

Understanding Costs and Sustainability of Sharia-Compliant Microfinance Products

While Islamic finance is a growing industry with more than 1,000 Islamic finance institutions and combined assets in excess of \$1.3 trillion (Reuters 2013), the development of sharia-compliant *microfinance* has been much less prolific. Since 2006, the number of service providers offering sharia-compliant microfinance products has doubled, albeit from a very small base, and the number of clients using such products has quadrupled (El-Zoghbi and Tarazi 2013). Nonetheless, customers of sharia-compliant microfinance products represent less than 1 percent of the number of clients served by conventional microfinance. The high costs of providing sharia-compliant products, particularly profit- and loss-sharing products such as *musharaka* or *mudaraba*, are often blamed for the lack of product diversity and customer take-up. But what are the costs of offering such products, and can they be sustainably offered by financial service providers (FSPs)? Are the underlying cost structures and business models required to offer

these products prohibiting the rise of a sustainable sharia-compliant microfinance sector?

This Focus Note explores these questions by delving into two case studies of products (*musharaka* and *salam*) of two different FSPs in different markets (Bank Al Baraka in Algeria and Wasil Foundation in Pakistan). The case studies look at the operational costs associated with these two products and project growth to assess the scale at which these types of products can be sustainable.¹ While these cases represent very nascent initiatives to roll out sharia-compliant products with relatively little outreach to date, they are nonetheless among the few globally that have been able to do so at all.

The two innovations presented here—from Bank Al Baraka and Wasil Foundation—offer a glimpse into how other FSPs might diversify their sharia-compliant portfolio and thus reach more clients. After examining these case studies, this paper offers preliminary takeaways on how service providers might incorporate some of the lessons of these FSPs to better serve their own markets.

Products with Limited Scale Today: *Musharaka* and *Salam*

While there is a variety of sharia-compliant products on offer today, the most prevalent is *murabaha*, which is essentially a cost-plus-fixed-fee transaction. This product most closely mimics conventional microfinance and has thus far been the most widely adapted by FSPs aiming to serve poor observant Muslims. However, in some markets, individuals may not perceive *murabaha* to be “authentic,” as they question whether the pricing model is little more than disguised interest. Because this type of product is already prevalent and operational structures and costs are quite similar to conventional microfinance,² we have not focused our research on it.

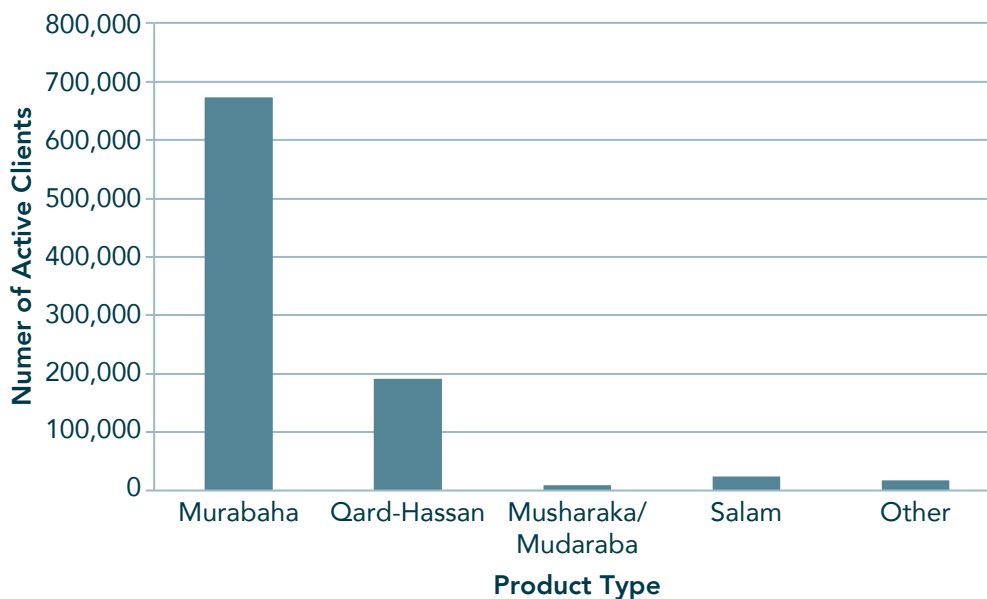
Box 1. Sharia-Compliant Products at a Glance

- **Ijara** is a type of contract for leasing.
- **Mudaraba** denotes trustee financing, in which one party acts as FSP by providing the funds, while the other party provides the managerial expertise in executing the project. Profits are shared according to a predetermined ratio, but any financial losses are borne entirely by the FSP while the manager loses time and effort.
- **Murabaha** is a “cost plus markup” sale contract.
- **Musharaka** is equity participation in a business venture, in which the parties share the profits or losses according to a predetermined ratio.
- **Qard-Hassan** is a noninterest-bearing loan. The lender cannot enforce repayment.
- **Salam** is an advance payment against future delivery used in agricultural contexts, allowing farmers to finance production in exchange for a future delivery of a crop.

¹ Because we do not look at demand, of course, this type of analysis is hypothetical; it assumes that demand would be there once the products are on offer, and the institution can expand its offering cost-effectively. In both of the cases discussed in this paper, the products are relatively young, and outreach remains limited in scale. Thus we rely on projections to understand what the future may hold for expansion and scale. As of today, there are no financial providers offering these types of products at scale.

² Note that the way *murabaha* is offered by FSPs varies greatly, some use vouchers and others function as wholesalers. A majority of providers that offer *murabaha* tend to use a voucher-based system that keeps the FSPs’ operational costs very similar to or only slightly higher than it would cost to disburse a loan in cash.

Figure 1. Number of Active Clients, by Type of Product



Source: CGAP Islamic microfinance survey, 2011.

The second most prevalent product is qard-hassan. Because of its characteristics of a benevolent loan, qard-hassan relies on a subsidy or donation of some kind, and thus by definition is not commercially viable. Some FSPs may choose to offer these types of products, but they would essentially do so from a socially responsible line of activity rather than their commercial side.

CGAP research on the supply of sharia-compliant microfinance shows that there is very limited outreach on profit-and-loss (P&L) type products such as musharaka and mudaraba, which are available to fewer than 9,500 clients (El-Zoghbi and Tarazi 2013). Yet P&L type contracts are the Islamic financial contracts most encouraged by sharia scholars as best reflecting sharia principles. This paper focuses on diminishing musharaka, a P&L product whereby the FSP and client jointly own a business and the FSP gradually transfers complete ownership to the client based on a predetermined schedule and P&L sharing arrangement, subject to actual business performance.

Outreach is also low for trade-based products, such as salam, which is available to fewer than 25,000 clients

(El-Zoghbi and Tarazi 2013). Salam contracts reflect Islamic principles because they are investing in a productive activity, and the funder is taking a risk in the business. Salam products are particularly relevant for the rural poor, one of the largest segments of the unserved. Salam is essentially a sales contract with deferred delivery of goods often used in agriculture as advance payment against future delivery of a crop yield, allowing farmers to finance the advance purchase of inputs to be used in crop production. The type of crop, amount, and delivery date of the expected crop yield is agreed to in advance.

The Case of Diminishing Musharaka Contracts

As noted, a musharaka contract is a P&L sharing investment agreement with equity participation by both a business owner and an FSP resulting in shared ownership. Both parties share the profits or losses according to a predetermined ratio based on the equity participation and schedule for a fixed period of time. This ratio can be variable, taking into account cyclicity in the business.³

³ Mudaraba is a variation of this P&L sharing scheme where the FSP provides cash for investing in an enterprise and receives a variable management fee during the contracted period for the use of the capital; this variable fee is based on the profit of the business.

Box 2. Getting the Metrics Right

Comparing sharia-compliant products with conventional *loans* is misleading.

Other than murabaha or qard-hassan, which are debt instruments, most other sharia-compliant products are **investment** instruments. Thus many of the metrics, benchmarks, and standards in the traditional microfinance space are not relevant for the sharia-compliant industry. Metrics such as nonperforming loans (NPLs), a commonly used indicator to denote the percentage of the total portfolio that is nonperforming, have no meaning for investment instruments, which have a different set of performance and risk metrics.

While musharaka products are comparable to a conventional bank's small and medium enterprise (SME) loan in terms of purpose, they are closer to equity in terms of contractual arrangements and obligations. Salam products are an alternative for a conventional agricultural bullet loan and are nearly identical to commodity-forward contracts in terms of structure.

With diminishing musharaka, equity participation on the part of the FSP is typically in the form of a cash contribution toward the purchase of an asset or working capital. Most importantly, the contract must clearly stipulate the use of the cash for a specific purpose. Over time, the business owner gradually buys back the FSP's share. The term "diminishing" refers to reduction of the FSP's ownership share over time. As the ratio and buy-back schedule are defined upon entering into a contract, *expected* profits are used to estimate the buy-back schedule. In practice, the buy-back of the shares is based on actual profits, and the contract duration is re-evaluated based on business performance. Ownership of the asset or working capital is transferred in full at the end of the contract period from the FSP to the client.

Bank Al Baraka (BAB), a Bahrain-based commercial Islamic bank, offers only sharia-compliant products. BAB Algeria was formed in 1991 and now has 20 branches in the country. BAB offers a wide range of sharia-compliant products for retail and business clients. However, *micro*-sharia-compliant products are relatively new within the BAB group.

The microproducts group in Algeria works independently from the rest of BAB's commercial operations and focuses its work in Ghardaia, a town of nearly 100,000 people on the edge of the Sahara desert. Ghardaia is home to a strong Mozabite community—a Muslim group known for its piety and sense of community. Mozabite community leaders, called *Notables*, play an important role in managing community affairs and are critical to the success of the diminishing musharaka product because they informally attest to the acumen and reputation of the business owner. As of September 2014, BAB had 54 outstanding diminishing musharaka contracts with a total investment value of US\$150,000.

Product Characteristics

The BAB diminishing musharaka product focuses on providing financing to micro, small, and medium enterprises in a range of industries, including trade, retail, grocery, bakeries, auto garages, and metalwork. BAB investments have a historical average of US\$6,250 (equivalent to 116 percent of the gross domestic product per capita). Contract terms are for periods of up to 36 months. This product is not currently used for agricultural purposes, although agricultural processing businesses would qualify. To qualify for a diminishing musharaka, clients must have been in business for at least one year, even if informally; operate at a profit; and have some inventory in stock. Clients are typically sole proprietorships with up to three informal and often irregular employees.

To enter into a contract, clients are required to have a registered business. If the client's business is informal, BAB will help the client register his or her business during the application process. No application, disbursement, or processing fees are associated with the product. A Notable must act as a "moral guarantor" for each client, vouching for his or her business acumen, character, integrity, and commitment to honoring the terms of the contract.

BAB makes the investment to the client through a BAB bank account, the opening of which is a prerequisite for BAB diminishing musharaka clients.

Conversely, payments to BAB are directly debited from the client's BAB account based on the profit-sharing agreement. During the course of the contract period, clients are required to keep a minimum balance of approximately US\$12.50.

On a quarterly basis approximately one week before a client buy-back payment, BAB meets with the client to review financial statements, business performance, and profit calculations to finalize the amount of the buy-back of BAB shares. If the profit is less than expected, BAB will receive a smaller payment based on the previously agreed profit-sharing ratio. BAB will also work with the client to try to improve the business operations and profitability. However, in cases of a loss, sharia principles prohibit BAB from forcing clients to pay.⁴ BAB is protected against losses by a portfolio guarantee provided by a European bank.

Cost Drivers and Risks

Based on analysis of current operating costs of BAB's diminishing musharaka product, three key drivers of costs will influence the profitability of this product line: (i) operational costs, of which managing the client relationship is the largest cost; (ii) cost of funds; and (iii) operating risks. It should be noted that this research did not look into the set-up phase of this business line, which undoubtedly included significant expenses related to staff training, product design and testing, and sharia certification.

Operational costs. Establishing and managing client relationships is the largest expense associated with BAB's sharia-compliant operation. The risks of this kind of product are like any equity investments—risks are higher than debt investments and must be hedged through careful client selection and appropriate risk-mitigation techniques. Thus the time involved in administering the diminishing musharaka product represents a significant cost driver. Staff responsible for identifying and managing client relationships must work closely with community leaders, the Notables,

to assess reputations of potential clients. They must also assess the financial position of the business. Typically, BAB clients have no accounting skills, and BAB staff are therefore required to create pro-forma financial statements on which to base the analysis of the business. Once a client has a diminishing musharaka contract with BAB, the staff person must manage the relationship by meeting with clients quarterly to review business records and confirm the profitability of the business before processing the buy-back.

As with conventional microfinance, acquiring new clients is far more time consuming than issuing repeat contracts. On average for new clients, the time required from client intake to contract approval is approximately three-and-a-half to four person-days of staff time, which is significantly higher than conventional microfinance or even SME finance, which typically requires less than one day of staff time. Post-contract, a staff member spends at least half a day a month on monitoring at the site and phone calls. With this time allocation, a staff member operating at maximum capacity would be able to issue a maximum of five diminishing musharaka contracts per month, and each month the number of new clients acquired would decline given that the staff member's time would shift toward the monitoring function. As a result, a staff member doing monitoring would be able to handle a maximum portfolio of 41 existing clients per month. To reach scale, the organization must increase the number of staff significantly, which in turn increases all of its operational expenses. In a nutshell, unlike conventional microfinance, there are limited economies of scale with the diminishing musharaka product. In other words, a majority of the costs—76 percent—are fixed and not variable.

Cost of funds. Cost of funds for the musharaka product is LIBOR + 3 percent.⁵ BAB is able to access capital at reasonable rates from international markets and its own asset base; it charges a minimal spread to the micro-sharia business unit for further

⁴ In some cases, BAB might go to the Notables as a last resort to work with the client to improve business performance.

⁵ For the purposes of analysis, cost of funds was calculated using 3.5 percent.

disbursement to clients. Because of the historically low LIBOR and the minimal internal spread charged by BAB to the micro-sharia business line, cost of funds is lower than would otherwise be likely. As the portfolio grows and the institution sources capital elsewhere, cost of funds will most likely become a larger percentage of overall expenses.

While costs of funds are out of the control of any institution, they are an important cost consideration as an FSP considers its operational and financial model. Many sharia-compliant FSPs often do not have access to sharia-compliant sources of capital. Until the entire ecosystem of sharia-compliant capital is in place, most FSPs offering sharia-compliant financial services will rely on borrowing from conventional sources.

Managing operating risks. Equity is inherently riskier than debt. BAB has structured the diminishing musharaka product to closely mimic a typical debt product, but it nonetheless carries more risk for the institution. To hedge against this, the organization must devote time and effort in managing the client relationship, as this is the main mechanism the bank has to reduce the risks of this type of equity financing. Additionally, BAB has arranged for a portfolio guarantee. While the exact cost of this guarantee is unknown, using guarantees of debt portfolios in the region as a reference, the costs of the guarantees are estimated at 5 percent of the portfolio. However, CGAP research shows that this type of guarantee is atypical and may not be readily available to other financial institutions in other countries.

Profitability Analysis

The existing scale of the BAB micro-sharia business is quite small, with only 54 existing contracts. While BAB indicates that it currently covers all of its operational costs, it does not allocate certain costs that would otherwise be expected of this type of business, such as indirect head office costs or the cost

of the portfolio guarantee. To determine whether this model could breakeven, CGAP looked at the existing cost structure of the operation, projected out to various growth scenarios, and added estimates for other costs BAB does not currently allocate to the product. The analysis reveals that **BAB would need to expand 10-fold to begin to cover its operational costs.**⁶ There may be some efficiencies that could be gained from modifying the operational delivery model such as by reducing the time and effort to analyze such small enterprises, but nonetheless, the nature of this product confirms the early hypothesis that the cost of operating a P&L-type product has fewer opportunities for achieving efficiencies of scale.

The Case of Salam Contracts

Salam is a sharia-compliant debt instrument for advance purchase agreements predominantly used in agriculture. The type of crop and the amount and delivery date of the expected crop yield is agreed to in advance and stipulated in the contract. These contracts allow farmers to finance the advance purchase of inputs like seed that will be used in crop production. In return for the advance cash purchase, the farmer sells the crop to the FSP at a predetermined rate. In some salam contracts, the FSP enters into a separate agreement with the farmer in which the farmer agrees to sell the crop on behalf of the FSP and share the proceeds of that sale with the FSP. It is also acceptable under the tenets of sharia for FSPs to require farmers to take out crop insurance before entering into a salam contract.

Wasil Foundation was established in 1992 as the Center for Women's Cooperative Development (CWCD), focusing on the microfinance needs of poor clients. In 2010, Wasil made a strategic decision to switch to all sharia-compliant microfinancing. Wasil works only with clients who are below the poverty line, defined as living on less than US\$1/day, and mostly rural poor. In Wasil's experience, sharia-compliant microfinance products better meet

⁶ CGAP's financial projects show that when BAB operations are expanded to over 500 active clients, the micro-sharia business can cover its operational costs.

the needs of the poor because the intention is for the FSP and the client to create wealth together, which leads to a higher probability of a successful relationship. Wasil has nearly 90 staff, of which 30 percent are in the head office in Lahore, Pakistan. Wasil has 16 branches in Punjab, where this product is currently on offer.

Given its microfinance mandate, Wasil finances only farmers with less than five hectares of land, focusing primarily on wheat farmers. Typically, the Pakistani government purchases wheat from large land owners only, thus excluding farmers with small yields. Wasil is thus an intermediary, aggregating the product of smallholders. Each Wasil branch uses a salam contract to negotiate a purchase price from individual farmers' groups—within a range provided by the head office. It aggregates these yields when harvested, and sells them in bulk to the government. This offers a modest profit margin to the institution while ensuring that farmers have access to a market from which they are otherwise excluded.

In the Wasil salam product, the farmer's contractual obligation ends with delivery of the crop. Wasil bears the risk of storage and sales; however, Wasil aggregates the crops of various clients and sells in bulk to mills for a better price than what the farmers would be able to get on their own. Wasil does not currently require clients to take out crop insurance. Additionally, Wasil has capped its profit margin to 30 percent, irrespective of the sale price of the crop, and provides any profits above and beyond this back to the clients. On the other hand, Wasil bears all risks associated with the crop sale.

As of June 2013, Wasil had just over 4,000 active clients in total. Salam represented a portfolio of nearly US\$100,000, almost 10 percent of Wasil's total portfolio.

Product Characteristics

The salam product was started in one branch in 2008, with eight wheat contracts for the purchase of a total of 22 tons of wheat; in 2009, Wasil had 29 salam contracts. The product was expanded to include rice crops in 2011.⁷ There are approximately 344 salam contracts today, of which 258 are for wheat and the remainder for rice. During the 2012–2013 wheat growing season (November to June),⁸ the average salam contract amount was in the range of US\$550 to \$650 for 2,200 kg of wheat.

On average, Wasil stores wheat for two to three months in warehouses rented for this purpose.⁹ After the clients deliver the wheat to Wasil offices, Wasil takes it to the warehouse for storage; a per bag fee is stipulated in each contract to offset the direct costs of moving the wheat from the branch to storage. Crops are accumulated until Wasil determines both the volume and market prices warrant bulk sale.

Wasil usually contracts for approximately one-third to two-thirds of the total crop amount of up to US\$720, meaning that it will not offer an advance purchase contract for all of a farmer's crop so that the farmer can use the remaining crop to feed his family or to sell or barter elsewhere. Contractually, Wasil cannot state which part of the crop (from a specific piece of land) is part of the salam agreement, only the crop variety, amount, delivery date, and price.

In theory, there is no cap on the maximum amount of profit that can be made on a salam contract (though, as stated, Wasil caps its own profit). Conversely, Wasil bears all the risk in case of falling wheat prices or loss of crop.¹⁰ To ensure it is serving the neediest, Wasil requires that its clients not have any other formal financial products from any institution.¹¹ Where available, all clients have their credit appraised

⁷ Wasil piloted salam contracts in cotton, but there were problems with storage (rotting) and price fluctuations. Maize was also tested but there were no resources to continue it because of storage issues (needs lots of attention and climate control).

⁸ The rice growing season in Pakistan is July to December, with harvest starting in September.

⁹ Rice dries out quickly, which results in it weighing less, so Wasil will store rice for a maximum 10–15 days.

¹⁰ Wasil's risks are at least in part mitigated by the bulk price set by the government.

¹¹ In some cases, farmers are allowed to be part of a loan program for a tractor from the Pakistan Agricultural Development Bank.

based on information pulled from the Pakistan microfinance database (called CID). Each client also submits to physical verification and assessment of the land to be used for the crop.

Cost Drivers and Risks

Based on analysis of current operating costs of Wasil's salam product, there are three key drivers of costs that will influence the profitability of this product line: (i) operating costs of which in this case the most important component is managing relationships; (ii) cost of funds; and (iii) costs associated with managing operating risks. As with BAB, the research did not explore the set-up costs associated with converting Wasil into a fully sharia-compliant FSP nor the training or research costs associated with identifying the appropriate commodities to serve.

Operating costs. The process of establishing and managing relationships with clients and farmer associations is the highest cost. Wasil goes through community leaders and farmer organizations to find potential clients, and these leaders or organizations serve as agents to disseminate information to potential clients about the salam product. Within each community or farmer organization is a *Numberdar*, who is numerate (although not necessarily literate) and has shown an aptitude for understanding business principles, contracts, effective crop yields, and an understanding of the principles of salam. The *Numberdar* will work with potential clients to make sure they understand the salam contract and help Wasil vet farmers who have a good possibility of being candidates for a successful salam contract. During the crop growing season, Wasil will monitor the farmers and the crop to ensure that all necessary measures are taken so that the crop yields meet the specifications in the contract, including appropriate fertilizer applications, irrigation, and pest control. At harvest, a Wasil representative will be present to ensure that the entire crop is harvested to meet the contractual volume requirements. Once harvested,

it is the farmer's responsibility to deliver the crop to Wasil. Wasil will verify the contract stipulations have been met in terms of type of crop and yield before releasing the client of his contractual obligations.

Cost of funds. Wasil's cost of funds is high, representing 11 percent on average for the portfolio. In fact, Wasil itself believes that this is not sustainable and that there should be another source of funding for its sharia-compliant portfolio. Nonetheless, from a cost perspective, Wasil would need to reflect market-based cost of funds through its accounting adjustments. Currently, all of Wasil's funding comes from the Pakistan Poverty Alleviation Funds (PPAF) through a conventional loan that Wasil uses to support its sharia-compliant portfolio. Historically, the cost of funds has been at Karachi Inter Bank Official Rate (KIBOR).¹² PPAF funding is structured as a conventional loan with equal quarterly installments. Wasil accesses these funds without pledging collateral for a 12-month loan term. Wasil has successfully negotiated with PPAF for a 20-month repayment term, payable on a schedule corresponding to the six-month salam growing season, for the proportion of the loan used to fund salam clients. As with BAB, Wasil's source of funding is not sharia-compliant for the time being.

Managing operating risks. Similar to any commodities futures contract, much of the risk in the salam contract comes from external factors. Natural disasters or harsh weather conditions can have a huge adverse impact on crop yield. Unique to the salam contract, Wasil bears risks with the price fluctuations in the spot market for the crop. Since the purchase price for the salam contract is fixed well in advance, Wasil has no protection against falling prices; conversely, Wasil has self-imposed a maximum gross profit margin of 30 percent on the price of wheat sold. Wasil is subject to any changes in domestic agricultural policy regarding the purchase price of wheat. At the same time, diversifying to other products would prove challenging given the costs associated with storage of other crops.

¹² KIBOR is a floating rate similar to LIBOR and used in Pakistan for the domestic market and Pakistani rupiah-denominated financial instruments.

Profitability Analysis

Like the BAB analysis above, CGAP has projected growth of the operation to assess how quickly it is able to become sustainable in light of the current cost structure. Unlike the musharaka product, the salam costs are linked to the amount of wheat or rice contracted, calculated in maund.¹³ As the amount of wheat or rice contracted increases, Wasil would need to incur greater costs for storage, transport, supervision by staff, and so on. Even at lower levels of production, such as only 10,000 maund, this product can yield profits for the financial institution (assuming operational costs similar to those of Wasil). Under the salam contract, the average size of contract is significantly lower than the salam product (US\$530 as opposed to US\$6,250), and yet the institution benefits from economies of scale and can consequently cover its costs much more quickly than with the diminishing musharaka product. In other words, the fixed costs associated with this product are relatively small (only 22 percent), which leaves significant flexibility for the FSP to grow and benefit from economies of scale.

What Can FSPs Learn from These Case Studies?

Deep technical know-how of the underlying industries financed is required. Both diminishing musharaka and salam products require a particularly high level of technical knowledge on the part of the financial institution. Vigilant reporting and transparency are required to verify performance against the risk-sharing or intended purpose agreed to in the contract, especially in the case of musharaka financing. Strong knowledge and connections with actors in the agricultural value chains served is required for the salam product. Consequently, this added vigilance and knowledge required for understanding the real economy served results in substantial operating costs, particularly for FSPs partnering with farmers or micro and small businesses

that are not accustomed to the rigors of formal accounting.

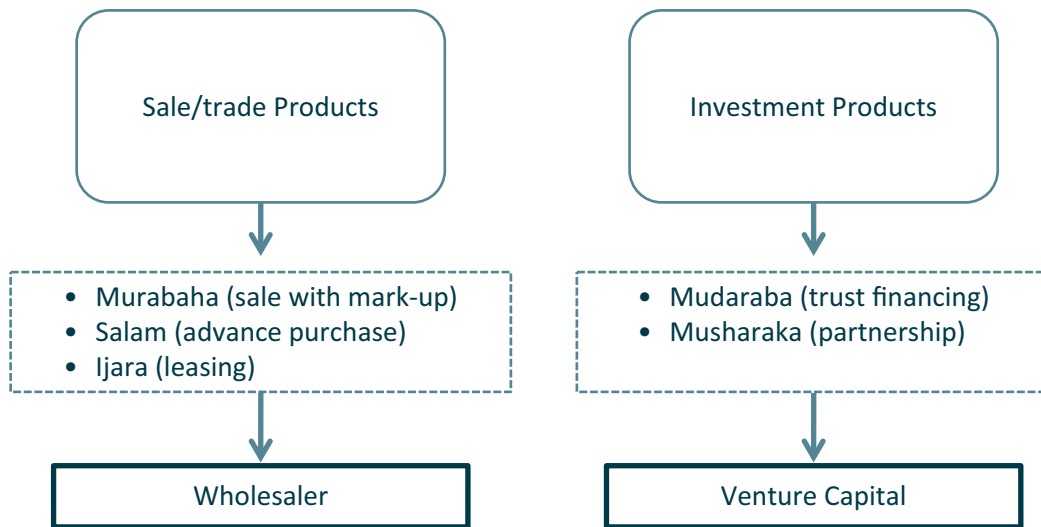
High operational costs overall, but salam has greater economies of scale over diminishing musharaka. Although both products bear high operational costs and high risks associated with potential failure of the underlying investments, the operating models required to offer the two products have very different cost structures. For diminishing musharaka, 76 percent of costs are fixed, while for salam it is only 22 percent. This implies that the scale potential for diminishing musharaka is relatively limited as compared to salam, which can benefit much more readily from economies of scale.

Dimensions of scale and sustainability differ for each product. In the case of diminishing musharaka, the level of effort required to assess a client's potential profitability is high, and measures to offset the risks, such as investing more time in learning about the business and the business owner, are expensive, limiting the upside to increased scale. On the other hand, once an FSP has invested in the know-how and the hedging instruments to reduce the weather and crop risks, the upside to reach scale with salam contracts is high. Furthermore, given the mandate of sharia-compliant FSPs working in rural areas, demand for salam products will likely remain high among their clients, as evidenced by Wasil's much larger portfolio. With a deeper client pool and a predictable financing cycle—pegged to crop production and harvesting cycles—there may be a greater potential for sustainability.

There is a potential trade-off between an Islamic philosophy of investment that prioritizes a development objective and risk-sharing with achieving operational efficiencies. Both institutions highlighted in this paper clearly prioritize their developmental mandates. They have introduced sharia-compliant financial products with

¹³ 1 maund = 32.7 kg

Figure 2. Product Categories and Business Models



business models that reflect the Islamic philosophy of fair financing schemes and sharing in the gains or losses—for instance, Wasil’s willingness to support poor farmers led it to cap its profit margin. Undoubtedly other FSPs may find ways to improve efficiencies, reduce risk, and reduce operational costs,¹⁴ but there is a risk that in the pursuit of efficiencies, these operational models may lose their essence.

Traditional FSP business models are not adapted for sharia-compliant products. Broadly, sharia-compliant products can be grouped into two categories: sale/trade-based products or investment products. Essentially, each category of product would require a different operational model. Sale/trade-type products require a business model that looks more like wholesalers than traditional FSPs, while investment products require a business model that looks more like venture capital funds than a typical bank.¹⁵

There is a need to understand return on investment (ROI) for each investee class. The two cases

covered represent nascent institutions with relatively limited outreach. This means that there was limited opportunity to analyze the underlying return on investment of their various investees. As institutions grow, they need to consider profitability of each class of investee (e.g., rice, wheat, corn, soya in the case of salam contracts), and manage its portfolio of investments so that ROI for the entire portfolio remains relatively robust.

What’s Next?

Lessons from BAB and Wasil demonstrate that institutions that are committed to offering sharia-compliant services can do so sustainably, but significant up-front investments are needed. The biggest investment is in the institution itself: FSPs need trained staff, new operational models, knowledge of the industries they aim to serve, and in the case of salam contracts, access to the infrastructure and contacts needed to store and sell the commodities contracted. Making these kinds of investments is a serious decision for any institution, one that should not be entered into lightly.

¹⁴ For example, some institutions set standards of performance per sector of activity and expect standard returns based on such standards, regardless of the actual performance of the invested business.

¹⁵ Some FSPs offer murabaha products using vouchers rather than directly engaging in wholesaling services. Depending on the country and the perceptions of authenticity to sharia principles, this approach may or may not be accepted as sharia-compliant by religiously observant Muslims.

One issue that FSPs need to consider is how comfortable they are with operational risks and in turn the limits to scale that some of these sharia-compliant products and business models have. The two types of sharia-compliant financial products covered in this paper are focused on productive investment; as such, there will be inherent limits to the size of the market they can serve. To offer financial products that address consumption smoothing needs of the poor, sharia-compliant FSPs are limited to products such as *qard-hassan*, which requires subsidies and in turn would not contribute to the financial viability of the FSP.

FSPs that choose to introduce an Islamic “window” rather than converting all of their operations to sharia-compliant may be able to balance costs and risks while expanding their operations to significant scale by cross-subsidizing some of the additional costs of the sharia-compliant window by their conventional operations. This approach requires further study as regulations, perceptions of clients, and other considerations would need to be explored, something that the research reflected in this paper did not do.

A precursor to any decision to enter the sharia-compliant space is a deep understanding of demand. While any FSP should understand demand before piloting and rolling out new financial products, this lesson is far more pronounced for sharia-compliant products, which require fundamental and significant changes in the operational business models of typical FSPs. Before making the institutional investments needed, it would be prudent for an FSP to fully understand demand-side needs, preferences, and behaviors. In general, most demand studies that explore sharia-compliant financial services have done so using techniques that do not get to the heart of what drives consumer choices. Asking any Muslim whether he or she prefers sharia-compliant products to conventional ones is likely to yield a preference for the former. Yet this will not necessarily be reflected

in the actual choices they make when these products are offered side by side. Much more work and investment needs to go into understanding these types of demand issues.

Ultimately, for sharia-compliant FSPs to flourish, these institutions will need to demonstrate financial viability to attract investment and grow. In the conventional microfinance world, this took an entire ecosystem of services to achieve—standardized metrics on performance, a platform in which these metrics were accessible (MIX Market), creation of investment vehicles dedicated to serving the segment, and so on. A similar ecosystem would need to emerge for the sharia-compliant industry to take off. In the meantime, it will probably remain limited to the creativity and drive of the individual founders and managers of these FSPs that believe in their mission.

Methodology

To analyze the costs of the two institutions, the study used a product costing technique—Traditional Cost Allocation (TCA) approach.¹⁶ As with any product-costing exercise, cost allocation is one of the main drivers of profitability. Where possible, primary source data were reviewed using the chart of account categories. Both BAB and Wasil use branch staff that are almost exclusively dedicated to these products, at least in some branches, which enabled direct costing in many cases. Head office, some branch or regional, and shared resources were allocated using the methodology adopted respectively by each institution.

CGAP conducted onsite visits to review the business model, explore client outreach tactics, understand product characteristics, review the contract process, meet with clients, and have detailed meetings on costs and expenses. Additionally, background material and data were gathered beforehand, with remote follow up after each visit.

¹⁶ The two most commonly acceptable product-costing methodologies in conventional microfinance are TCA and Activity Based Costing (ABC). ABC costing, while the most accurate, is challenging and often impractical in financial organizations that do not have rigorous and meticulous record keeping, process flows, and cost centers. See Helms and Grace (2004).

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CGAP
1818 H Street, NW
MSN P3-300
Washington, DC
20433 USA

Tel: 202-473-9594
Fax: 202-522-3744

Email:
cgap@worldbank.org
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