Middle-East Journal of Scientific Research 18 (4): 512-516, 2013
ISSN 1990-9233
© IDOSI Publications, 2013
DOI: 10.5829/idosi.mejsr.2013.18.4.11714

Financing the Poor, Sustaining the Provider: Issue on Transaction Cost in Microfinance Program

Norli Ali and Rashidah Abdul Rahman

Accounting Research Institute and Faculty of Accountancy, UiTM Shah Alam

Abstract: The objective of Islamic Microfinance is to reduce poverty and to bring about development by enabling the poor to enhance their earnings and enrich their social welfare. In order to achieve this objective, generating a sustainable source of loanable funds is crucial for the success of microfinance loan programs (MFLP). A sustainable source of loanable funds could be obtained if the institutions manage to recollect their amount invested that would cover the cost incurred in disbursing the loan. Therefore, transaction cost and repayment rate of the Islamic Microfinance are considered as critical factors that determined the survival of these institutions. This paper will discuss the types of transaction cost incurred by microfinance institutions in providing Islamic micro financing facilities to combat poverty. In addition, the paper proposes and suggests an efficient transaction cost framework to be applied in Islamic microfinance program namely Mudarabah, Musyarakah and Bai salam.

Key words:

INTRODUCTION

Various researchers like Khandker (2005) [1], Gertler *et. al* (2003) [2] among others have documented that microfinance program is effective as well as efficient in alleviating poverty. They argued that many microfinance program around the world for example Grameen Bank in Bangladesh, Amanah Ikhtiar in Malaysia, Bank Rakyat Indonesia in Indonesia to name a few have succeed in lessening the poverty level in their respective country. Impressed with the role played by microfinance in combating poverty, the United Nation has include the program as one of the items in its list of potential contributions to achieve the Millennium Development Goals set for 2015. The Millennium Development Goals is set to reduce half of the number of people living in poverty [3].

In Malaysia, microfinance is not a new phenomenon but it has been around since 1990s. Malaysia has established many organizations to provide wide range of Islamic microfinance product to small-medium enterprises. Microfinance in Malaysia has been operated by credit unions, co-operative banks and specialized credit windows of banks. Among the institutions that provide microfinance facilities in this country include Majlis Amanah Rakyat (MARA), Amanah Ikhtiar Malaysia (AIM), Agriculture Bank of Malaysia (BPM), Farmer Organization Authority (LPP), Yayasan Usaha Maju and many others.

In the recent years, Islamic financial products have become popular among market participants, both from Muslims as well as non-Muslims investors. The religious awareness among Muslims worldwide has promoted the demand for Islamic finance [4]. According to Karim *et. al* (2008) [5], the high demand of the Islamic microfinance facilities from the Muslims has prompted to the emergence of Islamic microfinance as a new market niche. There are various forms of Islamic financial institutions in the financial world for example, banks and non-banks, large and small, regulated and non-regulated, traditional and nontraditional among others and Islamic finance services for instant Islamic microfinance facilities.

The objective of Islamic Microfinance is to reduce poverty and to bring about development by enabling the poor to enhance their earnings and enrich their social welfare. This is in line with one of Islamic economic objective which is to ascertain that wealth is fairly shared among others without harming those who acquired it lawfully [6, 7]. In order to achieve this objective, microfinance provider should consistently

Corresponding Author: Norli Ali, Accounting Research Institute and Faculty of Accountancy, UiTM Shah Alam.
E-mail: norli170@salam.uitm.edu.my.

have a major impact in fighting against poverty; therefore, generating a sustainable source of loanable funds is crucial for the success of microfinance loan programs (MFLP). A sustainable source of loanable funds could be obtained if the institutions manage to recollect their amount invested that would cover the cost incurred in disbursing the loan. Therefore, transaction cost and repayment rate of the Islamic Microfinance are considered as critical factors that determined the survival of these institutions [8, 9]. This issue of transaction cost in Islamic microfinance has been an interest of previous researcher like Habib (2002) [10] who considered that one of the major problems associated with microfinance activity are high transaction cost. Habib (2002) [10] also argued that this issue has become a major constraint for the institutions to pursue their mission. This statement is supported by Ayayi (2013) [11] who states that microfinance program is a highly expensive business. The main reason for it being so expensive is due to high transaction and information cost. In summary, in order for the Islamic microfinance institutions to combat poverty, they need to survive; and in order for them to survive they need to make sure that they are able to generate sustainable loanable funds, which could be achieve via managing an efficient transaction cost framework.

This paper will discuss the types of transaction cost incurred by microfinance institutions in providing Islamic micro financing facilities to combat poverty. The following section will describe the concept of Islamic microfinance and the type of transaction cost incurred in the Islamic microfinance program. In addition, the paper will also propose and suggest an efficient transaction cost framework to be applied in Islamic microfinance program.

Islamic Microfinance: Islamic microfinance refers to a system of providing tiny loans to small, low-income Islamic clients which is based on Islamic principle. The motivation of Islamic microfinance is to promote prosperous economy that conforms to *shariah* concepts. The clients of Islamic microfinance facilities usually would be denied from other forms of financing, including those provided by Islamic bank. It is due to the reason that they (the clients) normally lack of collateral, as they do not own valuable assets that could be used to protect financial institutions against risk of loss. Thus, Islamic microfinance offers those who are non-bankable, a means of getting funds and at the same time is still consistent with *shariah* principles or Islamic way of life.

The *shariah* principles are based on two fundamental concepts, which are *Ibadat* and *Muamalat. Ibadat* are the rules regarding Man to God relationship while *muamalat* are those of Man to Man relationship. In the context of Islamic finance, the concept of *Muamalat* is the general rule that has to be followed. Under this concept, the transaction is not permissible if there is a prohibition in the *quran* and *hadith*. Among the prohibitions related to Islamic finance are the prohibition of *Riba*, the prohibition of *Maisir* and the prohibition of *Gharar* among others.

Prohibition of *Riba* is one of the principles of Islamic finance. *Riba* is defined as the excess of the amount borrowed that you need to pay. The prohibition of *riba* is recorded in surah al-baqarah verses 278 that says:

> *"O you who believe! Be afraid of Allah and give up what remains (due to you from riba (usury)) (from now onward), if you are (really) believers".*

Another is the prohibition of *Maisir* or gambling. All transactions in Islamic finance need to be free from the element of gambling or *Maisir* that is a game of chance. Gambling was declared illegal in Quran surah al-maidah verses 90;

> *"O you who believe! Intoxicants (all kind of alcoholic drinks) and gambling and Al-Ansab and Al- Azlam (arrows for seeking luck or decision) are an abomination of Shaitan's handiwork. So avoid (strictly all) that (abomination) in order that you may be successful".*

Uncertainty or *gharar* is another prohibition of Islamic finance. Uncertainty is ambiguous or doubtful element in a contract or transaction.

One major difference between conventional microfinance and Islamic microfinance is that the former charged interest as part of the pricing which is not complies with *Shariah* principle. The conventional microfinance product requires clients to pay more (principal plus interest) than what they borrowed and as mentioned above it is considered as *riba* and therefore prohibited by *shariah*. On the other hand, Islamic microfinance is an interest free financing facility, a system that strictly prohibit on granting or accepting any pre-determined, fixed rate of return. The prohibition of *riba* is based on two *Shariah* principles; that is money is not an asset, therefore it has no intrinsic value and the business risk shall not be borne solely by the borrowers,

but must be shared by funds providers [12]. Any cost incurred in providing the facility to the borrower would be considered as transaction cost and included in the pricing.

Ahmad (2009) [4] added that in comparisons to Islamic banks, Islamic microfinance has an advantage over the latter. This is because Islamic funds like *zakat, sadakah, waqf* as well as *infaq* can be a source of funds for Islamic microfinance program. In addition to that, Norma (2012) [3] suggested that Islamic microfinance product like General Savings Deposit, Qardhul Hassan Investment deposit and many others could also be used as a basis to generate capital for the Islamic microfinance service.

Transaction Cost in Microfinance Scheme

Transaction cost can be defined as the cost incurred in exchange. It arises in both the borrowers' side and the financial institutions' or lenders' side. Transaction cost on the borrowers' side mainly comprises of charges like application fees, administration fees, services fees, travelling cost as well as time spent in getting the loan among others. Meanwhile, those on the lenders' involve cost related to gather information on the borrower, administration cost, enforcement cost among others.

Several studies have argued that the unit transaction cost for small loans to the poor are high as compared to unit cost of larger loans. It is because, in contrast to most other loan for example corporate and personal loans, the size of average microfinance loan is relatively smaller whereas the fixed cost of those transactions are high. Therefore, on a percentage basis, the transaction cost for a microfinance loans are likely to be higher [9]. Sometimes, this cost could be too high that it may affect the sustainability of microfinance activity.

Shankar (2007) [9] identifies three types of costs besides interest rate that must be borne by microfinance institutions in providing loans. First is the cost of funds (cost of money that it lends), second, the cost of prudent financial practices (like provision for loan default) and third, the cost of transaction (screening, monitoring, enforcement and recovery costs).

With regard to this study, transaction cost is the cost of the field worker working on the group loan transaction. Adapting from Shankar (2007) [9], transaction cost to microfinance providers comprises of four elements namely screening cost, monitoring cost, enforcement cost and recovery cost.

Screening Cost: Screening cost includes cost related to screening of potential clients for the purpose of group formation [9]. For example, cost for collection of information on the background of potential clients like current occupation, education level and social status among others. Cost incurred in commuting hundreds of miles to meet potential borrowers also could be considered as part of screening cost.

Similar to Shankar (2007) [9] study, this paper suggests that screening cost should include;

- Cost of collection information on potential borrower
- Travelling cost incurred to meet potential borrower
- Cost related with forming a group of borrowers
- Cost of training potential borrower on the procedures to be followed

Monitoring Cost: Monitoring cost is defined as cost incurred on the monitoring of repayment activity by the borrower for example postage and telephone expenses incurred in reminding the borrowers. This type of cost includes [9];

- Cost of loan utilization checks
- Cost related with monitoring collection of repayment from borrowers

Enforcement Cost: Costs incurred due to deviation of business plan of the borrowers are referred to as enforcement cost. Usually, enforcement cost incurred when the provider needs to reproach borrowers, as suggested by Shankar (2007) [9], these include;

- Cost related with inspection of borrowers' progress
- Cost related with following up non-repayment from borrowers
- Cost of branch manager supervision
- Cost related with reproaching borrowers who have deviated from their original business

Recovery Cost: Recovery cost incurred due to delinquent borrowers. Thus, recovery cost involves various cost related with recovering repayment from delinquent borrowers.

Other Types of Transaction Cost: Besides the above mentioned transaction cost, the microfinance institution also have to bear other direct transaction cost like cost of other direct administrative activities relating to loan, cost

of documentation, cost of appraisal, cost of disbursement, cost of training of borrowers (ie entrepreneur, leadership, skills, etc) as well as cost of training of microfinance staffs [9]. In addition to the direct cost, the microfinance institution incurred the indirect cost. Indirect transaction cost comprises of allocated fixed cost of the branch office, regional and head office.

Structure of Islamic Microfinance Institutions: In Malaysia, Islamic microfinance is still in an early phase. Norma (2012) [3] reported that Islamic microfinance products offered by financial institutions are based on *Bai Inah* concept, which is a controversial debt-based lending while other institutions like Amanah Ikhtiar Malaysia (AIM) offered those of *Qard Hassan* concept, a benevolent loan but with 10% service charge imposed on the loan. Since the service charge is fixed, therefore its compliance to *Shariah* principle is debatable. According to Skully (2011) [13], "AIM in Malaysia, were not true Islamic Institution". The author argues that only few Islamic scholars would consider AIM as Islamic institution although it does not use the term interest and design their microfinance product to impose service fee.

This paper proposes three models of Islamic microfinance products namely *Mudarabah Musyarakah* and *Bai Salam.*

Mudarabah: This model is based on the concept of partnership where the microfinance client contributes labor and skills while the microfinance institution investing money in the program. Profit is shared based on a pre-determined ratio between both partners. Profit rate to microfinance institution should take into account the transaction cost incurred in the program. If partnership resulted in a loss, the losses would be borne by the microfinance institution. Therefore, it is very important for the microfinance to supervise and monitor the project run by the client.

Musyarakah: This model is also a form of partnership. Dirar (2009) [12] stated that this type of partnership is most suitable to single-time bound ventures like in seasonal crop, seasonal project or in trading expedition. It should be on project-based basis, where the microfinance institution may contribute the funds for working capital inclusive of wages, while the client contributes the use of his asset for example land, machinery or maybe his house as a business premise. The partners should agree on the profit sharing ratio. This profit sharing ratio should take into consideration transaction cost incurred in the project.

Dirar (2009) [12] further suggested that this concept could also be adopted for continuing business. In this model, the client may agree to buy out the microfinance institution (partner) by paying a certain percentage of the initial investment annually over an agreed period of time. Therefore, the annual profit earns by microfinance provider is diminishing as its share decreases each year.

Bai Salam: Bai Salam is the concept of advance payment of goods purchased. Based on this concept, the microfinance institution may purchase goods that are not in existence yet from the client. The price of the goods which inclusive of wages to the client, should be paid in advance. Once the goods completed, the microfinance institution may sells the goods to the third party at profit. The profit charged should consider the transaction cost incurred in the program.

CONCLUSION

One of the big challenge in microfinance program either conventional or Islamic microfinance is high transaction cost. In order to promote a sustainable microfinance institution, an efficient transaction cost model need to be adopted. This paper proposes three model of microfinance program that are conform to Islamic principle namely *Mudarabah, Musyarakah* and *Bai Salam*. The paper also suggests that the transaction cost incurred should be considered as part of the pricing mechanism. An issue that might come out form the proposed model is who should bear the losses from the program? According to Dirar (2009) [12], the issue could be resolved by using of *Zakat* funds as a tool to bail out legitimate defaulters of these services.

REFERENCES

1. Khandker, S.R., 2005. Microfinance and Poverty: Evidence Using Panel Data from Bangladesh. The World Bank Economic Review, 19(2): 263-286.
2. Gertler, P., D. Levine and E. Moretti, 2003. Do microfinance programs help families insure consumption against illness? CIDER Working papar C, pp: 03-129.
3. Norma, S., 2012. Microfinance and prospect for Islamic microfinance products: The case of Amanah Ikhtiar Malaysia. Advances in Asia Social Science, 1(1): 27-33.

4. Ahmad, A.U.F. and A.B.R. Ahmad, 2009. Islamic microfinance: The evidence from Australia. Humanomics, 25(3): 217-235.
5. Karim, N., M. Tarazi and X. Reille, 2008. Islamic microfinance: an emerging market niche. CGAP Focus Note, pp: 49.
6. Ibn, A., 2006. Treaties on Maqasid a-Shariah, (translated by El-Mesawa, M.E.-T), The International Institute of Islamic Thought, London in Asyraf, W.D. (2008). Banking for the poor:the role of Islamic banking in microfinance initiatives. Humanomics, 24(1): 49-66.
7. Asyraf, W.D., 2008. Banking for the poor: the role of Islamic banking in microfinance initiatives. Humanomics, 24(1): 49-66.
8. Cull, R., A. Dermiguc-kunt and J. Murdoch, 2009. Microfinance meets the market. Journal of Economics Perspective, 23(1): 167-129.
9. Shankar, S., 2007. Transaction cost in group microcredit in India. Management Decision, 45(8): 1331-1342.
10. Habib, A., 2002. Financing microenterprises: An analytical study of Islamic microfinance institution. Islamic Economic Studies, 9(2): 27-64.
11. Ayayi, 2013.
12. Dirar, I., 2009. A study on microfinance practices (Part II). Islamic Finance News, 6: 7.
13. Skully, M., 2011. Developing Islamic microfinance. Islamic Finance News, 8(22): 1-3.