A Framework for Regulating Islamic Microfinance Institutions

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Abstract

Regulation is crucial for many reasons. More important than that is to produce an effective regulatory framework. In this paper, we will find that the first step in this framework is the philosophical foundation of Islamic microfinance institution’s establishment that is formulated in their operations and incentives. Second, the policy issues related to regulations need to be addressed, among others: Islamic microfinance institution activities and Islamic microfinance institution-philanthropy links; effectiveness and sustainability; shariah based business model; who are the regulators; and ownership. Finally, several guidelines will be introduced to produce environmentally effective regulations, among others are the guideline on: the shariah advisory council, corporate governance, group lending policy, loan loss financing, minimum capital and micro-takaful scheme.

Keywords: regulation policy, Islamic microfinance institutions, regulatory philosophy, shariah

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A Framework for Regulating Islamic Microfinance Institutions

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1. Introduction

The sources of funds for Islamic microfinance institutions are typically provided by trustee and depositors and managed by the managers. There are the entrepreneurs who need capital for their microenterprise activities. The financial authority like central bank or ministry of finance or ministry of cooperative is responsible for the supervision and regulation of Islamic microfinance institutions.

The philosophy behind the financial authority’s supervision and regulation of Islamic microfinance institutions has three components. Firstly, the Islamic microfinance institution’s owners should confine their activities to the management and control of Islamic microfinance institutions; and Islamic microfinance institution should engage in activities related to shariah principles. They should not affiliate with entrepreneurs engaged in activities that are not permitted. Secondly, the transactions between an Islamic microfinance institution and its customers should be subjected to certain limits and restrictions. Finally, there must be effective and efficient supervision of the financial status and activities of Islamic microfinance institutions to ensure their safety and soundness.

Behind this philosophical view, how could Islamic microfinance institutions be regulated? This paper will first provide an overview of how the financial authority implements each of the philosophical components. Then, it will be followed by the policy issues related to regulation and several guidelines will be discussed to produce environmentally effective regulations.

2. Philosophical Foundation of Regulation

In discussing the philosophical foundation of regulation, we will take an approach of regulation where it will reflect our view on the nature and purpose of Islamic microfinance institutions. We will consider the theoretical foundations of Islamic microfinance which will be based on the interpretation of shariah principles that is formulated in their operations and incentives. More importantly than that is not only that they comply the shariah, but also their roles in providing capital to un-bankable society. They key is to design regulation so as to allow Islamic

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2 We will refer to Smolo and Ismail (2011). The similar model was also proposed by Maamor et al (2014)
microfinance institutions to play their role in the economy, especially in alleviating poverty. This approach involves a broader understanding on the philosophical perspectives of regulation.

**Epistemological Philosophy**

As a branch of philosophy that concerns with the nature and scope of knowledge which is derived from the belief of oneness of Good (or Al Tawhid) and the Al Tawhid affirms that the obedience to God and fulfillment of His command are human being’s duty. It also serves the purpose of creating human being on earth, i.e., the vicegerent of God on earth. In addition, surah Al-Ahzab, God has invested human being with His trust, a trust which heaven and earth were incapable of carrying and from which for they shied away with terror. Here, the divine trust is the fulfillment of the ethical part of the divine will, whose very nature requires that it will be realized in freedom, and human being is the only create capable of doing so. It is this exercise of human freedom regarding obedience to God’s commandment that makes fulfillment of the command moral.

It shows that al-tawhid tells us that God, being beneficent and purposive, does not create human being in sport or in vain. He has endowed human being with the senses, with reason and understanding, made them perfect – indeed, breathed into them of His spirit – to the end of preparing them to perform their great duty. In performing their duty, their ethical striving and action will enter the realm of space-time. Therefore, the earth (via the economic action) is the object of the human’s endeavor, and all humankind is to be involved in its and their own nature. In this perspective, how the economy via the Islamic microfinance institutions be operated? In particular, as mentioned by Abdullah and Ismail (2014), we want to clarify the essential relation of al-tawhid to the economic order of Islamic microfinance institutions.

The consensus process or shuratic in making the decision for providing loans to customers should be reached. The micro entrepreneurs need shari’ah compliant models of microfinance which is based on al-tawhid perspective. They cannot accept the practice of riba (as a proof in accepting al tawhid) as normally done by the conventional microfinance institutions.

Islamic microfinance institutions should also maintain to observe the aims (maqasid shari’ah) of providing the finance to the poor and needy. The Islamic microfinance institutions are not only providing “money” for them to move up from poverty line but also to “change” their human characters.

**Ethical Philosophy**

Ethic (or akhlak) is a branch of philosophy that deals with the human behavior or act in all aspects of life. Ethic is also a set of Islamic moral values which has been prescribed fundamentally in the Quran and implemented by Prophet Muhammad (saw) during his life. Principally, there are two types of akhlaq, good (or mahmudah) and bad (or mazmumah). Islam emphasizes the important of practicing good akhlaq in all aspect of human life and recognizes it as one of the purpose of sending His messengers. Muslim is also encouraged to have good akhlak in all aspects which will bring the business operates ethically.

Classical scholars such as Al-Ghazali in his encyclopedia Ihya’ Ulum al-Din (Revival of Islamic Sciences) for instance, dedicated a chapter on the ethics of earning and living (Kitab al-Adab al-Kasb wa al-Ma’ash), which precedes the chapter on lawful and unlawful matters (Kitāb al-Halāl wa al-Ḥaram), indicating the importance of ethical behavior in earning a livelihood. Scrutinizing this chapter of Ihya’, al-Ghazzali identifies justice, truthfulness and benevolence as the main ethical values that must be internalized.

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3 Refer to Al- Baqarah 2:30: And [mention, O Muhammad], when your Lord said to the angels, “Indeed, I will make upon the earth a successive authority.” They said, “Will You place upon it one who causes corruption therein and sheds blood, while we declare Your praise and sanctify You?” Allah said, “Indeed, I know that which you do not know.”

4 Refer to Al- Ahzab 33:72: Indeed, we offered the Trust to the heavens and the earth and the mountains, and they declined to bear it and feared it; but man [undertook to] bear it. Indeed, he was unjust and ignorant.

5 Refer to: Al-Qiyamah75:3 (“Does man think that We will not assemble his bones?”); Al-Mu’minun 23:115 (“Did ye then think that We had created you in jest, and that ye would not be brought back to Us (for account?)”) and Al- Anbiyaa` 21:16 (“And We did not create the heaven and earth and that between them in play”).

6 The Prophet (saw) said, “(I was sent to complement good morals) [Ahmad, Malik, Bazaar, Haithami and Ibn `Abd Al-Barr authenticated it. From Abu Hurairah]
by parties involved in business transactions. This view, as pointed by Ismail and Zali (2014) showed general explanation of business ethics and ethics of relation.

**Logical Philosophy**

The last part is logical philosophy. It tries to investigate human thought and a fundamental to the thinking straight, accurate and healthy. Learning about the rules of logic is expected to lay the foundation so that it can make accurate conclusions. Any ethical action must have reasons and be able to defend our actions if it is called upon to do so (Minja, 2009). In Islam, logic in business activities can be determined by ijtihad that must obey to the Shariah rules. In the logic behind it, the Muslim will be classified as a man who disobeys Allah. In this perspective, we can refer to Al-Ghazali’s major works like (Mizaan al-'Amal (The Criterion or Logic of Action), one of the early works on ethics. Al-Qaraḍāwi (1995) also observes that only in recent years Islamic business has been given due attention by Muslim scholars and researchers. He describes Islamic business as being Godly, ethical, humane and balanced, and is of the opinion that it is the responsibility of the state (i.e., financial authority) to ensure that the theories of Islamic economics are implemented through the legislation of laws to uphold righteousness and ethics.

The financial authority should promote and maintain Islamic microfinance institutions and their services for the public and foster higher standards of practices. Hence, traditionally, the financial authority as a regulator has to keep a close watch on these aspects of the Islamic microfinance institutions, i.e; safety, stability, structure, public confidence, market discipline and the basis for a public policy. Think of safety in terms of acting as a custodian for customers and capital funds as cushion or buffer protection. Stability is protecting the economy from the vibrations of the Islamic microfinance institution or ensuring a safe and secure Islamic microfinance institution by preventing financial panic or spillover effects.

The objective of focusing on the Islamic microfinance institution is due to risk, or fear of collapse of the microfinance system. In contrast, structure focuses on promoting competition and efficiency and protecting Islamic microfinance institution customers from a monopolistic system of microfinance institution.

**Safety and Stability**

The safety objective is to reduce the risk associated with Islamic microfinance institution businesses (i.e., protecting Islamic microfinance institutions from being exposed to much to external factors and making them a sustainable institution). Today the safety objective comes under the guise of subsidy and micro-takaful services. The Islamic microfinance institution stability objective is closely linked with the goal of poverty alleviation of the economy. The failure to address the outreach and help the poor and micro-small enterprises dominates regulatory thinking in this area.

The safety and stability objectives build on some fundamental microeconomic and macroeconomic ideas. One of the tasks of a macroeconomic poverty eradication policy is to reduce the poverty through providing the capital and employment to the poor and micro-small enterprises. Capital was perceived as having made the microfinance institution as “the pillars”. However, after more than three decades of Islamic microfinance institution operations, it seems that customers prefer to have a long relationship and on a wider scale.

**Promoting Competition and Efficiency through Microfinance Institutional Structure**

The structure objective is best viewed in terms of the degree of competitiveness and efficiency in the Islamic microfinance industry. The linkage between structure and competition is provided by the industrial organization model. This model links structure with conduct and then with performance.

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7 See Ghazanfar and Islahi (1997) in Islamic Economics Research Series, King Abdulaziz University.
Structure refers to the number of Islamic microfinance institutions in the market (i.e., sustainability), conduct refers to the behavior of the Islamic microfinance institutions in the market, and performance refers to the quantity and quality of products and services (i.e., outreach) by Islamic microfinance institutions in the market. The conclusion of the model is: the more Islamic microfinance institutions that exist in the market, the smaller the chances of non-competitive behavior and the greater the chances that high-quality products and services will be provided to customers. Hence in the business of providing financing and outreaching customers, a larger number of customers will mean low level of unemployment.

Public Confidence

In addition, to safety and stability as a prerequisite for public confidence. Microfinance institutions who are managed in Islamic ways could also create public confidence and the shariah compliant framework is very much needed here. Building confidence at the microeconomic level focuses on limiting the risk exposure of individual Islamic microfinance institution and at the macroeconomic level, isolating Islamic microfinance institution failures. The financial authority would try to see that each Islamic microfinance institution operates in a safe and sound manner. By pursuing the macroeconomic goal of limited failure prevention, the financial authority expects to maintain public confidence in the Islamic microfinance system.

Market Discipline

Both, disclosure and market discipline complement formal supervision, and clearly market participants (i.e., Islamic microfinance institution, customers, non-profit organizations) can play an important role. In free and open markets, market participants can use their investment and financing decisions to reward those Islamic microfinance institutions that are performing most effectively. Or more accurately, reward those Islamic microfinance institutions that their project will be the most effective performers as going forward.

How market participants make those projections is not always easy to determine. Even in a system with sophisticated analysis by rating agencies and other market practitioners (for example, Forbes provide the list of top microfinance institutions) that recognize the inherent strength or weaknesses of particular microfinance institutions, it seems that the market focuses heavily on short-term matters—for example, often seemingly unduly penalizing modest shortfalls from quarterly earnings estimates.

These market reactions can be explained to some extent by the difficulty of projecting the Islamic microfinance institutions’ performance based on available disclosures. For market discipline to be a truly effective complement to formal supervision, market participants must be armed with accurate and timely information, not just about current balance sheet and income statement elements, but also with information that has a longer-term value such as qualitative and quantitative information on the Islamic microfinance institutions’ business strategies, risk profiles, and risk appetites.

Basis for Public Policy

It is important for the financial authority to maintain a sound and stable Islamic microfinance institution. The main objective of a public policy is to establish a relationship that involves three major groups, i.e., capital providers, operators and customers. The capital providers are the government, cooperative members, individuals or private and non-governmental organizations (NGOs). Operators are those who operate businesses such as banks, cooperatives, and individual entrepreneurs. The microfinance customers are the micro-small enterprises (MSEs), low-income groups and mostly the poor.
The overall effectiveness of a public policy, however, will depend on the extent of its contribution to: reduce poverty; empower women or other disadvantaged/marginalized population groups; create employment; help existing businesses to grow or diversify their activities; and to encourage the development of new businesses. In this case, the financial authority usually employs two primary methods or instruments; utilization of public funds as sources of funds and providing capital to targeted groups.

In practice, the operators look at the profitability of their businesses. Normally, to make their businesses profitable, they will exclude the lower income group and the poor in extending their microfinance. This is because the revenue received may not be enough to cover the cost of providing financial services (sustainability). Since operators focus more on the profitability at the expense of the outreach (social responsibility), capital providers have to think of a way on how to change the operators’ objective. The capital providers (example, via zakat and waqf) are not only interested in the profitability of Islamic microfinance institutions, but also must uphold their social responsibility. This responsibility is translated by providing subsidized funds to be channeled to the operators. At the same time, there are also other operators that operate their businesses unsubsidized. This creates several Islamic microfinance institutions players in the market. Each of them competes in the market, and this raises the issues of sustainability, efficiency and competition among players.

3. Policy Issues Related to Regulations

This section will discuss several policy issues related to regulations. These issues cover the regulations on: Islamic microfinance institution activities and Islamic microfinance institution-philanthropy links; effectiveness and sustainability; shariah based business model; who are the regulators; and ownership.

Regulations on Islamic Microfinance institution Activities and Microfinance institution-philanthropy Links

Islamic microfinance institutions are synonym with the micro and small enterprise development. Therefore, micro-enterprise development programs cover financings and/or give classes to poor people to help them to start or to strengthen their businesses, building self-esteem and self-reliance, encouraging autonomy and creating community atmosphere. In the last few years, micro-small-enterprise development has become one of the most diverse and dynamic approaches to poverty alleviation, with literally hundreds of programs implemented by a wide range of microfinance institutions across the globe. Within the micro-small-enterprise field, micro-financing is the best known approach to providing micro-small-enterprise services.

Therefore, the reasons for allowing the degree to which microfinance institutions can only engage with micro-small enterprises are due to: first, Islamic microfinance institutions work with the targeted group (example, micro and small enterprises); second, government micro-financing programs and staff tend to be both paternalistic and distrustful of the targeted group; third, identifying and reaching the targeted group is extremely time consuming; fourth, government policies (e.g., licensing requirement) and an unstable economic climate (e.g., high inflation) counter business growth and saving potential; fifth, the targeted group often reject micro-financing programs because they do not want to assume the risks involved; and sixth, inflexible micro-financing criteria, such as group borrowing, initial financing repayments or collateral requirements are beyond the means of the poorest. Indeed, it is these regulations that help define what observers mean by the term “microfinance institution”.

Traditionally people with capital invest their money for the purpose of gaining profit. However, there are people who invest money not to get more money but to get rewards in the life hereafter. Islam provides several

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8 Social responsibility taken by donors in serving micro-credit means donors have to serve this financial service because the needy (low-income group and the poor) have no choice but to get loans from other formal financial institutions. Or else they will go to loan sharks to get loans and will have problems in paying back those loans.
mechanisms for Muslims to get the satisfaction at the same time investing for the life hereafter. One of the ways is through waqf and sadaqah (or philanthropy). The concern is how to make it fully utilized and continuously developed. And also the issue is how to ensure that the trustee will manage the property according to the interests of the original owners who endow it. This will require good governance and procedures.

Regulation on Effectiveness and Sustainability

The effectiveness of microfinance programs requires considerable attention so that the benefit of the programs can really be enjoyed by micro-enterprises. So, they can improve their business and enhance the quality of life. Sustainability of microfinance programs constitutes important component to support the achievement of micro-enterprise development, since it constitutes long-term process in which micro-enterprises require long-term access to financial institution. It indicates that the measurement of effectiveness (to evaluate the benefit of the programs) and the prediction of sustainability microfinance programs are required in developing micro-enterprises and Islamic microfinance institutions. The expectation of micro-enterprise development is that micro-enterprises can develop their business and Islamic microfinance institutions as an organizer of microfinance programs do not suffer losses. Therefore, the benefit of the programs should have been greater than the cost.

In general, microfinance programs concern about business and job creation, income generation, and other outcomes. These variables are measurable at the level of the individual, the business, the community, or the economy. Therefore, the measurement of effectiveness (success) of microfinance becomes important to examine whether the microfinance programs have attained its predetermined goals. This activity requires the determination on the method of measurement and the indicators of effectiveness of microfinance programs.

Furthermore, the indicators of effectiveness are not only tried to connect the microfinance programs with income and production enhancement, but also the repayment rate and outreach indicators such as: income of participants; the value and number of financing; saving accounts and the type of financial services offered; the number of branches; and the annual growth of assets over recent years. Therefore, the policy should be in place to select the customers to help making better allocation for sustainability and effectiveness of the financing as they will be a vehicle for economic development.

The effectiveness of microfinance is also related to the sustainability of the program, because achieving the success, micro-enterprises need long-term access to financial services. Therefore, financial sustainability or self-sufficiency is a prerequisite for making micro-financial services permanent as well as widely available. Sustainability is about creating institutions that can provide a positive flow of benefit for as long as they are needed. An Islamic microfinance institution can be said to be self-sustainable if, without the use of subsidies, grant or other concession resources, can profitably provide finance to micro-enterprises on an acceptable scale. Self-sustainability can be achieved via financial self-sufficiency and profitability. It reveals that, to continue growth, Islamic microfinance institutions are required to generate profit, balance the social objectives of reaching low-income entrepreneurs with generating a return for its investors. It has dual missions that are balancing a social agenda or social impact with its financial objective.

From the perspective of micro-enterprise development, we can conclude that the effectiveness of microfinance can be indicated by the success of business, income enhancement, rate of repayment and the benefit of the program to community, and the sustainability of the financing programs constituting important component to achieve the goal of programs. Profitability is necessary to achieve self-sustainability. Therefore, analyzing the ability of Islamic microfinance institutions profit generation is needed.

To achieve the profitability, financial resources should be allocated efficiently. Efficiency has important role related to profitability and sustainability. Increasing efficiency enables the Islamic microfinance institutions generates higher profit and this condition will create two benefits. First, the profit for savers and investors will increase; therefore, they are still interested in saving and investing their money in Islamic microfinance institutions. Second, the return earning of Islamic microfinance institutions will increase and can be used to add the capital that enable the Islamic microfinance institutions to operate in longer time, to reach more micro-enterprises so that eventually the sustainability can be achieved. Therefore, measuring and improving efficiency become important to encourage progress of Islamic microfinance institutions to achieve sustainability.
Regulation on Shariah Based Business Model

As part of an effort to help the struggle of the poor people, micro-enterprise development should be undertaken by giving loans at low charges. Giving loans at high charges causes the wealth of the poor precisely flows to the rich (capitalist) and it contradicts with the value of justice. The prohibition of interest (riba) in Islam constitutes the form of way out to avoid injustice.

Socio-economic justice is one of the most important characteristics of an ideal society. Among the most important teachings of Islam for establishing justice and eliminating exploitation in business transaction is the prohibition of all sources of unjustified enrichment. According to Chapra (1985) one of the important sources of unjustified earning is receiving any monetary advantage in a business transaction without giving a just counter value. Riba represents the prominent source of unjustified advantage. To achieve the socio-economic justice, Islam offers shariah based business model via different types of financing such qard, musharakah and mudharabah. Hence, there are different business models that can be offered for the establishment of Islamic microfinance institution.

Who are the Regulators?

Many regulators encourage private monitoring of Islamic microfinance institutions. For instance, regulators may require Islamic microfinance institutions to obtain certified audits and/or ratings from rating agencies. Regulators may also make Islamic microfinance institution directors legally liable if information is erroneous or misleading. Regulators may also compel Islamic microfinance institutions to produce accurate, comprehensive and consolidated information on the full range of Islamic microfinance institution activities and risk-management procedures. Furthermore, a country credibly imposes a “no deposit insurance” policy to stimulate private monitoring of microfinance institutions.

Some economists have advocated greater reliance on the private sector and expressed misgivings with official regulation of Islamic microfinance institutions. For instance, the “grabbing-hand” view of government regulations holds that Islamic microfinance institutions will pressure politicians who, in turn, can unduly influence regulators. Furthermore, in some countries, regulators are not well compensated and hence quickly move into Islamic microfinance institution, resulting in a situation in which regulators may have mixed objectives when it comes to strict adherence to the rules. Also, since regulators do not have their own wealth invested in Islamic microfinance institutions, they have different incentives from that of private owners or rabbul mal when it comes to monitoring and disciplining Islamic microfinance institutions. For example, the rabbul mal who act as capital contributors, via restricted deposits, are in a better position to monitor and discipline Islamic microfinance institutions.

However, questions are raised about placing excessive trust in private-sector monitoring, especially in a system with poorly-developed capital markets, accounting standards, and legal systems. A system with a weak institutional environment will benefit more from regulators containing excessive risk-taking behavior Islamic microfinance institution and thereby instilling more confidence in customers than would exist with private-sector monitoring. This view argues that, in weak institutional settings, increased reliance on private monitoring leads to exploitation of small savers and hence less Islamic microfinance institution development.

Ownership of Islamic Microfinance institutions

Economists hold sharply different views about the impact of government ownership of Islamic microfinance institutions on financial and economic development. The argument is that government ownership of Islamic microfinance institutions would facilitate the mobilization of funds and the allocation of those funds toward strategic projects with long-term benefits on an economy. According to this view, governments have adequate information and sufficient incentives to ensure socially desirable investments. Consequently, government ownership of Islamic
Microfinance institutions help economies overcome private capital-market failures, exploit externalities, and invest in strategic sectors. The government ownership of Islamic microfinance institutions to promote economic and financial development may be relevant in an underdeveloped financial system.

However, governments do not have sufficient incentives to ensure socially desirable investments. Government ownership tends to politicize resource allocation, soften budget constraints, and otherwise hinder economic efficiency. Thus, government ownership of Islamic microfinance institutions facilitates the financing of politically attractive projects, but not necessarily economically efficient projects.

4. Regulatory Environments
The policy-related issues mentioned earlier are important for an effective regulatory framework. Hence, several guidelines shall be introduced to produce environmentally effective regulations, among others the guideline on: the shariah advisory council, corporate governance, group lending policy, loan loss financing, minimum capital and micro-takaful scheme.

Guideline on Shariah Advisory Council

According to the discussion in section three, Islamic microfinance institutions need to comply the shariah. Hence, Islamic microfinance institution is required to set up a Shariah Advisory Council (SAC) to supervise its operations to ensure that those operations comply with the rules of shariah. The SAC advises the directors about matters pertaining to the operational issues of the Islamic microfinance institution. The SAC also takes the views of the Shariah Committees of relevant authorities such as National Shariah Advisory Council on issues relating to the industry.

Guideline on Corporate Governance

The operation of an Islamic microfinance institution embodies a number of features such as equity participation; and risk and profit-loss sharing arrangements and as trustee. On the one side, an Islamic microfinance institution is essentially a partner with its trustees, and also a partner with entrepreneurs, on the other side, when employing trustees' funds in productive direct investment. The trustee also shares in the profits according to a predetermined ratio, and is rewarded with profit returns for assuming risks.

These financial arrangements imply quite different stockholder relationships, and by corollary governance structures, from the conventional model since trustees have a direct financial stake in the microfinance institution's investment and equity participations and the benefits of investment should be restricted or unrestricted depending on the types of philanthropy. As discussed above, the Islamic microfinance institution is subject to an additional layer of governance since the suitability of its investment and financing must be in strict conformity with Islamic law and the expectations of the Muslim community. For this purpose, Islamic microfinance institutions should form the Shariah Advisory Council.

Therefore, the governance structures are quite different because the Islamic microfinance institution must obey a different set of rules - those of the Holy Qur'an - and meet the expectations of the Muslim community by providing Islamically-acceptable financing modes. There are two major differences from the conventional framework. First, and foremost, an Islamic microfinance institution must serve God. It must develop a distinctive ethics and culture, the main purpose of which is to create a collective morality and spirituality which, when combined with the production of goods and services, sustains the growth and advancement of the Islamic way of life.
Secondly, Islamic microfinance institutions are formed based on the Islamic legal concepts of *shirkah* (partnership) and *mudarabah* (profit-sharing). An Islamic microfinance institution is conceived as financial intermediary mobilizing funds from the public on *mudarabah* and trust basis and advancing capital to entrepreneurs.

**Guideline on Group Lending Policy**

The joint-liability lending (also known as group lending policy) practice, see for example Attanasio et al (2011) has been introduced since the establishment of Grameen bank in the 1970s. The practice has been widely adopted in microfinance programs in many developing countries as an important tool to provide credit to the poor. This practice has produced many positive results, like the expansion of the number of microfinance institutions and improvement of repayment rates.

This practice also benefits the poor, because most of whom do not have any collateral; it is very risky to lend them money. This lack of collateral, in addition to a severe lack of financial and personal information about each potential client, puts an Islamic microfinance institution in the impossible situation of guessing who is going to pay them back, and who is going to default or run off with their money.

Group lending, as mentioned in Ismail and Wan Yussof (2014), solves both of these problems. If one member of the group is unable to pay back their loan, the other members of the group must pay back that person’s share for them. This provides a form of insurance for the Islamic microfinance institutions, as they know they will get paid back, even if one person defaults on their loan or is unable to make a payment.

Group lending also addresses an Islamic microfinance institution’s lack of information by making the members of a community form their own groups. Since each member of the community has a more in-depth knowledge of who is likely to repay on time and who is more risky, all of the less risky people will group together leaving all of the risky people together. This means that the more responsible groups will very rarely have to pay for each other, whereas the more risky groups will have to pay for someone else more often, thus effectively creating a higher interest rate for those riskier people. The group-lending model is an ingenious way of overcoming some of the challenges that lending to the poor entails.

However, it also creates a negative result on the commitment to repayment meetings and can create social pressure for borrowers. A potential downside to group lending policy is that it often involves time-consuming weekly repayment meetings and exerts strong social pressure, making it potentially onerous for borrowers. This is one of the main reasons why Islamic microfinance institutions started to move from joint to individual lending.

It is also often argued that the high transaction costs faced by Islamic microfinance institutions in identifying and screening their clients, processing applications and collecting repayments keep prevent Islamic microfinance institution from reaching new clients and expanding their operations.

Understanding the factors affecting repayment performance, which may vary by (unobserved) group types, are thus of great policy relevance. In particular, more accurate risk scoring tools can help to overcome information asymmetries by aiding Islamic microfinance institutions to better classify their potential clients and understand the factors driving their behavior, further promoting the development and sustainability of microfinance programs.

**Guideline on Loan Loss Financing**

Islamic microfinance institutions may self-classify each of their financing assets within one of the five categories set forth below. In making the decision to classify a financing asset within one of the five classification categories listed, an Islamic microfinance institution may use its informed judgment but may be guided by the standards and components set forth below with respect to each category. Self-classifications of financing assets by Islamic microfinance institution may be subjected to classification decisions of the regulators. Differences between classification decisions of regulators with respect to any financing and that of the classifying Islamic microfinance institution may be subject to negotiation between them but the classification decision of regulators shall be deemed final for all purposes.
**Standard** - An asset classified as Standard is paid in a current manner and is supported by sound net worth and the paying capability of the buyer. The financing was made with sound standards of credit analysis. Standard assets are sufficiently secured with respect to both the principal amount and profit, and only a general provision shall be formed for standard assets in the amount of 1%.

**Watch-List** – An asset classified as Watch List is adequately protected, but is potentially weak. Such an asset constitutes an unwarranted credit risk, but not to the point of requiring a classification of Substandard. The credit risk may be minor, and in most instances, Islamic microfinance institution managements can correct the noted deficiencies with increased attention. Yet such risk is considered undue and unwarranted in light of the particular circumstances surrounding the asset.

Examples of Watch-List assets are those which may, if not corrected, become weakened by imprudent financing practices including but not limited to the Islamic microfinance institution financing officer’s inability to properly supervise them due to lack of expertise; the financing was not made in compliance with the Islamic microfinance institution’s internal policies; failure to maintain adequate and enforceable documentation; or poor control over collateral. Watch-List assets require a minimum financing provision of, say, 1.5%. Under no circumstances should a Watch List category be utilized as a compromise between the classification categories of Standard and Substandard.

**Substandard** – An asset classified as Substandard is inadequately protected by current sound net worth and paying capacity of the buyer or by the collateral, if any, supporting it. Such an asset has at least one well-defined weakness that jeopardizes the full repayment of the financing. It is characterized by the distinct possibility that the Islamic microfinance institution will sustain some loss if the deficiencies are not corrected. Assets that are past due 61-90 days for principal or profit payments must be classified as substandard at a minimum. Substandard assets require a minimum financing provision of 25%. Examples of substandard assets include the following: (i) primary sources of repayment are insufficient to service the financing and the Islamic microfinance institution must look to secondary sources of repayment, including collateral; (ii) the buyer’s current financial capability or cash flow is not sufficient to meet currently maturing financing; and (iii) the buyer’s business is significantly undercapitalized.

**Doubtful** – An asset classified as Doubtful has all the weaknesses inherent in one classified as Substandard with the added characteristic that these weaknesses make collection or liquidation in full, on the basis of current circumstances and values, highly questionable and improbable. Although the possibility of loss is thus extremely high, because of significant pending factors, reasonably specific, which could be expected to work to the advantage and strengthening of the asset, its classification as an estimated loss is deferred until its more exact status may be determined. Examples of such pending factors include but are not limited to mergers, acquisitions, capital restructuring, and the furnishing of new collateral or realistic refinancing plans. Assets that are past due 91-180 days for principal or profit payments (or deferred payment amounts) must be classified as doubtful at a minimum. Doubtful assets require a minimum financing provision of 50%.

**Loss** - An asset classified as a loss is considered not collectible and of such little value that its continuance as an asset is not warranted. A loss classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future. An asset that is past due over 180 days for principal or profit payments must be classified as loss. Loss assets require a financing provision of 100%.

**Guidelines on Minimum Capital**

Traditional approaches to Islamic microfinance institutions emphasize the positive features of capital adequacy requirements. Capital, or net worth, serves as a buffer against losses and failure. When faced with limited liability, Islamic microfinance institutions owners will avoid higher risk activities considering the amount of capital at risk.
relative to assets. With deposit insurance the regulatory capital requirements play a crucial role in aligning the incentives of Islamic microfinance institutions owners with fund owners and other financiers. However, disagreement may exist over whether the imposition of capital requirements actually reduces risk-taking incentives. Moreover, it is difficult - if not impossible - for regulators and supervisors to set capital standards that mimic those that would be demanded by well-informed, undistorted private-market participants.

For instance, actual capital requirements may increase risk-taking behavior. At the same time, capital requirement may also induce credit rationing, that produce a negative implications for economic growth.

Higher capital requirements may induce customers to shift to capital markets and in the process impair capital allocation, while raising capital requirements can increase the cost of capital. Thus, these provide conflicting predictions on whether capital requirements curtail or promote Islamic microfinance institutions performance and stability.

Therefore, at a time when existing regulatory capital requirements are widely viewed as being arbitrary and inadequate, it seems especially important to examine whether they even matter since capital adequacy standards might be introduced.

Guidelines on Micro-Takaful

One of the strategies to maintain the sustainability of Islamic microfinance institutions is to create a guarantee mechanism. It can be done through micro-takaful scheme. It is crucial to arrange micro-takaful mechanism for Islamic microfinance institutions’ financing operation. The practice of takaful for Islamic microfinance institutions as implemented by Indonesia Association for BMT (PBMTI) through Ta’awuni Model can be considered as a good one. The Ta’awuni Model tries to mitigate risk of financing, by providing guarantee for repayment of financing if the customers fail to do so due to unexpected incidence prevails.

This guideline may include the coverage against defaults on financing to micro-enterprises. For example, it can provide the facility such as 3 percent premium for 3-5-year financing and risk sharing (a guarantee for 75 percent of each financing). Furthermore, by doing this, it will contribute to a low arrears and default rate for Islamic microfinance institutions.

5. Conclusion

The aim of this paper is to provide a framework for addressing regulatory issues which impact Islamic microfinance institution operations and institutional development. The first step in regulating Islamic microfinance institutions is the philosophical foundation of its establishment that the interpretation of shariah principles that is formulated in their operations and incentives. However, before the introduction of regulations, several policy issues related to regulations need to be addressed, among others: Islamic microfinance institution activities and Islamic microfinance institution-philanthropy links; effectiveness and sustainability; shariah based business model; who are the regulators; and ownership. These policy related issues are important for an effective regulatory framework. Several guidelines have been introduced to produce environmentally effective regulations, among others are the guideline on: the shariah advisory council, corporate governance, group lending policy, loan loss financing, minimum capital and micro-takaful scheme.
References


