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A Comparison of Interest-Free and Interest-Based Microfinance in Bosnia and Herzegovina

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Abstract

Microfinance has long been used a developmental tool to fight poverty. It has been operational since the 1960s. Recent studies have shown positive impacts of microfinance with respect to generating income and smoothing consumption of its clients. On the other hand, a number of critics argue that microfinance has not been able to achieve its main objective of fighting poverty. This is due to the shift that has taken place in the industry from poverty-focus to profit-oriented business-focus. Above all, microfinance faces other challenges on its way to succeed. One of the major challenges is that the product is not universally applicable or it does not tailor with the belief system of the Muslims despite the fact that one third of the world poor are Muslims. There has been a growing effort to create an 'Islamic' model of microfinance. The Islamic Model of Microfinance represents a new paradigm of social enterprise in which profit and loss sharing replaces interest-based financing. The growth of Islamic microfinance has led organizations such as the Consultative Group to Assist the Poor (CGAP), a multilateral organization distributing knowledge about Islamic microfinance, and the Islamic Development Bank (IDB) to begin understanding this new way of approaching poverty. The objective of this paper is to review the existing Islamic microfinance institutions (IMFIs) in Bosnia and Herzegovina (BH), and to propose a Shariah compliant microfinance product in Islamic microfinance operations particularly in BH.

Keywords: Microcredit; Bosnia and Herzegovina; Microfinance Institutions; Interest-free Financing; Islamic Microfinance Institutions; Loans; Repayment; Poverty; Debt.

Introduction

Evolution of Microfinance

The failure of commercial banking to provide financial services to the poor has brought about interventions in the markets for financial services at the micro level. Consequently, microfinance emerged as an economic development approach intended to address the financial needs of the deprived groups in the society. The term microfinance refers to "the provision of financial services to low-income clients, including self-employed" (Ledgerwood, 1999, p. 1). The emergence of this new paradigm was encouraged by the successful story of microfinance innovations serving the poor throughout 1970s and 1980s. The most quoted examples are Grameen Bank Bangladesh, the *unit desa* system of Bank Rakyat Indonesia, ACCION International in the United States and in Latin

America and PRODEM, BancoSol's predecessor in Bolivia. The microfinance adopts market-oriented and enterprise development approach. It emphasizes institutional programme innovations to reduce costs and risks and has greater potential to expand the financial frontier to the poor in sustainable manner (Littlefield, Morduch, & Hashemi, 2003).

In Bosnia and Herzegovina (BH), the majority of MFIs were established as affiliates of international networks during the post-conflict reconstruction efforts in BH. As such, they received the majority of funding from donations. As MFIs increased in size and became more efficient and profitable, they began to attract more funds from commercial sources. There are 25 microcredit institutions in BH where; 16 in the Federation of Bosnia and Herzegovina (FBH), from which 15 microcredit foundations (MCFs) and one microcredit company (MCC) and; 9 in Republika Srpska (RS) of which 5 microcredit foundations and 4 microcredit companies. BH as a country is comprised of three regional entities, Federation with 10 Cantons, Serbian Republic (Republika Srpska) and Brcko District (BD).

The Association of Microfinance Institutions (AMFI) in BH which was established in 2000 is the primary microfinance network operating in the country. AMFI currently has nine MFIs members which according to the MIX (2008), account for 98 percent of Bosnia's microfinance portfolio. MFIs in BH state that their main purpose is to empower women and assist returnees and IDPs to return to their pre-war houses. Other objectives include reconstructing destroyed houses, starting small businesses, assisting socially disadvantaged persons, improving living conditions of the poor and assisting poor students to afford a good education. Four microcredit foundations from BH were ranked among 50 most successful microcredit institutions worldwide by the most influential finance magazine Forbes in 2007 (http://amfi.ba/en/).

Islamic Banks

The concern over poverty reduction via microfinance initiative is also of relevance to Islamic banks. As business entity established within the ambit of Shari`ah, Islamic banks are expected to be guided by Islamic economic objectives, among others, to ensure that wealth is fairly circulated among as many hands as possible without causing any harm to those who acquire it lawfully (Ibn Ashur, 2006). Indeed, Islamic banking industry is one of the fastest growing industries, having posted double-digit annual growth rates for almost 30 years (Iqbal & Molyneux, 2005). Started as a small rural banking experiment in the remote villages of Egypt in the early 1970s, Islamic Banking has now reached a level where many mega-international banks worldwide offering this kind of products. Unfortunately, the vast majority of Islamic commercial banks do not service the poor nor do they share their technical knowledge and expertise with Islamic MFIs.

In Bosnia and Herzegovina, the Bosnia Bank International (BBI) is the only operating Islamic bank since its establishment in 2000. In comparison with the year 2011, BBI recorded significant growth in all its business lines in 2012. Total assets grew by 27%, total revenues increased by 17% and net profit grew by 27% (https://www.bbi.ba/en/). Recognizing the role of microfinance in alleviating poverty and developing the local economy, BBI has launched its microloans in 2012. More details about this line of microloans are presented in methodology and data collection sections of this paper.

Incompatibility with Islamic Principles

According to CGAP (2008) 72 percent of people living in Muslim majority countries do not use formal financial services. Even when financial services are accessible, some Muslims view conventional banking products as incompatible with Islamic principles and laws (Sharia law).

Some microfinance institutions (MFIs) have stepped into servicing poor Muslim clients who demand financial products in accordance with Islamic financial principles leading to the development of Islamic microfinance as a new market niche. This new practice has the potential not only to respond to the unmet demands of the Muslim poor but also to combine Islamic social principles of caring for the less fortunate. This new niche has the prospective to provide millions of poor Muslims, who reject conventional microfinance products, access to Sharia compliant financial products.

Based on Islamic Sharia principles, it is not permissible to charge, pay or receive interest; this ban on interest is derived from two essential Sharia principles. One principle asserts that money has no intrinsic worth. Money is not an asset by itself and can increase in value only if it joins with other resources to undertake productive activity. Therefore, money cannot be bought and sold as a commodity, and it cannot increase in value over time. According to second principle, fund providers (Islamic MFIs) must share the business risk. Providers of funds are not considered creditors (who are typically guaranteed a predetermined rate of return), but rather investors (who share the rewards as well as risks associated with their investment which is based on profit and loss principles). To this end, the system places the responsibility on the financer (Islamic MFI) and the borrower (entrepreneur), as they both share the risks and benefits associated with the financial transaction. Many Islamic microfinance programmes also integrate the zakah principles (act of giving) in their financing model to ensure that the extreme poor are not left out. This is done by providing interest free-loans (Qard-hasan) to the poor by utilizing the funds provided through zakah (See Table 1 below, which compares Islamic MFIs versus conventional MFIs).

Islamic Microfinance

Recognizing that microfinance can be an important channel in poverty alleviation, Islamic microfinance is increasingly seen, especially in Muslim majority countries, as an alternative to conventional microfinance to alleviate the poor out of poverty. Islamic MFIs have been developed with the sole purpose of providing the poor who have little or no access to capital from the commercial banking sector with viable financial services that are in accordance with Islamic principles.

Despite the strong demand for Islamic microfinance products and services, the growth of this sector has been slow. This is mainly due to the fact that Islamic microfinance services are generally provided by non-governmental organizations (NGOs) who may not possess the adequate technical expertise or funding to ensure the proper implementation and sustainability in servicing the very poor. On the contrary, the Islamic commercial banking sector, which provides Islamic products to the non-poor, has seen tremendous growth in the past three decades.

In Bosnia and Herzegovina, Micro First Islamic is the only officially registered interest-free, not for profit micro-credit institution since 2001, while Human Appeal International running its limited microloans program as part of its humanitarian activities in BH. BBI is the third Islamic financial institution that adopted the microloans approach within its financial scheme in BH. More details about these three microcredit programs are provided in the methodology and data collection sections of this paper.

Paper Rationale and Structure

The literature that explores Islamic microfinance in Bosnia and Herzegovina (BH) is very limited and scarce. Therefore, the main aim of the paper is to review the operating interest free microfinance institutions and programs in Bosnia and Herzegovina and to assess the potentials of Islamic financing schemes for micro financing purposes. The paper argues that Islamic finance has an important role for furthering socio-economic development of the poor and small (micro) entrepreneurs without charging interest. Furthermore, Islamic financing schemes have moral and ethical attributes that can effectively motivate micro entrepreneurs to thrive. The paper also argues that there is a nexus between Islamic banking and microfinance as many elements of microfinance could be considered consistent with the broader goals of Islamic banking.

This paper is structured as follows. The previous sections provided a brief review of the evolution of microfinance and Islamic Banking globally and locally in BH. It explained the incompatibility of the interest based microfinance approach to Islamic principles and among Muslim communities as well. The following sections discuss differences and similarities between conventional and Islamic microfinance and the diverse financial instruments that Islamic banking can apply together with other available microfinance mechanisms which can be integrated into microfinance programmes. Comparisons between conventional and Islamic microfinance institutions are backed up with secondary data, which show the differences in performance of

MCOs in the Federation of Bosnia and Herzegovina (FBH) during the period 2008-2012. The final section presents the conclusions that are found in this paper including the fundamental differences between interest free microfinance institutions (IF MFIs) and interest based microfinance institutions (IB MFIs).

Litereture review

In 1997, the first Microcredit Summit launched a nine-year campaign to reach 100 million of the world's poorest families, especially the women of those families, with credit for self-employment and other financial and business services by the year 2005. The World Bank has also declared 2005 as the year of microfinance with the aim to expand their poverty eradication campaign. The success of the first phase of the Campaign, during which those with microloans grew from reaching 7.6 million of the world's poorest families in 1997 to more than 100 million in 2007. In November of 2006, the Campaign was re-launched with two new goals. First, reaching 175 million poorest families with microfinance; second, helping 100 million families to lift themselves out of extreme poverty. In addition, the Campaign had four core themes that focused not only on the number of clients reached but also on the quality of the practitioners' work: Reaching the Poorest, Empowering Women, Financial Self-Sustainability, A Positive, Measureable Impact.

Principles of Interest-Based Microfinance

Microfinance grew out of experiments in Latin America and South Asia, but the best known start was in Bangladesh in 1976, following the wide-spread famine in 1974. Advocates argue that the microfinance movement has helped to reduce poverty, improved schooling levels, and generated or expanded millions of small businesses. The idea of microfinance has now spread globally, with replications in Africa, Latin America, Asia, and Eastern Europe, as well as richer economies like Norway, the United States, and England.

Among *the features of microfinance* are disbursements of small size loans to the recipients that are normally micro entrepreneurs. The loans are given for the purpose of new income generation project or business expansion and smoothing consumption. The terms and conditions of the loan are normally easy to understand and flexible. It is provided for short term financing and repayments can be made on a weekly or longer basis. *The procedures and processes* of loan disbursements are normally fast and easy. Additional capital can also be given after the full settlement of the previous loan. Microfinance is an alternative for micro entrepreneurs, which are normally not eligible or bankable to receive loans from commercial banks.

The *basic principle* of microfinance as shortly explained by Dr. Muhamad Yunus, the founder of Grameen Bank Bangladesh, and the recipient of the Nobel Peace Prize in 2006, that credit is a fundamental human right. The *primary mission* of microfinance is, therefore to help poor people in assisting themselves to become economically independent. Credit or loan is given for self employment and for financing additional income generating activities. The assumption of the *Grameen model* is that the expertise of the poor is underutilized. In addition, it is also believed that charity will not be effective in eradicating poverty as it will lead to dependency and lack of initiative among the poor. In the case of Grameen Bank of Bangladesh, women comprised of 95% of the borrowers, and they are more reliable than men in terms of repayments (Gibbons and Kassim, 1990).

In order to facilitate *loan process* for the poor, loan is given without collateral or guarantor, and normally is based on trust, which is not the case in BH, as borrowers should provide guarantor/(s) and other official documents that will be activated and proceeded to the court in case of repayment failure. Microfinance is an alternative for loan because the conventional banking system recognized the poor as not-credit worthy. *Loan facility* is provided based on the belief that "people should not go to the bank but bank should go to the people". In order to obtain the loan, the prospect borrower needs to join the recipient group of microfinance. The group members are given small loans, and the new loans will be given after the previous loans are repaid. The *repayment scheme* is on short term basis on a scale of a week or every two weeks. The loans are also given together *compulsory saving* package (e.g. compulsory saving in the group fund) or *voluntary saving*. The loan priority is for establishing social capital through group joint projects established among the loan recipients. In BH, the *individual lending approach* is dominantly applied by most of MFIs other than the group based approach; the installments are mostly done on monthly bases; and MFIs are not allowed to receive deposits from their clients regardless whether they are done voluntarily or compulsorily.

Fruman and Goldberg (1997) explained that good microfinance programs are characterized by the followings:

- Small, usually short-term loans, and secure savings products.
- Streamlined, simplified borrower and investment appraisal.
- Alternative approaches to collateral.
- Quick disbursement of repeat loans after timely repayment.
- Above-market interest rates to cover the high transactions costs inherent in microfinance.
- High repayment rates.
- Convenient location and timing of services.

Principles of Interest-Free Microfinance

The Grameen Bank is an outstanding example of a successful microfinance institution. The award of the Nobel Prize in 2006 to the founder of the Grameen Bank, Muhammad Yunus, brought microfinance to international attention. Although Bangladesh is a predominantly Muslim country, the Grameen Bank is not a *shari'ah* compliant financial institution as it charges interest on loans, and pays interest to depositors.

There are also wider concerns with conventional microfinance from a Muslim perspective. Although the provision of alternatives to exploitative lending is applauded, there is issue of whether these are sustainable if they conflict with the values and beliefs of local Muslim communities. As interestingly pointed out by Wilson (2007), simply extending materialism and consumerism into rural poor communities and urban shanty town settlements could actually undermine social cohesion, by raising false expectations which could not be fulfilled, resulting in long term frustration and possible discontent or even economic crime. Supporters of Islamic alternatives to conventional microfinance have as their aim the enhancement of Islamic society, rather than with the promotion of values that might be contrary to *shari'ah*. Comprehensive Islamic microfinance should involve not only credit through *debt finance*, but the provision of *equity financing* via mudarabah and musharakah, *savings schemes* via wadiah and mudarabah *deposits*, money transfers such as through zakat and sadaqah, and *insurance* via takaful concept.

The below Table 1 summarizes the possible differences in characteristics and objectives between the conventional microfinance and Islamic microfinance.

Table 1: Differences between Conventional and Islamic Microfinance

Items	Conventional MFI	Islamic MFI
Liabilities (Source of Fund)	External Funds, Saving of Client	External Funds, Saving of Clients, Islamic Charitable Sources
Asset (Mode of Financing)	Interest-Based	Islamic Financial Instrument
Financing the Poorest	Poorest are left out	Poorest can be included by integrating with microfinance
Funds Transfer	Cash Given	Goods Transferred
Deduction at Inception of Contract	Part of the Funds Deducted as Inception	No deduction at inception
Target Group	Women	Family
Objective of Targeting Women	Empowerment of Women	Ease of Availability
Liability of the Loan (Which given to Women)	Recipient	Recipient and Spouse
Work Incentive of Employees	Monetary	Monetary and Religious

Dealing with Default	Group/Center pressure and threat	Group / Center Spouse Guarantee, and Islamic Ethic
Social Development Program	Secular (non-Islamic) behavioral, ethical, and social development	Religious (includes behavior, ethics and social)

Source: Ahmed (2002)

Islamic Banking and Microfinance

Currently, there are about 270 Islamic banks worldwide with a market capitalization in excess of US$13 billion. The assets of Islamic banks worldwide are estimated at more than US$265 billion and financial investments are above US$400 billion. Islamic bank deposits are estimated at over US$202 billion worldwide with an average growth of between 10 and 20%. Furthermore, Islamic bonds are currently estimated at around US$30 billion and are the 'hot issue' in Islamic finance. In addition, Islamic equity funds are estimated at more than US$3.3 billion worldwide with a growth of more than 25% over seven years and the global Takaful premium is estimated at around US$2 billion (Abdul Rahman, 2007).

Due to the massive expansion in Islamic banking activities, some commercial banks started to offer Islamic banking facilities (e.g. state-owned banks in Egypt, National Commercial Bank in Saudi Arabia). Furthermore, the Islamic financial product is also now offered by the European banks (i.e. Kleinwort Benson of London and the Swiss Banking Corporation). Such developments show that the Islamic financial instruments are increasingly being accepted internationally, even in non-Islamic countries and the basic principles are well understood in those countries (Wilson, 2000). Despite the wide acceptance of Islamic banking worldwide, the concept of financing for the poor or microfinance by Islamic banks was not well developed. Most Islamic banks, as in the case of conventional commercial banks, did not provide easy access to financing to the poor.

Concern over credit provision and finance accessibility for the poor via microfinance is also relevant to Islamic banks that should place greater social welfare responsibilities and religious commitments to achieve the Islamic economic objectives, including social justice, equitable distribution of income and wealth and promoting economic development. Many writers such as Al-Harran (1990, 1996, 1999), Akhtar (1996, 1998), Dhumale and Sapcanin (1999), Ahmed (2001), and others, believe in the great potential of Islamic banking to be involved in microfinance programmes to cater for the needs of the poor who usually fall outside the formal banking sector.

In addition to the innovative approaches used by many microfinance institutions, Islamic banking can apply diverse financial instruments together with other available mechanisms such as zakah, charity and waqf which can be integrated into microfinance programmes to promote entrepreneurship amongst the poor and subsequently alleviate poverty (Akhtar, 1996, 1998; S. Al-Harran, 1995, 1996, 1999; S. A. S. Al-Harran, 1990; Al-ZamZami & Grace, 2000; Dhumale & Sapcanin, 1998; Hassan & Alamgir, 2002).

Many elements of microfinance could be considered consistent with the broader goals of Islamic banking. Both systems advocate entrepreneurship and risk sharing and believe the poor should take part in such activities (Dhumale and Sapcanin, 1999). At a very basic level, the disbursement of collateral-free loans in certain instances is an example of how Islamic banking and microfinance share common aims. This close relationship would not only provide obvious benefits for poor entrepreneurs who would otherwise be left out of credit markets, but investing in microenterprises would also give investors in Islamic banks an opportunity to diversify their investments.

Islamic Microfinance and Islamic Banking

Unlocking the potential of Islamic microfinance is the key to providing financial access to millions of Muslim poor and an essential tool to achieve the goal of making poverty history by 2015, as pledged in the United Nations' Millennium Development Goals. To achieve a more balanced world it would require only $30 billion to provide microfinance facilities to world's poorest 175 million families. The final outcome will also contribute towards inclusiveness and the integration of Islamic microfinance into the Islamic financial system.

Islamic microfinance is still in its infancy with less than 1% of total global microfinance outreach: a few hundred thousand customers are managed by a couple of hundred institutions (mostly NGOs) operating in not more than 20 countries. Challenges in reaching a sustainable scale are mainly due to the not-for-profit culture of the Islamic microfinance institutions (IMFIs) that feature an over-dependence on grants coupled with a lack of operational efficiency and of proper risk management. This, in turn, obliges the IMFIs to constantly look for injections of funds to keep running, to ration their funds thereby limiting access to financial services by some people or geographical areas and, above all, does not entice them to collect the extra savings necessary to build those permanent local financial institutions that can attract domestic deposits, recycle them into loans, and provide other financial services (Alberto, 2011).

Three basic instruments of Islamic finance could be built into the design of a successful microfinance program: *mudaraba* (trustee financing), *musharaka* (equity participation), and *murabaha* (cost plus markup) (Abdouli, 1991). Comparatively, *qardhul hasan*, *murabahah* and *ijarah* schemes are relatively easy to manage and will ensure; the capital needs (*qardhul hasan*), equipments (*murabahah*) and leased equipments (*ijarah*) for potential micro entrepreneurs and the poor. Participatory schemes such as *mudarabah* and *musharakah*, on the other hand, have great potentials for microfinance purposes as these schemes can satisfy the risk sharing needs of the micro entrepreneurs. These schemes, however, require specialized skills in managing risks inherent in the structure of the contract. In theory, different schemes can be used for different purposes depending on the risk profile of the micro entrepreneurs.

Instruments in Islamic finance

Mudarabah; has the potential to be adapted as Islamic microfinance scheme. *Mudarabah* is where the capital provider or microfinance institution (*rabbul mal*) and the small entrepreneur (*mudarib*) become a partner. The profits from the project are shared between capital provider and entrepreneur, but the financial loss will be borne entirely by the capital provider. Two of the conditions for a mudaraba-type venture show the level of partnership implicit in Islamic contracts (Hasanuzzaman, 1994, p. 7);

- "*The gross or net return on capital or entrepreneurship should not be predetermined.*
- *Partners should share not only profits but also losses in proportion to their shares in the enterprise*".

Musharakah; can also be developed as a micro finance scheme where Islamic bank will enter into a partnership with micro entrepreneurs. If there is profit, it will be shared based on pre-agreed ratio, and if there is loss, it will then be shared according to capital contribution ratio. The distinguishing features of this type of contract are the nature of the business activity and the duration of the gestation period for the business. Two or more partners contribute to the capital and expertise of an investment (Dhumale, and Sapcanin, 1999).

***Murabahah*;** using *murabahah* as a mode of microfinance requires Islamic bank to acquire and purchase asset or business equipment then sells the asset to entrepreneur at mark-up. Repayments of the selling price will be paid on installment basis. The Islamic bank will become the owner of the asset until the full settlement (Dhumale, and Sapcanin, 1999).

Ijarah; is a long term contract of rental subject to specified conditions as prescribed by the *shari'ah*. Unlike conventional finance lease, the lessor (Islamic bank) not only owned the asset but takes the responsibility of monitoring the used of asset and discharges its responsibility to maintain and repair the asset in case of mechanical default that are not due to wear and tear. The bank should first purchase the asset prior to execution of an *ijarah* contract. The bank takes possession of the assets and subsequently offers the asset for lease to customer. The bank then is responsible for the risks associated with the asset.

Ijarah Muntahia Bitamleek; is an elaborate concept of *ijarah* where the transfer of ownership will take place at the end of the contract and pre-agreed between the lessor and the lessee. The title of the asset will be transferred to the lessee either by way of gift, token price, pre-determined price at the beginning of the contract or through gradual transfer of ownership. *Ijarah Muntahia Bitamleek* is more suitable for micro finance scheme especially for micro entrepreneurs who are in need of assets or equipments.

***Qardhul Hasan*;** is another simple concept that can be advanced for microfinance purposes is *qardhul hasan* or simply means an interest free loan. Islamic bank can provide this scheme to the entrepreneurs who are in need of small start-up capital and have no business experience. The Islamic bank then will only be allowed to charge a service fee to cover the administrative and transactions costs of these loans so long as such costs are not related to the maturity or amount of the loan (Dhumale, and Sapcanin, 1999). The term of repayment will be on installment basis for an agreed period.

Description of avaliable funds

Interest Based Microcredit Organizations (IB MCOs) in BH

The law on micro-credit organizations (Law on MCOs) regulates the establishment, registration, activities, form of organization, business operations, manner of management, termination of operations and supervision of micro-credit organization performance (MCO), that is micro credit foundation (MCF) and micro-credit companies (MCC) in the Federation of BH. The authorities of the (BA FBH) over these activities are regulated by the Law on the (BA FBH) and internal acts of the Agency. Since 2008, when the MCOs initiated the operations with the registration in the authorized registries, the Agency revoked a total of six licenses for operations, four due to merger with other MCFs, and two due to failure to implement the conditions for operations which lead to termination of operations of these MCFs. In comparison to 2008, the number of issued licenses for operations of MCOs from 20 decreased to 14 currently active licenses for operations, which presents a decline by 30%.

According to the reports of BA FBH and AMFI (2012), covering the period from 1996-2012, total amount of assets in BAM were 499.7 million, gross portfolio in BAM was 417.2 million (83% of total assets). Liabilities on taken loans in BAM were 312.04 million, capital in BAM was 163.5 million (33% of total liabilities). Amount of cash collected in BAM was 25.4 million (5% of total assets). In the report, amount of placements to banks in BAM was 8.3 million (2% of total assets) and profit (Surplus of income over expenses) in BAM was 13.24 million. Portfolio at risk over 30 days (PAR>30 days) was reported to be 1.9%. Also, capital in comparison to total assets ranged from 2% in some MCOs to 76% in others. Fixed assets in comparison to total assets ranged from nil in some MCOs to 21% in others. Total receivables in comparison to gross portfolio ranged from 4% in some MCOs to 115% in others. Number of active loans was 248,000 while number of users (individuals and legal entities) was 191,000. Average usage of loans was 1.3 with an average loan size of 1,682 BAM. Number of employees was 1,554. With the current institutional capacities, MCOs can place 12,000 to 15,000 loans ranging in worth between 36,000,000 BAM to 50,000,000 BAM on a monthly basis. Similarly, MCOs can place 145,000 to 180,000 loans in worth between BAM 415,000,000 to BAM 540,000,000 on a yearly basis.

When we look at the overall performance since 1996 until December 2012, we see that number of loans disbursed were 2,235,000 with an amount of financing in BAM 6,527,000,000. Average loan size in BAM was 2,920. Effective interest rate ranged from 27% to 39%. Repayment rate was 85% during the global financial crises in 2009, 89% in 2010, 93% in 2011 and 95% in 2012. Most of these loans were financially sustainable. About 560,000 persons used micro loans, with one or more loans per person, or more precisely, every person had on average 4.5 loans/individuals. More than 60% of persons those who were not able to meet pre-conditions for commercial banks' loans could use micro loans.

In terms of financing conditions, the required minimum age of applicant was 18 at the time of application and repayment had to be made on monthly installments. The repayment period ranged from 12 to 36 months without a grace period. Users who regularly paid off the financing would be permitted for new funding, and the amount was gradually increased if conditions were fulfilled.

As far as the types of loans distributed, housing, business, service activities, agriculture, production, trading were the main types of loans. MCOs distributed 139.3 million BAM for individuals in 2011. These loans were mostly distributed for agriculture, service activities, trading, housing and production. Main target groups for the loans were returnees, women, individuals (98% of total users), and legal entities (2% of total users).

Interest Free Microcredit institutions (IF MCIs) in BH

There are three kinds of interest free microcredit institutions in BH. The first one is Micro First Islamic (MFI) that registered as a microcredit foundation and the second one is Bosnia Bank International (BBI) that registered as a Bank since its establishment. The third one is Human Appeal International (HAI) that registered as a NGO.

(Islamic) Bosnia Bank International (BBI)

According to the information obtained through questionnaires and interviewing two persons in charge in BBI, there are two microcredit lines launched by BBI bank with the objective to enhance the repatriation process of the returnees to their pre-war houses and properties; the first one called Trust fund, and it is available to all returnees within the country of BH. While the second one is “Al- Maktoum fund” which is precisely allocated to the returnees in Bratunac town in the Republika Sirpska.

Trust Fund

The objective of the fund is to provide micro-finance for the return of refugees, enabling to start their own business in the field of agricultural activities and livestock breeding, and other similar activities, which adequately match the location of the return. The above stated goal is achieved through the granting of financing to users through a large network of existing and or specially designed products by BBI. These products include construction or reconstruction of stables and associated facilities for cattle, poultry and meat, milk and eggs, the construction of other facilities that are necessary for the agricultural industry and the necessary machinery and equipment (refrigerators, generators, small generators, etc.), providing equipment and livestock (cages, nest, a place for growing and watering, cleaning apparatus, apparatus for maintaining optimal temperature, etc.), buying the main herd / flock for production, purchase of agricultural machinery and equipment, purchase of agricultural tools, the purchase and installation of greenhouses, buying seeds and plants for gardens and fruit growing, financing service in the field of animal husbandry and cultivation of plants (eg. Medicinal plants, etc.), financing farms, other purchases related to agricultural activities.

Gross portfolio of the fund in BAM is 4,088,473.09 and the number of active loans was 3,132. Number of microloans disbursed since the beginning of the program was 4,032. Amount of financing disbursed in BAM since the beginning of the program was 12,294,215.99. Average loan size in BAM was 6,007.00. Percentage of financing fees and service charges was 5.77% while the collection percentage was 94.13%.

According to the fund conditions, the age of the applicant must be minimum 18 and maximum 65 at the time of maturity of funding. The fund will use a method of financing that are consistent with Shari'ah exert little funding preferring individual amounts between 2,000 (two thousand) to 6,000 (six thousand) U.S. dollars, an exception may be granted is outside this framework. Refunds funding are made in monthly installments. The repayment period ranges from 12 to 48 months, including a grace period of three to eight months. Resources returned by the user are kept in the account of the fund in order to use the new funding to increase the total number of users. Users who regularly paid off the financing are permitted new funding, and gradually increase the amount of funding for which conditions have been fulfilled. As means of ensuring the repayment of loans, the fund may take one or more of the following; one or more of eligible guarantors for the bank; the contract for the purchase of agricultural products assigned at BBI;

bills of exchange or promissory notes of the company that buys products marked “no protest”; pledge of movable property (a mortgage); the insurance terms endorsed in favor of the Bank; bills exchange or promissory notes of client indicating “no protest”; firm warranty, company collateral acceptable to the bank from the standpoint of financial policy for legal entities.

Al-Maktoum Fund

The objective of the fund is the same of the previous one while the activities and products that are financed by this fund are assigned only to three category of agriculture; dairy farming and production; poultry; and beekeeping. Gross portfolio of the fund was 300,000 BAM. The number of active loans was 69. The number of microloans disbursed since the beginning of the program was 98 and the amount of financing disbursed in BAM since the beginning of the program was 992,277.15. Average loan size in BAM was 10,125.28. Percentage of financing fees and service charges was nil. Collection percentage is 97.14%. In addition to the conditions that mentioned in the previous “Trust Fund” the size of the loan ranges between 2,000 to 15,000 U.S. dollars, an exception may be granted outside this framework. Refunds funding is made in monthly installments. Repayment period ranged from 12 to 84 months, including a grace period of up to twelve months.

Micro First Islamic (MFI)

This fund is the only interest free, non-profit microcredit foundation operating in BH since 2001. It has two offices in BH; one in the capital city Sarajevo and another one in Tuzla city. It has three loan officers; each of them covers one of the three cantons where it focuses its operation (Tuzla Canton, Sarajevo Canton and Zenica–Doboj Canton). According to the annual report MFI (2012), its main goal is to help households to become sustainable, and to promote the Bosnian economy. But this is not reflected by the types of the distributed loans, since only around 10% of loans were distributed for business manner, while the rest were disbursed for social manners. The types of loans distributed include housing, business, orphans, education, and social loans. In 2012, MFI distributed 1,345 loans, from which 355 (26.4 %) housing loans, 137 (10.2%) business loans, 729 (54.2%) social loans, 83 (6.2%) educational loans and 41 (3.1%) orphan loans. This reflects the tendency of the policy of this institution in focusing on social cases and trying to meet their needs and smoothing their consumption by distributing around 90% to this kind of loans, while only 10% for business purposes. Gross portfolio of the fund was 1.748 million BAM. The amount of assets was 1.665 million BAM. The capital was 1.428 million BAM. Donated capital was 3.488 million BAM. Liabilities taken on loans were 109,000 BAM. Deficit of income over expenses (losses) was 34,000 BAM. Portfolio in risk over 30 days was 9.7%. Capital in comparison to total assets was -1.6%, fixed assets ratio in comparison to total assets were -124%. Total receivables in comparison to gross portfolio were 77% as the number of active loans were 1,345. Average loan size was 1,980 in BAM.

Number of microloans disbursed since the beginning of the program was 13,237 from which 46% are women and 54% are men. Amount of financing disbursed in BAM since the beginning of the program around 26 million. Percentage of financing fees and service charges differed from less than 3% during 2001-2006, up to 5% in 2006/2007 then 7.5% during 2008-2013 and lastly 10% since the beginning of 2014. Repayment rate ranged from about 60% during the global financial crises in 2008/2009 up to 95% in most other years since its establishment in 2001. The financial sustainability was also improving from less than 25% in 2001 up to 100% in 2008/2009, to 80% during 2010-2013, while expected to reach again it full sustainability in 2014 due to the increase in the service charges that applied since 2014.

According to the financing conditions, the age of the applicant must be 18 year at the time of application. Maximum size of loans could be 3,470 U.S. dollars, an exception may be granted outside this framework. Refunds of the funding are made in monthly installments. The repayment period ranged from 12 to 24 months, without a grace period. Users who are regularly paid off the financing will be permitted new funding, and gradually increase the amount of funding for which conditions have been fulfilled. MFI doesn’t involve in it service in any of Islamic banking technique other than Qard-Hasan loans with an annual service charge margin that comes up to 10% from the loan value. Target groups of the fund are returnees, orphans, shehid families, war invalids and veterans, retired, and other vulnerable categories.

Table 2 summarizes 50 borrowers' perspectives about the interest issue and their preference in getting loans from interest free microfinance institutions; 88% of borrowers expressed their readiness to seek loans from interest-free MCFs even if they are more expensive, 52% want to comply with Shariah, 48% preferred to get loans from (IF MFIs) due to cheaper cost, and 68% expressed of feeling more obligation to make their prepayments due to compliance with Shariah.

Table 2: Borrowers' perspectives about interest-free and interest-based loans

Questions	**Yes Number (%)**	**No Number (%)**	**Other answers Number (%)**
1. Were there any other loans available to you when you received the loan from the interest-free MCF?	45 (90%)	1 (2%)	4 no answer (8%)
2. Why did you seek a loan from interest-free rather than any other MCFs?	-	-	26 Compliance with shariah (52%) 24 Low admin costs (48%)
3. Would you seek loans from interest-free MCF even if it is more expensive than interest-based loans?	44(88%)	6 (12%)	
4. Do you feel there is an extra obligation to repay because Interest-free is in compliance with Shariah?	34 (68%)	14(28%)	2 no answer (4%)
Total number of questionnaires	50		

Source; Hamad (2012)

Human Appeal Microcredit Fund

Human Appeal International"HAI" is NGO operating in BH since 1993 in relief and social programs. It has main office in Sarajevo and branch office in Tuzla city, its headquarter office is United Arab Emirates"UAE". It has launched its interest free microcredit program in 2006 with aim to promote the economic status of its clients by providing "Qard-Hasan" loans without charging any admin or service fees, since all these fees are covered by the NGO itself. HAI has two funds running under Qard-Hasan approach; one is precisely for orphans, and another is for the rest of its clients.

According to the information obtained through questionnaires and interviewing two persons in charge in HAI; the main goals of these two funds are smoothing the consumption needs and enhance the financial sustainability by financing the start-up of small businesses of its clients. The fund is provided for breeding sheep and cows, agriculture, beekeeping and sewing. Gross portfolio outstanding in BAM; 210,000 from which 155,000 BAM for orphans fund and 60,000 BAM for other clients fund. The number of active loans was 132 from which 102 for orphans and 30 for other clients. The number of microloans disbursed since the beginning of the program was 936 from which 346 for orphans and 590 for other clients. The amount of financing disbursed in BAM since the beginning of the program was 1,640,870 from which 460,870 BAM for orphan fund, and 1,180,000 BAM for other clients. Average loan size in BAM was 1,500 for orphan fund and 2,000

BAM for other clients. The % of financing fees and service charges are nil for both funds. Repayment rate is 100% for orphan fund, and 95% for other clients' fund. The financial sustainability; all financial and operational costs are covered by HAI itself.

According to the financing conditions, the age of the applicant must be 18 year at the time of application. Maximum size of loans can be 1,500 BAM for orphans fund and 2,000 BAM for other clients' fund. Repayment loans are to be made every two months installments for orphans and on monthly bases for others. The repayment period 24 months for orphans fund and 12 months for other clients fund. Grace period is two months for both funds.

Target groups of this fund include orphans' families who have sponsorship in HAI for the orphans' fund and clients in need for another fund.

Research methodology

This paper uses exploratory research method where a combination of qualitative and quantitative primary and secondary data is used as most appropriate. The Primary data directly obtained from persons in charge of Bosnia Bank International (BBI) and Micro First Islamic (MFI). Questionnaires prepared and sent to persons in charge in both institutions and followed by interviewing them over telephone to obtain more details about the objectives of their funds, financing conditions, target groups and beneficiary category, requirements for ensuring funds, source of funds and donors, lending mechanisms, grace period, gender distribution and sorts of activities and projects funded. The collected information also included some financial indicators like; Gross portfolio, portfolio at risk over 30 days, total liabilities and liabilities taken on loans, bad loans or written off loans, total assets, own capital and donated capital, profit/loss or surplus/deficit over expenses, liquidity and financial sustainability. The financial indicators included some other ratios as well; Capital to total assets, fixed assets to total assets and total receivables to gross portfolio. The interviews and questionnaires included some other performance indictors as; Number of loans disbursed, number of active loans, number of borrowers, number of employees in these institutions, number of loans per loan officer, repayment rate, repayment mode, receivables from written off loans, average size of loans, admin and services charges.

The secondary data included the 2012 annual report that obtained through email from headquarter of MFI in Birmingham. The 2012 annual reports of AMFI and BA FBH and some updates are obtained from the website of AMFI (http://amfi.ba/en/), BA FBH (http://www.fba.ba/en/) and BBI (https://www.bbi.ba/en/).

Data analysis and findings

Table 3 summarizes the differences and similarities between the conventional microfinance and Islamic microfinance in BH. The following are the main findings when comparing the performance of IB MCOs and IF MCOs in BH;

The capacity gap between those two kinds of MCOs is very huge in favors to the interest based ones, as the IB MCOs have 20 time bigger capital, 10 time higher donated capital, 67 time bigger gross portfolio, 25 time better liquidity, 100 time bigger total assets, 50 time higher number of active loans and users, 100 time bigger number of loans and amount of money disbursed, and 100 time bigger number of staff employed than the IF MCOs.

The main reason of this gap is the limitation of IF MCOs to access both international and local funds, due to "Shariah" restrictions that prohibit giving or taking any interest (Riba). Although the Islamic Development Bank (IDB) has taken the initiative by injecting a start-up amount of about 5 million BAM to BBI for the aim to launch a new line product of microcredit with better lending conditions that enable poor people to apply and get small loans from BBI, but the IDB still reluctant to directing such support to other microcredit institutions that do not deal with Interest (Riba) and suffering scarce of funds resources.

This gap seems much wider when it comes to other indicators like profitability, where IB MCOs generated an amount of 13.2 millions BM in 2012, while the interest free MFI suffered a loss of 34,000 BAM; The ratio of capital in comparison to total assets comes to up to 76% in some IB MCOs, while it drops to lesser than -1% in MFI; The ratio of fixed assets in comparison to total assets comes to up to 21% in some IB MCOs, while it drops to -124% in interest free MFI.

Table 3: Comparison between interest-based and interest-free microfinance institutions in BH

Items	Interest Free Microfinance Institutions (IF MFIs)				% IF/IB	Interest Based (IB MFIs) In 2012
	MFI	BBI Two funds	HAI Two funds	Total		
Capital in BAM	1,428,000	2,500,000	1,000,000	7,928 ,000	5%	163,500,000
Donated capital in BAM	3,488,000	-	1,000,000	4,488,000	9.6%	46,936,000
Gross Portfolio in (BAM)	1,748,000	4,388,473	213,000	6,349,473	1.5%	417,200,000
Liquidity (Cash+ Bank Placements) in BAM	450,000	750,000	250,000	1,450,000	4%	33,700,000
Total assets in BAM	1,665,000	5,500,000	1,000,000	5,890,000	1%	499,700,000
PAR>30 days (%)	9.7%	-	-	9.7%	500%	1.9%
Profit/Loss in BAM	-34,000	-	-			13,240,000
Total number of disbursed loans since the start of the program	13,237	4130	936	18,303	1%	2,235,000
Total disbursed amount since the start in (BAM)	26,000,000	13,286,492	1,640,871	40,927,363	1%	6,527,000,000
Active loans number	1,500	3201	132	4,832	2%	248,000
Average size of loans in (BAM)	1,980	6,007/10,125	1500/2000	-	Similar BBI out	1,682
Grace period	Non	3-12 months	2 months	-	-	Non
Repayment mode	Monthly	monthly	Monthly	-	-	Monthly
Lending mechanism	individual	Individual	individual			Individual/ legal entities
Repayment period	1-2 years	1-7 year	1-2 years	-	-	1-3 years
Interest rate/charges	5-10%	5,77% / No	No	-	0-25%	27-39%
Repayment rate	Currently 91.3%	94% - 97%	95-100%	-	Almost same	95%
Financial sustainability	80%	100%	Grants	-	-	11/14 sustainable
Number of employees in MFIs	10	4	2	16	1%	1,554
Number of users	Currently 1,350	3,200	132	4,582	2%	191,000
Gender distribution	46% females 54% males		No evidence			No evidence
Target groups	Orphans, women, poor, Students, war invalids and veterans, retired, returnees				Returnees, women, individuals/ legal entities	
Types of distributed loans	BBI and HAI; 100% business loans MFI; (26.4 %) housing, (10.2%) business, (54.2%) social, (6.2%) education, and (3%) orphan loans				75% business, 14% housing 11% other	

Resource; Questionnaires and 2012 reports of (BA FBH) and (AMFI)

As far as lending mechanism, IB MCOs mixed between the dominated individual lending approach with 98% of total users, and the legal entities approach with only 2% of total users, while IF MCOs adopted only the individual lending approach. Both institutions adopted the monthly repayment mode rather than the weekly one. While two of (IF MCOs) allow grace period of 2-12 months, the (IB MCOs) don't allow.

The repayment rate in both institutions shown a sharp decline during the global financial crises, as it ranged from 85% in 2009 to 89% in 2010, to 93% in 2011 before it comes back to its pre-crises 95% in 2012 for IB MCOs, while it ranged for IF MCOs from less than 70% in 2009/2010 to 91.3% by the end of 2012. Both institutions are giving attention to business loans more than consumption loans, as BBI and HAI are 100% targeting business loans, since only 10% provided by (MFI) was for business, while 75% of the targeted loans by (IB MFIs) were for business.

Both institutions continue to invest efforts in the collection of the receivables from written off loans, as MCOs collected 10.1 million BAM of the written off principle, that is 1.5 million BAM of written off interest, which is evident from the reported extraordinary income at the end of 2012.

(IB MFIs) seems almost fully sustainable as by end 2012 they generated 13.24 million BAM surplus of income over expenses, while the (IF MFIs) excluding BBI bank, are either depending on grants like HAI, or struggling to reach its financial sustainability as in case of Micro First Islamic (MFI). IF MFIs seem to be more socially and user oriented than the (IB MFIs) ones, as part of them are charging from 4-9 times lesser loan fees that the IB ones, while other IB MFIs charge no fees. Also some of IF MFIs are precisely targeting the returnees, while others paying more attention to marginalized social groups like; retirees, female headed households, orphans, and war invalids and veterans.

The bellow Table 4 summarizes the differences in the performance of MCOs (both interest based and interest free) in the Federation of Bosnia and Herzegovina (FBH) between the years 2008 and 2012.

Reviewing the aggregate balance sheet of (IB MCOs) over the years, the largest amount was reported at the end of 2008, when it was 902 million BAM. Aggregate balance sheet amount as of 31.12.2012 is 499.7 million BAM, which presents a decline of a high 45% in comparison to 2008. In the capital structure the most significant is the surplus of income over expenses which is 104.8 million BAM, and constitutes 64% of total capital of MCFs. The decline in liabilities taken on loans failed by 54% reflects loosing the trust of international and local donors. This has led to a decline in portfolio by 50% and in balance sheet by 45%, as well as in surplus of income over expenses by 64%.

The repayment and average effective interest rates kept almost same; about 95% and 32% respectively. Although the write off loans show an improve from 12.13% in 2010 to 5.21% in 2011 to 3.88% by end of 2012, but this reflects big increase in the written off ration by 112% when compared to 1.75% in 2008.

Table 4: Differences in Performance of Microcredit Organizations (MCOs) in (FBH)

Items	Performance Comparison of IBMCOs in BH		Difference %
	2008	2012	
Capital in BAM	193.4 million	163.5 million	-15%
Gross Portfolio in BAM	830.2 million	417.2 million	-50%
Total assets in BAM	901.9 million	499.7 million	-45%
Liabilities taken for loans in BAM	679.5 million	312.2 million	-54%

Cash in BAM	29.24 million (6%) (in 2011)	25.3 million (5%)	
Placements to banks in BAM	14.98 million (3%) (in 2011)	8.3 million (2%)	
Surplus of income over expenses in BAM (11MCOs surplus, 3 MCOs deficit)	37.3 million	13.14 million	-64%
PAR>30 days	2.7%	1.9%	+36%
Repayment rate (the standard of BA is not less than 95%)	95.00%	95.12%	+0,1%
Written off (the standard of BA is not higher than 3%)	1.74%	3.88%	-112%
Average of effective interest rate	32.35	31.99%	+1%
Financial sustainability (11 MCOs sustainable and 3 MCOs unsustainable)	100%	79%	-21%
Number of employees in MCOs	1790	1554	-13%

Resource; 2012 reports of (BA FBH) and (AMFI)

Three of MCOs suffered deficit of income over expenses, while 11 MCOs achieved surplus in income and the number of employees in MCOs declined by 13%. In the asset structure of MCOs, the cash funds are 25.4 million BAM or 5% with a decline rate of 13% in comparison to 31.12.2011., and mainly relate to cash funds of MCF. Placements to banks are 8.3 million BAM or 2% and are lower by 45% in comparison to the end of 2011.

Conclusions

This paper highlights the relevance of microfinance as a globally accepted practice to Islamic banking system that promotes financing activities to the poor. These Shari'ah injunctions interweave Islamic financial transactions with genuine concern for poverty eradication, social justice and equal distribution of wealth at the same time as prohibiting involvement in illegal activities which are detrimental to social and environmental well-being.

There are fundamental differences between (IF MFIs) and (IB MFIs), not only in the way have they practiced their businesses, but above all the values which guide IBMFIs whole operation and outlook. The paper argues that IF MFIs are more socially and poor users oriented than IB MFIs, in regards to the charged cost of loans, approved grace period and grants, flexibility in repayment failure, and targeting the most marginalized groups.

Since (IF MFIs) in BH have a very limited capacity, either in available or allocated funds for their operation in microfinance or in their human resources and outreach, (IF MFIs) is argued as occupying a very small room in microfinance.

The Islamic (interest free) microfinance industry should shift from a charity-based, donor-dependent approach to a market-based, for-profits approach and clearly separate the role of donors' funds from that of private capital. On the one hand, grants should be temporary start-up support, designed to get an institution to the point where it can tap private funding sources (investors with equity/loans and deposits). This for-profit approach will help to address the issues of operational efficiency, transparency, risk management, product diversification

Since Islamic banking in BH has not addressed the needs of financing the interest free microcredit foundations (IF MCFs) nor allocated enough funds for financing the poor and micro entrepreneurs, Islamic microfinance is argued as a missing room in Islamic banking.

The paper also argues that (IF MFIs) are more welcomed than (IB MFIs) and can operate more effectively within the Muslims community in BH, as the majority of the interviewed users expressed their willingness to adhere to Shariah by not getting loans with interest, and because the loans of IFMFIs are almost 4 times cheaper than those of IBMFIs.

In addition to the innovative approaches used by many microfinance institutions, Islamic banking can apply diverse financial instruments together with other available mechanisms such as zakah, charity and waqf which can be integrated into microfinance programmes to promote entrepreneurship amongst the poor and subsequently alleviate poverty.

The sharp decline in the performance of IBMFIs since 2008 up to date has resulted to loss of confidence of many funders and donors to this sector, as well as damage to its image among many segments of Bosnian society. This opens the floodgates to IFMFIs to bridge this gap, and to impose itself as a strong competitor and more suitable alternative for the development of communities and fighting against poverty.

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