ISLAMIC RESEARCH AND TRAINING INSTITUTE (IRTI)

INSTITUT ISLAMIQUE DE RECHERCHES ET DE FORMATION (IIRF)

المعهد الإسلامي للبحوث والتدريب

A MEMBER OF THE ISLAMIC DEVELOPMENT BANK GROUP

عضو مجموعة البنك الإسلامي للتنمية

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Dr. Widiyanto Misilan
Universitas Sultan Agong

Subject: Invitation to participate in the Policy Roundtable Discussion (PRD) during the 12th World Islamic Economic Forum (WIEF), 3-4 August 2016, Jakarta, Indonesia

السلام عليكم ورحمة الله وبركاته

In conjunction with the 12th World Islamic Economic Forum (WIEF), the Islamic Research and Training Institute (IRTI), and Agricultural & Rural Development Department (AGRD) of Islamic Development Bank Group will be organizing Policy Roundtable Discussion (PRD) under the theme: **"Enabling Regulatory Environment for Islamic Microfinance Institutions".** This event is part of the OIC-IDBG joint effort for the development of Microfinance programs under the Islamic Microfinance for Poverty Alleviation and Capacity Transfer (IMPACT) program. The event will bring together stakeholders from central banks and related partners to discuss the findings from several papers on bank regulation and supervision in several countries and its relationship with the development of Islamic Microfinance Institutions.

The Policy Roundtable Discussion will discuss the following: a) experiences of financial authority in regulating and supervising the Islamic microfinance institutions; b) range and type of issues considered in working to improve the enabling environment; and c) range and type of issues considered in protecting MFI clients.

The event will take place during 3-4 August, 2016 in Jakarta, Indonesia. I am pleased to invite you to participate the above program. IRTI-IDB will provide your round-trip economy class ticket from your hometown to Jakarta and hotel accommodation during the program. For any question and clarification, please feel free to contact Prof. Dr. Abdul Ghafar Ismail at agismail@isdb.org.

Yours Sincerely,

Prof. Dr. Mohamed Azmi Omar
Director General, IRTI

18/7/2016

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POSTAL ADDRESS: P.O.BOX 9201, JEDDAH 21413
KINGDOM OF SAUDI ARABIA
TELEPHONE: ( 00966-2 ) 6361400 CABLE ADDRESS:BANKISLAMI- JEDDAH
FACSIMILE: ( 00966-2 ) 6378927 / 6366871

B.P.9201 DJEDDAH 21413
ROYAUME D'ARABIE SAOUDITE
ADRESSE TELEGRAPHIQUE : BANKISLAMI-DJEDDAH
TELEPHONE: ( 00966-2 ) 6361400
FACSIMILE : ( 00966-2 ) 6378927 / 6366871
E-Mail: IRTI@ISDB.ORG. Home page: HTTP://WWW.IRTI.ORG

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# CONCEPT NOTE

# POLICY ROUNDTABLE DISCUSSION

**3-4 AUGUST 2016**
**JAKARTA, INDONESIA**
**(IN CONJUNCTION WITH 12TH WIEF)**
**JAKARTA CONVENTION CENTER**

| IDBG Member | Department | Focal Point Name |
|---|---|---|
| | IRTI/AGRD | Abdul Ghafar Ismail<br>Syed Hassan Alsagoff |

## Specific Title

Policy roundtable discussion (PRD) with the theme **"Enabling Regulatory Environment for Islamic Microfinance Institutions"**

## Introduction and Background

The attainment in reducing poverty and the effectiveness of microfinance program depends on the soundness and stability of Islamic microfinance institutions. Through supervising and regulating Islamic microfinance institutions, the financial authority is better able to make policy decisions. In order to promote an enabling environment, the Financial Authority needs to strike the optimal balance between: a) strengthening confidence in the industry through rules that facilitate the Microfinance business; b) protecting the welfare of the poor clients through ensuring that they are treated fairly; and c) ensuring that the sector will be in the interest of the general public. Over regulation may also stifle growth and increase the operating cost of MFIs which will be passed on to their poor clients. Supervision involves monitoring and examining the condition of Islamic microfinance institutions and their compliance with laws and regulations. If an Islamic microfinance institution under the financial authority's jurisdiction is found to have problems or be noncompliant, the financial authority may use its power to request the operators to correct the problems. Regulation includes issuing specific regulations and guidelines to govern the operations, activities and acquisitions of Islamic microfinance institutions.

The financial authority supervises and regulates a different type of Islamic microfinance institutions and activities. The financial authority works in conjunction with other federal and state authorities to ensure that Islamic microfinance institutions safely manage their operations and provide fair and equitable services to consumers. The financial authority also gather information on trends in the Islamic microfinance industry, which helps the financial authority meet its other responsibilities, including determining public policy on poverty eradication.

## Relevance of the Activity

An enabling regulatory and supervisory environment strongly affects both the viability and sustainability of the Islamic microfinance institutions at the base of the pyramid, as well as the value proposition for poor consumers or marginalized group that might induce them to choose Islamic microfinance institutions. Furthermore, the studies on regulation and supervision to promote financial inclusion in the early 2000s that cover the topics such as a flexible and risk-based approach to bring confident among the stakeholders (via KYC policy) and clear permission to do business that complies shariah were among the hot areas. The same is true, with limited exceptions, of basic issues in financial consumer protection; and market conduct and services of Islamic microfinance institutions to the poor.

While our concern has always focused on the question of what approaches to regulation and supervision promote an enabling environment for bringing poor customers into the world of formal finance, numerous forces have helped to drive a significant evolution in the range and type of issues considered in working to improve the enabling environment. Therefore, this policy roundtable discussion is very timely and in line with theme of 12th WIEF, i.e., Decentralizing Growth and Empowering Future Business. In addition, this event is a follow up action from the Expert Group Discussion that was held during the side event of the 41st Annual Meeting of IDB (15th – 19th May 2016).

## Objectives

The objective of the PRD is as follows:

a. To discuss the experiences of financial authority in regulating and supervising the Islamic microfinance institutions
b. To discuss the range and type of issues considered in working to improve the enabling environment
c. To discuss the range and type of issues considered in protecting MFI clients

## Description and/or the Issues to be addressed

This PRD will discuss the findings from several papers on bank regulation and supervision in several countries to assess the relationship between specific regulatory and supervisory practices and Islamic microfinance institutions development, efficiency, and fragility. The PRD will also address: (i) regulatory restrictions on Islamic microfinance institutions and the mixing of socio-finance institutions; (ii) financial authority as public policy agent; (iii) policy related to regulation and supervisions; and (iv) financial authority's power, independence, and resources. The PRD will discuss policies that differentiate the Islamic Microfinance from conventional finance (eg. Ability to own and trade assets, imposition of Value-added Tax). It will also discuss policies that hinder the practice of Islamic Microfinance (eg. Capital Adequacy Standard based on SRB and IRB approaches that discourage transactions such as True Murabaha, Mudaraba etc) and how to address them. The results, albeit tentative, raise a cautionary flag regarding government policies that rely excessively on direct government supervision and regulation of bank activities. The findings instead suggest that policies that rely on guidelines that (a) force accurate information disclosure, (b) empower the trustee of socio-finance related institutions control of Islamic microfinance institutions, and (c) foster incentives for private agents to exert corporate control work best to promote Islamic microfinance institutions development, performance and stability.

## Proposed Speakers

Please see in the proposed agenda below

## Local Counterparts

Perhimpunan BMT is the co-host and partners of the workshop in coordination with WIEF.

## Targeted Participants

About 20 participants made up of Central Banks, operators, and policymakers.

## Expected Outcome/impact

a. An event providing a forum for stimulating discussion on enabling regulatory environment;
b. Provide participants access to privileged information while fostering free and extensive discussions on various issues of regulation and supervision;
c. Collection and dissemination of a reliable body of evidence on important policies being deliberated upon.

## Proposed Agenda

Day 1: 3rd August 2016

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|---|---|
| 8.30am – 9.00am | **Opening Session:**<br>▪ **Recitation from the Holy Quran**<br>▪ **Statement by Chairman**<br>▪ **Statement by PBMT** |
| 9.00am - 10.30am | **Session I: The current regulatory agenda**<br>⇒ **The impact of the global issues on regulation**<br>⇒ **International regulatory influences: BIS and IFSB**<br>⇒ **Conduct risk and culture**<br>⇒ **Personal liability**<br>⇒ **KYC issues relating to Islamic Microfinance**<br><br>**Paper prepared by Prof Abdul Ghafar Ismail, IRTI** |
| 10.30am-10.45am | **Coffee and Networking** |
| 10.45am-12.30pm | **Session II: The Regulators**<br>⇒ **The regulatory parameter and regulated activities**<br>⇒ **The Prudential Regulation Authority: powers, role and remit**<br>⇒ **PRA's objectives**<br>⇒ **The microfinance institutions: conduct of business** |

| | |
|---|---|
| | ⇒ Rethinking the MFI's objectives as a financial intermediary to a business intermediary<br>⇒ Role of Shariah Supervision in Islamic Microfinance<br><br>Papers prepared Moch. Muchlasin, Sharia Non Bank Financial Institutions Directorate, Indonesia Financial Services Authority and Dr Daud Bakar, Amanie Business Solution |
| 12.30pm – 14.00pm | Lunch and Prayer |
| 14.00pm – 16.00pm | Session III: Rules that differentiate Islamic Microfinance from Conventional Microfinance: Balancing the Risks and Benefits<br>⇒ Creating a Conducive Legal and Policy Framework<br>⇒ VAT- should it be imposed on Islamic Microfinance Institutions?<br>⇒ Measuring Risk-weighted Assets from a business risk perspective rather than a credit perspective<br>⇒ Protecting MFI savings: Reviewing Capital Adequacy Policy<br>⇒ The microfinance institutions: conduct of business<br><br>Papers prepared by Dr Badr El Din Gureshi Mustafa, General Manager Microfinance Unit, Central Bank of Sudan and Mr Saeed Ahmad State Bank of Pakistan |

Day 2: 4th August 2016

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| 8.30am – 9.00am | Coffee and Networking |
| 9.00am - 10.30am | Session IV: Smart Campaign: Reviewing the 7 Client Protection Principles and its Application to Islamic Microfinance Policies<br>⇒ Appropriate Design and Delivery<br>⇒ Prevention of Over-indebtedness<br>⇒ Transparency<br>⇒ Responsible Pricing<br>⇒ Fair and respectful treatment of clients<br>⇒ Privacy of client data<br>⇒ Mechanisms for compliant resolution<br><br>Papers prepared by Moch. Muchlasin from OJK and Ir H. Saat Suharto, PBMT |
| 10.30am-10.45am | Coffee and Networking |
| 10.45am-12.30pm | Session V: Supervision and Enforcement<br>⇒ Vertical Supervisory Classifications (for small to large MFIs)<br>⇒ Horizontal supervisory classification (comparison of light to heavy regulated regimes)<br>⇒ The MFI Systematic Framework (Macro, Meso and Micro)<br>⇒ Role of regulators in using their enforcement powers<br><br>Papers prepared by Mr Mohamed Ali Elhassein, Microfinance Unit, Central Bank of Sudan and Representative from the Microcredit Regulatory Authority, Bangladesh |

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| 12.30pm – 14.00pm | **Lunch and Prayer** |
| 14.00pm – 16.00pm | **Session VI: Developing a Policy and Standards Toolkit for Islamic Microfinance**<br><br>⇒ **Developing a toolkit that will accommodate the various supervisory classifications (vertical and horizontal)**<br>⇒ **Composition and framework of the toolkit**<br>⇒ **Next steps**<br><br>**Facilitator: Br Syed Hassan and Prof Abdul Ghafar will co-present a proposed skeletal framework on the Policy and Standards toolkit from light framework on Policy to a detailed Micro, Meso and Macro regulations to develop an MFU unit within the central bank to promote Islamic Microfinance.** |

# A Framework for Regulating Islamic Microfinance Institutions

**Abdul Ghafar Ismail**[1]
Islamic Research and Training Institute
Islamic Development Bank
8111 King Khalid St., Al NuzlahYamania Dist.
Unit No. 1 Jeddah 22332-2444, Kingdom of Saudi Arabia
and
**Widiyanto bin Mislan Cokrohadisumarto**[2]
Faculty of Economics
Sultan Agung Islamic University
Jl. Raya Kaligawe Km 4, Semarang,
Central Java Indonesia

Paper to be presented at the Policy Roundtable Discussion on Enabling Regulatory Environment for Islamic Microfinance Institutions, 3-4 August 2016, Jakarta, Indonesia

## 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, we will discuss the experience of several countries in regulating Islamic microfinance institutions.

*Keywords*: regulation policy, Islamic microfinance institutions, regulatory philosophy, shariah
*JEL Classification*:D03, G21, G23, G28, P40,

[1] Professor of Islamic banking and financial economics at Islamic Research and Training Institute. He is also AmBank Group Resident Fellow for Perdana Leadership Foundation and Fellow for Yayasan Pembangunan Ekonomi Islam Malaysia.
[2] Lecturer of Islamic Economics and the head of magister management program Faculty of Economics Sultan Agung Islamic University, Semarang, Central Java, Indonesia.

## 1. Introduction

Individuals, trustee and government provide the sources of funds for Islamic microfinance institutions (IMFI). There are the entrepreneurs who utilise those funds for their microenterprise activities. The financial authorities such as central bank or ministry of finance or ministry of cooperative are responsible for the supervision and regulation of Islamic microfinance institutions.

The regulatory approach has benefited the development of IMFI in many jurisdictions. In adopting the best approach, the financial authority should consider the following three components: Firstly, the owners should confine their activities to the management and control of IMFI; and they should engage in activities related to shariah principles. They should not affiliate with entrepreneurs engaged in activities that are not permitted under the shariah principles. Secondly, the transactions between an IMFI 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 IMFI. This is to ensure their safety and soundness.

Once the regulatory framework is in place, the regulatory risk might exist. Among the risk that might present is that of regulatory arbitrage, whereby operators of an IMFI seeking a license might choose to be constituted under an institutional format which is subject to least possible external regulation and supervision, as well as the lowest possible amount of capitalization at entry. Does it appear in each jurisdictions?

Behind this approach and risk, how could IMFI be regulated? Furthermore, the regulatory framework is needed in response to the rapid growth of various models of IMFI around the world. Hence, a policy research paper entitled "*A Framework for Regulating Islamic Microfinance Institutions"* is prepared to provide a framework for addressing regulatory issues, which affect the operations and the institutional development of IMFI.

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. An Insight into 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 IMFI. 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.[3] More importantly than that is not only that they comply the shariah, but also their roles in providing services to un-bankable society. The key is to design regulation so as to allow Islamic 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*

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[3] We will refer to Smolo and Ismail (2011). The similar model was also proposed by Maamor et al (2014)

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 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.[4] In 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.[5] 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.[6] 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 IMFI 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 IMFI.

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 conventional microfinance institutions.

IMFI should also maintain to observe the aims (*maqasid shari'ah*) of providing the finance to the poor and needy. IMFIs 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.[7] Principally, there are two types of *akhlaq*, good (or *mahmudah*) and bad (or *mazmumah*). Islam emphasizes the important of practicing good *akhlak* 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.

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[4] 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.*" Please also refer to Abdullah and Ismail (2016)

[5] 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*.

[6] Refer to: Al-Qiyaamah75:3 ("*Does man think that We will not assemble his bones?*"); Al-Mu'minuun 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*").

[7] 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]

Classical scholars such as Al-Ghazali in his encyclopedia Iḥya' '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-Ḥalāl wa al-Ḥaram*), indicating the importance of ethical behavior in earning a livelihood. Scrutinizing this chapter of Iḥya', al-Ghazzali identifies justice, truthfulness and benevolence as the main ethical values that must be internalized 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 logical philosophy 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.[8] 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.

## 3. Reasons of Regulations

The financial authority should promote and maintain IFMI 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 following aspects: *safety*, *stability*, *structure*, *public confidence*, *market discipline* and the *basis for a public policy*. Think of *safet*y 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 spill over effects.

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

*Safety and Stability*

The safety objective is to reduce the risk associated with IMFI businesses (i.e., protecting IFMI from being exposed too much to external factors and making them a sustainable institution). Today the safety objective comes under the guise of subsidy and micro-takaful services. IMFI stability objective is closely linked with the goal of poverty alleviation of the economy. The

[8] See Ghazanfar and Islahi (1997) in Islamic Economics Research Series, King Abdulaziz University.

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 IFMI 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.[9] This model links structure with conduct and then with performance.

*Structur*e refers to the number of IFMI in the market (i.e., sustainability), *conduct* refers to the behaviour of IFMI in the market, and *performance* refers to the quantity and quality of products and services (i.e., outreach) by IFMI in the market.[10] The conclusion of the model is the more IMFI 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 prerequsite 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

[9] The country experience, see Ismail and Elzahi (2016) shows that IMFI change and develop as their scale and scope of their operations grow beyond delivery of financing services to include savings, deposit and other financial services. Growth also prompts innovative approaches to achieving and maintaining financial stability. Expanding outreach requires increasing funding rsources and exposes the limits to grants and donor funds. Commercial funding sources can usually be accessed when the policy and legal environment are appropriate and only if the IMFI has the legal status and financial standing

[10] In the 1990s, best pratices in microfinance introduced key indicators for measuring an institution's sucess particularly outreach and financial sustainability

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.[11] 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, PBMT and AlHuda 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.[12]

*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, 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 the objectives of shariah (or maqasid shariah): 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 financing. 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

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[11] Ismail (2016). Free market Between Free Market and State Capitalism: How Islamic Economics System Shape the Future Global Economy? New York: Nova Science Publisher

[12] Refer to case studies in Widiyanto Mislan Cokrohadisumarto, Abdul Ghafar Ismail and Kartiko A. Wibowo (2016) *BMT: Praktik dan Kasus*. Jakarta: Rajawali Pers.

social responsibility.[13] This responsibility is translated by providing subsidized funds to be channeled to the operators. At the same time, also other operators 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 operators.

## 4. 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 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.

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[13] 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.

*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 in relation 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.

*Regulators*

Many developed countries 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

## 5. Experiences in Regulating Islamic Microfinance Institutions

In this section, the discussion will focus on two subjects that are the design of Islamic microfinance industry and the activities of Islamic microfinance institutions. The discussion will be based on the experiences of several countries.

### 5.1 Design of Islamic Microfinance Industry

There are several related questions in discussing the subject. Among others are: Does a different design exist? Or more importantly, does this design matter? What are the determinants of this design? How does this design affect the principal-agent relationship? Does the design affect the corporate control? Does the regulation need to be amended?

As reported in Table 1, the design could be seen in the contact of: types of Islamic microfinance institutions (column 1), ownership (column 2), legal basis/legal origin (column 3), and legal form (column 4).

#### *Types of Islamic Microfinance Institutions*

Each Islamic microfinance institution can be categorized as: (i) full-fledge Islamic microfinance institutions (IMFI), (ii) full-fledged Islamic microfinance banks (IMFI as subsidiary) (iii) Islamic microfinance services by full-fledged Islamic banks; (iv) Islamic microfinance services by conventional banks; and (v) Islamic microfinance services by conventional microfinance banks. (MFBs).

**Full-fledged Islamic Microfinance Banks, initially,** are mandatory to be licensed by the financial authority either for microfinance services on the national, provincial, regional, and district level. Each full-fledged Islamic microfinance bank shall be mandatory to have been appointed with a Shari'ah advisor after qualifying with the fit and proper criteria for the said job and responsibility prescribed by financial authority. As per the guidelines, all the asset and liability side products are required to be vetted and properly modelled/sutured prior to launch in the supervision and guidance of an independent Shari'ah advisor.

While Islamic microfinance can be offered by full-fledged Islamic banks, financial authority requires that the bank be licensed prior to launch. In a nutshell, financial authority gave an opportunity to the financial sector to perform in and for the microfinance industry in a Shari'ah compliant mode under actually supervised, safe, and regulated environment, which builds donors' and investors' confidence.

**Full-fledged Islamic banks** can also offer Islamic microfinance for financial inclusion and microfinance services, but the prerequisites, as stated earlier; to initiate Islamic microfinance shall prevail. Islamic banks can offer Islamic microfinance products through four different ways prescribed by financial authority as: through established counters of Islamic microfinance at existing branches; standalone Islamic microfinance branches and mobile banking; establishing independent and subsidiary Islamic microfinance banks; and networking and developed linkages with existing IMFBs and MFIs.

**Islamic Microfinance services by conventional banks** can be provided through different institutional level models such as: Islamic microfinance counters at existing branches; Islamic microfinance standalone branches and mobile banking; establishing independent Islamic microfinance banks as subsidiary of conventional banks; and networking and developed linkages with existing IMFBs and MFIs.

**Islamic Microfinance services by conventional microfinance banks**, after getting license, Islamic microfinance institutions can offer products under the regulatory supervision of financial authority. The conventional microfinance bank is licensed for microfinance operations on financial strength, net capital (capital free from actual and potential losses), and adequacy of the capital, asset and liability base with respective products, which are critically examined. The appointment of an independent Shari'ah advisor after qualifying fit and proper criteria is the significant element, which is mandatory.

Regulation based on typology of financial institutions rather than on intermediation activities creates incentives for *regulatory arbitrage*. Operators of financial institutions seek out licensing categories which requiring the least initial capital commitment and the lowest degree of mandatory regulation. All participants in the financial system including microfinance stakeholders benefit from a transparent regulatory framework, which establishes the continuum where MFIs can progressively evolve into formal financial institutions. The regulatory framework model identifies *thresholds* of financial intermediation activities, which would *trigger* a requirement to satisfy *external or mandatory* regulatory guidelines. As financial institutions, it would be prudent for all of the different types of MFIs to observe *internal or voluntary* guidelines for risk management. Table 1 accents the key features of the regulatory framework model -- identifying the fund generating activities that trigger a need for mandatory external guidelines and summarizing the proposed regulatory measures and agencies to carry them out.

### *Ownership*

As shown in column 2, Table 1, government, organization or individual (or mixed agent) may own IMFI. 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 poverty alleviation. According to this view, governments have adequate information and sufficient incentives to ensure socially desirable investments. Consequently, government ownership of Islamic microfinance institutions helps 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.

***Legal basis***

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 (column 3, Table 1) imply quite different stockholder relationships, and by corollary governance structures, from the conventional model (which follow the common law or other law origin in relation to limited liability (legal form – column 4, Table 1) 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 (mandatory or voluntary sadaqah).

## 5.2 Islamic Microfinance Activities

The activities of Islamic microfinance institutions can be seen from: authorized activities (column 5, Table 1), fund sources (column 6, Table 1) and targeted market (column 7, Table 1). Differences in the organizational and operating characteristics of the various types of MFIs leave them vulnerable to certain risks. The risk-based approach to financial regulation shows that while there may be no major variances in the structure of their assets, MFIs are differentiated by the structure of their liabilities -- i.e., how their assets and operations are funded and the adequacy of capital in leveraging additional resources to fund operations. Linking the wholesale funding, limited deposit-taking and unrestricted deposit-taking activities to an institution's qualifying capital base results in *limits* to the asset build-up that MFIs can prudently undertake, without having to instruct them on how to carry out their businesses. The authorization to mobilize funds from the public in turn carries related requirements to comply with prudential standards and guidelines on certain asset side activities, e.g., limits on concentration in loan exposure to sectors, restrictions on insider and related-party loans, provisions for possible loan losses, etc.

## 5.3 Who are the Regulators?

As shown in column 7 Table 1, it creates a dual regulator or two tier regulator (such as public and private monitoring system). In practice, there is also no separation between regulation and supervision.

## 6. 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. The experience in regulating Islamic microfinance institutions shows that the types of Islamic microfinance, activities and two-tier or dual regulators matters for an effective regulation.

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Table 1: Islamic Microfinance institutions and regulatory framework

| **Type of MFI** | **Ownership** | **Legal Basis** | **Organized as** | **Fund Source** | **Authorized Activities** | **Agency Jurisdiction** | **Agency Supervision** | **Target Market** |
|---|---|---|---|---|---|---|---|---|
| | | | | | | | | |
| **Panel A** | | | | | | | | |
| **Banks in Microfinance** | Private / State | Companies Act; Banking Law | Limited Liability Company | Equity capital, loans and deposits | Full-service bank | Central Bank | Central Bank, FSA | Individuals, Enterprises |
| | | | | | | | | |
| **Panel B** | | | | | | | | |
| **Non-banks financial institutions (NBFI) in Microfinance** | | | | | | | | |
| | | | | | | | | |
| ***Agriculture Bank*** | State-owned | Companies Act; NBFI Law | Company limited by Guarantee | Government loans, deposits | Full-service bank, Specific loans | Central Bank | Central Bank, FSA | Individuals, Enterprises |
| | | | | | | | | |
| ***SME Bank*** | State-owned | Companies Act; NBFI Law | Company limited by Guarantee | Gov't loans, deposits | Full-service bank, Specific loans | Central Bank | Central Bank,FSA | Individuals & SME enterpreneurs |
| | | | | | | | | |
| ***Lending institutions*** | Individuals | Local Government Act, Companies Act; NBFI Law | Limited Liability Company | Owner capital, Commercial loans | Lending services | Ministry | None | Individuals; small business |
| | | | | | | | | |
| | | | | | | | | |
| ***Cooperatives*** | Individuals | Law on Cooperatives | Cooperative Society | Members' share capital & deposits | Members only, deposits and micro-loans | Ministry | Ministry | Individual members; small business |
| | | | | | | | | |
| ***Pawnshop/Ar Rahnu*** | Individuals | Law on Cooperatives; NBFI law; Law on Cooperatives | Cooperative Society | Gov't loans, Commercial loans | Pawning, small loans | Ministry | Ministry | Individuals |
| | | | | | | | | |
| ***Microfinance Institutions*** | Individuals and organizations | Law on Cooperatives; Law on Trusts and Charitable Institutions | Cooperative Society | Grants & donations | Micro-loans; Non-financial services; loans | Ministry | Ministry | Individuals |
| | | | | | | | | |
| ***Baytul Mal*** | State-owned | Law on Zakat | Non Profit Organization | Payee | Zakat Collector; Zakat Distributor | Ministry | Ministry | Gharimun (individual) debt |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | | | | | | |
| ***Waqf*** | State-owned | Law on Zakat | Non Profit Organization | Volunteers | Trustee | Ministry | Ministry | |