrowers are not added.

22. Borrowers, who manage their business in an efficient way, and pay back their loans on time are eligible to get second loan with the same amount or bigger based on their businesses need and according to the following table:

Number of loans	Maximum Loan Size	Maximum Repayment Period
First time borrower	YR 20,000	Six months
Second time borrower	YR 40,000	Eight months
Third time borrower	YR 60,000	Ten months
Fourth time borrower	YR 80,000	Twelve months
Fifth time borrower	YR 100,000	Twelve months

Annex (1)

Characteristics of The Loans

District	Rabasa			Salakhan			Omal			Zaied		
	M	F	T	M	F	T	M	F	T	M	F	T
Total Loans Distributed	482	66	548	361	92	453	25	5	30	27	3	
Active Loans	373	51	424	290	73	363	25	5	30	27	3	

Loans Classification

District	Rabasa			Salakhan			Omal			Zaied		
	M	F	T	M	F	T	M	F	T	M	F	T
First Time Borrower	410	61	471	328	87	415	25	5	30	27	3	
Second Time Borrower	62	5	67	33	5	38	0	0	0	0	0	
Third Time Borrower	7	0	7	0	0	0	0	0	0	0	0	
Fourth Time Borrower	2	0	2	0	0	0	0	0	0	0	0	
Fifth Time Borrower	1		1	0	0	0	0	0	0	0	0	
Total	482	66	548	361	92	453	25	5	30	27	3	

Loans Type/Number

District	Rabasa			Salakhan			Omal			Zaied		
	M	F	T	M	F	T	M	F	T	M	F	T
Production	67	16	83	30	13	43	0	0	0	1	0	
Services	162	17	179	98	2	100	1	0	1	7	1	
Commercial	253	33	286	233	77	310	24	5	29	19	2	
Total	482	66	548	361	92	453	25	5	30	27	3	

Loans Type/ Amount in YR

District	Rabasa			Salakhan			Omal			Zaied		
	Production	Services	Commercial	Productio	Services	Commercia	Produc	Services	Commer	Producti	Services	Comm
First Time Borrower	1,507,000	3,070,000	4,412,500	835,000	1,720,000	5,042,000	0	20,000	450,000	20,000	157,000	390,(
Second Time Borrower	100,000	720,000	1,840,000	0	510,000	1,035,000	0	0	0	0	0	
Third Time Borrower	0	123,000	300,000	0	0	0	0	0	0	0	0	
Fourth Time Borrower	0	0	200,000	0	0	0	0	0	0	0	0	
Fifth Time Borrower	0	0	100,000	0	0	0	0	0	0	0	0	
Total	1,607,000	3,913,000	6,852,500	835,000	2,230,000	6,077,000	0	0	0	0	0	

ANNEX (2)

Islamic Banking "Loan" models: Mudaraba and Murabaha *

I. Mudaraba

In the case of *Mudaraba*, the micro finance project and the micro business, are *partners* in the business, with the project putting in the money and the micro-entrepreneur the "sweat"[3]. The micro-entrepreneur is rewarded for his/her work *and* shares in the profit. The project only shares in the profit. The profit-sharing rates are *pre-determined* but the profit is unknown.

In effect, the project takes "equity" in the micro business through the "loan". Initially the micro finance project owns 100 percent of the shares and hence is entitled to the pre-determined profit sharing rate of all the profit. However, with each installment repaid, the micro entrepreneur "buys back" shares. As a result, the micro finance project is with each installment received entitled to less profit. The profit sharing rate obviously remains the same, but the amount of profit to be shared decreases.

The following case provides a numerical example:

- the micro-entrepreneur is a vegetable trader; he makes a weekly profit of 1000
- the micro credit project provides a loan of 10,000 to be repaid in 20 weekly installments
- witeach installment, the entrepreneur buys back a share of 500
- profit per share is 50 (1000/20)
- the project and the entrepreneur agree on the following profits-sharing rates:
- the project's sharing rate is 35 % of weekly profit (to which project is entitled)
- the entrepreneur sharing rate is also 35 % of weekly profit (to which entrepreneur is entitled)
- the entrepreneur is rewarded for his work: this is 30 percent of weekly profit (to which entrepreneur is entitled)

Financial dynamics:

- in the first week, the project owns 100 percent of the shares and is entitled to 35 % 100 percent of the weekly profit of 1000; the project gets 350 (35 % x 1000)
- the entrepreneurs gets 65 % (30 % + 35%) of the weekly profit of 1000, which is 650.
- the entrepreneur uses 500 of this 650 to buy back one share
- in the second week, the micro finance project is only entitled to 35 percent of 19/20 of the weekly profit of 1000, which is 332
- the entrepreneur gets the remainder (1000 -/- 332) = 668; this is equal to (65 % x 950) + 50; 950 is the profit to be shared with the project; the 50 is the profit per share; as the entrepreneur owns now one share (500 he "bought back"), he does not have to share the profit made on his "own" share
- the entrepreneur again uses his money to "buy back" a second share.
- with the third installment, the project is only entitled to 18/20 of the profit of 1000;
- the project will get then 35 % x 18/20 x 1000 = 35 % x 900 = 315.
- the entrepreneur gets: 65 % x 900 + 100 (2 times 50)
- The following table provides the detailed calculations.

[3] Note that the principle of Mudaraba is the same as that of Musharaka. In both cases, the financing organization and the business work in partnership. In case of Mudaraba, only the financier puts in money and the entrepreneur the "sweat", while in case of Musharaka, both the financier and the entrepreneur put in funds.

Table: Case on Mudaraba

Week	Profit to be shared	Income Project	Income entrepreneur	
1	20/20 x 1000 = 1000	1000x35% = 350	1000x65 % + 0 = 650	= 500 + 150
2	19/20 x 1000 = 950	950 x 35% = 333	950 x 65 % + 50 = 667	= 500 + 167
3	18/20 x 1000 = 900	900 x 35% = 315	900 x 65 % + 100 = 685	= 500 + 185
4	17/20 x 1000 = 850	850 x 35% = 298	850 x 65 % + 150 = 702	= 500 + 202
5	16/20 x 1000 = 800	800 x 35% = 280	800 x 65 % + 200 = 720	= 500 + 220
6	15/20 x 1000 = 750	750 x 35% = 263	750 x 65 % + 250 = 737	= 500 + 237
7	14/20 x 1000 = 700	700 x 35% = 245	700 x 65 % + 300 = 755	= 500 + 255
8	13/20 x 1000 = 650	650 x 35% = 228	650 x 65 % + 350 = 772	= 500 + 272
9	12/20 x 1000 = 600	600 x 35% = 210	600 x 65 % + 400 = 790	= 500 + 240
10	11/20 x 1000 = 550	550 x 35% = 193	550 x 65 % + 450 = 807	= 500 + 307
11	10/20 x 1000 = 500	500 x 35% = 175	500 x 65 % + 500 = 825	= 500 + 325
12	09/20 x 1000 = 450	450 x 35% = 158	450 x 65 % + 550 = 842	= 500 + 342
13	08/20 x 1000 = 400	400 x 35% = 140	400 x 65 % + 600 = 860	= 500 + 360
14	07/20 x 1000 = 350	350 x 35% = 123	350 x 65 % + 650 = 877	= 500 + 377
15	06/20 x 1000 = 300	300 x 35% = 105	300 x 65 % + 700 = 895	= 500 + 395
16	05/20 x 1000 = 250	250 x 35% = 88	250 x 65 % + 750 = 912	= 500 + 412
17	04/20 x 1000 = 200	200 x 35% = 70	200 x 65 % + 800 = 930	= 500 + 430
18	03/20 x 1000 = 150	150 x 35% = 53	150 x 65 % + 850 = 947	= 500 + 447
19	02/20 x 1000 = 100	100 x 35% = 35	100 x 65 % + 900 = 965	= 500 + 465
20	01/20 x 1000= 50	50 x 35% = 18	50 x 65 % +1000= 982	= 500 + 482
Total		3680	16320	10000+ 6320

The "profit" sharing option -provided there is profit - is extremely lucrative for the micro finance project. If we for simplicity reasons do not include the time value of money, the project makes an effective interest revenue of 3680/10000 = 36.8 percent for a 10-week loan; this is 3.68 % weekly and over 190 percent annually. The profit sharing percentages (35 % versus 65 %) are very low compared to current local practice (supplier credit; informal money lending).

The previous example shows that *Mudaraba* for businesses with a short profit cycle (such as traders who profit on a weekly or daily basis) is complicated. For businesses with a longer profit cycle, the application of Mudaraba is more straightforward, as the following example shows.

- The micro business takes a loan of YR 20,000 to raise four goats; this business is common and people know the profit well in advance; normally the business raises the goats and resells them after 5 to 8 months for YR 40,000, hence 100 percent profit. The "working capital" i.e. foodstuff is considered "free" because the goats live around the dwelling and eat whatever they can find.
- The micro finance projects takes "equity" of YR 20,000; in this case it takes 20 shares of 1000 each. The project and the entrepreneur agree on the following profit sharing rates: 35 % for the project; 35 % for the entrepreneur and 30 % for the entrepreneur's work
- After 5 months, when the entrepreneur has sold the goats and has made a profit of YR 20,000, he repays the "principal" through "buying back" the 20 shares at 1000 each, and he pays the project its share in the profit: 35 % of 20,000, which is 7000

The effective interest income for the project for 5 months is 35 percent, which is 1.7 percent weekly and 91 percent annually.

II. Murabaha

Murabaha is most comparable with trade finance in the case of working capital and leasing in the case of investment capital. The project literally buys the goods, and resells them to the micro businesses for the costs of goods plus a mark-up for "administration costs". It is quite common that the borrower pays for the goods in (equal) installments. The project owns the good until the last installment is paid.

Evaluation of the Islamic Banking "Loan" Models

Evaluation from the perspective of the borrower. Focus group discussion showed that the borrowers initially prefer the profit-sharing mechanism, Mudaraba. They are familiar with the concept because it is used as a common practice for supplier credit and informal finance. Many potential borrowers reject the "buy-resell with mark-up" concept of Murabaha, saying it is very similar to the practice of fixed interest rates (Riba) which is against Islamic religious practices (Sharia). Not all borrowers understood that the profit-sharing mechanism is more expensive for them. Some of them foresee the potential conflicts between the project and the borrower on the determination of the profit. Others do not like the profit-sharing because they do not want to reveal to the project (and their groups) how much profits they make. It appears that women, who are not exposed to the current informal finance practices used by the men, were more open to the "buy-resell" option, saying it was more simple and easier to understand.

Evaluation from the perspective of the micro-finance project. Obviously the "buy-resell" option with repayments in installments is the easiest to administer and monitor for the project. It is basically similar to a loan with a fixed interest rate. The "profit-sharing" mechanism is difficult to understand (for loan officers and borrowers alike) and is difficult to implement in practice; even when profit is "known" the administration and monitoring is cumbersome. As a result, administration expenses will be substantially higher.

The main issue however is the "determination" of profits. It could be applicable for business operations that are common and known by everybody such as vegetable trade or goat raising; the profits are commonly known and cheating could be avoided. But even these straightforward cases, the entrepreneur has numerous incentives to cheat and be dishonest, claiming that he/she did not make the predicted profit for whatever "excuse"[4]. It is almost impossible for the project to determine whether these excuses are really the truth or made up by the borrower. The only "enforcement" mechanisms are the group members of the dishonest borrower and the fact that the borrower knows that if he/she is caught cheating, he/she will loose access to future loans. Apart from the "cheating" issues, profit sharing is obviously much more risky to the project than "buy-resell".

If profit-sharing would be used, it would be most cumbersome to implement for trade finance or those businesses with short profit cycles; at each installment, the loan officer has to collect and administerdifferent amount such as in the example described above. The loan officer would end up having numerous clients, each in different repayment phases.

The profit sharing concept appears most applicable to finance of investment capital such as goats or equipment where the "loan" plus profit is repaid at the end of the business cycle. In effect, this is similar to a "bullet-loan" where principal and interest are repaid and end of maturity. The disadvantage however is that such a loan does not instill repayment discipline. This can be however counteracted by the weekly meetings where borrowers have to show up and pay their weekly contribution to the emergency fund.

[4] Examples for "excuses" are: the goat got sick; the goat died; the goat ran away; the vegetables were stolen; the vegetables perished, the customers did not buy; I could not sell because my sister was ill…..etc.

The following table summarizes the key points:

Issue	Mudaraba (profit-sharing)	Murabaha (buy-resell)
Most applicable for:	- "fixed" assets (investment capital)	- working capital; and - investment capital
Price (costs to the borrowers)	- high	- lower
Acceptance by borrower	- high	- lower
Risk to the borrower	- low	- high
Risk to the project	- high	- low
Administration	- complex, especially in case of financing businesses with a short business cycle	- simple and easy
Enforcement	- difficult because of opportuni-ties for cheating	- much less difficult because the project owns the goods until the last installment is paid
Administration costs	- high	- lower