

A FURTHER NICHE MARKET:
Islamic Microfinance in the Middle East and North Africa

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November 2008

I. Introduction

The two “niche” markets of Islamic finance and microfinance are the latest buzzwords being thrown around in both board meetings on Wall Street and planning meetings at G8 summits.¹ The two movements have grown in depth and popularity since their respective inceptions nearly four decades ago. The crowning moment for the microfinance movement came in 2006 when Bangladeshi economist Muhammad Yunus and his Grameen Bank shared the Nobel Peace Prize. With this event the world was openly acknowledging that the poor are “bankable” and that small loans to people who lack access to mainstream banking services can be an effective tool for alleviating poverty and raising standards of living. The microfinance movement of today has matured to the point where a portion of microfinance institutes (MFIs) worldwide is commercially viable. Islamic finance, after developing for sometime in Muslim countries finally made headlines in the West in 1999 when Dow Jones & Company launched the first Islamic indexes, which as of 2008 include nearly 70 Shari`a-compliant measures covering equity and fixed income securities across the globe.²

As these two economic movements have gained notoriety, they have also gained substantial international investment. From 2004-2006 the stock of foreign capital investment in MFIs—covering both debt and equity—more than tripled to \$4 billion as international retail banks, investment banks, pension funds and private equity funds looked for ways to channel capital into microfinance, and investment banking techniques were being introduced to create alternative investment vehicles that appeal to an increasingly broad range of investors.³ Over the same period, the issuance of *sukuks*, non-interest-bearing securities based on Islamic principles, quadrupled from \$7.2 billion in 2004 to over \$27 billion in 2006, boosted by hedge funds and conventional institutional investors looking to diversify portfolios.⁴ More

¹ At the 2007 G8 summit in Heiligendamm, Germany, James Mwangi, the CEO of Equity Bank, a Kenyan financial institution offering microfinance services to its clients, gave a keynote address entitled, “Contributions of Microcredits to Overcoming the Spell of Poverty Also in Africa.” His speech was followed by a roundtable discussion on eradicating poverty; a goal G8 countries are under pressure to achieve. Mwangi focused will be on increasing the accessibility of financial services to the low-income population, who are currently neglected from the sector.

² “Dow Jones Islamic Market Indexes.” Brochure. Dow Jones & Company, Inc. 2008.

http://www.djindexes.com/mdsidx/downloads/brochure_info/Islamic_broch.pdf

³ Forster, Sarah and Xavier Reille. “Foreign Capital Investment in Microfinance.” Focus Note 44. CGAP, Washington, D.C. February 2008. <http://www.cgap.org/p/site/c/template.rc/1.9.2584>. p 1.

⁴ Jobst, Andrew, Peter Kunzel, Paul Mills, and Amadou Sy. “Islamic Finance Expanding Rapidly.” IMFSurvey Magazine, IMF Research. September 19, 2007. <http://www.imf.org/external/pubs/ft/survey/so/2007/res0919b.htm>

recently with the current global credit crisis, investors from a wide range of financial services have suggested that Islamic finance may be a potential “haven from speculative excess.”⁵

At the same time as these two markets were growing and maturing, the economies of the traditionally Islamic world, the Middle East and North Africa (MENA) region, have developed at varying rates of economic growth and lackluster rates of human development, due to the constraints of a finite amount of arable land and water resources, high rates of population growth, slow political and economic reform and oil-dependent financial systems in some states. According to the World Bank’s “Middle East and North Africa: 2008 Economic Developments and Prospects Report,” MENA’s growth rate of 5.7% in 2007 compares unfavorably with the 10% growth rate of the East Asia and the Pacific region, the 8.4% rate of South Asia, and even the 6.1% rate of the Sub-Saharan Africa region.⁶ Income poverty is still a significant issue in the MENA with 29.9% of the total population (approximately 87 million people) living on \$2.00 a day in 2001, which is a higher incidence than in East and Central Asia (19.3%) and on par with 33.1% in Latin America and the Caribbean.⁷ Additionally as of 2008, the MENA region faces a 13% unemployment rate, making it one of the highest regional rates in the world when compared with the 6% average rate for all middle-income countries.⁸ The MENA region will have to create 55 to 70 million jobs between now and 2020 to keep pace with and bring the rate of unemployment down to the global norm.⁹ The need to generate greater economic prospects in the MENA region is obvious.

A discussion of the “effectiveness” of microfinance in poverty alleviation and economic development over the long term is beyond the scope of this paper. For the sake of space and argument the following general assumption about microfinance (that many development specialists have also argued)

⁵ Desai, Umesh. “Credit crisis gives Islamic finance a chance to shine.” International Herald Tribune. August 19, 2008. <http://www.iht.com/articles/2008/08/18/business/invest19.php>

⁶ The World Bank. “Questions and Answers.” *Middle East and North Africa: 2008 Economic Developments and Prospects Report*. The World Bank. <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/MENAEXT/0,,contentMDK:21819850~pagePK:146736~piPK:146830~theSitePK:256299,00.html>

⁷ The World Bank. “World Bank: Middle East and North Africa Strategy Paper.” The World Bank. 2001. <http://web.austin.utexas.edu/chenry/global/coursemats/World%20Bank%20Group%20%20MENA%20Region%20Strategy%20Paper.htm>

⁸ “Agriculture & Rural Development Brief” The World Bank. September 2008. <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/MENAEXT/0,,contentMDK:20528258~pagePK:146736~piPK:226340~theSitePK:256299,00.html>

⁹ Noland, Marcus and Howard Peck. “Looming Beyond the Boom.” Op-ed in VoxEU.org August 1, 2008. <http://www.voxeu.org/index.php?q=node/1496>

will be made: microfinance, when applied appropriately (i.e. to fit local circumstances and meet local needs), can be a stimulus of decentralized economic growth from a grass-roots level in developing countries.¹⁰ With the rise of microfinance and Islamic finance internationally, economists, theologians, development specialists and policy-makers have begun asking whether there is any potential synergy between these two “niche” markets that can be used to address the dismal political economy of the MENA. Can microfinance facilities expand their reach in the MENA by offering Islamic financial instruments to those who for religious or cultural reasons are reluctant to try conventional financial instruments?

This paper explores the use of Islamic finance instruments in MENA MFIs, arguing that the experiences of Islamic MFIs operating in the MENA in the last decade demonstrate that Islamic MFIs can be competitive with conventional MFIs in the region, can address the basic financial needs of their clients in a cost-effective manner and can meet the reported demand of lower income groups for religiously tailored financial services. Divided into five parts the papers proceeds as follows:

-Part two is devoted to a discussion of the background, methodology and present strengths and weaknesses of the young, but growing, microfinance movement the MENA.

-Part three explores the philosophy, evolution and instruments of Islamic finance and concludes with a discussion of potential synergies between Islamic finance and microfinance.

-Part four gives an overview and comparison of two seminal case studies in the use of Islamic finance instruments in MFIs: a) the *Sandug* project in Jabal Al-Hoss, Syria; and b) the Hodeidah Microfinance Programme (HMFP) in Hodeidah, Yemen. These two studies warrant special attention because of the expressed interest of academics, microfinance experts and Islamic bankers, in a hybrid of microfinance and Islamic finance,¹¹ there are few examples of MFIs actually operating in the field of

¹⁰ For a brief overview of the debate of the “effectiveness” of microfinance see: Keith Epstein and Geri Smith’s article “The Ugly Side of Microlending: How big Mexican banks profit as many poor borrowers get trapped in a maze of debt” (*BusinessWeek*, December 13, 2007). Or for a more in-depth look at the impact of microfinance on economic development see Jeffrey Sachs’ book [The End of Poverty: Economic Possibilities for Our Time](#) and Thomas W. Dichter’s book [Despite Good Intentions Why Development Assistance to the Third World Has Failed](#).

¹¹ For example, in April 2007, the Islamic Finance Project (IFP) of the Islamic Legal Studies Program (ILSP) at Harvard Law School hosted a symposium entitled “Financing the Poor: Towards an Islamic Microfinance,” which was attended by over 120 scholars, professionals, and students and featured such speakers as: Robert A. Annibale,

Islamic finance and even fewer studies of those in existence. The methodology, products employed and results of the Syrian and Yemeni Islamic MFIs will be reviewed against other MFIs operating in their respective countries and in the MENA region.

-Part five, the final section of this paper, synthesizes the previous three sections, and discusses the future of Islamic MFIs in the context of the political economy of the MENA.

II. Microfinance

MFIs differ from formal financial institutions in their target customers, i.e. those who are traditionally excluded from conventional financial services, and their alternative approach to “collateral” that comes from the concept of joint-liability. For the purposes of this paper, microfinance is defined as the provision of financial services to the *entrepreneurial* poor. A distinction must be made between those who can use economic activities to increase their income, moving them closer to or above the poverty line (the *entrepreneurial* poor) and then those who require economic assistance simply to survive (the *extremely* poor).¹² Making financial services—small short term loans, savings and deposit services and insurance—available to the entrepreneurial poor can increase household incomes, reduce unemployment and generate demand for more goods and services.

The microfinance movement began in the 1970s, as an experimental program in Bangladesh in which groups of poor women with no collateral were extended small loans from a state funded NGO to invest in productive activities. In place of collateral, “group solidarity” also referred to as “joint-liability” was used to guarantee repayment of the loans, which were made at high, but not unfeasible interest rates. This group-lending model was popularized by Muhammad Yunus’s Grameen Bank, and then replicated worldwide, with each new program amending the model to fit local needs. A variation of the Grameen model was implemented in Yemen in 1997 and is the first case study of an Islamic MFI covered in part four of this paper. A second MFI model is the “village bank” model in which an implementing agency establishes individual village banks of 30 to 50 members who all provide some amount of initial capital

Global Director of Microfinance at Citigroup, Aamir Rehman, former Global Head of Strategy at HSBC Amanah, Hans Dieter Seibel, Professor at the University of Cologne, Germany, and Samer Badawi of the Consultative Group to Assist the Poor, Washington, D.C.

¹²Brandsma, Judith and Laurence Hart, “Making Microfinance Work Better in the Middle East and North Africa.” World Bank Institute and World Bank. 1999. p 3.

that is then matched by the agency. As the banks accumulate capital internally from repayments of the loans, they gradually become self-sufficient MFIs. This is the model used in the Syrian case study that is also discussed in section four. Other MFI models include credit unions and self-help groups, both of which maintain the concept of joint-liability to ensure repayment.¹³

The Consultative Group to Assist the Poor (CGAP), a multi-donor consortium dedicated to advancing microfinance, has defined the best practices for MFIs as:

- (i) *inclusive* financial services that are tailored to the community's needs; an emphasis on *access* to microfinance services and not the *cost* of services;
- (ii) *sustainability* through a shift from a charity-based, donor-dependent approach to a market-based, for-profit approach;
- (iii) systemic *transparency* with standardized accounting and reporting techniques;
- (iv) *capacity building* mandate within the proper *regulatory framework* supported by the state.¹⁴

The characteristics of microfinance methodology most relevant to the MENA region are flexibility and joint liability.

As the rates of expansion of MFIs in the MENA differ dramatically and state-reported poverty levels are often undervalued, the estimates of the potential market for microfinance and the current market penetration in the MENA are generally imprecise. It was estimated in 2004 that 19%-23% (1.9 million to 3.7 million potential borrowers) of potential microfinance market was being served, leaving close to three million households without access to credit.¹⁵ Microfinance's history in the MENA is very young compared to other regions such as Latin America or South Asia where microfinance was in large part pioneered. This has both positive and negative aspects. Since microfinance was pioneered elsewhere,

¹³ Khan, Tariqullah, et al. "Framework and Strategies for Development of Islamic Microfinance Services." Discussion Paper for the IFSD Forum 2007 "Islamic Microfinance Development: Challenges and Initiatives." Islamic Research and Training Institute, Islamic Development Bank. Dakar, Senegal. May 27, 2007. www.ifsdforum.com/2007/MF_paper_May05.pdf p 12.

¹⁴ For a detailed best practices guidelines see CGAP's "Good Practice Guidelines for Funders of Microfinance." <http://www.cgap.org/p/site/c/template.rc/1.26.1429>

¹⁵ A rough estimate of the potential market for credit in the region can be calculated based on the national poverty headcount percentages. It is common practice in the microfinance industry to assume that not more than one member per household should have a loan (because with an increasing number of household members borrowing, the household risks becoming permanently indebted). If we assume that the average size of a poor household is seven, we can compute the number of poor households per country. Not every poor person is a good entrepreneur or has a good project to finance. If we assume that 40% of all poor households would be eligible for a loan, we can calculate the potential market for credit (in terms of number of potential borrowers). Brandsma, Judith and Deena Burjorjee. "Microfinance In the Arab States: Building Inclusive Financial Sectors." United Nations Capital Development Fund. October 2004. p 31-32.

many unproductive practices have already been identified, and therefore the best practices can be immediately implemented in the MENA. At the same time, the expectations of the potential positive effects of microfinance are unrealistic. The authors of 1999 World Bank report on regional microfinance, “Making Microfinance Work Better in the Middle East and North Africa.” cautioned that microfinance should not be seen as a panacea for or solution to unemployment.¹⁶

MFIs in the MENA are too heavily focused on one product: credit for enterprise investment. Credit is just one of the many financial services the poor may need such as emergency loans or savings and deposit services. Though “the sector is characterized by good exposure to and understanding of industry good practices, norms, and procedures, which are applied widely across the region,” both donor dependency and government-funded lending programs continue to be key issues for MENA MFIs. Few MENA MFIs have been successful in gaining access to commercial capital, forcing them to rely on donor funding. Additionally state-subsidized lending programs for unemployment in countries such as Egypt, Tunisia, Lebanon and Jordan, continue to provide credit at below market interest rates to vast numbers of people in the region having a distortionary effect on any analysis of the state of the MENA microfinance industry. Most of these state programs lend at subsidized interest rates, have low repayment rates and target mostly men.¹⁷

III. Islamic Finance

People often only associate Islamic finance with the strict prohibitions of charging or receiving interest and gambling, which in Arabic as referred to respectively as *riba* and *gharar*. However, more generally the term “Islamic finance” defines an entire system of finance based on Islamic law, or *Shari`a*. Using readings of the Quran and the *Hadith*, the oral traditions of the words and deeds of the prophet Muhammad, Islamic scholars have derived the fundamental precepts for an Islamic financial system. The five fundamental precepts most relevant to microfinance are:

- 1) money has no intrinsic value in and of itself;

¹⁶ Brandsma, Judith and Laurence Hart, “Making Microfinance Work Better in the Middle East and North Africa.” World Bank Institute and World Bank. 1999. p 2

¹⁷ Brandsma, Judith and Laurence Hart, “Making Microfinance Work Better in the Middle East and North Africa.” World Bank Institute and World Bank. 1999. p 18-19.

- 2) all financial transactions must be linked directly or indirectly to a an economic activity, i.e. backed by real durable assets;
- 3) investors must also share in the risk of their funding;
- 4) contracts must be mutual and explicit i.e. all parties involved agree to the exact terms and conditions and have complete knowledge of what is being bought or sold;
- 5) and all activities financed must be consistent with Shari`a e.g. such taboo activities as pork or alcohol consumption and gambling cannot be funded.¹⁸

Although there is no central “Shari`a finance authority” to specifically define or enforce Islamic standards, the industry’s most well known Shari`a finance scholars agree upon the five precepts above. Today the majority of the debate and controversy within Islamic finance centers on the implementation of Islamic financial instruments.¹⁹

Out of these five initial Islamic finance precepts came two experiments in Islamic banking in the early 1950s and 1960s: one in rural Egypt and the other in urban Kuala Lumpur, Malaysia. The Malay bank, Tabung Hajji, established in 1956, was created in order to collect savings for *hajjis* (those who are going to perform the *hajj*, the compulsory pilgrimage to Mecca, an obligation of Islam that must be carried out at least once in the lifetime of every able-bodied Muslim who can afford to do so). The bank would then invest the hajjis’ savings in accordance with Islamic law. The Egyptian experiment, known as the Mit Ghamr Savings Bank, was a rural co-operative village banking system, very similar to the second model of microfinance mentioned earlier in part two of this paper. Dr. Ahmed al Najjir with the help of German funding, established the Mit Ghamr project in 1963.²⁰ It accepted three types of deposits: demand deposits on which no interest was paid, investment deposits on which a profit-share was paid or to which

¹⁸ For an in depth discussion of the fundamentals of Islamic Finance see Mahmoud A. El-Gamal’s Islamic Finance: Law, Economics and Practice (Cambridge University Press, 2006).

¹⁹ A detailed discussion of the current issues and debates within the Islamic Finance world is covered in Clement Henry and Rodney Wilson’s edited compilation of country-specific and topical essays The Politics of Islamic Finance (Edinburgh University Press, 2004).

²⁰ In 1967 the Mit Ghamr experiment was shut down and the banks were liquidated by Egyptian authorities who feared Islamic extremist and members of the Muslim Brotherhood had infiltrated the bank as clients and members. Unfortunately, little is known of the banks success as no formal studies were published on the bank except for the writings of Dr. al Najjir who emphasized that the process of generating savings through local efforts created a new “energy” among the poor peasants and farmers. For more discussion of the Mit Ghamr project see: Mozer Kahf’s essay “Islamic Banks: the Rise of a New Power Alliance of Wealth and Shari`a Scholarship” in Clement Henry and Rodney Wilson’s The Politics of Islamic Finance (Edinburgh University Press, 2004).

a loss-share was charged, and *zakah* deposits.²¹ Additionally, depositors had the right to take out small loans for productive purposes.

Today's Islamic banking system, however, did not develop from Dr. al Najjir's model. Rather contemporary Islamic banking started in 1975 with the establishment of the Dubai Islamic Bank, followed by the Kuwait Finance House, the Faisal Islamic Banks in Egypt and Sudan, and the al Baraka banks, all of which were financed by the dearth of wealth following the dramatic rise in oil prices in 1973. The present system has been criticized for too closely mimicking conventional banking practices and for "failing to deliver economic and social development to Muslim populations that remain among the poorest and least educated in the world."²²

With the aforementioned precepts of fairness, risk sharing and materiality in mind, Islamic finance experts have developed products that comply with the general prohibition of interest and at the same time generate profit. Though there are many kinds of Islamic financial products on the market today, the three products most relevant to microfinance are: *mudaraba* and *musharaka*, *murabaha*, and *ijara*. *Musharaka* and *mudaraba* are profit-loss sharing schemes most often encouraged by Sharia scholars. In a *musharaka* contract the parties share the profits or losses of a business venture by a predetermined ratio. It is essentially an equity-participation venture in which the bank or financier remains a partner throughout the operation. *Mudaraba*, on the other hand, denotes trustee financing. One party provides the funds and the other party executes and manages the project. If a *mudaraba* venture results in a loss, the financier loses the contributed capital and the manager loses time and effort; and if the venture results in a gain, profits are shared according to a predetermined ratio.

Often referred to as a "cost plus markup sale" contract, *murabaha* is an asset-backed sales contract used to finance the purchase of goods needed by the client as working capital. In this contract the client requests a specific commodity from the bank or financier, who buys it directly from the market and then sells it back to the client with a fixed mark-up for the service provided. Ownership and in turn the

²¹ El-Gamal, Mahmoud A. "Mutuality as an Antidote to Rent-Seeking Shari'a-Arbitrage in Islamic Finance." Rice University. April 2005. www.ruf.rice.edu/~elgamal/files/Mutuality.pdf

²² El-Gamal, Mahmoud A. "Mutuality as an Antidote to Rent-Seeking Shari'a-Arbitrage in Islamic Finance." Rice University. April 2005. www.ruf.rice.edu/~elgamal/files/Mutuality.pdf

maintenance of the commodity remain the liability of the financier until the client completely repays the financier, which can be done either by an installment plan or in a lump sum. The “markup” is distinct from interest as it remains fixed at the contract’s inception and even in the case of past due date.

The fourth Islamic finance product relevant to microfinance, *ijara*, is a leasing contract commonly used to finance equipment such as small machinery. An *ijara* lease is explicit in its definitions of the duration and schedule of re payments. The contract also clearly states that the financier owns and is liable for the maintenance of the machinery. A fifth product that deserves mention as many microfinance experts have argued its potential utility and appeal to low income traditional clients is Islamic “savings.” Yet it is rarely employed by Islamic MFIs today. Islamic savings products work on a *mudaraba*-like basis in the sense that a “saver” deposits his or her money in the business of an financial institution which then invests its own managerial expertise and time in intermediating the deposits in a Shari`a compliant manner. Serving as the “interest,” the profits or losses of these investments are then shared between the depositor and the bank pursuant to a predetermined agreement.²³

IV. Islamic Microfinance

On both an ideological level and practical level, microfinance and Islamic finance complement one another. Islamic finance’s emphases on entrepreneurialship, materiality, and risk sharing are reflected in microfinance’s basic model of joint-liability lending to the entrepreneurial poor.²⁴ On an abstract level, both services are considered unconventional solutions to specific financial needs that are unmet by today’s conventional financial services industry. Both movements began from egalitarian approaches, (if one considers the initial manifestation of Islamic finance the Mit Ghamr Village Bank model and not the present model, which mimics conventional banks.)

With microfinance’s and Islamic finance’s shared stress on entrepreneurialism and shared end goal of society’s overall development in mind, the next question is whether there is a market for a

²³ This section draws heavily from the definitions of basic Islamic contracts in Nimrah Karim, Michael Tarazi and Xavier Reille’s “Islamic Microfinance: An Emerging Niche Market.” Focus Note 49. Washington, D.C.: CGAP, August 2008. <http://www.cgap.org/p/site/c/template.rc/1.9.5029>

²⁴ Dhumale, Rahul and Amela Sapcanin, “An Application of Islamic Banking Principles. to Microfinance. Technical Note.” United Nations Development Programme and World Bank. 1998. p 1. <http://www.gdrc.org/icm/country/wana/wb-bnkprinciples.pdf>

“hybrid” of the two. According to several recent surveys and studies, there appears to be a great demand for Islamic microfinance products in majority Muslim countries. According to CGAP’s 2008 Focus Note on Islamic microfinance: “...just as there are many mainstream banking clients who demand Islamic financial products, there are also many poor people who insist on these products...Shari`a compliance in some societies may be less a religious principle than a cultural one and even the less religiously observant prefer Shari`a compliant products.”²⁵

An International Finance Corporation (IFC) commissioned study in Syria revealed that 37.8% of respondents gave religious reasons for not obtaining microfinance.²⁶ According to a recent CGAP study on the value of MFIs offering Islamic finance instruments, 40 % of the poor in Yemen demanded Shari`a compliant financial services.²⁷ It should be highlighted that the authors of the CGAP study made specific note of anecdotal evidence that suggests perhaps survey respondents may have verbally expressed a preference for Islamic products simply to demonstrate piety and when given a hypothetical choice between two products, respondents opted for the lower priced conventional product over the more expensive Islamic finance product. Therefore, despite expressed interest in Islamic microfinance products, more research is needed to establish the exact extent and nature of demand if the microfinance industry is to meet this demand in a cost-effective and socially productive manner.

The application of Islamic finance to microfinance was first discussed in depth in 1997 in Rahul Dhumale and Amela Sapcanin’s article, “An Application of Islamic Banking Principles to Microfinance. A Technical Note.” They argued that from a microfinance standpoint the mudaraba model (profit-share) has more drawbacks than the murabaha model (cost plus markup). The strengths and weaknesses of the two models when applied to microfinance are summarized in the following chart:

²⁵ Nimrah Karim, Michael Tarazi and Xavier Reille. “Islamic Microfinance: An Emerging Niche Market.” Focus Note 49. Washington, D.C.: CGAP, August 2008. p 5. <http://www.cgap.org/p/site/c/template.rc/1.9.5029>

²⁶ Akinci, M., Çetin, O., Khalaf, R. and Libois, W. “Syria Microfinance Market Assessment International Finance Corporation (IFC) & Grameen-Jameel Pan-Arab Microfinance Limited. July 2008. p. 10. <http://www.microfinancegateway.org/content/article/detail/50620>

²⁷ Nimrah Karim, Michael Tarazi and Xavier Reille. “Islamic Microfinance: An Emerging Niche Market.” Focus Note 49. Washington, D.C.: CGAP, August 2008. p 5. <http://www.cgap.org/p/site/c/template.rc/1.9.5029>

Applying Islamic Finance Instruments to microfinance

Issue	Mudaraba (profit sharing)	Murabaha (cost plus markup)
Financing best suited for	Fixed Assets	Working and investment capital
Cost to client	Higher because of the higher profit share of program due to the products higher risk	Lower
Initial client acceptance	Higher at first. Some clients may later be reluctant to disclose their profits.	Lower because model looks like to fixed interest rates
Risk to client	Lower if no predetermined minimum profit is mandated	Higher
Risk to program	Higher if no predetermined minimum profit is mandated	Lower
Administrative costs	High given the complexity of the repayment schedule and calculation of profit for each loan. Margin of error is also high given that a single loan officer may manage 100-200 clients.	Initially high because of the high volume of buy-resell transactions, but monitoring and administration is simple as repayments are made in equal installments or one lump sum
Enforcement	Difficult because of possible lack of transparency in determining profit.	Easy because the MFI owns the good until the client has completed paid it back.
<p><i>Source: Dhumale, Rahul and Amela Sapcanin, "An Application of Islamic Banking Principles. to Microfinance. Technical Note." United Nations Development Programme and World Bank. 1998. http://www.gdrc.org/icm/country/wana/wb-</i></p>		

The murabaha model is overall more cost effective, has a lower margin of error, and provides immediate collateral for a MFI because the MFI owns the goods until the last installment is paid.

The most recent and most comprehensive study of the performance and outreach of Islamic microfinance was a CGAP global survey in 2007 in which information was collected from over 126 Islamic MFIs and MFI experts in 19 Muslim countries. The survey revealed that Islamic MFIs have a total global outreach of 380,000 clients (or an estimated one-half 1% of total microfinance outreach).²⁸

²⁸ According to Microfinance Information exchanges Autumn 2007 "MicroBanking Bulletin," the total microfinance outreach is based on an estimated 77 million microcredit clients. Nimrah Karim, Michael Tarazi and Xavier Reille. "Islamic Microfinance: An Emerging Niche Market." Focus Note 49. Washington, D.C.: CGAP, August 2008. p 1. <http://www.cgap.org/p/site/c/template.rc/1.9.5029>

80,000 of the above clients are served through a network of Indonesian cooperatives and another 100,000 of the total clients are served by two large MFIs in Bangladesh.

It must be stressed that the MENA region is particularly underserved as CGAP's survey revealed that Islamic MFIs were concentrated in three countries Indonesia, Bangladesh and Afghanistan, accounting for 80% of the global outreach. Of the 126 Islamic MFIs that CGAP surveyed, the MENA Islamic MFI breakdown is as follows: Bahrain 4 Islamic MFIs, Jordan 1, Lebanon 1, West Bank and Gaza 1, Saudi Arabia 1, Sudan 3, Syria 1 and Yemen 1. CGAP also identified that over 70% of the financial products offered were murabaha, cost plus markup. Finally, the CGAP study stressed that Islamic microfinance "is still in its infancy, with no scalable institutions reaching clients on a regional and national level."

For the purposes of statistical or policy analyses, the above conclusion is true, yet, for the purpose of this paper the two Islamic MFIs case studies previously mentioned, the Jabal al Hoss Village Banking program in Syria and the Hodeidah program in Yemen, still warrant discussion. Both programs have long tenures (eight and 11 years respectively) and have achieved substantial success in their areas of operation - rural in the case of Syria and urban for Yemen.²⁹ In general MFIs in Syria and Yemen are still defining themselves and so far there is minimal government regulation of the industry, allowing the Islamic MFIs to operate with little intervention.

A. Yemen: The Hodeidah Microfinance Programme

Yemen is one of the poorest countries in the MENA, ranking 153rd out of 177 countries on the UNDP's 2007/2008 Human Development Report, with a Human Development Index (HDI) score of 0.508. (See page 18 for a more complete look at Yemen's Human Development Indicators). Access to formal financial services in Yemen is very limited - banks serve predominately urban businessmen. Other formal services, such as the postal savings system and money exchange offices, play minor roles changing and transferring money. The main sources of credit available to the general population tend to be informal i.e. family and friends who lend money "free of charge," but with a high "social costs."

²⁹ El Hawary, Dahlia and Wafik Grais, "The Compatibility of Islamic Financial Services and Microfinance: A Little Explored Avenue for Expanding Outreach." United Nations Capital Development Fund Newsletter. Issue 14, July 2005.

Additionally, wholesalers will often extend credit to their well-known customers. Despite customers preferring store credit to cash credit, the wholesalers' credit lending has its drawbacks: borrowers are forced to buy only from the wholesalers and often pressured to buy extra items; this credit is not available during high seasons; and the cost of credit varies from one area to another and is hard to estimate.³⁰

Established jointly in 1997 by the United Nations Development Program and the Yemeni government-funded Social Fund for Development (SFD), the Hodeidah Microfinance Programme (HMFP) is the first of its kind in Yemen to employ Islamic banking principles in a microfinance methodology offering financial products that fit local customs and address economic needs. The Hodeidah program was developed based on the findings of an extensive market survey in which potential clients were interviewed to determine their preference for types of credit: conventional or Shari`a compliant. The economy of Hodeidah, a port city along Yemen's Red Sea coast, is dominated by fishing, food production and small industries such as handicrafts. Beginning in the 1990s, the city began to see a large number of families return to the city from the Gulf States after the first Gulf War. As of 2002 close to 30% of the total population of Hodeidah were returnees and made up a key market segment of the HMFP.³¹

³⁰ Aliriani, Kais Ali. "Microfinance in Yemen: Providing Financial Services to the Poor in Yemen." Small and Micro Enterprise Development Unit, Social Fund for Development. Sana'a, Yemen. February 2002.

³¹ Al-ZamZami, Ahmed and Lorna Grace. "Islamic Banking Principles Applied to Microfinance Case Study: Hodeidah Microfinance Program, Yemen." Special Unit for Microfinance (SUM), United Nations Capital Development Fund. September 24, 2001. p. 5.

Human development index		MONITORING HUMAN DEVELOPMENT: ENLARGING PEOPLE'S CHOICES . . .				
		Arab States	Sub-Saharan Africa	Syrian Arab Republic	Yemen	
Indicators						
Human development index value	2005	0.699	0.493	0.724	0.508	
Life expectancy at birth, annual estimates (years)	2005a	67.5	49.6	73.6	61.5	
Adult literacy rate (% aged 15 and older)	1995-2005b	70.3	60.3	80.8	54.1	g
GDP per capita (PPP US\$)	2005	6,716	1,998	3,808	930	
Human poverty index (HPI-1) rank		31	82	
Population, total (millions)	1975	144.4 T	314.1 T	7.5	7.1	
	2005	313.9 T	722.7 T	18.9	21.1	
	2015c	380.4 T	913.2 T	23.5	28.3	
Population, annual growth rate (%)	1975-2005	2.6	2.8	3.1	3.6	
	2005-15c	1.9	2.3	2.2	2.9	
Internet users (per 1,000 people)	1990	0	0	0	0	
	2005	88	26	58	9	h
GDP (current US\$ billions)	2005	1,043.4 T	589.9 T	26.3	15.1	
Official development assistance received (net disbursements) per capita (US\$)	2005d	94.3	41.7	4.1	16	
Youth unemployment rate, total (% of labour force aged 15-24)	2006e	0	0	
Unemployment rate Total (% of labour force)	1996-2005f	0	0	11.7	11.5	

Notes:

a. The HDI rank is determined using HDI values to the sixth decimal point.

b. Data refer to national literacy estimates from censuses or surveys conducted between 1995 and 2005, unless otherwise specified. Due to differences in methodology and timeliness of underlying data, comparisons across countries and over time should be made with caution. For more details, see <http://www.uis.unesco.org/>.

c. Data refer to medium-variant projections.

d. ODA receipts are total net ODA flows from DAC countries as well as Taiwan Province of China, Czech Republic, Hungary, Iceland, Israel, Republic of Korea, Kuwait, Poland, Saudi Arabia, Slovakia, Turkey, United Arab Emirates and other small donors, including Estonia, Latvia, Lithuania and Slovenia, and concessional lending from multilateral organizations. A negative value indicates that repayments of ODA loans exceed the amount of ODA received.

e. The age range may be 16-24 for some countries.

f. Data refer to the most recent year during the period specified.

g. UNESCO Institute for Statistics estimates based on its Global Age-specific Literacy Projections model, April 2007.

h. Data refer to 2004.

Source:

column 1: calculated on the basis of data in columns 6-8; see Technical note 1 for details.

Affairs, Population Division. New York. Accessed July 2007, unless otherwise specified.

youth literacy rates. May. Montreal, unless otherwise specified.

for HDRO by the World Bank.

column 5: determined on the basis of HPI-1 values in column 2.

Affairs, Population Division. New York. Accessed July 2007.

Affairs, Population Division. New York. Accessed July 2007.

Affairs, Population Division. New York. Accessed July 2007.

column 9: calculated on the basis of columns 1 and 2.

column 10: calculated on the basis of columns 1 and 2.

Bank.

Bank.

Bank.

Development Assistance Committee). 2007. Correspondence on official development assistance disbursed. May. Paris.

[<http://www.oecd.org/statsportal/>]. Accessed July 2007.

column 16: ILO (International Labour Organization). 2007b. LABORSTA Database. Accessed 22 June 2007.

The program adheres to the precepts of Islamic finance and uses the murabaha model of cost plus markup for its target clientele. When it was first introduced it faced several challenges: some clients refused to receive credit due to their religious beliefs and some local religious leaders announced that the project practiced riba i.e. usury. After the project management team explained in detail the religious legality of the transactions to the religious leaders, many coalesced and retracted their statements.³²

The HMFP uses predominantly a group-based lending methodology, with only 10% of all loans given on an individual basis. The loans are all made at the same time to individuals within a group with the idea that group members will provide guarantees and support to one another to ensure repayment. However, in reality, members “provide more of a ‘moral’ guarantee and also take on some responsibility for tracking down errant members as needed. They also sign a document that guarantees other members’ loans.”³³ The groups are not required to meet regularly and members are not confined to the same loan amounts or the same activities. By June 2000 the HMFP had 1,770 active clients, 23% of whom were women, and \$350,000 in outstanding debts with an average loan disbursement size was \$240. By 2006, the HMFP had 3,551 active borrowers, 85% of whom were women, had made 22,710 loans that year.

Although the early stages of the program saw some periods of instability as it was developing systems and procedures and expanding rapidly, overall the HMFP has maintained good credit quality. The portfolio at risk (>30days) as a percentage of outstanding loans, a useful indicator of MFI stability and credit, ranged between a high of 4.2 and low of 1.7 between 1999 and 2001 when the program was undergoing a change in management. However, according to the most recent report of the program, the SFD’s 2006 Annual Report, the HMFP had a portfolio at risk of 0.024%, which was considerably lower than the SFD’s other microenterprise projects, which had average portfolio risks between 2% and 4%.³⁴ Also the

³² Al-ZamZami, Ahmed and Lorna Grace. “Islamic Banking Principles Applied to Microfinance Case Study: Hodeidah Microfinance Program, Yemen.” Special Unit for Microfinance (SUM), United Nations Capital Development Fund. September 24, 2001. p. 6.

³³ Al-ZamZami, Ahmed and Lorna Grace. “Islamic Banking Principles Applied to Microfinance Case Study: Hodeidah Microfinance Program, Yemen.” Special Unit for Microfinance (SUM), United Nations Capital Development Fund. September 24, 2001. p. 5.

³⁴ Social Fund for Development. “Annual Report 2006.” Social Fund for Development, Sana’a 2007. http://www.sfd-yemen.org/SMED_Unit.htm. p 56.

HMFP's portfolio at risk rate is below the average of MFIs across the MENA which was 2.1% in 2004.³⁵ Another sign of the programs high credit quality is that the SFD agreed in 2006 to provide the Hodeidah Microcredit Program with an additional 41.5 million rials to guarantee the continuous flow of funds to expand on-lending activities, in accordance with HMFP's strategic action plan.

In terms of sustainability, the program has the long-term goal to be sustainable in terms of both operations and financing. According to a 2001 UN evaluation of the program, operating self sufficiency (income earned divided by total operating costs, including loan losses and cost of funds) had increased from 29% in December of 1999 to 97.1% in June of 2001. Financial self-sufficiency, however, only increased from 22% to 73.6% in that same period. The 2001 UN evaluation cautioned that: "the prospect of sustainability remains an open ended question for HMFP. Given their added costs due to this type of financing (murabaha), the lower productivity per staff unit has heavy consequences on their cost structure."³⁶ The 2001 UN evaluation also pointed out the challenges faced by the HMFP in their efforts to adapt murabaha financing to a conventional microfinance model. The differences in the two models are summarized in the following table:

³⁵Microfinance Information eXchange. "Benchmarking Arab Microfinance." a report from The Microfinance Information eXchange, Sanabel. December 2004. http://www.sanabelnetwork.org/en/mf_publications. p 13-15.

³⁶ Al-ZamZami, Ahmed and Lorna Grace. "Islamic Banking Principles Applied to Microfinance Case Study: Hodeidah Microfinance Program, Yemen." Special Unit for Microfinance (SUM), United Nations Capital Development Fund. September 24, 2001. p 14.

Comparisons with traditional microfinance operations

Element	Murabaha/HMFP	Traditional MFI
Accounting	No amortization of service charge over life of loan	Amortization or equal split of interest over life of loan
	Lump sum at end	No capitalization of interest
	Capitalization of service charge, overstatement of assets	
Loan Utility	Restricted to an economic activity	Client has the option to apply loan freely
Patterns of Disbursements	Significant impact of seasonality on income	Some impact of seasonality on income
Planning/Analysis	Does not fit into typical forecasting models	
	Data needs to be adjusted for standard analytical formats	
Control/Risk	Field officers handle disbursement	Client bears risk after receiving disbursement

B. Syria: Jabal al-Hoss The Village Banks

The Syrian Arab Republic, though more developed than Yemen, still falls below both regional and international development standards. According to the UNDP's 2007/2008 Human Development Report, Syria's HDI score is 0.724, which gives the country a rank of 108th out of 177 countries. Though Syria's GDP per capita and adult literacy rates out pace Yemen, ranking the Levant nation higher on HDI, the two countries have comparable rates of unemployment (close to 11%) and population growth (about 2.7%). Refer to chart on page 15 for a full comparison of Syria's development indicators with that of Yemen.

Syria's microfinance industry much like Yemen's is young and the general population's access to formal financial services is very limited. State-owned banks dominate Syria's formal financial services sector, though over the past three years an increasing number of private banks have been established. The

private banks do not have nationwide branch networks and currently only target large corporate enterprises and high net worth individuals.³⁷ Informal moneylenders have stepped in to fill the gap in demand for financial services by the poor and unbanked. These informal lenders continue to offer credit at exorbitantly high interest rates. It is estimated that they provide up to 73% of the total credit used by the poor at an average interest rate of 77 % (annualized).³⁸ These numbers are indicative of both the major gap in supply and demand for financial services and the enormous untapped market that microfinance providers could fill.

When compared to the Hodeidah Islamic MFI, the Jabal al Hoss Syrian Islamic MFI has been evaluated and reported on more heavily even though it was established several years later.³⁹ In 2000 as a joint project of the Syrian Ministry of Agriculture and Agrarian Reform and the United Nations Development Program, the Rural Community Development Project (RCDP) was established in the rural region of Jabal al Hoss as neither an NGO nor a regulated financial institution. Rather, the RCDP currently operates under a general Memorandum of Understanding among the Ministry of Agriculture and Agrarian Reform, the State Planning Commission and UNDP, which was set to be reevaluated in 2007. This status allows the program to operate at least for the time being outside Syria's restrictive national laws for banks and NGOs.

Known for the beauty of its mud dome shaped homes, the hilly Jabal al Hoss region, just southeast of the large Northern city of Aleppo, is one of the poorest in Syria, covering 157,000 hectares of land, 85% of which is arable. The principle economic activity of the area is animal husbandry with a focus on sheep rearing. Most of the residents are forced to find seasonal employment to supplement family income, working in other parts of Syria picking cotton or olives or in Lebanon and Jordan in construction or

³⁷ Akinci, M., Çetin, O., Khalaf, R. and Libois, W. "Syria Microfinance Market Assessment International Finance Corporation (IFC) & Grameen-Jameel Pan-Arab Microfinance Limited. July 2008. p 11.

<http://www.microfinancegateway.org/content/article/detail/50620>

³⁸ "Policy and Regulatory Framework for Microfinance in Syria." Working Paper. Consultative Group to Assist Poor (CGAP) and The World Bank. January 2008. p 18.

³⁹ It should be noted that this paper is limited to English-language resources, therefore there may be more literature on both these case studies and Islamic microfinance in general in Arabic.

menial labor.⁴⁰ The RCDP's primary objective is to establish sustainable local financial institutions that are owned and managed by the people themselves. These institutions in Arabic are called *sanadiq* (or *sandug* in the singular), literally meaning a "savings box." They are self-managed and autonomous in their decision-making and have modified conventional financial products to reflect local values i.e. Shari`a compliant financial instruments.

The sanadiq system is very similar to Dr. al Najjir's Mit Ghamr Savings Project in that it uses community savings to offer local low-income people financial services for income generating activities. It is the only membership-based microfinance model in the region that also pays dividends to its shareholders using a profit-sharing scheme. According to a discussion paper released at the "Islamic Microfinance Development: Challenges and Initiatives" Conference in 2007, the sanadiq system has "successfully demonstrated the practicality of the Islamic participatory approach of risk and profit-sharing."⁴¹ The Islamic features of the RCDP model are:

- (i) A *musharaka*-type structure owned and managed by the poor villagers who buy shares to become members and receive dividends annually if profits are sufficient
- (ii) Financing is based on the concept of *murabaha* – high profit rates with net profits shared among members
- (iii) Good governance through committees with fair election and voting procedures. (Exemplifying the Fairness and Transparency principles of Islamic finance)
- (iv) The project management team is responsible for creating awareness of microfinance practices, ensuring clients have complete disclosure of loan contracts and that new committee members receive proper training. (Transparency-in-contracts principle)
- (v) Financial management of the funds is based on standardized by-laws and statutes for each of the village funds resulting in "fair" credit decisions and low transaction costs that fit the needs of each village. (Transparency and Egalitarian principles)
- (vi) Men and women have equal opportunity to become as owners and receive loans. (Egalitarian principle)

Each sandug is initially financed through member share capital for its first three months. If the sandug's performance in this first three month period is sound, then the UNDP provides additional capital injection to increase the sandug's outreach, loan size and loan periods. For a villager to become a member

⁴⁰ Buerli, Marcus and Aden aw Hassan. "Microfinance in Marginal Dry Areas: Impact of Village Credit and Savings Associations on Poverty in the Jabal al Hoss Region in Syria." International Center for Agriculture Research in Dry Areas. Aleppo, Syria. 2004. p 1.

⁴¹ Khan, Tariqullah at al. "Framework and Strategies for Development of Islamic Microfinance Services." Discussion Paper for IFSD Forum 2007 "Islamic Microfinance Development: Challenges and Initiatives." Islamic Research and Training Institute, Islamic Development Banks. Dakar, Senegal. May 27, 2007. www.ifsdforum.com/2007/MF_paper_May05.pdf p 27-28.

and in turn gain access to credit, a compulsory savings of \$20 is required with an option for the client to save an additional \$20 in voluntary savings. This is the mechanism used for capitalizing the sanduq for on-lending. The RCDP loan disbursement methodology adopted emphasizes flexible lending with no standardized loan terms i.e. loan size, period, and installment periods may vary to fit each member's needs. The profit margin is set according to the *murabaha* cost plus markup principle.⁴² Loan guarantees are based on a debenture signed by the borrower, a group guarantee or in some cases physical collateral.

The program has been remarkably successful so far. Since the RCDP's establishment in 2000 to 2002, the number of sanduq established increased from the initial nine to 22 with an additional central sanduq, the *sanduq markazi*, an institution created to provide liquidity and exchange money for all sanduq.⁴³ According to the UNDP, several comparative statistical studies conducted between 2000 and 2005 showed that sanduq clients improved their standard of living (housing, nutrition, education, women's empowerment and general income increase).⁴⁴ Between 2000 and 2006, over 10,700 loans were disbursed by 32 sanduq to 2,279 active borrowers. In this same period the total number of shareholders reached 7,378 with a share capital of \$280,681. These shareholders enjoy an average return on equity of 24 %. The loan portfolio outstanding is \$1,792,969, while portfolio at risk (<30days) is 5.5% and the program has maintained a repayment rate of 97 %.⁴⁵ This repayment rate is within the range of the rates of other major MFIs operating in Syria (95-99%). Additionally, according to CGAP's 2008 report, it is 95% operationally self-sufficient and 83% financially self-sufficient, placing it on par with the other UN-funded MFI in Syria, the Microenterprises and Microfinance Department, which is a conventional MFI operating in urban areas and with mainly Palestinian refugees.

⁴² Imady, Omar and Hans Dieter Seibel. "Sanduq: A Microfinance Innovation in Jabal al Hoss, Syria." NENARACA Newsletter, September 2003, Amman, Jordan. www.uni-koeln.de/ew-fak/aef/05-2004/2003-1%20Sanduq%20article%20NENARACA.pdf p 5.

⁴³ Imady, Omar and Hans Dieter Seibel. "Sanduq: A Microfinance Innovation in Jabal al Hoss, Syria." NENARACA Newsletter, September 2003, Amman, Jordan. www.uni-koeln.de/ew-fak/aef/05-2004/2003-1%20Sanduq%20article%20NENARACA.pdf p. 12.

⁴⁴ "Rural Community Development at Jabal al Hoss." Project Description, UNDP Syria website. <http://www.undp.org.sy/index.php/our-work/poverty-reduction/64-rural-community-development-at-jabal-al-hoss>

⁴⁵ "Policy and Regulatory Framework for Microfinance in Syria." Working Paper. Consultative Group to Assist Poor (CGAP) and The World Bank. January 2008. p 20.

As the Jabal al Hoss program has established itself as an alternative community banking system that can be competitive with the non-Islamic MFIs in Syria, it now faces the task of becoming an independent, self-sufficient financial institution. According to CGAP's 2008 report on Syrian MFIs, the main challenge facing the RCDP today is its legal structure. As mentioned earlier the RCDP operates under a memorandum of understanding with the Syria government. When the memorandum expires the RCDP will face the decision of transforming itself either into a financial institution (under the Microfinance Legislative Decree Number 15) or to an NGO. While the option of transforming itself into a financial institution offers the RCDP the opportunity for greater growth and expansion of services, the RCDP will have to raise a minimum capital requirement of \$4,750,865 as stipulated by the Microfinance decree in order to attain the status of a financial institution. The other options of transforming itself into an NGO would not allow the program to accept members' compulsory savings, as NGOs do not have the legal authority to accept deposits.

V. Conclusion

As the microfinance movement moves toward a for-profit model and players in the Islamic finance movement call for a return to its social development values, there is a potential for both movements to better serve the MENA region through Islamic microfinance institutes. In light of the cases studies of two Islamic MFIs previously discussed, Islamic MFIs can be both competitive with conventional MFIs in the region and meet the reported demand for religiously tailored financial services for lower income groups. If we are to assume that microfinance in general can improve standard of living and alleviate poverty, Islamic MFIs appear to be doing as well as their conventional microfinance counterparts.

The future growth of Islamic MFIs within the MENA will be dictated by the institutions ability to maintain rates that are competitive with conventional MFIs and that cover the increased operating costs that Islamic financial products entail. If Islamic MFIs end goal is self-sufficiency, they will have to expand their outreach and look to commercial sources of funding. More importantly though, new regulation on the legal status of MFIs (NGO or financial institutions) will in large part dictate whether the microfinance industry will be able to expand in the MENA. The legal standing of an NGO or financial

institution has direct implications for the products MFIs may offer such as saving and in the end determines whether they can become self sufficient and even profitable.

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