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Islamic Development Bank

ECONOMIC EMPOWERMENT FOR FINANCIAL INSTITUTIONS

ECONOMIC EMPOWERMENT DESIGN TOOLKIT

ECONOMIC EMPOWERMENT DEPARTMENT (EED)

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Foreword from H.E the IsDB President

We find ourselves in a period of remarkable economic and social transformation. The developing and developed countries are evolving, shifting towards changing trends, norms, and realities. Civilization is on the threshold of a fourth technology-driven industrial revolution involving a digital transformation accelerated and galvanized by the Covid-19 pandemic. A new era has dawned upon us, and there is no turning back. The way we live, work, and interact has been intrinsically and profoundly altered. Navigating through this new reality necessitates that we reformulate traditional approaches to tackling poverty, sustainable growth, and development.

Under this new model, our 57 member countries–mainly developing nations–face unprecedented socioeconomic challenges and financial constraints. If left unchecked, these challenges threaten to plunge the global economy into economic malaise and secular stagnation, pushing millions more into poverty traps, which the IsDB and the international development community need to tackle.

Thus, the need to introduce innovative and unorthodox approaches/solutions to effectively provide lasting remedies and deliver impact has become exceptionally important. Achieving sustainable growth and development in the modern context demands a shift in the global development discourse, from a short-term (band-aid) mindset to a longer-term approach that seeks to address the root causes of growth stagnation and development degradation.

Therefore, under the President's Five-Year Program, the Islamic Development Bank has heralded a new paradigm to address development, the economic empowerment approach. Spearheaded by our newly formed Economic Empowerment Department, it is a neo-impact investment philosophy that aims to transform aid recipients and destitute, poverty-stricken individuals into empowered, productive members of society with the ability to take control of their economic destiny.

Traditional access to finance solutions provided by financial and microfinance institutions is not enough. To empower the poor, integrated, comprehensive, and customized solutions that enable the poor to

participate in highly competitive economic landscapes - thereby leveling the playing field - must be adopted.

Consequently, the Islamic Development Bank's economic empowerment approach emphasizes business engineering and design, i.e., the quality at the inception of projects, programs, and initiatives. By combining access to finance and (i) access to markets, (ii) capacity building, (iii) supporting regulatory environment, and (iv) supporting infrastructure, this innovative approach endeavors to ensure that the poor are economically included and assimilated into the mainstream economy as active participants and contributors to sustainable growth and development.

Islamic Development Bank has extensive experience supporting our partner financial institutions' transition from conventional institutions to economic empowerment financial institutions that utilize Islamic financial instruments effectively.

In this regard, this Economic Empowerment Design toolkit aims to provide guidance and practical tools to embark on this journey. The toolkit will explain how a microfinance/financial institution can implement the economic empowerment methodology by analyzing value chains with the highest potential. The toolkit guides how the value chain analysis will help identify and pursue business opportunities with their clients. In addition, this toolkit includes detailed case studies that clarify the different business modules of the economic empowerment approach. These case studies were taken from previous IsDB success stories in selected member countries (Palestine, Sudan, Egypt, and Tunisia).

This Economic Empowerment Design Toolkit and the other two complementing toolkits – the Monitoring & Evaluation Toolkit and Islamic Financial Product Implementation Toolkit – will significantly contribute to mainstreaming the economic empowerment methodology.

This is important if we would like to innovate our financial inclusion approach and make a significant developmental impact. We need a radical transformation to keep the promise we made, achieving the Sustainable Development Goals.

I believe economic empowerment is one of these radical transformations needed to contribute significantly to global challenges such as employment creation and poverty alleviation.

Dr. Bandar M. H. Hajjar

Chairman, Islamic Development Bank Group

Acknowledgement

The Economic Empowerment Design Toolkit is an essential resource for client-centric financial institutions interested in enhancing the value they provide to their clients. The toolkit accumulates various technical studies, consultancy reports, standard operating procedures, operating manuals, and other resources. These documents were consolidated to guide financial institutions interested in going beyond financing/credit operations to strengthening their partnership with their clients by offering them economic opportunities.

Ultimately, the toolkit aims to provide accessible and easy-to-understand resources that simplify the processes leading to the adoption of the Islamic modes of finance and shariah-compliant banking, spurring the growth of the Islamic finance ecosystem. It shares the practical application of economic empowerment based on global best practices.

Developing the toolkit would not have been possible without the dedication of the Economic Empowerment Department staff, particularly the Programs Team, led by Syed Hassan Alsagoff [1], with invaluable contributions from Mohamed Mazen Dakhli [2] and Mehmet Fehmi Eken [3], as well as the critical support provided by Smail Haddad [4] and Hazem Hamdy Hassan [5] for the editorial review and Aboubacar Kante [6] and Elhadi Elnahoui [7] for the Sharia review.

Furthermore, the Economic Empowerment Department is indebted to our partner financial institutions and experts who have selflessly contributed to the input and review of the toolkit. Special appreciation goes to the partner financial institutions that have provided inputs and the materials needed to develop this document. These partner financial institutions include (i) Agrokredit, Albania; (ii) Akhuwat, Pakistan; (iii) Alshanek ya Balady Association for Sustainable Development, Egypt; (iv) Amanah Ikhtiar Malaysia; (v) IRADA Microfinance, Bank of Khartoum, Sudan; (vi) Islami Bank Bangladesh; (vii) Micro Small and Medium Enterprise Development Agency (MSMEDA), Egypt; (viii) Rahmania Foundation, Indonesia; (ix) Wasil Foundation, Pakistan; (x) Zaman Bank, Kazakhstan; and (xi) Zitouna Tamkeen, Tunisia.

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Abbreviations

ATM	Automated Teller Machines
BDS	Business Development Services
BOK	Bank of Khartoum
CBA	Cost Benefit Analysis
CGAP	Consultative Group to Assist the Poor
DEEP	Deprived Families Economic Empowerment Program
DFI	Development Financial Institution
EE	Economic Empowerment
EED	Economic Empowerment Department
EGP	Egyptian Pounds
FAO	Food and Agriculture Organization of the United Nations
FI	Financial Institution
G20	Group of 20 Nations
GDP	Gross Domestic Product
GNP	Gross National Product
IF	Islamic Finance
IFC	International Finance Cooperation
IFI	Islamic Finance Institution
IMF	International Monetary Fund
IMFI	Islamic Microfinance Institution
IRR	Internal Rate of Return
IsDB	Islamic Development Bank
ISFD	Islamic Solidarity Fund for Development
MFI	Microfinance Institution
MIS	Management Information System
MOU	Memorandum of Understanding
MSE	Micro and Small Enterprises
MSME	Micro Small and Medium Enterprises
MSMEDA	Micro Small and Medium Enterprise Development Agency
NGO	Non-Governmental Organization
PAPP	Program of Assistance to the Palestinian People
PAR	Portfolio at Risk
PESTLE	Political, Economic, Social, Technological, Legal and Environmental
PPD	Public Private Dialogue
PSR	Profit-Sharing Ratio
ROI	Return on Investment
SDG	Sudanese Guinea
SME	Small and Medium Enterprises
SWOT	Strengths Weaknesses Opportunities and Threats
UFA	Universal Financial Access
UNDP	United Nations Development Program
VAT	Value Added Taxes
VC	Value Chain
VCM	Value Chain Management
WB	World Bank
YES	Youth Employment Support Program
ZT	Zitouna Tamkeen

Economic Empowerment Introduction and Methodology

1. INTRODUCTION

When Professor Muhammad Yunus of Grameen introduced microfinance, he broke all misconceptions that no bank can, or should, lend money to the poor, because they are not creditworthy. The Nobel Peace Prize laureate demonstrated that by forming groups, provision of collateral is unnecessary, as social pressure ensures that the group members repay their debt on time. Within a short time, microfinance expanded as a viable business proposition when governments, donors and private institutions attempted to replicate the model. However, various evaluation studies showed that the high interest rates (above 30%) imposed on the poor resulted in mixed results in terms of poverty alleviation. The microfinance industry produced various models, some being more developmental and dependent on subsidies, while others focus on efficiency to operate on a commercial basis. The development-oriented microfinance programmes supported by governments and donors typically complement the line of financing with business development support. The assumption is that if the business of the beneficiary is successful, he will be able to repay the loan and his livelihood will also improve. At the other end of the spectrum, some banks adopted additional risk mitigation measures to ensure that loans are repaid.

Islamic microfinance institutions (IMFIs) made a start similar to that of Islamic Financial Institutions (IFIs), adapting the conventional model to be Sharia compliant. In fact, most IMFIs started their operations with Murabaha financing, and as a result, their effectiveness as a means of poverty alleviation remain as limited as their conventional counterparts.

Islamic finance requires financial institutions (FIs) to engage in trade and investment; it promotes risk-sharing and fairness in the relationship between financier and entrepreneur. In addition, it promotes the involvement of FIs in the value-chain (i.e. value adding in the process of getting the product from the supplier to the consumer) and prohibits investment in any industry that may be detrimental to the society. Therefore, in alignment with the spirit of Islamic Finance, FIs should shift their focus from financial inclusion (providing appropriate financial solutions for the poor) to economic inclusion (by helping the poor gain opportunities to improve their income-generating ability). This approach that aims to shift the focus from financial inclusion to economic inclusion is called “Economic Empowerment” in IsDB.

Economic Empowerment is an approach that enables economically disadvantaged populations to play an active role in the economic cycle in their countries and let them realistically aspire for a decent living. Economic Empowerment, as practiced in IsDB, is the provision of a package of Sharia-compliant financial and non-financial services to individuals, groups and MSMEs that are excluded from the traditional financial system, with a view to uplifting their conditions by generating real economic value in the transactions that are conducted with actors within the value chain. Economic Empowerment is often seen as the component that embodies the true objectives of Islamic Finance, given that it contributes to (a) income growth; (b) redistribution of income and (c) promotion of equal economic opportunities for the members of society as positive measures to uplift livelihoods.

This toolkit aims to promote the salient values of Islamic finance in Economic Empowerment programmes/projects. Development of the toolkit was built on the expertise and experiences of experts from successful microfinance and Economic Empowerment partner institutions, which we hope the toolkit will help others emulate. Their contribution of lessons learnt and best practices highlighted in the toolkit aims to help all FIs develop not just Sharia-compliant products, but products that will also truly support Economic Empowerment of the poor by sustainably improving their livelihoods. The toolkit will

There are 689 million people living on less than US$1.90 a day.

In 2018, four out of five people below the international poverty line lived in rural areas, 50% of the poor are children and women represent a majority of the poor in most regions.

At higher poverty lines, 24.1% of the world lived on less than US$3.20 a day and 43.6% on less than $5.50 a day in 2017.

Today, close to one-third of adults – 1.7 billion – are still unbanked.

World Bank

help different FIs expand their range of products and services accordingly, and will be a useful reference for donors, NGOs and governments in IsDB member and non-member countries.

Microfinance institutions (MFIs) and other FIs may continue to use their existing standard operating procedures relating to the sourcing and management of clients and to appraisal, disbursement and collection processes, as they hardly ever conflict with the principles of Sharia, if at all. This Economic Empowerment Design Toolkit proposes modifications to existing processes related to accounting, structure of financing, monitoring and engagement with clients through value chain investments. The toolkit will highlight what MFIs and other FIs need to introduce/adjust to enable them to apply the Economic Empowerment methodology. In doing so, MFIs will be encouraged to perform the role of a trader or an investor instead of an arm's length lender. The toolkit follows an incremental approach that will develop their capacity to engage with the value chain through practical approaches.

Most MFIs/FIs will welcome the freedom promoted by Islamic Finance to (a) buy and sell assets; (b) negotiate with buyers and suppliers and (c) develop new business opportunities for investments. However, they would need capacity-building and guidance on how to incorporate these new processes into their existing business models. How can they conduct trading transactions? What are the operational and market risks involved? How can such risks be mitigated? The toolkit aims to answer as many questions as possible relating to how an MFI/FI can promote Economic Empowerment by identifying and pursuing business opportunities with their clients.

This toolkit is a compilation of various reports structured in a comprehensive manner in order to achieve the objectives mentioned above. In addition, it also includes examples and practices from some of the best Islamic microfinance and Economic Empowerment institutions operating around the world today. The contribution of these institutions to the toolkit is very much appreciated and their guidance in its development helped IsDB ensure its practicality.

It is very important that MFIs/FIs have a clear understanding of the Economic Empowerment methodology that will be elaborated in this chapter, where we discuss the business model, the theory of change and the impact of conventional microfinance and financial inclusion initiatives. We then explain why financial inclusion in itself is not enough to alleviate poverty and why non-financial interventions are also important. The IsDB Economic Empowerment approach, which utilizes Islamic finance modalities to provide financial and non-financial services to the poor, is elaborated as a comprehensive approach that overcomes the shortcomings found in conventional microfinance/microcredit. Additionally, we address what the institutions need to do to enhance their impact on poverty alleviation. We also present a typical transformational journey of an MFI/FI into a practicing Economic Empowerment institution. Finally, we offer four detailed case studies that illustrate different business models for the Economic Empowerment approach. These case studies were taken from previous IsDB success stories in four member countries (Egypt, Palestine, Sudan and Tunisia).

As this is the first toolkit of its kind, we welcome any feedback on how it can be improved in subsequent editions.

2. MICROFINANCE AND FINANCIAL INCLUSION: SILVER BULLETS FOR POVERTY REDUCTION?

Lack of access to financial services is considered as one of the key constraints on inclusive economic growth in the developing world. Indeed, it is the key constraint on the growth of micro, small and medium businesses – often the single source of income for poor households, which hampers employment, economic growth and shared prosperity.

Today, close to one-third of the world's 1.7 billion adults are still unbanked, according to the latest figures (World Bank, 2018). In addition, for the first time in over 20 years, global extreme poverty is expected to rise in 2020, as the Covid-19 disruption compounds the negative forces of conflict and climate change, which were already slowing down the progress of poverty reduction efforts. The global extreme poverty rate fell to 9.2% in 2017, from 10.1% in 2015. That is equivalent to 689 million people living on less than US$1.9 a day. At higher poverty lines, 24.1% of the world lived on less thanUS$3.20 a day and 43.6% on less than US$5.50 a day in 2017. Also, in 2018, four out of five people below the international poverty line lived in rural areas, 50% of the poor were children. Women represented the majority of the poor in most regions and among some age groups. About 70% of the global poor aged 15 and over have had no schooling or only some basic education (World Bank, 2020).

Against this reality, microfinance surfaced as a key initiative of development efforts to assist the low-income population. Microfinance is often defined as "the provision of financial services to low-income poor and very poor self-employed people" (Otero, 1999). It mainly covers savings and credit services (Schreiner & Colombet, 2001), but can also include other financial services such as insurance and payment services (Oikocredit, 2006; Ledgerwood, 1999). In IsDB, microfinance services (loans, savings and insurance) are rendered to the active poor to take advantage of economic opportunities, increase their earnings, satisfy basic needs and protect them against shocks (Andaloussi & Hasnaoui, 2010).

The earliest institutionalization of microcredit rendering services was recorded in the 14th century (1388) in Germany in the form of cash endowment (Rahmenstiftung) and in the 15th century in the Ottoman empire and the non-Arab Islamic world (the Balkans, Malay) as cash Awqaf (Cizakca, 1998). It is presumed that in the non-Arabic speaking Islamic world, the practice goes back even earlier without any trace due to the loss of records between the 8th and 14th centuries. In the modern financial landscape history, one of the earliest formal institutions to offer savings and credit services to rural smallholder farmers was the Mit Ghamr Bank of Egypt in 1963. The bank was later closed in 1973 and its operation was taken over by the National Bank of Egypt.

> The international funding for financial inclusion has increased to US$ 52 billion in 2019 from US$ 26 billion in 2011.
>
> The Consultative Group to Assist the Poor (CGAP)
> Funder Survey Global Snapshot

In 2002, the Monterrey Consensus that governments adopted at the International Conference on Financing for Development explicitly recognized that "microfinance and credit for micro, small and medium enterprises… as well as national savings schemes are important for enhancing the social and economic impact of the financial sector." It further recommended that "development banks, commercial banks and other financial institutions, whether independently or in cooperation, can be effective instruments for facilitating access to finance, including equity financing, for such enterprises…" Towards achieving the Millennium Development Goals, the United Nations General Assembly designated 2005 as the International Year of Microcredit to "address the constraints that exclude people from full participation in the financial sector." At the World Summit at the United Nations in September 2005, the Heads of States recognized "the need for access to financial services, in particular for the poor, including through microfinance and microcredit" (Obaidullah & Khan, Islamic Microfinance

Development, 2008). However, it was the celebrated efforts of the Grameen Bank[1] in providing access to finance to the un-bankable poor communities in Bangladesh through the then innovative group lending scheme that spurred many attempts to replicate the model all over the world. Since then, both private and public sectors have jumped onto the bandwagon, creating thousands of MFIs. This was evidenced by the increase in cross-border commitment of funders to improve access to finance. The international funding for financial inclusion has increased to US$ 52 billion in 2019 from US$ 26 billion in 2011. A recent study projected that the global market for microfinance will reach US$313.7 billion by 2025 (Reportlinker, 2020).

In addition, financial inclusion plays a major role in the 2030 Agenda for Sustainable Development Goals (SDGs), which were formally adopted in the United Nations General Assembly 2015. While the SDGs do not explicitly target financial inclusion, greater access to financial services is a key enabler for many of them. In fact, financial inclusion is identified as an enabler for 7 of the 17 SDGs (including eliminating poverty, creating jobs, improving gender equality and good health), and 16 out of 169 specific targets in these SDGs are directly related to expanding access to banking, insurance and financial services for all. For example, financial inclusion is measured under SDG 8 (Decent Work and Economic Growth). Under indicator 8.10.1, the (a) number of commercial bank branches per 100,000 adults and (b) number of automated teller machines (ATMs) per 100,000 adults are measured. More specifically to the poor, indicator 8.10.2 measures the proportion of adults (15 years and older) with an account at a bank or other FI or with a mobile money service provider. In addition to the SDGs, the G20 committed to advance financial inclusion worldwide and reaffirmed its commitment to implement the G20 High-Level Principles for Digital Financial Inclusion.

While microfinance and financial inclusion programmes have been successful in challenging the notion that the poor are un-bankable to the extent of asserting that "access to financial services is a basic human right", the jury is still out as to how effective the current microfinance players have been in achieving its objectives of alleviating poverty and improving people's welfare. Several MFIs have been credited for successfully implementing microfinance as a sustainable means for poverty alleviation, while others have been criticized for exploiting the poor for economic gain.

The success of microfinance programmes in providing services to the poor is measured on various social goals, and those differ from one MFI to another. It is mostly weighted based on clients' ability to meet their basic needs, acquire assets or even to start small businesses. Another measure is reducing the vulnerability of the poor; their ability to cope with shocks and to finance their emergency needs. Based on several research studies that have been conducted in various countries, there are still mixed results on the effectiveness of microfinance in achieving its objectives.

Early studies, mostly employing qualitative or difference of difference methods on cross sectional and panel data, suggested positive impacts:

- Participation in microfinance does improve potential resistance to vulnerability (Murdoch, 1998; Mustafa, et al., 1996)
- Increase perception of women empowerment and material well-being (Mustafa, et al., 1996; Panjaitan-Drioadisuryo & Cloud, 1999)
- Increase profit on self-employment (McKernan, 2002)
- Improve asset ownership (Shirazi, 2012)
- Benefits the poorest and has sustained impact on poverty reduction among programme participants (Khandker, 2003).

Among the criticism raised on the early practice of microfinance was on the dependency of the poor to continuously borrow from the MFIs (Remenyi & Quinones, 2000), and observations that the poor also use it for consumption purposes (Shirazi, 2012) as, they do not possess the required mentality for entrepreneurship (Dichter, 2007).

1 Prof. Muhammad Yunus and the Grameen Bank received the Noble Peace Prize in 2006 "for their efforts to create economic and social development from below".

Later studies employing randomized control trials were available in late 2010. A study in India (Banerjee & Duflo, 2011; Buchet, Marshall, Starita, Thomas, & Yalouris, 2011) found that microfinance does increase access to credit and business activities and shift the expenditure pattern away from wasteful consumption. However, there was no evidence found that microfinance improves client welfare in terms of the measurable dimensions of healthcare and education. Another study in Morocco (Crepon, Devoto, Duflo, & Parienta, 2011) suggests that microfinance is an opportunity that different clients will take advantage of in different ways.

While it is proven that microfinance benefited mostly those engaging in agricultural activities (livestock), the study failed to find evidence that the clients are more resilient towards income and health shocks. However, a study in South Africa (Karlan & Zinman, 2010) found that consumer credit did increase borrower wellbeing in terms of income and food consumption, as well as the probability of future financing.

Similarly, access to micro-saving products was found to increase household income and make clients less vulnerable to health shocks, as suggested by a study in Kenya (Dupas & Robinson, 2011). Meanwhile, there have been several crises involving MFIs recorded at massive scales, e.g. Nicaragua in 2008, Kolar state of India in 2009, Bosnia and Herzegovina in 2009, Nigeria in 2010 and the Indian state of Andhra Pradesh in 2010, as well as Pakistan in 2010 (Chen, Rasmussen, & Reille, 2010). These crises were argued to occur due to inadequate governance systems to ensure transparency and prudence in both credit policy and its social goals. Governance systems were needed to prevent MFIs from becoming legalized loan sharks.

To date, it is estimated that 77 randomized control trial evaluation studies have been conducted on microfinance. J-PAL published a report titled "Where Credit is Due" to try to make sense of data collected from 7 of those studies conducted in Bosnia, Ethiopia, India, Mexico, Mongolia, Morocco and the Philippines[2]. Some of the key results include:

a) The demand for many microcredit products was modest. Take-up of loans by eligible borrowers ranged between 13 to 31%, which is much lower than what MFIs had forecasted.

b) Despite some evidence of business expansion, none of the seven studies found a significant impact on household income for borrowers.

c) There is little evidence that microcredit had substantial effects on women's empowerment or investment in children's schooling, but it did not have widespread harmful effects either.

In summary, based on the numerous evaluation studies conducted, the evidence is inconclusive whether conventional microcredit alleviates poverty. In a section found in the same report titled "The problem with Profit", the report explains why it was difficult to determine whether credit led to higher profit for poor clients. . In impact evaluation, it was important to be able to measure the change (i.e. profit or benefit generated by poor clients) and attribute this change to the intervention (i.e. credit provided by MFIs). However, this was challenging. It cited problems on how to measure income, determine its actual source and attribute this to the credit provided. If a poor client of a microfinance institution comes out of poverty, is it really because of the credit he/she received?

> There are still mixed results on how effective microfinance is in achieving its objective, while there have been several crises of microfinance recorded at massive scales. For example, Nicaragua in 2008, Kolar state in India in 2009, Bosnia and Herzegovina in 2009, Nigeria in 2010, the Indian state of Andhra Pradesh in early October 2010 and Pakistan in 2010.

Although the report was unable to draw any conclusions on the benefits of credit on poverty alleviation, it highlighted several lessons learnt:

- Not all borrowers may have access to or want to take high-return investment opportunities.

2 See:
- https://www.povertyactionlab.org/policy-insight/ microcredit-impacts-and-limitations
- https://www.poverty-action.org/sites/default/files/ publications/Where-Credit-is-Due_web.pdf

This suggests a lack of business engineering to identify the business opportunities that have high-return investment and the potential of creating decent sustainable jobs.

- Many borrowers use loans for consumption rather than investment, suggesting that there were high non-entrepreneurial returns to credit.
- Microloans also tend to be costly to deliver and expensive for low-income borrowers.
- Lack of soft skills and capacity building in business aspects for the borrowers.

Based on this analysis, the J-PAL study recommendations included:

- Innovations to target high-potential entrepreneurs and offer more flexible lending products may lead to more high-return entrepreneurial investments.
- Donors with the goal of supporting poverty reduction should not finance or subsidize traditional microcredit lending, but should instead support innovations in targeting, product design and consumer protection.

In theory, Islamic finance may offer a breakthrough. If we can measure the value generated to the poor clients through risk-sharing and attribute these benefits to the Islamic financial product, we can demonstrate that Islamic Finance has a positive impact on the poor. The Economic Empowerment methodology embodies the spirit of Islamic finance by promoting risk-sharing through trading and investment transactions. It is also in line with the lessons learnt generated by JPAL RCT studies. However, conventional finance, it is possible measure the impact of Economic Empowerment interventions. for The impact of such interventions is measured by determining the benefit gained by the client in the form of savings or income and attribute this benefit to the intervention. Below are some examples from the field on how the impact of Islamic finance interventions is calculated.

Investment Transactions (Mudaraba, Musharakah) Case Study: Guinea, Sudan

The MFI invests in a venture in collaboration with the client at an agreed profit-sharing ratio of 60% (MFI): 40% (client). The venture makes US$2,000 profit in one month.

- Profit earned by the client: 40% x US$2,000 = US$800
- Profit earned by the client in one day = US$800/30 days = US$26.66

From the above example, the impact of the intervention is the profit earned by the client that month (US$800). We can also conclude that the intervention helped the client come out of poverty by earning US$26.66 per day that month- well above the poverty line benchmark (i.e. US$2.50 per day)

Trading Transactions (Murabaha) Case Study: Albania, Indonesia, Palestine

The MFI provides Murabaha financing of US$2,000 over a period of 6 months (180 days). As part of the transaction, the MFI negotiates a discount of 30% on its purchase price and passes the savings to the client. The mark up charged by the MFI is comparable to the market interest rates in the region.

- Savings benefitted by the client as a result of negotiation: 30% x US$2,000 = US$600
- Profit earned by the client in one day = US$600/ 180 days = US$3.33

From the above, we can clearly measure the savings made by the client as a result of the negotiation (US$600), which is fully attributed to the Murabaha product intervention. The amount of benefit of US$3.33 per day is also above the poverty line benchmark of US$2.50 per day. Similar examples for other Islamic Financial products can be found in the Monitoring & Evaluation Toolkit.

3. THEORY OF CHANGE IN ECONOMIC EMPOWERMENT: FROM FINANCIAL TO ECONOMIC INCLUSION

The Economic Empowerment methodology considers the multifaceted needs of the poor, which go beyond financial services. Studies indicate that microloans are more beneficial to borrowers living above the poverty line than to borrowers living below the poverty line (Kenan Bağcı and Erhan Türbedar, 2019). Clients with more income are willing to take the risks, such as investing in new technologies that will most likely increase income flows. Poor borrowers, on the other hand, tend to take out conservative loans that protect their subsistence. Most poor clients are caught in subsistence activities. A poor person obtaining a microloan will eventually become a poor person in debt. Therefore, for MFIs to play a major role in taking these poor people out of poverty, they really need to also provide non-financial services that would enable the poor to utilize the line of finance in a very viable manner and sustain business opportunities.

Poverty alleviation is indeed about addressing a much broader set of needs. Amartya Sen, the Nobel Prize-winning economist, eloquently argues that development be seen as a “process of expanding the real freedoms that people enjoy.” In the Economic Empowerment approach, these freedoms can be achieved by focusing on the productivity and economic sustainability of the activities of vulnerable groups. Therefore, in this approach, poverty alleviation starts with economic inclusion. The objective of economic inclusion is to establish a genuine relationship between the recipient of financing and the economy. The economic inclusion of a person involves a process linking him/her to the real economy by discovering investment opportunities that align with his/her skills and needs, opening up communication channels with economic players, developing technical and managerial capacity building plans and, of course, funding. Value chain financing plays an important role in developing financial products suited for economic inclusion.

The process is triggered with the identification of the economic and strategic partner (value chain leader) and obtaining a firm commitment from its side to absorb the production of the financing beneficiaries over a specific period of time. Then, the MFI/FI should develop and engineer its own development project and expand its scope of services to business development for the benefit of the poor. Once all the variables and components of the project are sealed in a realistic business model, capacity-building modules are developed, and beneficiaries are contacted and selected to be part of the project. Ultimately, funding is dispensed, and a partnership is concluded between the marginalized populations and the strategic and commercial partner. Finally, assistance and project follow-up are to be done during the lifetime of the contractual agreement.

The fruits of these development efforts are, nonetheless, limited by the quality of the infrastructure where the poor populations live. Undoubtedly, achieving higher income would make it easier to access health, education, clean water and quality housing. However, executing development projects without taking into consideration the complications related to infrastructure is certainly a flawed approach with punctured results. Hence, a fundamental pillar in developing Economic Empowerment projects is to build solid and sustainable partnerships with the public sector, private sector and civil society, with a view to developing effective synergies between all partners towards building a solid ecosystem with a direct impact on healthcare, education, housing, water and sanitation services. This collaboration will eventually lead to a more balanced and broader intervention for a better quality of life.

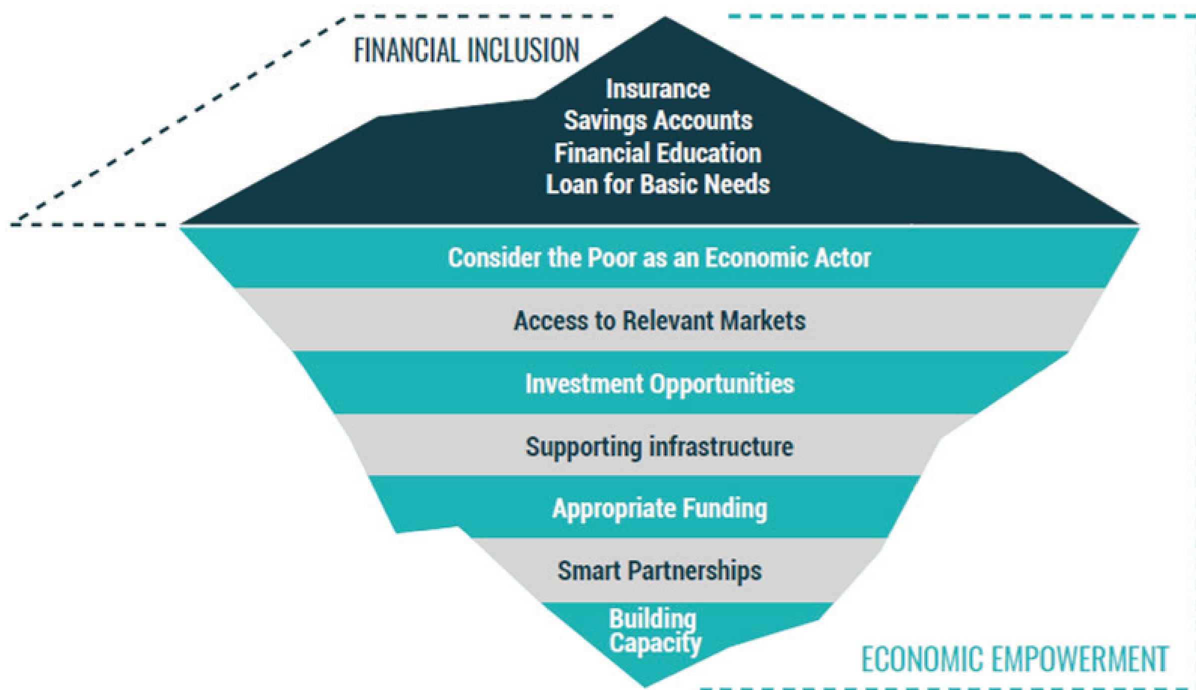
In conclusion, the IsDB Economic Empowerment approach addresses the following six obstacles to unlock the full potential of the poor:

- Difficult access to well designed and profitable project opportunities

- Lack of intelligent partnerships supporting economic activities of the poor
- Insufficient affordable and appropriate supporting infrastructure
- Lack of access to appropriate funding
- Lack of capacity and weak self-belief in potential
- Difficulty in access to relevant markets

As such, the Economic Empowerment methodology represents a paradigm shift from financial inclusion to economic inclusion, as it aims to provide economic opportunities to the poor through financial and non-financial solutions that aim to help them in their journey towards a better life. It provides the poor with appropriate access to the required inputs/means to not only achieve their financial inclusion but also enable them to contribute to the economy.

Figure 1.1 From Financial to Economic Inclusion: The Economic Empowerment Paradigm Shift



Economic Empowerment of the poor contributes significantly to the SDGs agenda. It is also IsDB's approach for poverty reduction, especially as it aspires to transform people's lives and make them economically independent, rather than mere recipients of aid. Higher and more stable income for the poor would improve their nutritional intake and ensure food security for their families. Disadvantaged poor women who are economically included are empowered to overcome their economic and social barriers and, hence, to lead their families out of poverty.

Figure 1.2 Direct Impact of IsDB's Economic Empowerment on SDGs

On a larger scale, Economic Empowerment initiatives in different countries contribute to reducing inequalities between their citizens, as more people enjoy access to, and are more included in, economic activities. The methodology encourages addressing the barriers through building partnerships locally and internationally, where different partners join forces, mobilize resources and contribute, based on their comparative advantages, to tackling the multifaceted needs of the poor.

4. ISDB'S APPROACH IN ASSISTING THE POOR BY PROMOTING ECONOMIC EMPOWERMENT FIS

Developing the capacity of MFIs/FIs to trade and invest

Most Islamic MFIs/FIs started as Islamic banks did; they converted conventional interest-bearing debt instruments into Sharia-compliant ones (e.g. Murabaha, Salam and Ijara). Once an Islamic MFI matures and understands its clients and business opportunities better, it can provide more products to serve its clients.

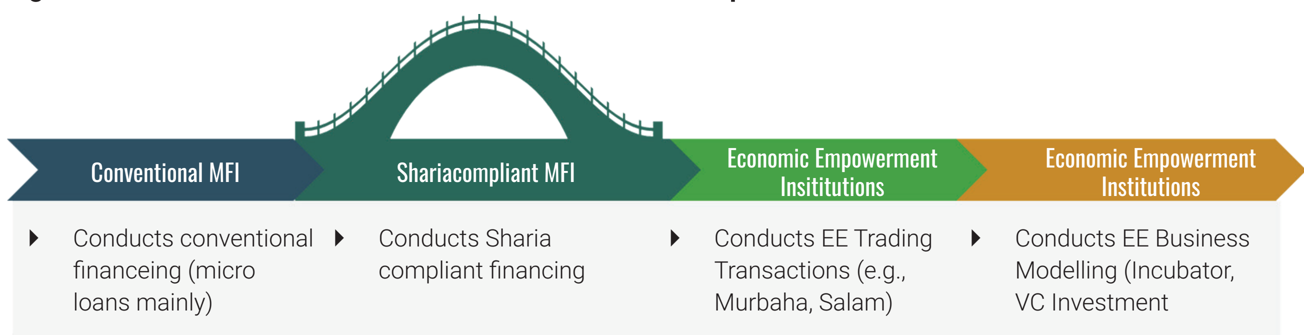
In the earlier years, the conventional way of supporting an access-to-finance effort was often focused only on the sustainability of the MFIs/FIs in rendering the financial services, as well as the breadth and depth of the offered services. The success of these institutions was often measured by their financial sustainability, breadth and depth of outreach, portfolio quality and efficiency. In recent years, the focus has slowly been moving towards striking a balance between the social and financial performance of the MFI/FI, how the social objectives are immersed into the FI's goal and strategy and how faithful the FI is in reflecting the social goals in its day-to-day business and in monitoring these goals. This is well captured in the Universal Standards for Social Performance Management (CGAP, 2014) and other initiatives that seek to institutionalize this balance between the social and financial performance among MFIs/FIs.

The MFI/FI's capability to identify and manage risk at the operational level should be improved beyond relying solely on a third-party guarantee. It should share the risk of its clients as business partners. Other institutions may also provide vocational training and agricultural extension services, leveraging on existing investments that are being made to develop the workforce and generate employment.

To ensure that the engagement is sustainable, any activity that is conducted to mitigate business risks should be included in the business model of the MFI/FI. Concurrently, the institution must ensure that the client is fairly compensated for the transaction in proportion to the risks that they are taking. By financing their clients and ensuring their success, MFIs/FIs will generate sustainable employment while ensuring a steady income from their investments.

The diagram below shows the evolution that takes place through capacity building. As a minimum requirement, a conventional institution is required to provide financial products that are Shariah-compliant. Further capacity building and understanding of the sector that is being financed will allow it to play a more value-added role in conducting trade with its clients. Once confident of its knowledge and the risks involved in the sector, the MFI/FI can engage in business models to mitigate such risks by providing sophisticated support so that it would be more feasible to make impact investments with its clients.

Figure 1.3 Evolution from a Conventional to an Economic Empowerment Institution



The evolution usually starts by understanding the suppliers from whom the MFI/FI purchases using Murabaha financing, which is the most common financial instrument. By understanding the suppliers and the prices in the market, the MFI/FI adds value by negotiating with key suppliers for lower prices on behalf of the clients and/or recommending alternative suppliers who are providing the same asset at a lower price.

Conducting trading transactions helps Economic Empowerment institutions better understand their clients and their businesses. They will also better understand who the suppliers in the market are and the prices that the products are being traded for and determine whether there is any market failure that they can help address on behalf of their clients. This knowledge will also help them better understand opportunities in the value chain. They can exploit these opportunities by developing strategic partnerships that help their clients have a fair partnership with key actors in the value chain. With knowledge and experience in intervening in the value chain, Economic Empowerment institutions can develop win-win value propositions that benefit them and their clients.

In the project design of conventional microfinance, guarantees and capacity building is usually subsidized with grants. Clients are likely to demonstrate a positive improvement while the grants last. However, once the grants expire, it will be challenging to maintain their business models. Such FIs often face the 'mission drift' dilemma. Many may have to adapt without the grants and target other segments of the market.

Comparison of Donor Support for the Microfinance Sector

Figure 1.4 How Donors Support Conventional MFIs

Credit Insurance Company ▸ Shares/takes risk ▸ Collects premium from borrowers/bank	Donor may provide funding support to credit insurance company to share the risks with the conventional MFI. Donor provides loans to MFI. Capacity building to MFI, if provided, focuses on improving efficiency. Donor also provides capacity building for MFI borrowers through an incubator or consultant in the form of financial literacy training, business development, etc.
Conventional MFI ▸ Focuses on providing/collecting credit	
Incubator/Consultant Company ▸ Provides capacity building to improve success rate ▸ Funded through grants	

Lessons Learnt

- MFI benefits from donor guidance on improving efficiency.
- Donor monitors and ensures that MFI remains focused on development objective.
- Capacity building for borrowers helps improve success rate.
- Projects demonstrate success in the near term but face challenges relating to sustainability.
- When grants run out, MFIs tend to suffer the risk of "mission drift", moving from rural to urban areas where costs and risks are lower.
- MFIs are left to find another donor or measures like increasing interest rates to ensure profitability at the expense of their developmental objectives.

In comparison, the Economic Empowerment model is more sustainable for both client and MFI/FI. By helping the MFI/FI improve its value proposition, the clients' business and projects will be more competitive and sustainable, while ensuring that the financing contributes to poverty alleviation. The provision of non-financial services and risk sharing would then be part of the value proposition of the MFI/FI. If it can

develop a sustainable value proposition by doing business with its clients, it will be competitive in the market and sustainable in the long term. With better experience and knowledge of the financed sectors, the MFI/FI is likely to improve the way it finances the businesses of its clients and to avoid issues relating to 'mission drift'.

Figure 1.5 How IsDB Promotes Economic Empowerment among MFIs

Economic Empowerment Institution

- Focuses on sourcing business opportunities
- Profits only when poor profits
- Helps source supplies
- Conducts capacity building to improve quality and reliability
- Helps source customers
- Sustainability depends on how well it does business

IsDB supports MFIs by providing a small grant aimed at developing the capacity of the institution to conduct trade and investment with the poor. The relationship between the institution and its clients becomes that of trading or investment collaboration, rather than as a debtor and creditor. The MFI selects its clients based on whether they can execute the business transaction, not on how much collateral/ guarantees they have to repay their debt.

Lessons Learnt

- The MFI starts with easier trade-oriented modes of finance, such as Murabaha.
- Provides direct financing to suppliers instead of cash. This helps ensure that loans are used as intended and for productive purposes.
- The MFI monitors the growth of clients' businesses and provides them with assistance when needed in the form of advice, access to business partners, etc.
- Recourse to restructuring payments taken more seriously before resorting to liquidating collaterals.
- Salam financing is effective in providing access to markets for MFI clients.
- The MFI has a better ability to negotiate with input suppliers and buyers. Benefits are shared between the MFI and client.
- MFIs that focus on certain subsectors of the market, instead of lending broadly for every sector, have a better ability to control the business risks involved.
- Profitability of the MFI is determined not only by how efficient it is, but also by how well it negotiates and does business within its chosen value chains.

Methodology of empowering the poor through Economic Empowerment

The idea that a commercial bank can have the poor as clients, providing them with the full suite of financial services is appealing. However, most conventional commercial banks find it difficult to balance the social needs of the poor with profit maximization. Hence, in its supported projects, IsDB tries to establish a separate entity within the banks to solely to engineer business opportunities for the MFI/FI and its clients. This entity must observe the social goals of the FI, as well as sustainability goals of the investment. To achieve the aim of poverty alleviation through empowering the poor, the Islamic Economic Empowerment entity should do the following:

1. **Improve client wellbeing through:**

a) Ensuring the clients' basic needs of food, water, shelter and energy are met as part of the intervention

b) Providing safety nets to make clients more resistant to shocks. Risks related to life and business should be covered by insurance and savings products.

c) Transferring the ownership of project assets to the client once their capacity is developed.

2. **Provide business development support including:**

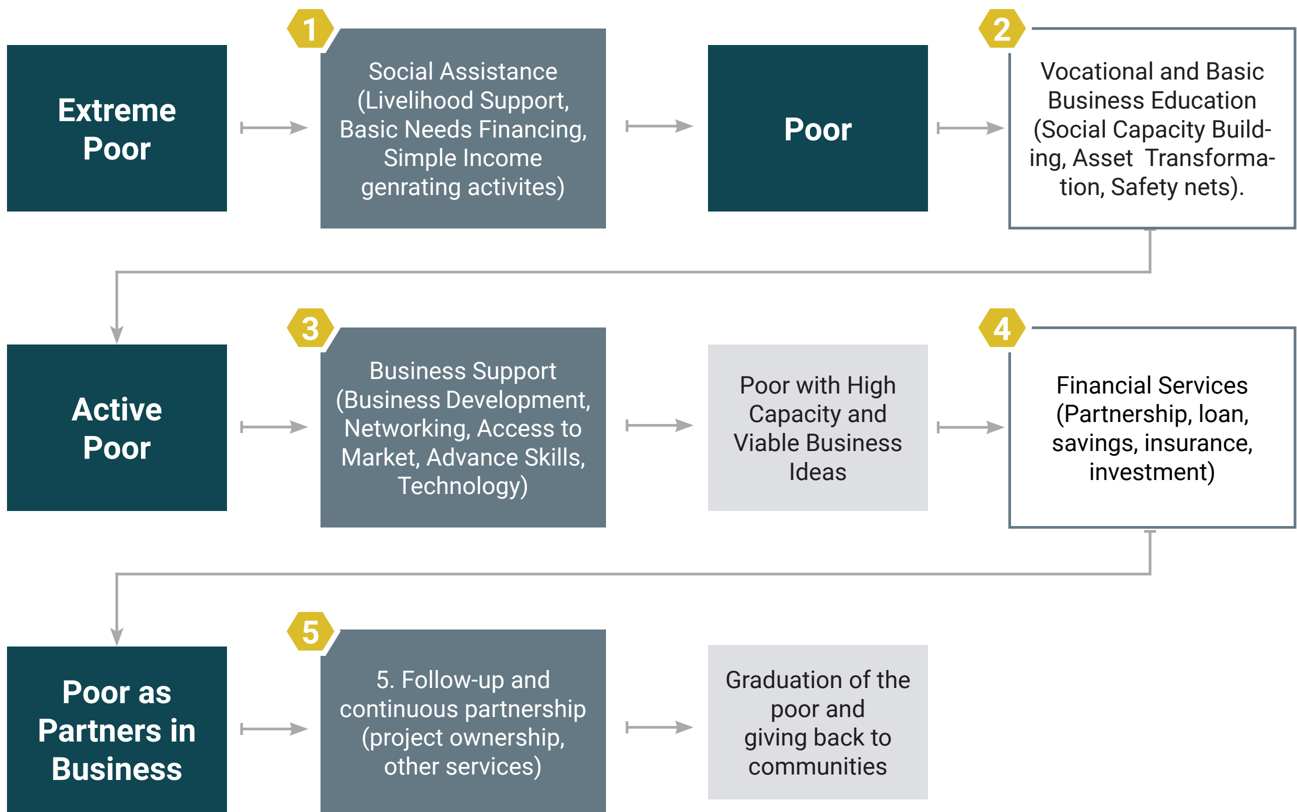
a) Partner and share business risks with the poor. Tie the entity's profits with the profits of its clients.

b) Assist the client in developing/refining the business model and provide the necessary capacity building to ensure a better chance of success for the client.

c) Facilitate access to markets, skills and technology by engaging various stakeholders in the value chain.

These steps are explained in the following diagram, with some adjustment, as highlighted by (Andaloussi & Hasnaoui, 2010). Not all the beneficiaries should go through all the stages of assistance. Each client will have needs that should be carefully assessed by the MFI/FI. The capacity passed to the beneficiary should also be customized according to the business sector where the beneficiary is engaged or is deemed fit to be involved in. Therefore, it is crucial for the MFI/FI practising the Economic Empowerment approach to have (i) a market study to pinpoint good business opportunities for development of MSME, and (ii) a grounded and thorough assessment of the beneficiary's needs to identify capacity building requirements of the client.

Figure 1.6 Understanding the Poor Client's Needs for Economic Inclusion



In dealing with the poor as partners, the MFI/FI practising Economic Empowerment approach must recognize the importance of client wellbeing. Without having their basic needs fulfilled, it would be difficult for the poor to exert their best in the business investment or conduct any other productive economic activities. Without food, they will not be productive. Without access to electricity or clean water, the poor will not be able to study after dark or will have to spend precious daytime to fetch clean water from a far distance. During events of importance (birth, marriage, death), they will be obliged to use their resources, which should otherwise have been invested in the business. In the event of an accident or a natural disaster, they may have to resort to loan sharks. Even though the poor may be active in the economy, they are highly prone to become inactive. Therefore, MFIs/FIs that are to collaborate with the poor must address all these concerns to ensure they are collaborating with the active poor, either by providing the service itself, or through collaboration with other partners.

MFIs/FIs may tap into Zakat and (cash) Waqf funds to finance these necessities. This can be channelled to the end-beneficiaries in the form of Qard Hasan (interest-free loan) or grant (Sadaqah or Zakat). Zakat and Waqf funds have a huge untapped

potential (Obaidullah, Role of Microfinance in Poverty Alleviation: Lessons from Experiences in Selected IDB Member Countries, 2008; Andaloussi & Hasnaoui, 2010), particularly to: (a) cover losses resulting from the default of very small microenterprises; (b) cover part of the expenses incurred by MFIs/FIs in evaluating and financing microenterprises operated by the very poor; (c) provide micro-Takaful (mutual insurance) to enhance the resilience of the active-poor to external shocks; and (d) build the capacity of households to undertake income-generating activities.

Provide business development support

The Grameen Bank experience has demonstrated the viability of providing uncollateralized group financing to the poor. Instead of physical collateral, social collateral was pledged, with each group member acting as a guarantor of the other group members. This innovation enabled MFIs to do what would have never even occurred to banks- to provide uncollateralized capital to poor clients who are deemed a high-default risk. However, this risk mitigation measure only assures the bank that there are multiple guarantors who would be willing to repay on behalf of their groupmate. It mitigates the risk of repayment, but not the risk of business failure.

The most effective way to ensure beneficiary success is to be involved in his/her business, in much the same manner as venture capital funds are involved in the companies they invest in. Venture capitalists are typically involved in the business decisions, supporting their investee's business development and helping them be more operationally efficient. Similarly, MFIs/IFIs should play the role of an investor instead of a lender, especially when providing Musharaka and Mudaraba financing. As a committed investor, the MFI/IFI will share the business risk with its investees and work with them to improve their business model, helping them with all the elements necessary for the success of the business, including access to (a) management (of running the business); (b) money (cash); (c) market (input and output); and (d) know-how (technology and skilled labour).

It is noteworthy that cash is only one of the four components needed for a business to succeed. A business also needs customers, skilled management and advanced technology to improve productivity. Besides labour (mostly unskilled), the poor may not have the capacity to fulfil the remaining requirements. The most viable way for a MFI/FI to make venture capital investments is through large-scale group financing. The economies of scale generated from large-scale project financing will enable it to provide the non-financial services needed for the success of the project.

Even if venture capital investing is deemed too risky, especially in the initial stages, MFIs/FIs that conduct trade should help their clients mitigate some of the risks involved in their business. By doing so, they mitigate the risk of their clients' inability to repay without highly demanding collateral requirements.

Table 1.1 Requirement of a Typical Poor Client

Key Success Factors in Business	Requirements of a Typical MFI client (e.g. small-scale farmer)
Access to management	Operating the business effectively and efficiently with the required policies and processes
Access to money	Financing needs to purchase agricultural inputs, infrastructure, machinery and training
Access to markets	Ability to sell to a customer who can purchase all the products at a high price to maximize profit
Access to know-how	Acquiring high technology machinery to enhance productivity as well as the necessary training to utilize the technology. Training in latest agricultural methods of production to enhance yields

For example, in many agricultural products, farmers require seeds and fertilizers to grow their crops. They also need appropriate infrastructure, including irrigation channels to deliver water to their farms. In addition, as many farmers still use old inefficient methods of farming, they need to receive training from extension workers on the latest farming techniques, as well as to know what and when to plant. They also require high technology equipment that would help them regulate temperature, humidity, water supply, etc. Machinery such as tractors, rice thrashers and foot pumps would also enhance their productivity. Even if they had all of that, they would still not be able to maximize the benefit generated from their harvest unless they can sell their products at a fair price, if at all.

Promoting Economic Empowerment through impact financing

How can FIs provide not just financing but also include non-financial services as part of their financing packages? By providing, Sharia-compliant instruments, these institutions provide financing that can create impact through engaging with the beneficiary in trade and investment, instead of merely being an arm's length lender. Some of the key value-added benefits derived include the following:

Islamic Finance at a Glance

Islamic finance is based on Sharia (Islamic law), and has been practiced for hundreds of years. The industry has grown exponentially since the 1980s. Islamic finance institutions are similar to conventional financial institutions but differ in some of their operating principles:

- All financial transactions within Islamic finance must be *Sharia- compliant.*
- All Islamic financial transactions must be *asset-backed*, using tangible assets. Money is not a tangible asset.
- Under Islamic law, *Riba* (interest) is considered to be usurious and is forbidden. Instead, Islamic fiinance institutions work under a variety of mechanisms based around the idea of profit through trade or equity.

Key Terms

- *Murabaha:* Whereby banks buy products on behalf of clients and sell them back to the client at a profit..
- *Musharaka*: A profit-sharing venture in which parties must share the associated risks and profits.
- *Mudaraba*: Entrepreneurship financing similar to Musharaka except that only the investor is subject to losses.
- *Takaful*: Insurance in the form of asset protection products.
- *Ijara*: Leasing agreements where the institution buys the product on behalf of the client and leases it back through installment payments.

Table 1.2 Value creation of Islamic Financial Instruments

Trade-Oriented Financing:

Type of financing	How does it work?	How does it add value and create impact?
Murabaha	FI buys the product on behalf of the client and sells it at a profit.	FI is able to source effectively for the lowest price and passes the savings to its client.
Salam	FI buys the product from farmers/ producers who undertake to supply and deliver to FI after a certain period.	Since FIs will be repaid in produce, it will have to find a market for that produce. FIs are able to negotiate for better prices than the farmers and some of the benefit can be shared with the beneficiaries.
Ijara	FI purchases asset and leases it to beneficiary.	Ownership risk is borne by the FI during the tenor of the lease.

Investment-Oriented Financing:

Type of financing	How does it work?	How does it add value and create impact?
Musharaka Mutanaqisa	FI buys the product on behalf of the client and sells it at a profit.	FI is able to source effectively for the lowest price and passes the savings to its client.
Mudaraba	FI provides all the financing, while the beneficiary provides the expertise. Profits are shared at a predetermined profit-sharing ratio. All losses are borne by FI.	As an investor, FI will be highly involved in the decision-making process to ensure that the investment is profitable.

5. CASE STUDIES FOR ECONOMIC EMPOWERMENT IN PRACTICE

The IsDB Economic Empowerment methodology was developed based on 20 years of IsDB experience in supporting the poor through Islamic microfinance. The first Islamic microfinance project of IsDB was in 2001 for Guinea, amounting to US$1.45 million. Since then, 56 projects amounting to US$548 million have been approved. These interventions include the Microfinance Support Programme, financed by the Islamic Solidarity Fund for Development (ISFD) and equity investments under the Microfinance Development Programme.

Impactful MFIs/IFIs supported by IsDB have been successful in conducting group-oriented value-chain Islamic microfinance. They have also been able to negotiate for better suppliers and buyers in the value chain on behalf of their clients. By developing the partner MFI/FI capacities to engage in trade and investment with farmers through actual involvement in the value-chain (instead of being arm's length lenders), IsDB has helped initiate the implementation of the Economic Empowerment approach. Such institutions have become more competitive, and this has helped them have a better prospect of ensuring sustainability, while delivering value to their client

IsDB has observed several successful business models, where microfinance or the MFIs/FIs are able to go beyond the role of the financial intermediary and provide economic opportunities to their clients that are value-adding and contribute to poverty alleviation. Below are some of the business models that highlight how this difference in methodology has contributed to the welfare of poor local communities.

Case Study 1: Loan, capacity building and trade through Salam in Palestine

The challenge: Families hard hit with poverty within a struggling economy in a conflict area

Poverty and unemployment rates in Palestine are still imposing a serious challenge; about one out of three individuals (29.2%) were living below the poverty line in 2017. The Gaza Strip contributes more to national poverty than the West Bank; its share of the poor population is 71.2%, compared to 28.8% in the West Bank.

Economic growth is the most powerful instrument for reducing poverty and improving the quality of life. In the case of Palestine, despite the increase in GDP, this has not been noticeably reflected on reducing poverty and unemployment rates. To address this challenge, IsDB initiated the creation and design of an innovative initiative in Palestine called the Deprived Families Economic Empowerment Program (DEEP), which emerged in 2006 to empower the poor and marginalized Palestinians with the aim of uplifting them from being dependent on humanitarian aid and charity to contributing members of the society.

The solution: A pilot livelihoods and microfinance programme that matured into a national and transformational poverty-reduction programme

DEEP is a programme funded mainly by Arab funds through IsDB and executed by UNDP/PAPP, under the leadership of the Palestinian Authority (PA), represented by the Ministry of Social Affairs. DEEP works through intermediary NGOs, MFIs, and private sector institutions to provide a comprehensive package of financial and non-financial services to meet the needs of 32,000 poor and extremely poor families in Palestine.

By offering a package of financial and non-financial services that address their needs, the programme successfully maximized the economic potential of the chronically poor and brought them out of the cycle of poverty.

Transformational change through DEEP

At the national policy level

DEEP is a pioneering initiative that enhanced social protection with Economic Empowerment. DEEP influenced the social protection policy in the State of Palestine through the adoption by the Ministry of Social Development of Economic Empowerment for low-income families as a social protection intervention. Economic Empowerment is now perceived as the first, rather than last, resort for deprived families in government policies and programmes.

DEEP replaces the disempowering effects of humanitarian aid, which not only fails to provide solutions to structural problems, but also pacifies people and erodes their collective agency. In contrast, DEEP aims to promote deprived families as potentially active agents and equal participants in economic development.

Providing a loan for a business partner: Economic Empowerment through Islamic microfinance

DEEP microfinance is a customized modality for Economic Empowerment, development and income-generation in compliance with Islamic financial principles. It offers a variety of Islamic microfinance tools that respond to the specific financing needs of the poor.

The principles of DEEP microfinance encourage risk-sharing, individual rights and duties, property rights and the sanctity of contracts. They enable microentrepreneurs to increase their incomes through expanding and developing their enterprises with the support of the MFIs/IFIs. DEEP microfinance provides mainly asset-transfer financing to the beneficiary projects. This does not only reduce vulnerability; it also allows poor households to move from day-to-day survival to a solid business plan for their future. Most of the Palestinian people are Muslims, and they prefer to receive Islamic, rather than conventional, financing (according to an IFC study, about 60% of the Palestinian people prefer the Islamic financing approach). Thus, DEEP produced Islamic microfinance tools that fit the needs of the poor and allow them to earn income in a dignified manner.

Several of the MFIs receive support not only from IsDB, but also from other donors. As such, they offer both conventional and Sharia-compliant loans to their clients. It was reported that two women borrowed from the same MFI, one under the conventional window and the other under the Islamic window. Both women ran small sewing businesses employing 2-3 women in their shops. However, due to illness or injury, both women were unable to make their repayments to the MFI. In such a scenario, what did the MFI do?

For this case, the Islamic window of the MFI hired a replacement on behalf of its beneficiary in order to ensure that her business continues despite her absence. The woman's employees were able to continue with their work, since the shop remained open while the woman recovered at home. Her repayment schedule was frozen until she returned to work 3 months later. In stark contrast, the conventional window of the MFI continued to request payments from its beneficiary despite her condition. She had to close her business and lay off her employees. Her repayment obligations continued to increase with compound interest and late payment fees. As she was unable to make her repayments, the MFI took her to court to liquidate her collateral.

Linking the poor to the market systems: trade through Salam

Tremendous efforts have been exerted in DEEP to shift the focus of finance providers from simply providing credit to clients towards offering integrated business-development services that increase the sustainability of projects and prevent low-income families from falling into more debt because of failing businesses. This approach implied working on the local market systems to improve the livelihoods of the poor through partnerships with the private sector in the form of collective group projects.

For example, Maftoul (couscous) is commonly made by Palestinian women and has high demand in Europe. MFIs, supported by DEEP, provide Salam (advance purchase) financing to a women's cooperative, part of which is in the form of raw materials, while the remaining is given in cash. In exchange, the cooperative promises to deliver a certain amount of Maftoul. The cooperative subcontracts this to its members. Once the women deliver the Maftoul to the cooperative, it delivers the Maftoul to the MFI, which packages and exports it to Europe. The MFI ensures that the quality of the Maftoul and its packaging meets the required standards to export to Europe.

Business Development Services

In addition to supporting income-generating activities, DEEP offers, through specialized service providers, parallel business development support to the families to enable them to develop their services and products, expand business operations, access new markets and

build partnerships at the local, national and regional levels.

Business development support enables beneficiaries to sustain and expand their projects. Selected target groups undergo an intensive and comprehensive practical training programme on the Competency-based Economies Formation of Enterprise modality to acquire the necessary skills needed to run a micro-enterprise.

In addition, during this training, participants polish and refine their business ideas through a participatory process between the project owner and the trainers to check for economic and marketing feasibility and identify other gaps at an early stage before implementation.

Moreover, in order to ensure that the beneficiaries are running their businesses in an optimum manner, and to ensure the sustainability of the businesses, follow up and business coaching is conducted to help beneficiaries deal with the various issues they might face in marketing, production, finance, etc.

Management Information System (MIS)

The MIS is the main pillar of the operational efficiency of DEEP, especially in light of the extensive quality-assurance and monitoring functions. This system was gradually developed and customized based on needs. The MIS was built in alignment with the different programmatic service lines and related business processes to be able to facilitate the capturing and storage of information and its exchange among all stakeholders. The system is web-based and can be accessed by all partners with different functions and levels of authority.

This was another breakthrough in the programme, where different NGOs and MFIs built synergies in the field by providing technical assistance such as training, consultation, psychosocial support, referrals and networking with other specialized service providers who can offer medical, mental health or social services.

The impact and results: Sustainable economic impact

DEEP has been largely responsible for creating a transformative change in attitudes towards poor households. Traditionally, poor people tended to be perceived as social and economic burdens that needed to be endured. The project demonstrated that poor households are valuable assets who can, if their potentials are realized, lead to socioeconomic development. These results provide concrete justification for maintaining DEEP. The positive contribution of the programme towards economic sustainability is clearly demonstrated. DEEP managed to support more than 15,000 poor households by establishing income-generating projects for them, enabling 37% to graduate from poverty. More than 85% of the supported businesses are still functioning, creating about US$22 million of economic value-addition annually. The programme has attracted about US$80 million of new financing for the MSMEs in its portfolio. Equally important is the programme's contribution towards a better understanding of how DEEP can help eradicate poverty through various innovative Economic Empowerment business models. External evaluation presented hard data on the direct role of DEEP in creating employment opportunities, providing sustainable sources of income to poor households that might have otherwise been left out.

DEEP has expanded from a small-scale pilot innovation into a programme that eventually gained international and national recognition and support. It has been scaled up to have a stronger impact on the country's poverty alleviation efforts, serving as an important complementary measure to the government provision of social safety network services.

The success of DEEP is a case of dedication, commitment and innovation by IsDB, the government, UNDP, civil society institutions and poor households to enhance their standard of life. The success of the programme was accomplished through a unique partnership model. For this project to be scaled up at the national level, several considerations and associated risks should be addressed. The "vision for scale" was reflected in the original design of the initiative, which was responsive to the demands in a timely manner and had close linkages to the national

priorities. Taking the above lessons into consideration has helped ensure the programme's sustainability and created an enabling policy environment for its eventual scaling up to become a national scheme.

One of the most attractive features of DEEP has been its transferability and sustainability. Having established the basic methodology, and following several training sessions, the programme has been successfully replicated in the different local contexts of (a) different regions within Palestine, namely the West Bank, East Jerusalem and Gaza; (b) different localities of rural and urban areas and of refugee camps; (c) different NGOs and MFIs; and (d) different economic activities, such as agriculture, services and manufacturing. It was also adapted to a national scale. The ease and success of these adaptations can be attributed to the simple but ingenuous methodology that allows for efficient standardized training while remaining flexible and responsive to varied contexts.

The IsDB Economic Empowerment Department (EED) is expanding the model in the country. A US$500 million Economic Empowerment Fund for Palestine has been created to promote the model nationally. Besides expending the model in Palestine, EED is also replicating the Economic Empowerment model applied in DEEP in various other member countries. DEEP, which started as a pilot, has been mainstreamed successfully, not only nationally, but also internationally across IsDB member countries.

Case Study 2: Venture capital investment through diminishing Musharaka (Wad Balal Cattle Fattening Project in Sudan)

The challenge: How to realize the strong potential of beef production through exports to the Middle East

In February 2008, Bank of Khartoum (BOK) and Emirates and Sudan Bank merged to form the largest bank in Sudan under the name Bank of Khartoum with SDG 860 million of equity. Bank of Khartoum operates under Islamic banking standards and has a comprehensive suite of retail services with a network of 58 branches, 137 ATMs and 10 cash deposit machines, auto finance, home finance, education finance, Takaful, internet banking, SMS alerts, discount and supplementary cards and the first and only banking call centre. At that time, all the microfinance operations of the Bank of Khartoum were under the Microfinance Unit of the Department of Retail, SME and Microfinance. The unit was established in 2009 with IsDB support and assistance. Later, the Microfinance Unit was spun off into the IRADA Microfinance Company, with BOK (75%) and IsDB (25%) as shareholders.

The Wad Balal Cattle Fattening Project was initially conceived by a group of established Sudanese businessmen living and working abroad. Instead of just providing aid through cash transfers, the businessmen wanted to contribute to the improvement of their village, which was mainly in the livestock industry. The businessmen wanted to use their connections to supply the Middle East with livestock from Wad Balal.

Palestine - Deprived families Economic Empowerment Program (DEEP)

Winner of the "Palestine International Award for Excellence and Creativity", 2011

- Started with US$10 million and reached US$131 million coming from other donors
- 16,042 projects created for families
- 52,000 direct and indirect job opportunities created

There was a strong demand for beef in the Middle East but to successfully meet the export market standards, they needed to help their suppliers (livestock herders) with the necessary infrastructure.

The solution: Venture capital investment through diminishing Musharaka

With this idea, they developed a business plan and approached BOK for assistance. The business plan was refined and the BOK board subsequently

approved SDG9.30 million (including SDG4.27 million for purchasing calves) for the project based on recommendations in the feasibility study.

The group of businessmen registered the Wad Balal Company with the mission of investing in livestock production assets for the community, as well as to purchase the livestock from the community for export to the Middle East. In addition, they also helped the herders register the Wad Balal Association, with the aim of supplying livestock to their company. In this project, BOK made two main contracts: (a) a Murabaha financing to purchase calves for the Wad Balal Association; and (b) a diminishing Musharaka financing to purchase livestock production assets for the Wad Balal Company. Due to the low educational level and capacity of the members of the Wad Balal Association, the Wad Balal Company was expected to help the association maintain production standards for export. In the first contract, BOK would provide the financing for the purchase of calves for the association. By purchasing in bulk, BOK helped the association to acquire calves at a lower price. The mark-up of the Murabaha was set at 15% per annum. No collateral was provided for the transaction, but the Wad Balal Company agreed to provide a 55% guarantee for repayment of the cattle financing.

In the second contract, the businessmen invested about SDG321,000 (6% of the capital), while BOK invested SDG5.03 million (94% of the capital). The capital was used to purchase fixed assets and alfalfa feed and for other operating expenses. These assets and services were to be leased to the Wad Balal Association at an 18% leasing profit, which was also estimated at 21% of the export sales and 19% of local sales. This leasing profit was to be used to purchase the shares owned by BOK over a period of 5 years, including a 2-year grace period. As Wad Balal Company's shares increase over time, their share of profits would also increase. True to its social objectives, the Wad Balal Company gave an irrevocable guarantee to utilize their gained profits in the following manner: (a) 40% to purchase more calves for the poor to enable more of them to join the association; (b) 40% for social development projects (e.g. education, medical etc.); and (c) 20% for the management of the company. Under the diminishing Musharaka agreement, the businessmen agreed to mortgage their land as collateral against negligence and mismanagement.

The impact and results: sustainable economic impact

The work done by BOK embodies the spirit of Islamic finance in its operations. In doing so, it developed an innovative methodology of Economic Empowerment initiatives (solidarity and value-chain project group financing). Instead of providing small loans, which defines the microfinance industry, BOK ventured far in empowering the poor by doing business with them. By sharing risks and profits with the poor, BOK was able to help thousands of vulnerable people in Sudan earn a better living by generating jobs. It managed to build a portfolio of more than 100,000 business partners/clients. Large projects were developed involving hundreds, even thousands in some cases, of poor beneficiaries with each investment amounting up to USD3 million. This methodology was found to be more sustainable (IRR about 20% per annum) and more effective in alleviating poverty (each beneficiary received more income by sharing the venture's profits and being co-owners of the venture). By being a

Sudan – IRADA (BOK) Projects

Winners of the "Ethical Finance Innovation Challenge and Awards", 2014

- IsDB's investee, IRADA, developed EE programmes worth US$65 million.
- Started with US$65 million from IRADA, then reached US$189 million: US$104 million from local banks, and US$20 million from the Zakat Authority.
- Impacting 172,000 poor every year (directly and indirectly).
- Utilizes 13 financing methods, wherein Murabaha represents only10%.

real partner in these businesses, BOK developed its expertise in the area of agriculture and livestock development. Like any large professionally run business, BOK helps poor farmers run the business, while developing their capacity to assume the ownership of the business after a period of time.

Finally, the implications for donors, especially IsDB, are very significant. As a shareholder of the Bank of Khartoum, IsDB has been successful in creating a mini-development bank in the process.

Case Study 3: Development of an incubator through partnership (Ard El Khair Cattle Fattening Incubator in Egypt)

The challenge: Creating sustainable self-employment, especially for female youth at the bottom of the pyramid

Unemployment among the youth is one of the most important challenges facing Egypt, with 650,000 new entrants into the labour force every year. Over 25% of Egyptians aged 20-29 are unemployed. The Arab Spring revolution, which was driven by the youth in 2011, further worsened the economic situation.

Many of the youth have difficulty in getting a job, and starting a new business is just as challenging, with difficulties in registering property, taxes and other regulatory issues. Micro and small enterprises (MSEs) account for approximately 85% of the non-agricultural private sector employment. However, despite its importance in generating employment, they only receive 1% of bank credit, according to the Central Bank of Egypt. In addition, most of this credit is provided on conventional terms, which are not suitable for 90% of the self-professed Muslim population. For young women, this disadvantage is intensified by the difficulties faced by all new labour market entrants, including delayed school-to-work transition and low-quality jobs (Assaad 2008). In other words, female youth face challenges in finding decent work both as women and as young people.

The solution: Partner with Ard El Khair to develop an incubator programme to support female youth businesses in cattle fattening

IsDB provided restricted Mudaraba financing under a special programme dedicated to creating employment for youth. The Youth Employment Support (YES) programme provided US$50 million to Egypt through the Micro Small and Medium Enterprise Development Agency (MSMEDA), formerly known as the Social Fund for Development. The programme provided unemployed potentially active youth, particularly heads of households (men and women), with opportunities to be more self-sufficient by establishing income-generating activities. Although the YES programme was focused on youth employment, the challenge was to ensure that the most vulnerable segments of the population were not left out. Ard El Khair, which was financed by the YES programme in Egypt, aimed to address that challenge by helping female youth in rural areas.

Ard El Khair is an Egyptian joint stock company that focuses its activities on animal livestock production. Its extensive experience enabled it to establish an academy to transfer its livestock production expertise to smallholders. Ard El Khair locates its farms in the poorest governates of the country and provides job opportunities to the people in those regions. As the executing agency of the YES programme, MSMEDA approached Ard El Khair and informed its officials about the Islamic microfinance programme and the Murabaha product that they had developed. Instead of creating standalone farms and hiring staff to run those farms, a feasibility study was developed to create an incubator based on the expertise of Ard El Khair. The company would run the incubator programme for poor young women for a period of about 9 months to develop their capacity in cattle fattening.

There have been several rounds of financing so far, with an average of 150 poor youths incubated (90% of whom were women). These youths were selected from an average of 2,000 applicants per round. The selection process was done jointly between Ard El Khair and MSMEDA. Under their arrangement, MSMEDA focuses on the legal and financial arrangements and needs, while Ard El Khair engages the young women and provides with technical expertise in cattle fattening, as follows:

1. The actual sourcing of the young calves would be done by Ard El Khair and in bulk to ensure a low price

2. Ard El Khair would provide the client with technical know-how on cattle fattening
3. Ard El Khair would arrange for the sale of the end-beneficiary's fattened cattle in the market
4. Ard El Khair would also enter into a partnership agreement with the end beneficiary
5. Ard El Khair would facilitate the borrowing process for the beneficiary by acting as the guarantor, while the beneficiary would commit herself to the incubation programme and work in the farm for 12 hours per week during the incubation period of 9 months

Once the beneficiaries were selected for the financing round, a tripartite agreement would be signed between Ard El Khair, MSMEDA and the beneficiaries reiterating the main articles of the MOU, as well as the technical and guarantee scheme agreements that would govern the various aspects of the project implementation, including the procurement of cattle for fattening, production, training and marketing processes.

The last step would involve the actual loan agreement between MSMEDA and the beneficiary. Following the screening process, MSMEDA would approve a loan of EGP500,000 for each of the 150 beneficiaries, totalling EGP75 million (US$4.28 million) under each round of financing. These Murabaha loans with a 5% mark-up would be used to purchase 20 cattle heads for each young woman. Ard El Khair would provide animal feed and veterinary services, as well as a small allowance which would later be deducted from the proceeds of selling the cows. The financing would be channelled directly to Ard El Khair for the purchase of the cattle. The company would purchase 3,000 cattle heads at the lowest possible cost through an international bidding process for each financing round.

The young women were required to put in 3 hours per day for 4 days a week. Their presence was monitored through a punch-in punch-out system. During this incubation period, the young women would receive an allowance from Ard El Khair. By the end of the training, Ard El Khair would sell the fattened cattle to their clients, including hotels, schools and wholesalers, and distribute the residual income to the young women after deducting the cost of production and marketing. Post-incubation, the women could still rely on Ard El Khair for advice and services (e.g. veterinary). In addition, they could seek assistance from Ard El Khair to purchase the cattle on their behalf. The young women also had the option to get Ard El Khair to sell the fattened cattle on their behalf to markets that would otherwise be inaccessible to them.

Impact and results: Economic Empowerment through incubation

The Economic Empowerment model of Ard El Khair facilitates partnership between private and public-sector entities and underprivileged segments of society. The young women who were incubated were treated as partners and not as debtors. About 600 poor young women living in rural areas have been given a source of income on a sustainable basis from 4 rounds of incubation of about 9 months each in just one farm. This pilot has proven to be so successful that it is set to be replicated in Ard El Khair's other farms. By doing this, Ard El Khair will be able to gradually expand their business without requiring to physically expand.

Ard El Khair will also be able to create many more jobs in the process. Instead of hiring only 150 people on a long-term employment contract, they can effectively create 150 jobs a year for each farm (since the graduating batch remains self-employed by starting a small cattle-fattening business at home and is replaced with new young women partners).

As for the women entrepreneurs who were incubated, they received a good income of US$166 per month, in addition to receiving training on cattle fattening. After graduation, they received certification that made them eligible for a loan to set up their own small farm near their homes. The commitment required to work at the training farm is reasonable, as the women could still balance their work with their family commitments. In addition, the skills that they learnt will enable them to develop a small productive business at home to earn a better income for themselves and their families. Due to the success of the pilot, the Ard El Khair incubator has been expanded to several locations in rural Egypt, with more than US$26 million financed through this initiative.

Egypt - "Ard El-Kheir Incubator" of the Youth Employment Support Programme

Selected from among 850 projects to be featured in the Paris Peace forum, 2020

- US$29 million financing provided to support mostly young women (80%)
- 1,000 rural youth accessed technical know-how, adequate financing and markets in a sustainable manner and continuing to benefit 160 new rural youth yearly

Case Study 4: Partnership with a leading firm (Danone in Tunisia)

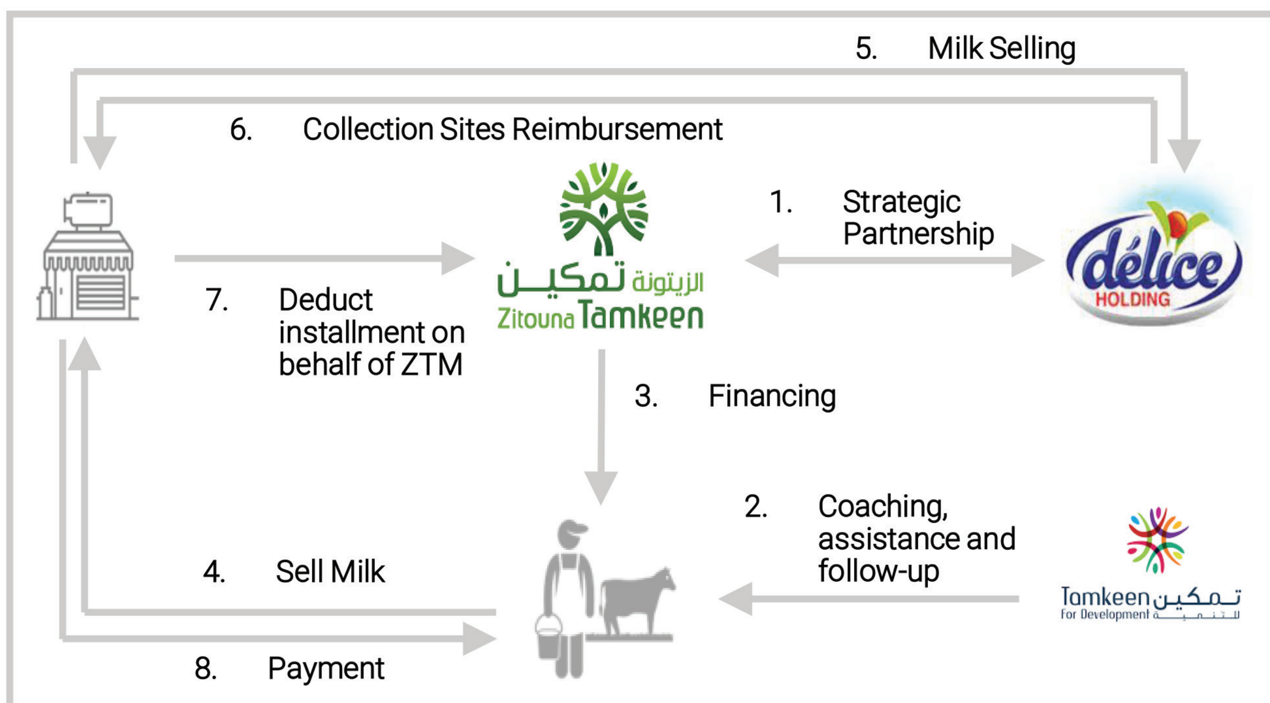
The challenge: Providing financing to dairy farmers while ensuring a market to sell their milk

Tunisia has a strong dairy farming sector that is dominated by smallholders with no access to good markets. Additionally, the milk they produce does not meet the standards of large companies such as Danone. Zitouna Tamkeen (ZT) decided to take up the challenge of closing this gap. To that end, it developed a business model under an initiative called "Hlib El Khir" (milk of prosperity).

The solution: Partnership with a leading firm

Hlib El Khir is ZT's first Economic Empowerment project in the dairy value chain. It is a unique strategic partnership between ZT and the Danone-Délice Holding Group. Hlib El Khir aims to increase the production and productivity of small dairy farmers and improve their socioeconomic conditions. Délice Holding is the offtaker of this project and the leader of the dairy VC in Tunisia, with more than 65% of market share. The key actors that drive the dairy VC are the milk collection centres and the small farmers that produce the milk. This project will include, as a first step over five years, 5,500 farmers in the north-western region of Tunisia covering four provinces. It has the potential to impact 125,000 farmers across Tunisia.

Figure 1.7 Business Model of Hlib Elkhir Project



Each flow represents a transfer of commodities (milk) or cash (repayment of credit, financing). The scheme was initiated following a partnership between Zitouna Tamkeen and Délice Holding as the culmination of discussions between the two parties regarding the setup of a joint project bringing together their objectives for the sector and society.

The partnership was triggered by the signature of a framework agreement and a concept note with Délice Holding. The project then went into the technical and financial assessment stage, carried out by ZT's Business Engineering Department. Once this step was completed, the project was transferred to the Operations Department for execution. In the meantime, ZT launched an outreach campaign targeting potential beneficiaries of the Hlib Elkhir project. Beneficiaries are selected based on specific criteria, and once selected, they advance to the funding stage.

Farmers start milk production as soon as they get the heifers and production equipment, bought at a reduced price as a result of ZT's negotiations with the suppliers. The milk is collected by the collection centres then transported to Délice, who pays the collection centres monthly an amount corresponding to the quantity of milk received, at a selling price with a premium negotiated by ZT for the benefit of the farmers. The collection centre deducts the amount of the monthly credit payment for each farmer then transfers the remaining amount to him. As such, the farmers receive the net amounts after payment of their monthly obligations. The collection centre then transfers the sum of the collected dues to ZT in one transaction at the end of each month.

In this case, the circuit is defined as closed; the flows of goods and money circulate periodically and systematically with the aim of minimizing ZT's operational costs and securing a constant flow of milk to Délice.

In addition to securing an offtaker for the entire production for a period of 5 years, the farmers also benefit from 3 years of close monitoring and follow-up (twice a month), as well as technical trainings.

The project is having a significant impact on the lives of the small milk producers in the north-western region of Tunisia. In fact, it helped them to triple their assets (i.e. the number of cows) and their monthly income. The Hlib Elkhir project is a successful mixture of appropriate financing, adequate training, constant monitoring, guaranteed offtake and protection through an insurance scheme covering cases of herd mortality.

Zitouna Tamkeen - Impact & Achievements

Zitouna Tamkeen has taken giant strides and quickly positioned itself in the microfinance and Economic Empowerment sector in Tunisia, gaining national and international acclaim despite its young age.

Just one year after commencing its activities, the institution ventured to double the objectives it announced at inception in terms of the volume of financing, number of branches and the number of beneficiaries, given the huge demand for its products and services. Today, around three years after its operations began, the institution has succeeded in financing more than 12,000 income-generating projects. These have led to the provision or sustainability of more than 40,000 direct and indirect jobs, with a total finance portfolio of about 70 million dinars through a network of 19 branches, most of them in the hinterland and least developed regions. This is in clear harmony with the vision and mission of the institution and three regional managements and two mobile branches to access the outlying and difficult regions.

It is noteworthy that the institution attaches considerable attention to women empowerment. This has been translated into 40% of its financing going to women, a proportion that will be raised up to more than 50% by the year 2021. The institution's interventions cover all productive sectors without exception, and it places marked emphasis on the farming sector, agro-allied industries and services, various commercial activities and small industries. This blends perfectly with the comparative advantages of the Tunisian economy and the map of the country's economic fabric.

The institution has offered a package of products that have been designed in accordance with the needs of the beneficiaries and/or the target regions. Zitouna

Tamkeen also entered into partnerships with hundreds of suppliers from various fields and negotiated with them in the context of framework contracts to give preferential prices to customers, which could be 20% discounted compare to what is offered in the market. This is what gives the institution a significant competitive advantage over its competitors.

Tunisia - Zitouna Tamkeen institution

Winner of the "Best Agricultural and Rural Finance Product", 2017

- Reputable local and international shareholders participated in its capital
- 14,000 income-generating projects financed so far
- 40,000 direct and indirect jobs created so far
- 20 value chain projects engineered for poor people

CHAPTER 02

Assessment and Strategy

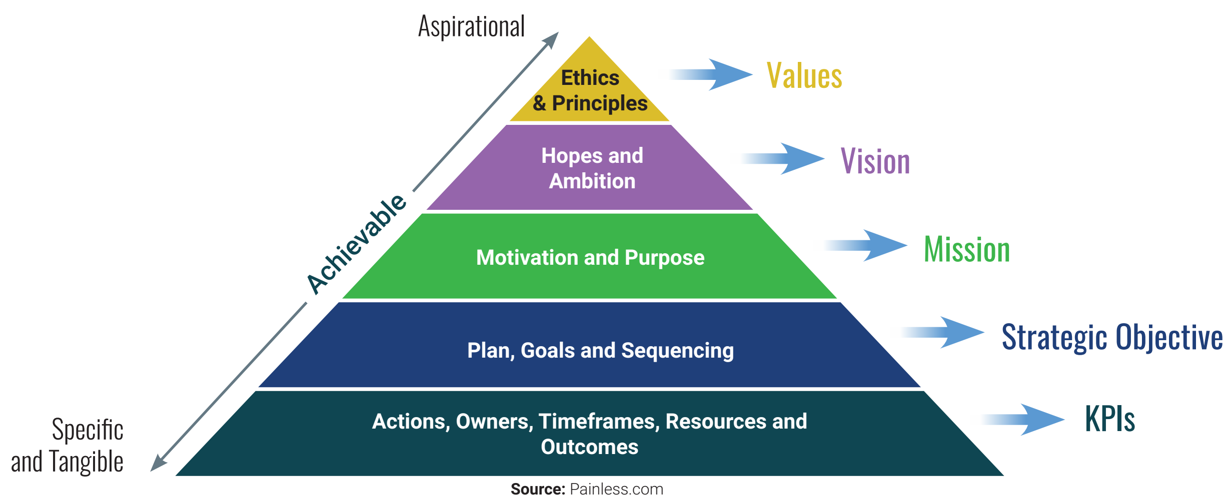
> "Finance without strategy is just numbers, and strategy without finance is just dreaming."
>
> Emmanuel Faber, CFO and Head of Strategy, Danone

1. ASSESSMENT OF THE CURRENT SITUATION

Assessment and strategy help the management of an MFI/FI take stock of the current performance. It is a self-reflection of not only the challenges faced by the MFI/FI , but also the opportunities available to it. It allows the management to clearly understand the performance from various viewpoints and helps it chart ways of improvement with available resources. It also ensures that the management is in touch with the perceptions and sentiments of various stakeholders, especially its clients. The decision to embark on its economic empowerment journey provides an opportunity for the FI to revise its strategy and goals.

The business landscape of microfinance, and of the financial sector in general, is populated by a variety of entities, organizations and individual investors who run their institutions based on certain strategies that evolve from the initial motives of engaging in the specific business. A strategy should include a vision, mission and objectives for the institution.

Figure 2.1 Strategizing Current State Assessment



Source: Painless.com

The institution's vision is its purpose of engaging in its chosen business, providing a focus and explaining to the world the rationale for its existence. Following are examples of vision statements expressing their respective institutions' aspirations:

"To be one of the 10 biggest microfinance institutions in the world" – IRADA, Sudan

"Zitouna Tamkeen aims to become an internationally renowned player in Islamic microfinance." – Zitouna Tamkeen, Tunisia

"Akhuwat aims to alleviate poverty by creating a bond of solidarity between the affluent and the marginalized" – Akhuwat, Pakistan

The mission statement should explain how the institution plans to achieve its vision through its value

proposition. Depending on the vision of the institution, and taking into account how the institution intends to portray itself to the market, the mission statement is developed. Following are examples of mission statements:

"Contribute to sustainable economic and social development for low-income and economically active people in Sudan through outstanding performance in the field of Islamic microfinance through fair partnerships with various partners." – IRADA, Sudan

"Participate in the financial and economic inclusion of the disadvantaged population by adopting an economic empowerment approach through the tools of Islamic finance." – Zitouna Tamkeen, Tunisia

"Our goal is to develop and sustain a social system based on mutual support. We extend a helping hand to the poverty-stricken by providing interest-free loans, so they can start a business and become self-reliable." – Akhuwat, Pakistan

Every institution should have an objective and core values. In fact, it is crucial for the institution to define its core values and set some objective goals. Once the institution is up and running, the objectives might change. However, the culture of the institution is not easily shifted by external/internal factors. Therefore, it is very important to ensure that the institution's objectives are consistent with its vision and mission statements. Combined, they form the basis of its strategy. The institution's core values indicate the business and ethical boundaries around the activities it wishes to undertake. Following are examples of core values defined by Akhuwat in Pakistan and Zitouna Tamkeen in Tunisia:

Table 2.1 Examples of Core Values

Akhuwat, Pakistan	Zitouna Tamkeen, Tunisia
W-free loans	Solidarity
Use of religious places [1]	Sharing
Transforming borrowers to donors	Citizenship
Spirit of volunteerism	Engagement
Non-discrimination on any basis	Ambition
	Integrity and transparency

Strategy definitions and perspectives

The word "strategy' is derived from the Greek military word strategia (art of troop leader; office of general, command, generalship[2]) . Nowadays, the word is used by the wider community to explain the scope of business activities. Islamic microfinance and economic empowerment institutions are no exception. There are many definitions of strategy, the simplest being:

"Strategy is the direction and scope of an organization over the long term, which achieves advantage in a changing environment through its configuration of resources and competencies with the aim of fulfilling stakeholder expectations." Johnson, Scholes and Whittington (2010).

"A strategy is the pattern or plan that integrates an organization's major goals, policies and action sequences into a cohesive whole. A well formulated strategy helps to marshal and allocate an organization's resources into a unique and viable posture based on its relative internal competencies and shortcomings, anticipated changes in the environment and contingent moves by intelligent opponents." Quinn (1997)

1 The Akhuwat Model institutionalizes the use of local religious places, e.g. mosques, temples and churches, as centers for loan disbursements and avenues for community participation. Using the existing infrastructure for operations allows us to minimize our expenditure, have a higher level of transparency and accountability and create a sense of goodwill amongst the community.

2 https://en.wikipedia.org/wiki/Strategy

"Strategy is the determination of 'what kind of business the firm should seek to be in and pertain(s) to the relationship between the firm and its environment". Ansoff (1968)

It is very important for any FI to develop the strategy according to its vision and purpose, and the strategy should not only be for meeting material goals:

"Strategy is not principally concerned with employee motivation, or with finance, or with accounting, or with production scheduling and inventory control…. In most industries, there are many firms which have their finance and accounting right, their human relations right, their information technology adapted to their needs. For one firm to succeed in these areas does not damage others…it is normal to look at the best practice in other firms. But strategy is not like that….successful strategy is rarely copycat strategy. t is based on doing well what rivals cannot or cannot do readily" – John Kay

Organization-level strategy concerns establishing and sustaining a competitive advantage in the markets in which the MFI practicing economic empowerment has chosen to operate. It is of a larger scale and longer term and should be relevant to the entire organization. Its tactics relate to the process of implementing the strategy on a day-to-day basis.

The organization's strategy must fulfil the following:

- Determine the scope of its activities – goals, markets served and value created;
- Match its activities to a dynamic business environment;
- Establish and maintain a competitive advantage;
- Match its activities to its capabilities and constantly innovate; and
- Maximize resource productivity.

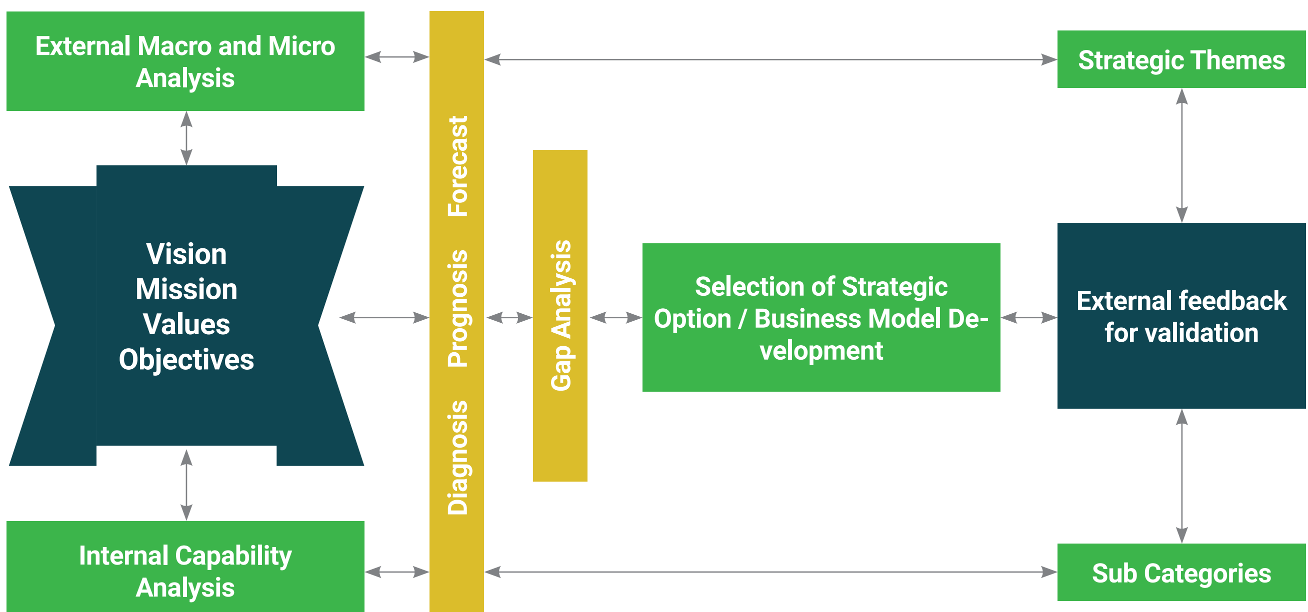
It should be noted that there is no one-size-fits-all strategy for FIs to implement in promoting economic empowerment. The strategy needs to be customized to the needs of the customers and the market.

Strategic analysis

FIs / MFIs need to devise a process for strategy development. This guide aims to serve as an effective tool for such a process. There should be a constant relationship between analysis, formulation and implementation. The process should address the following aspects:

- It is important to use creativity and analysis at all stages of the strategy development and implementation processes;
- The process should create choices;

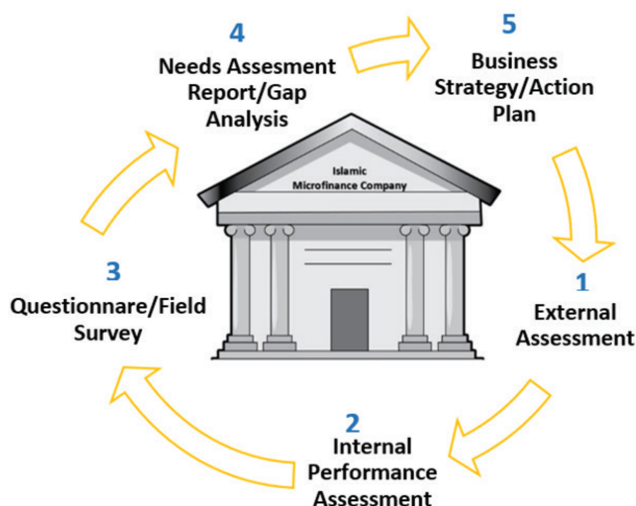
Figure 2.2 Selection of Strategic Options



- The elements must consistently interact to maintain relevance of the strategy and competitiveness of the business, constantly creating value for key stakeholders;
- During implementation, continuous feedback from the process should be used to update the strategy as needed;
- External analysis of the broader external drivers also ensures that the strategy is responsive to the business environment changes; and
- Internal control mechanisms and systems should keep the institution's management informed, and the strategy should be upgraded and corrected as appropriate.

The process of strategy development can also be viewed through the combination of several assessments that lead to an action plan, as can be seen in Figure 2.2 An external desktop assessment should be conducted and followed by an internal performance assessment to explore the current performance of the MFI/FI. Based on this, questionnaires, field surveys and interviews can be conducted to validate the findings of the assessment and seek guidance regarding the future position towards which the MFI/FI is keen to move. This will result in an assessment report of the client's needs as well as a gap analysis report on the capacity of the MFI/FI to fulfil those needs. That report will then inform the business strategy, which recommends what needs to be done to close the gaps and how.

Figure 2.3 Development of the FI's Business Strategy



This chapter of the toolkit will detail the various stages of developing the MFI/ FI's strategy, which may include the adoption of the EE approach. The business strategy will act as a guide for the MFI/FI institution on what its contemplated achievements and set milestones. This will be followed by concrete steps such as conducting a value chain analysis (detailed in the following chapter) to select the value chain, better understand the market and its stakeholders and develop a new product (Chapter 4). Materials to implement the financing operations can be found in the Islamic Financial Instruments Product Toolkit.

Analysis of the external environment: PESTLE

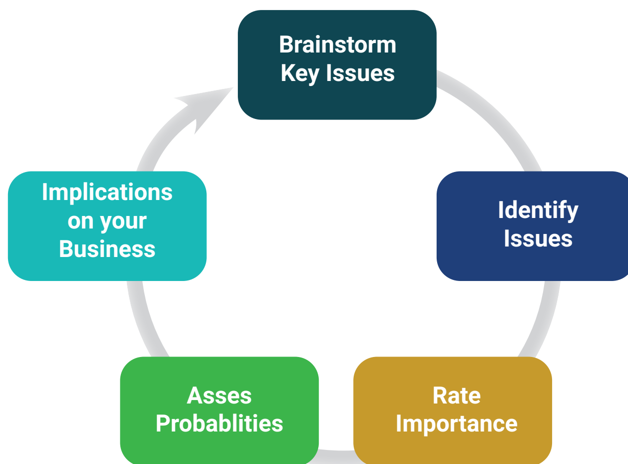
The assessment and strategy begin with looking at the macro factors. Although these factors are not within the scope of direct influence, and certainly control, of most organizations operating in certain markets, they often influence the pattern of behaviour of customers, competitors, collaborators and other stakeholders.

Key influencers of the business can be assessed with the help of a framework named PESTLE; an abbreviation of the key external and internal **Political, Economic, Social, Technological, Legal** and **Environmental** influencers. The categories are thinly bordered and they influence each other and, most importantly, the business itself. Most MFIs/FIs operate nowadays in countries where all these categories are highly interrelated and very fragile. For example, the existence or absence of an Islamic banking law and regulations significantly affects the operations of the contemplated MFI/FI. In addition, technological advancement may considerably ease the operations of the institution.

One must keep focus on identifying the issues. Once the key issues are brainstormed and defined, the most important ones can be selected from among them. The key issues are then ranked according to their importance. Each issue is then analysed for potential impact. Lastly, the direct and indirect impact on the business is also analysed. The PESTLE process should identify issues fitting the following criteria:

1. Outside the control of the organization
2. Have an impact on the business

Figure 2.4 PESTLE Analysis Process



Source: IRTI Advisory Services

It is very important to remember that the PESTLE analysis is there to give the big picture about the environment in which the institution plans to operate. It enables the analyser to assess the potential risks that the institution might be exposed to and can also be used to weigh the potential impact of external factors.

Political Factors (P): It is always advisable to keep a close eye on the government and potential policy changes in the business environment where the institution is operating. Simple changes in the labour law, financing rules or taxes might have a detrimental effect on business viability. In addition, changes in the government's priorities can also affect the business community significantly. In countries where a common law is followed, such as the West African Economic and Monetary Union (UEMOA), the legislations are unified and, therefore, the countries under such umbrella bodies might be affected significantly.

If the intended IFI is being established in a country that has ties with neighbouring countries, it would be worthwhile to assess the potential effect of such ties on the future of the business. It is recommended to review the following in connection with political factors:

It is important to remember that political factors include government attitude towards employment,

Employment laws	Consumer laws	Environmental regulations
Taxation	Trade restrictions and permits	Health / safety requirements

consumer protection, the environment, taxation, trade restrictions and social reforms, as well as bureaucracy and the level of corruption in the country.

Economic Factors (E): MFIs/FIs should always assess potential changes to an economy's inflation rate, taxes, interest rates, exchange rates, trade regulations and excise duties. Indicators such as unemployment rates, general skill levels, availability of required expertise, wage ranges, working practices and labour costs should be monitored. As MFIs/FIs will be dependent on the general purchasing power of the residents in a particular country, it is recommended to determine the economic viability of the market by monitoring the current cost of living and earning levels, as well as available market of consumer finance.

Organizations need to have a strategy that can be modified to fit the changes in the economic situation and financing aspects of the macroeconomic situation in the country of operation. Therefore, concepts such as globalization, taxation, potential implications of profitability fluctuations, embargos and trade tariffs should be assessed. For example, an economy with rising inflation will have an adverse effect on the pricing of the products and will, therefore, affect the purchase power of the customers. In addition, the rate of growth of market confidence in the country could also be significant for the operations of the institution. Economic analysis cannot be done without exploring the general trends in official economic indicators such as GDP, GNP and consumer indexes. PESTLE highlights areas that require further analysis for the feasibility of the project. Some of the factors may include:

Inflation	Taxes and duties	Finance and credit	Working practices
Exchange rates	Cost of living	GDP and GNP	Global effect

Social Factors (S): There are several social factors that might affect the operations of the MFI/FI, including:

- Age distribution of the potential customers
- Population growth rate
- Employment levels

- Income statistics
- Education level and career trends
- Religious beliefs
- Cultural and social conventions
- Purchasing Habits
- "Saving" culture

It is also important to look at matters such as the attitude towards health, career, environment and social justice. In international markets, social and cross-cultural matters play a major role in strengthening trading relationships, and success depends on how deep the institution understands the effect on its business. A simple example would be managing local staff while respecting their cultural background.

Technological Factors (T): These are the key factors that can determine the long-term success of the institution. Technological issues have a direct impact on the institution's operations and sales. A few years back, it would have been impossible to imagine the amount of information that would be available to end users by a touch of screen. Technological developments are bringing the customers ever closer to the service providers. In the case of MFIs/FIs, digital finance has revolutionized how money transfers, savings and other financial transactions are made, making the process more convenient and cost effective for both the client and the MFI/FI.

In certain jurisdictions, when investment is considered, technology plays an immense role in the decision-making process. The following factors need to be assessed carefully and deeply:

- Rate of change in technology
- Use of outsourcing for the process
- Research and development
- Knowledge management systems in use
- Network coverage
- Production efficiency
- Quality and pricing mechanisms
- Intellectual property
- Patents and licenses
- Government activities and regulations on technology

Legal Factors (L): When considering an investment, a list of legal factors needs to be considered. That includes employment, competition, health and safety. Anticipated legislations should also be studied.

The list could include the following topics:

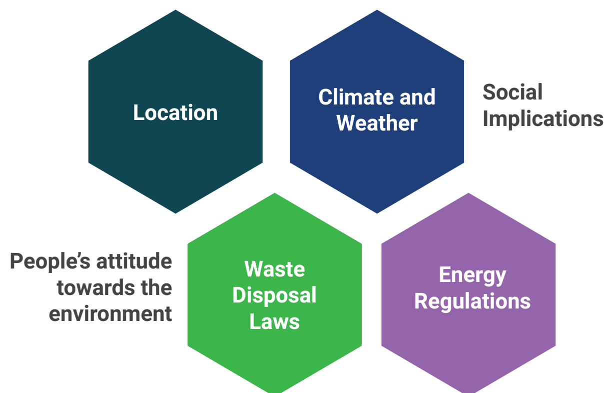
- Investor protection laws
- Taxation
- Employment regulations
- Consumer protection
- Advertising regulations
- Import and export regulations
- Health and safety
- Compliance

There is a rise in the number of regulatory bodies that have been set up to monitor the compliance of organizations with legislation related to all operating areas, including consumer protection, employment welfare, waste disposal, income taxation, accounting, etc. In addition, there are certain activities that are restricted by law.

It is very important to consider all national and international laws that might have even the slightest impact on the operations of the MFI/FI while formulating its business strategy. Some of the typical legislations that may hinder a Sharia-compliant financial institution relate to its ability to purchase and own assets on its balance sheet. In addition, the question of whether it will be charged value-added taxes is a contentious one, as such taxes would be detrimental to its competitiveness in comparison to its conventional counterparts if applied to its transactions. To ensure a level playing field, VAT should be waived for Sharia-compliant MFI/FIs.

Environmental Factors (E): Environmental dynamics might also affect the business of various institutions. Climatic changes and their associated impacts in the country might cause unavoidable environmental damages. They may affect the client's agricultural businesses, which in turn would affect how the MFI/FI should manage such risks.

Figure 2.5 Main Environmental Factors



As shown in Figure 2.5, there are external factors that may affect the business strategies of FIs. These factors are interdependent. Therefore, environmental factors have a crucial influence on the institution's performance. Hence, environmental analysis is also essential to identify how such factors can affect the financial institution.

2. ANALYSIS OF THE ENVIRONMENT: SWOT

Besides conducting an analysis of external factors, a comparative analysis of the external and internal environments of the organization is a fundamental input to its strategy development. This can be done by conducting a SWOT analysis.

SWOT Analysis

The purpose of undertaking structured analysis is to create a basis for considering the strengths, weaknesses, opportunities and threats that will shape the strategy of an organization. What may appear at first sight to be an opportunity may turn into a threat considering an institution's resources or culture, or of the expectations of stakeholders. Put simply, institution strategies aim to take account of opportunities and circumvent threats, and to build on their strengths and correct their weaknesses.

The SWOT framework of strengths, weaknesses, opportunities and threats is a technique now familiar to directors, although there is a twofold danger in its common use:

- It is often not preceded by structured, rigorous thought and analysis. In such cases, it would be little more than a summary of current perceptions rather than an objective analysis.
- Once completed, it is not often used to best effect as a basis on which to build strategic options.

When a SWOT analysis is perfected, it provides a clear statement of the current strategic position of the institution. It can then act as a tool for the management to evaluate and devise the institution's strategy and then to communicate it to all concerned.

Formulation of the SWOT analysis:

- List the key strengths, weaknesses, opportunities and threats under the respective SWOT headings. This is best achieved by team brainstorming to arrive at the first draft list, which will inevitably be too long to manage.
- Prioritize the points and agree on the key issues, aiming for a maximum of three or four points under each heading.
- Tabulate these key points against the impact they are likely to have on the organization so that you can ask, 'What can we do about them? How can the institution respond?'

This presents a firm view of the current capabilities and the key environmental forces on which to build strategic options.

Strengths

This refers to those areas where the business is competent and/or particularly strong. Normally, the decision as to whether something can be regarded as a strength is determined by a broad comparison with competitors in a similar situation and/or the opinion of target customers. To be regarded as a strength, an element must be at least as good as, but preferably better than, the same or similar element in a competitor business.

Weaknesses

This refers to areas where an organization lacks capability, either in comparison to a competitor or in terms of its ability to pursue an opportunity. An institution may lack capability in certain respects but be no worse than all its competitors. It may not,

therefore, be weak in relative terms, but may still lack the ability to pursue an opportunity.

Table 2.2 Strength and Weakness Perceptions

	Strengths	Weaknesses
Personal perception		
Customers' perception		
Competitors' perception		

The strengths and weaknesses should be analysed from three perspectives:

- Personal perceptions of an employee with full knowledge of the business
- Customers who receive the products and services offered by the institution
- In comparison with competitors

Opportunities

This refers to situations that offer the institution the chance to enhance its position through, for example, increased sales, lower costs, improved capability, etc. Opportunities may take many forms; they should, however, be realistic and within the capacity of the business to exploit, even though this might mean some changes in capability. Generally, they arise as a result of changes in the business environment. For example, the changing population structure in terms of age changes the nature of demand and creates opportunity.

Threats

Threats refer to situations that have the potential to inflict damage on the business through, for example, decreased sales, higher costs, lowered capability etc. Threats can also take many forms and should be dealt with rationally. Normally, they also arise because of changes in the external environment.

Process

The first step is to identify events, trends, etc. that have the potential to impact the organization. Each item should be analysed using the following four criteria, to identify the most significant opportunities and threats:

Impact/importance, timing, direction of development (getting weaker or stronger), and probability of occurrence.

- Impact indicates the effect of the threat/ opportunity on the business. It includes both the nature of the impact and its magnitude in terms of costs and benefits involved, (magnitude – small, medium or large).
- Timing identifies when the impact is likely to manifest itself (short, medium or long term).
- Direction of development examines whether the item is growing (G) or declining (D).
- The probability of occurrence reflects the likelihood that the item will occur and is judged on a continuum from certain to impossible.

Table 2.3 Identifying Opportunities and Threats

	Impact	Timings	Development	Probability
Opportunities 1. 2. 3.				
Threats 1. 2. 3.				

Source: Institute of Directors Reading Material

3. CURRENT SITUATION PERFORMANCE ASSESSMENT OF THE MFI/FI

MFIs/FIs need to clearly distinguish themselves from their conventional counterparts by communicating the value-addition they provide their clients with. By implementing the Economic Empowerment methodology, they will demonstrate the benefits of Islamic Finance. These MFIs/FIs which are also known as Economic Empowerment institutions must continuously distinguish themselves, innovate and excel by providing products and services that will benefit their clients. This is not a one-off activity, but, rather, a continuous journey to improve performance.

Differentiation Factor 1:

Unlike conventional MFIs/FIs, Islamic MFI/FIs practicing economic empowerment offer financial products that are backed by commodities/hard assets or availability of joint venture opportunities.

Why is it better? This measure prevents exploitation of the poor, especially women who may be compelled to borrow on behalf of their male relatives for consumption purposes. It is meant to ensure that the financing provided is not diverted to expenses it was not sanctioned for.

How can MFIs/FIs improve their performance? Although MFIs/FIs have the option to appoint their clients as agents to purchase the product on their behalf, they need to ensure that the asset being financed is purchased. This is done by MFIs/FIs themselves to firstly make any purchases before they get sold to client at a deferred payment price. They should also ensure that the asset is properly insured, if required, and that it is utilized in the proper manner by the client in order to maximize the benefit.

Differentiation Factor 2:

Economic empowerment institutions are not allowed to finance any activity that is prohibited under Sharia. This includes supporting any activity that can cause harm to society.

Why is it better? This is to ensure that loans are not provided for any activity that may be harmful to society, such as financing the purchase of cigarettes for end consumers or, conversely, financing a cigarette factory.

How can FIs improve their performance? Always ensure that the activities financed are not harmful to society in any way. There should be a list of prohibited activities that officers are made aware of. In addition, FIs should not support the financing of any assets that may be used to promote a prohibited activity. For example, financing machinery that appears to be Sharia-compliant in itself, if it is expected to be used in a cigarette factory.

Differentiation Factor 3:

Economic empowerment institutions should not profit in any way in excess of the contractually agreed profit margin or profit share. Conventional financial institutions earn additional income through charging compounding interest and penalties.

Why is it better? This ensures transparency on what the MFI/FI is expected to earn from the client. It eliminates the incentive for the MFI/FI to earn additional income at the expense of a client who is in difficulty. It also prevents over-indebtedness, as the client would only be liable to repay the maximum sale price in the case of Murabaha. Any penalties charged to prevent negligent debtors would mandatorily be channelled to charitable purposes.

How can MFIs/FIs improve their performance? MFIs/FIs should ensure a low Portfolio at Risk by keeping track of the profitability of their clients and providing any assistance as required. The risk of non-payment or delay in payment would result in losses for the MFI/FI. Every financing operation should have an expected profit for the client at the approval stage. Estimated actual profits earned by the client should be recorded to establish whether the expected profit was achieved by the client.

Differentiation Factor 4:

In conducting trade and investment, Economic Empowerment institutions deal with their clients as business partners, unlike conventional MFIs/FIs that provide arm's length loans to their debtor clients.

Why is it better? By providing interest-based financing, MFIs/FIs are only advancing cash at an expense to their client (i.e. their client pays rent for the advanced cash). In contrast, Economic Empowerment institutions can add value to their clients by negotiating with various stakeholders, innovating through technology and finding solutions to challenges faced by their clients, etc.

How can Islamic MFIs improve their performance? In most cases, the first value proposition an MFI/FI can provide is to conduct negotiations with input providers to purchase seeds and fertilizers on behalf of their clients at a lower price, and to conduct negotiations with output providers to purchase their client's produce at a higher price. The MFI/FI can enhance quality, improve packaging, provide branding and suggest and introduce new products. MFIs/FIs applying the EE model should view themselves as business entities that have a mission to conduct business transaction; not just provide credit. Hence, they are free to enter any business that would add value, subject to risk assessment, and not enhance only their own profits, but also benefit their clients.

While the above are clear departure points from conventional FIs, how do we determine whether a MFI/FI is successful? How do we know whether it is performing well? On what basis or factors can we measure and monitor its performance?

Every MFI/FI has its strengths and weaknesses. After conducting an external analysis, the institution should conduct an internal analysis and establish an understanding of its current performance. This performance analysis will be part of its assessment and strategy that is developed to improve its performance.

Determining baseline performance

Performance monitoring is the most important factor of any business. Economic empowerment institutions measure their performance in three key dimensions, namely (a) financial performance; (b) social performance; and (c) Economic Empowerment impact performance. A summary of the performance analysis can be found below. For more details, please refer to the Monitoring and Evaluation Toolkit. Financial performance measures how profitable and efficient a MFI/FI is. The analysis of these indicators will also determine how sustainable and well managed it is. Social performance measures the MFI/FI's effectiveness in achieving its stated social goals and creating value for clients. It also ensures that the MFI/FI does not conduct any practices that may be harmful to its clients. Lastly, Economic Empowerment impact performance measures the FI's journey from being Sharia-compliant to a Sharia-performing Economic Empowerment institution. It quantitatively and qualitatively measures the added value and impact of an FI's intervention for its client.

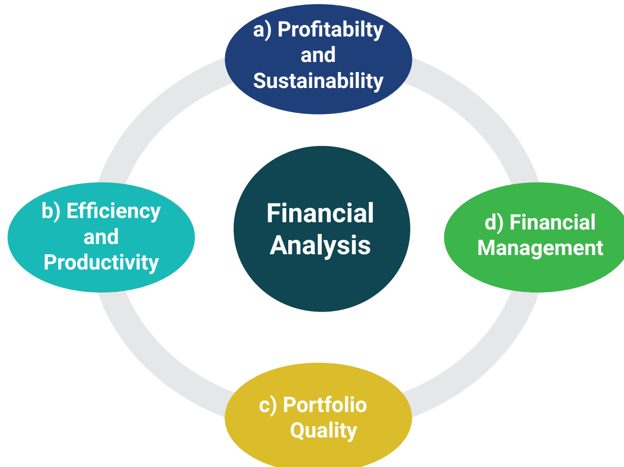
The indicators can be easily measured if they are captured in the core banking system or a management information system (MIS), which is tailor-made for microfinance business segment. The MFI/FI can easily monitor its performance over regular intervals to determine whether key performance milestones were met. MFI/FIs can measure their performance against the baseline and expected performance, as well as benchmark their performance against other MFIs/FIs to better understand how competitive they are in the sector.

Financial performance

The financial performance of the MFI/FI measures its financial viability, efficiency, sustainability and portfolio quality analyses. Those analyses should be based on the MFI/FI's balance sheet and income statements, and the interrelations among its accounts, including assets, liabilities and equity.

The baseline evaluation highlights several key ratios to understand the behaviour with complex mathematical and statistical modelling, measurement and research. The indicators are grouped into four categories, as depicted in Figure 2.6 below.

Figure 2.6 Financial Analysis



a. Profitability and sustainability indicators: They are the most comprehensive ratios to reflect the ability of the MFI/FI to continue operating in the future. It makes no difference whether the FI is non-profit or for-profit, since all FIs are striving for sustainability, and investors and donors seek institutions with potential for sustainability. There are five basic profitability/ sustainability ratios:

i. Return on Assets

ii. Return on Equity

iii. Operational Self-Sufficiency

iv. Financial Self-Sufficiency

v. Profit Margin

b. Efficiency and productivity indicators: This group of indicators obviously affects the bottom line directly, and is important to look at closely, because the most important factor that influences these ratios can be controlled very directly by management – that is, how much money is spent on what. Here, staff costs and productivity play a major role. In a competitive environment, efficiency and productivity are the most important means to gain a competitive edge. Decisions about credit methodology, credit terms (loan size, maturities etc.) and markets in which to operate also affect efficiency and productivity. The five efficiency and productivity indicators considered here are as follows:

i. Operating Expense Ratio

ii. Cost per Borrower

iii. Loan Officer Productivity

iv. Staff Productivity Ratios

c. Portfolio quality indicators: The loan portfolio is the engine that drives a MFI/FI. Quality, price and availability of resources are important in running a successful MFI/FI. Because a MFI/FI receives its revenue over time, not at the time of "sale" (loan disbursement), it will definitely continue to worry about quality long after the "sale" of the loan is complete. High quality also means low delinquency. Because MFIs/FIs have very different policies regarding how they report and manage delinquency, it is important to ensure that the same definitions are used when comparing ratios between institutions. Some of the indicators to review the quality of the portfolio include the following:

i. Portfolio at Risk more than 30 days

ii. Unrealized Portfolio Revenue

iii. Restructured Portfolio

iv. Write-off Ratio

d. Financial management indicators: Financial Management ratios are also sometimes referred to as Asset/Liability Management Ratios. The basis of financial intermediation is the ability to manage assets (the use of funds) and liabilities (the source of funds). Asset/liability management is required on the following levels:

- Rate of return of financing: The MFI/FI must make sure that the use of funds generates more revenue than the cost of funds.
- Asset management: Funds should be used to create assets that produce the most revenue (i.e. the most "productive").
- Leverage: The MFI/FI seeks to utilize funds to increase assets and thereby increase revenue and net profit. At the same time, the MFI/FI must manage the cost and use of its borrowings so that it generates more revenue than it pays in interest

and fee expenses on those borrowings. It must also be wary of borrowing more than it can repay at times of trouble.

- Liquidity management: The MFI/FI must also make sure that it has sufficient ("liquid") funds available to meet any short-term obligations.

The key indicators that need to be measured include:

i. Debt/Equity Ratio

ii. Cost of Funds Ratio

iii. Financial Expenses Ratio

iv. Liquidity Ratio

v. Portfolio yield

Social performance analysis

An Economic Empowerment institution's social performance refers to its effectiveness in achieving its stated social goals and creating value for clients. There are two key dimensions for implementing responsible finance: client protection and social performance management. Client protection is the effort to provide fair and safe services for clients. Social Performance Management (SPM) includes client protection but is also explicitly concerned with how to generate benefits for poor clients. Client protection is the responsibility of all providers, while SPM is essential for all double bottom-line institutions—those with both financial and social goals. The detailed indicators can be found in the Monitoring and Evaluation Manual.

Six universal standards of SPM

Standard 1: Define and monitor social goals

Standard 2: Ensure board, management and employee commitment to social goals

Standard 3: Design products, services and delivery channels that meet client's needs and preferences

Standard 4: Treat clients responsibly

Standard 5: Treat employees responsibly

Standard 6: Balance financial and social performance

Seven client protection principles

Principle 1: Appropriate product design and delivery

Providers will take adequate care to design products and delivery channels in such a way that they do not cause clients harm. Products and delivery channels will be designed with client characteristics taken into account.

Principle 2: Prevention of over-indebtedness

Providers will take adequate care in all phases of their credit process to determine that clients have the capacity to repay without becoming over-indebted. In addition, providers will implement and monitor internal systems that support prevention of over-indebtedness and will foster efforts to improve market level credit risk management (such as credit information sharing).

Principle 3: Transparency

Providers will communicate clear, sufficient and timely information in a manner and language clients can understand so that clients can make informed decisions. The need for transparent information on pricing, terms and conditions of products is highlighted.

Principle 4: Responsible pricing

Pricing, terms and conditions will be set in a way that is affordable to clients while allowing for financial institutions to be sustainable. Providers will strive to provide positive real returns on deposits.

Principle 5: Fair and respectful treatment of clients

Financial service providers and their agents will treat their clients fairly and respectfully. They will not discriminate. Providers will ensure adequate safeguards to detect and correct corruption, as well as aggressive or abusive treatment by their employees and agents, particularly during the loan sales and debt collection processes.

Principle 6: Privacy of client data

The privacy of individual client data will be respected in accordance with the laws and regulations of individual jurisdictions. Such data will only be used for the purposes specified at the time the information

is collected or as permitted by law, unless otherwise agreed with the client.

Principle 7: Mechanisms for complaint resolution

Providers will have in place timely and responsive mechanisms for receiving client complaints and resolving problems and will use these mechanisms both to correct individual actions and to improve their products and services.

Sharia-performing Economic Empowerment institution

Implementing the Economic Empowerment methodology is a journey rather than a destination. The goal of an Economic Empowerment institution as a social business is to support its clients by partnering with them as businesses, actively engaging in the value chain to find win-win solutions for both parties. The first step of a conventional MFI/FI interested in practicing Islamic finance is to be Sharia-compliant. Once compliant, it can improve its knowledge of the market and conduct more business with its clients and be a Sharia-performing Economic Empowerment institution that creates positive impact for its clients.

Qualitative and quantitative indicators have been devised for each financial instrument/product that is developed. For illustration purposes, the indicators for Murabaha are shown below. Further descriptive details and indicators for other products (i.e. Salam, Ijara, Qard Hasan, Mudaraba, Musharaka, Diminishing Musharakah) can be found in the Monitoring and Evaluation Toolkit.

Figure 2.7 Journey from a Conventional to Economic Empowerment Institution

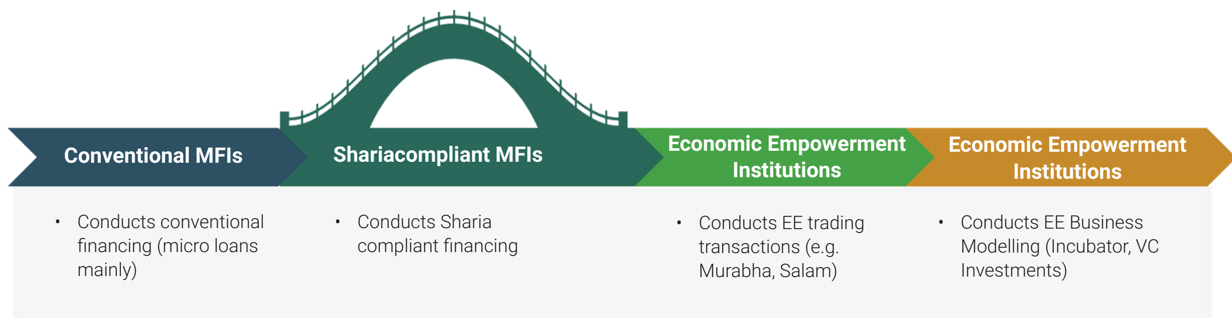


Table 2.4 Murabaha Qualitative Indicators

Indicator	Non-financial value to address business risks provided	Economic empowerment impact points
Pays directly to supplier and takes ownership of the product prior to selling to client (i.e. MFI/FI ensures bona fide supplier and asset).	‣ Mitigates payment receipt risk ‣ Ensures the existence of the seller and asset.	1 point
Conducts quality check on behalf of the client. FI checks that the asset meets the required quality specification.	‣ Ensures the quality of the asset based on the needs of the client ‣ Mitigates non-performance risk of the supplier	1 point
Ascertains that asset purchased by client is transferred by arranging for asset transportation to the client or ensuring that timely delivery is made.	‣ Ensures the asset is safely transferred and is in the possession of the of the client. ‣ Mitigates transportation risks of the client.	1 point

Indicator	Non-financial value to address business risks provided	Economic empowerment impact points
FI analyses contractual data to better understand the value chain and be able to propose alternative suppliers and/or better products and help the clients make better decisions.	▸ Promotes price transparency with clients ▸ Helps clients make informed decisions with available historical data on similar previous transactions	1 point
Sources alternative suppliers or negotiates on behalf of the client. The spot rate of the asset is lower than the spot rate quoted by the client and the overall selling price for Murabaha is lower than the overall costs (including the average market interest rate) if financed by a conventional MFI/FI.	▸ Helps client negotiate with suppliers for lower prices and, hence, save money. For example, client provides invoice for fertilizer amounting to $1,000. FI negotiates for a lower price (e.g. 5% discount - $950). In addition, the selling price for Murabaha (after 30% profit, i.e. $1,235) is lower than the overall costs (after 30% interest, i.e. $1,300) if financed by a conventional MFI/FI.	1 point
Sources alternative suppliers or negotiates on behalf of the client. The spot rate of the asset is lower than the spot rate quoted by the client by at least 10% of the overall selling price for Murabaha and is at least 10% lower than the overall costs (including the average market interest rate) if financed by a conventional MFI/FI.	▸ Helps client negotiate with suppliers for lower prices and, hence, save money. For example, client provides invoice for fertilizer amounting to $1,000. FI negotiates for a lower price (e.g. 15% discount - $850). In addition, the selling price for Murabaha (after 30%*$850 profit, i.e. $1,105) is lower than the overall costs (after 30%*$1,000 interest, i.e. $1,300) if financed by a conventional MFI/FI.	1 point
Sources alternative suppliers or negotiates on behalf of the client. The spot rate of the asset is lower than the spot rate quoted by the client by at least 20% and the overall selling price is at least 20% lower than the overall costs (including the average market interest rate) if financed by a conventional MFI/FI.	▸ Helps client negotiate with suppliers for lower prices and, hence, save money. For example, client provides invoice for fertilizer amounting to $1,000. MFI /FI negotiates for a lower price (e.g. 25% discount - $750). In addition, the selling price for Murabaha (after 30%*$750 profit, i.e. $975) is at least 20% lower than the overall costs (after 30%*$1000 interest, i.e. $1,300) if financed by a conventional MFI/FI.	1 point
Sources alternative suppliers or negotiates on behalf of the client. The spot rate of the asset is lower than the spot rate quoted by the client by at least 30% and the overall selling price is at least 30% lower than the overall costs (including the average market interest rate) if financed by a conventional MFI/FI.	▸ Helps client negotiate with suppliers for lower prices and, hence, save money. For example, client provides invoice for fertilizer amounting to $1,000. MFI/FI negotiates for a lower price (eg 35% discount - $650). In addition, the selling price for Murabaha (after 30%*$650 profit, i.e. $845) is at least 30% lower than the overall costs (after 30%*$1000 interest, i.e. $13,00) if financed by a conventional MFI/FI.	1 point
Total possible economic empowerment impact points for Murabaha		8 points

Table 2.5 Murabaha Quantitative Indicators

Type of products/ interventions	Quantitative indicators
Murabaha	Example: client needs $1,000 to buy fertilizer and seeds. FI negotiates with supplier at retailer or wholesaler level, gets 30% discount. Negotiated purchase price $700 (purchase price). Client borrows from FI at 30% profit per annum over 1 year. Pays $910 (selling price) after 12 months ($700 principle, $210 profit). The market interest rate is 30%. The poverty line is set at $2.50 per day.

Impact of choosing Islamic loan compared to conventional loan

Savings or benefit generated from choosing Islamic loan compared to conventional loan
= Cost of conventional loan (principle + interest)- Murabaha selling price
= $1,300-$910
= $ 390

Percentage of savings or benefit generated from choosing Islamic loan compared to conventional loan
= (Cost of conventional loan (principle + interest) - Murabaha selling price)/cost of conventional loan (principle + interest)*100%
= ($1,300 - $910)/ $1,300*100%
= 30.00%

Savings or benefit generated from choosing Islamic loan compared to conventional loan contributing to poverty alleviation
= (Cost of conventional loan (principle + interest)- Murabaha selling price)/ financing tenor in number of days) /poverty line (income per day)*100%
= ($1,300 - $910)/365/2.5*100%
= 42.74%

Impact of negotiation with supplier

Savings or benefit generated due to negotiation conducted by MFI/FI
= Initial spot purchase price-negotiated purchase price of MFI/FI
= $1,000-$700
= $300

Percentage of savings or benefit generated due to negotiation conducted by MFI/FI
= (Initial spot purchase price-negotiated purchase price of MFU)/initial spot purchase price*100%
= ($1.000-$700)/$1,000*100%
= $300/$1,000*100%
= 30%

Percentage contribution of savings or benefit generated that is directly contributing to poverty alleviation as a result of direct negotiation
= (Initial spot purchase price–negotiated purchase price of MFI)/ financing tenor in number of days)/ poverty line (income per day)
= ($1,000 - $700)/365/2.50*100%
= $300/ 365/2.50*100%
= 32.88%

Type of products/ interventions	Quantitative indicators
Combined indicator- impact of negotiation by MFI/FI less any additional cost Savings or benefit generated due to negotiation less any additional cost incurred = Benefit of negotiation–cost of negotiation = Initial spot purchase price–negotiated purchase price of MFI/FI–(profit rate of Murabaha*initial spot purchase price–market interest rate*loan principle) = $1,000-$700–(30% (profit rate)*$1,000–30% (interest rate)*$1,000) = $300-0 = $300 Percentage of savings or benefit generated due to negotiation less the possible additional cost incurred = (Benefit of negotiation–cost of negotiation)/initial spot purchase price = (Initial spot purchase price–negotiated purchase price of MFI–(profit rate of Murabaha*initial spot purchase price–market interest rate*loan principle))/initial spot purchase price = ($1,000-$700–(30% (profit rate)*$1,000–30% (interest rate))/$1,000*100% = ($300-0)/$1,000*100% = 30% Percentage of savings or benefit generated due to negotiation less the possible additional cost incurred that is directly contributing to poverty alleviation = (Benefit of negotiation–cost of negotiation)/financing tenor in number of days/poverty line (income per day) = Initial spot purchase price– negotiated purchase price of MFI-(profit rate of Murabaha*initial spot purchase price-market interest rate*loan principle)/financing tenor in number of days/poverty line (income per day) = ($1,000-$700-(30% (profit rate)*$1,000-30% (interest rate))/ 65/2.50*100% = ($300-0)/365/2.50*100% = 32.88%	

4. OBTAINING FEEDBACK FROM CLIENT SURVEYS, FOCUS GROUP DISCUSSIONS AND INTERVIEWS

In addition to the external analysis and internal performance assessment, the strategy should also include management and client surveys to understand the general needs of potential clients. Furthermore, the general needs assessment study might be expanded with other studies, such as management expectations. To deliver a concrete and comprehensive study, the MFI/FI needs to identify the best source in order to select properly from data available for the analysis.

There are several ways to obtain feedback. In many cases, feedback from clients is embedded in the appraisal and monitoring process. Usually there are three methods of obtaining feedback: client surveys, focus group discussions and personal interviews.

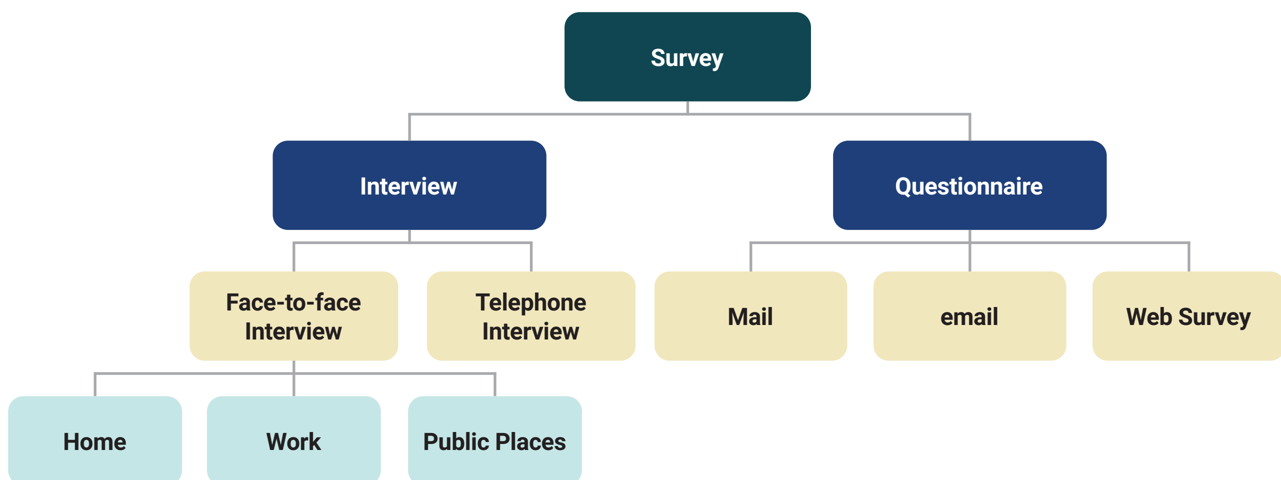
Surveys and questionnaires

A survey is an entire system that includes data collection, data analysis and data interpretation processes. Since data collection starts from a designated population, the source should provide data represented as statistical values. As a result, after the interpretation process the data will be ready for the generating process. Generally, surveys can be divided into two wide-ranging categories: the questionnaire and the interview (Trochim, 2016). Questionnaires commonly use the paper-and-pencil

technique in which a respondent reads the questions and answer in writing. On the other hand, interviews can be conceived as a conversation in which a survey-taker asks questions of one or more persons and prepares his/her survey based on what respondents say. As such, although interviews and questionnaires are made up of sequences of questions in context, the former is a verbal dialogue or discussion on the telephone, whereas the latter usually occurs in writing.

Question generation: The MFI/FI needs to create questions for the survey. There are several approaches to generating questions. However, the MFI/FI must be clear on its methodology[3]. For instance, it has to prepare neutral questions that are not formulated in a way that would favour a particular answer over the others.

Figure 2.8 Survey Types



Before tapping into the financial market, a MFI/FI should conduct surveys to understand the business concept, trends and practices.

Surveys are a great way to gather valuable market research from your target audience and the results can help you gain media coverage to promote your business (Pollard, 2014).

Objectives: The main objectives need to be clear and written in the business plan. Writing objectives will help the MFI/FI shape the survey along with a guideline with the verbalized questions.

Achievement: What the institution wants to accomplish with the results of the survey needs to be stated.

Target audience: MFIs/FIs need to define who will be the respondents of the survey. If they know the target audience, it will help them generate first-rate surveys.

Circulation: Survey-takers can meet the respondents one by one or the MFI/FI might distribute the survey to the possible respondents online or via email.

Multiple choices: For more efficiency and responsiveness, answer options can be generated and shown under the questions. As such, respondents could quickly complete the survey. For example, the MFI/FI might ask them to choose one answer from a list of multiple-choice answers.

Demonstration and due diligence: Prior to actually conducting the survey, the MFI/FI should complete its internal due diligence and test the survey to identify potential errors.

Evaluating results: After collecting the answered surveys, the MFI/FI needs to record them properly.

Result presentation: Presentations could be in different formats, such as formal/informal/graph reports and/or infographic.

Result dissemination: This is the final and most

3 Using dynamic questions in the survey might reduce the intellectual hardship on the respondents. Such hardship could require intensive thinking or effort of the respondent, thus decreasing data quality and accuracy.

important part of the survey process, as it connects the FI with its target audience. There is a variety of options for result dissemination, such as press releases, commercial advertorials or in an email to the selected potential clients. Of course, the results should also be disseminated internally for the management and team to develop the strategy.

Interviews

A personal interview survey is generally conducted face-to-face. This method needs to utilize a specific target population for a better result. In the personal interview, the interviewer works directly with the respondent and has the opportunity to inquire or ask follow-up questions.

Interviews are mostly easier for respondents who have a clear opinion or impression. Given that time management is crucial in interviews, it is also very important to have well-trained interviewers who know how to respond to any important incident.

Apart from face-to-face interviews, telephone interviews enable a researcher to gather information rapidly. Due to financial constraints, most interviews in the market have been conducted via telephone. As with face-to-face interviews, telephone interviews allow the interviewer to obtain some personal information from the respondent. Based on such specific information, questions would be to the point, and respondents would give permission to the interviewer to ask relevant questions.

Questionnaires

Questionnaires are a less personal form of research methods than interviews. Questionnaires can be sent to potential respondents via mail or email. There could be specific questionnaires that pop up on the potential client's screen while using the web. There are many advantages to this new method. In terms of cost-cutting benefits, this method is relatively inexpensive to operators. Questionnaires could be sent to a wide number of people and respondents could fill out the requested information at their own convenience. The only disadvantage might be the low response rates of mail questionnaires.

Another possible type is group-administered questionnaires. In this case, a number of respondents are brought together and asked to respond to a structured sequence of questions. The interviewer could conduct the questionnaire with those who are willing to respond with the assurance that there could be a higher response rate. On the other hand, if the respondents are not certain of details and/or how to answer the questions, they could ask for more explanation.

In both group interviews and focus groups, the interviewers facilitate the sessions. People work as a group, listening to each other's comments and answering the questions. One person would take notes for the entire group; they do not complete an interview individually. In some cases, the respondent is asked to mail the outcome, or the interviewer could return to pick it up. This approach attempts to blend the advantages of mail surveys and group-administered questionnaires.

As shown in Table 2.6 below, both interviews and questionnaires have their own advantages and disadvantages. The selected mode is usually based on the type of analysis of findings needed and the resources available (Statistical Computation Lab, 2010).

Focus group discussion

Focus groups are very important when it comes to disclose any piece of real information. However, this requires a cooperative environment that puts participants at ease to respond to all the questions in their own words and add some meaning to their answers[4].

Generally, surveys are the basic tool for gathering data on people's characteristics. However, for better understanding and in-depth analysis, focus groups come into place. A focus group discussion has its own way to gather people from similar backgrounds or experiences to discuss a specific topic of interest[5]

4 Guidelines for Conducting a Focus Group: How to Conduct a Focus Group - Duke University, 2005

5 Overseas Development Institute: https://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/7074.pdf

Table 2.6 Strengths and Weaknesses of Survey Techniques

Type of Survey	Strengths	Weaknesses
Face-to-face interview	Explain questions; explore issues; make observations; use visual aids	Expensive, requires interviewer training
- At home or work	Accuracy, better sampling	Expensive
- In public places	Less costly, more people in less time	Less representative sample
Telephone survey	Accurate, inexpensive	No personal observations
Written questionnaire	Least cost per respondent	Bias due to low response rate
- By mail	Allows anonymity	Slow
- By email	Less costly, quicker results	Less representative sample
- Web survey	Quicker data processing	Requires computing expertise

. A moderator or group-facilitator guides the group of participants. Discussion topics are defined and group members participate in discussions in a lively manner.

Focus group formation

- A focus group is a small group of six to ten people led through an open discussion by a skilled moderator. The group needs to be large enough to generate rich discussion but not so large that some participants might be left out.
- The focus group moderator encourages disclosure in an open and spontaneous format. The moderator's goal is to generate a maximum number of different ideas and opinions from as many different people in the time allocated.
- The ideal amount of time to set aside for a focus group is anywhere from 45 to 90 minutes. Beyond that, most groups are not productive, and it becomes an imposition on participant time.
- Focus groups are structured around a set of carefully predetermined questions – usually no more than 10 – but the discussion is free-flowing. Ideally, participant comments will stimulate and influence the thinking and sharing of others. Some people even find themselves changing their thoughts and opinions during the group.
- A homogeneous group of strangers comprises the focus group. Homogeneity levels the playing field and reduces inhibitions among people who will probably never see each other again.

Content of the feedback questions

Now that we have decided how to obtain feedback, we need to determine what the content of the feedback questions will be. The feedback can answer many questions that can be categorized as follows:

a. What are the client's financial needs?

b. What are the clients non-financial needs to ensure that the investment will make a return?

c. Is the client satisfied with the products and services of the MFI/FI?

d. What is the client's understanding of, and expectation from, Sharia-compliant products and services?

e. Questions around the financial sector's trends and activities, competitors, etc.

f. Client demographic details

As mentioned above, developing a feedback tool should take into consideration the main objective of doing so. In general, there are three type of research that can be conducted, depending on the objective and scope of the research: exploratory research, descriptive research and causal research.

Exploratory research is research conducted for a problem that has not been studied more clearly, intended to establish priorities, develop operational

definitions and improve the final research design. Exploratory research helps determine the best research design, data-collection method and selection of subjects. For example, a MFI/FI could carry out an exploratory research on the clients' preferences or priorities when it comes to selecting a financial partner.

Descriptive research is used to describe characteristics of a population or phenomenon being studied. It does not answer questions about how/ when/why the characteristics occurred. For example, a MFI/IFI could carry out a descriptive research on the level of satisfaction of its clients. It could also be used to appraise the client's overall perception of Islamic finance.

Causal research, also called explanatory research, is the investigation of cause-and-effect relationships. To determine causality, it is important to observe variation in the variable assumed to cause the change in the other variable(s) and then measure the changes in the latter. For example, a MFI/IFI may want to carry out a research on client acceptance of changes that are planned to be introduced for Sharia-compliance.

a. What are the client's financial needs?

Questions that may be asked include the following:

- Have you taken a loan from a microfinance/ financial institution?
- Are you currently availing financing from any financial institution?
- What did you use the loan for?
- Besides loans, what are financial products do you use?

◊ Savings ◊ Insurance ◊ Payments

- What type of financing do you need?

◊ Purchase Assets ◊ Purchase inventory ◊ Working collateral

- What is the financing quantum that you need?
  - Less than $100
  - More than $100 and less than $500
  - More than $500 and less than $1000
  - More than $500 and less than $5,000
  - More than $5,000 and less than $10,000
- What tenor do you need?
  - Less than 3 months
  - More than 3 months and less than 6 months
  - More than 6 months and less than 12 months
  - More than 12 months and less than 18 months
  - More than 18 months and less than 24 months
  - More than 24 months
- Why are you not obtaining bank facilities?
  - Lack of collaterals
  - Uncertain business outlook
  - Poor financial performance
  - Lack of track record
- What is your main source(s) of income? (select a maximum of three
  - Agriculture business
  - Transportation business
  - Trading business
  - Services business
  - Other businesses
  - Salary from odd jobs
  - Salary from fixed job
  - Remittances

b. What are the client's non-financial needs to ensure that the investment will make a return?

Questions that may be asked include the following:

- Do you have a good relationship with your input supplier?
- Do you think you can get a better price from your input supplier?
- What are the skills qualifying you to work in the sector you are in?
- What skills do you need to earn a better income in the sector you are in?
- What information do you need to help you earn a better income?
- Do you have a good relationship with your buyer(s)?
- Do you think you can get a better price from your buyer(s)?

- What is the cost of producing your product/ providing your service?
- What is the profit margin? (profit/ price sold to buyer)
- What is the end-user market price of your product?
- What proportion of the price do you earn? (price sold to buyer/ price of product paid by end consumer in market)
- What do you need to develop more quality and value-added products?
- What do you need to expand the production quantity of your products?

c. Is the client satisfied with the products and services of the MFI/FI?

Questions that may be asked include the following:

- Are you satisfied with the financing product? (specify product:_________)
  - What is the aspect that you like the most?
  - What is aspect that can be improved?
- Are you satisfied with the savings product? (specify product:_________)
  - What is the aspect that you like the most?
  - What is aspect that can be improved?
- Are you satisfied with the insurance product? (specify product:_________)
  - What is the aspect that you like the most?
  - What is aspect that can be improved?
- Are you satisfied with our customer service?
  - What are do you like most about our service?
  - What can we improve about our service?
- Have the FI helped improve your income?
  - Please specify how the FI has helped you earn a better income.
  - Please specify what the FI can do to help you better your business
- What mode of payment will be suitable for you? (monthly, lump-sum, bi-monthly, weekly, quarterly, other……)
- Do you think Takaful/insurance is important to cover repayment of your financing/loan in case of mishaps to you or to members of your household?
- Would you recommend us to your family and friends?

d. What is the client's understanding and expectation from Sharia-compliant products and services?

Questions that may be asked include the following:

- Do you need access to financing products?
- Have you taken up any financing products?
- Are Sharia-compliant products and services important to you?
- If you have taken financial products, what are the challenges you face in getting the financing?
- In your opinion, are Sharia-compliant products and services better than conventional products? Please explain.
- What is your reason for choosing Sharia-compliant products over other conventional financing products?
- What is your level of knowledge in Islamic finance (poor, fair, good, very good)?
- Are you able to explain to someone what the difference in a Sharia-compliant product is?

e. Financial sector/competitor trends, activities

Questions that may be asked include the following:

- Have you taken any loans from other financial institutions?
- What aspects do you think we are better at compared to other financial institutions?
- What aspects do you believe we can improve in comparison with other financial institutions?
- Do our financial product offerings meet your needs? What other financial products do you think we should consider introducing?
- What aspects of our financial products can be improved to better meet your needs?
- Is the profit rate comparable with the interest rates charged by conventional financial institutions?
- Do you get better value by doing business with our financial institution?

f. Client demographic details

Demographic information may include:

- Education
- Age
- Occupation
- Number of dependents
- Monthly income and expenses
- Gender

Designing effective questions

When drafting the questionnaire, one should take into consideration not only the objective of the questionnaire, but also the dynamics of how the questions will be asked; whether it will be in a focus group setting, individual interviews or through written questionnaire. While there are many questions that can be asked, it is important to prioritize and to ask only the most important ones to ensure that the respondent is not overwhelmed to the extent of responding indifferently.

Focus Group

- The number of questions for any group should be 12 at most. Ten is better, and eight is ideal.
- Focus group participants will not have a chance to see the questions they are being asked. So, to make sure they understand and can fully respond to the questions posed. The questions should be
  - Short and to the point
  - Focused on one dimension each
  - Unambiguously worded
  - Open-ended or sentence completion types
  - Non-threatening or embarrassing
  - Worded in a way that they cannot be answered with a simple “yes” or “no” answer (use “why” and “how” instead).

Figure 2.9 The 3 types of focus group questions:

Engagement Questions	Exploration Questions	Exit Question
Making participants comfortable with the topic of discussion	Get to the meat of the discussion	Check to see if anything was missed in the discussion

Example: Questions to a focus group for a needs assessment survey

We are a team from the …… Firm and we have been contracted by …… and its local partners to conduct a survey on your preferences and needs in terms of financial products in your area and tailored to your specific business need. Would you be willing to spare us some time to help us understand the possible issues? Any information you give us will be kept strictly confidential and your identity will not be used in any of the consequent reports.

Do we have your consent?

Yes ( ) Continue with Interview

No ( ) Terminate and move to next group

Table 2.7 List of Members that have Consented to the Focus Group Survey

No.	Name of member	Yes	Remarks
1			
2			
3			

Written survey questionnaire

- Keep your survey simple. Use simple and direct language. It should be easy to understand, and it should prompt a quick answer from the client.
- Clients should be able to complete the survey within 15 mins. When a survey is too long, respondents may drop out, stop paying attention or start getting angry and frustrated. Their reaction to conducting the survey will be reflected in their responses.
- Use scale rather than a basic yes or no question. This will allow you to analyse the intensity of the opinions that have been received.
- Avoid leading questions. Questions should be phrased in a non-biased manner.
- Explain why respondents should help. Clients are more likely to take the survey if they see something of positive value for them. Make it specific to them. Explain the objectives of the survey and how the question asked is relevant.
- Justify requests for sensitive information. Explain

clearly the need for information that clients perceive to be sensitive.

- Save sensitive or complex questions for the end.
- Put your questions in a logical order to prevent misunderstanding.
- Use interesting or engaging types of questions. Use sliders and scales as well as pictures
- Pre-test the survey and administer it with a few potential respondents (or your friends) to get feedback. Ask people to think out loud as they are answering the survey questions. Probe them: "What does that mean to you?"

Interviews

- Make your interviewee comfortable – dress in a manner similar to them (you in a suit them in a tracksuit is going to make it feel like a job interview rather than a user test). Make sure they understand you are testing a product or an idea and not the user themselves. Offer them a drink. Conduct a little small talk (but only a little) before you start, etc.
- Try to keep the interview on time and heading in the right direction – the reason scripts are useful because you can reference them for this.
- Try to focus on the interviewee and not on note making – it's just plain rude to bury your head in your notes. Maintain eye contact, keep a conversation flowing and record the interview rather than getting lost in note making.
- Thank the interviewee at the end of the process – not only this is polite, but you can offer a chance for the interviewee to ask any question of their own at this point too.
- Include qualitative data besides quantitative data - User interviews tend to provide qualitative rather than quantitative data. Compiling the results of many interviews can be challenging.
- Make sure you begin by explaining the purpose of the interview – what are you trying to achieve?
- Also explain how the person's data and any data you collect from the interview will be used.
- Try to keep leading questions to a minimum
- Keep it reasonably short. If you read the script aloud and it takes more than 10 minutes to read, it's probably too long. Interviews should, ideally, be less than an hour long, and the majority of the time spent should be the interviewee talking and the researcher listening.
- Don't forget that scripts are a guide. If you find something interesting taking place during an interview and there are no questions on the script to explore that idea, explore it anyway. Feel free to amend the script for future uses.
- When scheduling your interviews, it's a good idea to leave 30 minutes or so between each interview, as this gives the interviewer some time to make additional notes and compile their thoughts while everything is still fresh in their mind.

5. GAP ANALYSIS REPORT

A gap analysis is a method of analysing any differences between actual and desired performance. Gap analysis involves determining, documenting and improving the difference between business requirements and current capabilities. Gap analysis naturally flows from benchmarking and from other assessments. Once the general expectation of performance in an industry is understood, it is possible to compare that expectation with the FI's current level of performance. This comparison becomes the gap analysis. Such analysis can be performed at the strategic or at the operational level of an organization. The analysis aims to compile all the findings found under the previous sections of this chapter, including PESTLE analysis, SWOT analysis, performance Analysis and feedback Analysis. An example of how such an analysis can be done is shown in the Table 2.8 below:

6. BUSINESS STRATEGY ACTION PLAN

The gap analysis shows us what needs to be done in order to improve the strengths, address the weaknesses, capitalize on available opportunities or prevent any harmful threats that may be faced by the MFI/FI. Once the solution is determined, it can be considered a mini-project or activity that can be broken down into many tasks. This is where the action plan is developed, with each identified task assigned to a

Table 2.8 Example of a Gap Analysis

Type of analysis	Gap finding (assessment of current situation compared to ideal situation)	Proposed activity/project to be undertaken	Target achievement in proposed time
PESTLE-Technology	Mobile transfer solution available in the country is not utilized by the FI	To work with digital platform provider to provide a payment service	Launch digital payment service in 12 months
SWOT	The profit rates charged are high due to high cost of funds	Mobilize more savings from customers through awareness and promotions	Savings to make up at least 60% of the funding structure from the current 40%.
Financial Performance	PAR90 is high compared to industry standard	Review appraisal process	Evaluate reasons for PAR with recommendations submitted to management in 2 months
Financial performance	OSS ratio is too close to 100%. Needs to be increased to 150%	Workload assessment to be conducted to enhance efficiency	Workload assessment study with recommendations submitted to management in 2 months
Social performance	Staff manual does not include policy on over-indebtedness and discrimination	Update staff manual	Updated manual with new policies approved by management in 2 months
Staff performance	Lack of mechanism for compliance handling and resolution	Propose and set up a system	System approved by management and deployed in 6 months
Economic empowerment impact performance	Murabaha product qualitative indicator received one point. It could be higher	Take steps to ensure FI is able to negotiate Murabaha purchase to obtain a higher point rating	Attain 4 points in 12 months.
Economic empowerment impact performance	Savings generated from Islamic loans compared to conventional loans is zero.	Reduce cost of funds and negotiate for better prices to ensure that client savings is on average 10% of financing size	Achieve 10% savings for clients on average in 12 months
Feedback from clients	Non-acceptance of mobile collaterals unlike other FIs	Explore how mobile collaterals can be used	Propose to management recommendations in 3 months
Feedback from clients	Lack of appropriate Sharia-compliant products for agriculture clients	Develop a new product that meets the needs of agricultural clients	Launch product in 9 months.

Table 2.9 Example of an Action Plan

Key Findings	Recommended Actions			
	Status of follow-up actions	By when	By whom	Required resources/ budget
Lack of information about agriculture clients	Conduct surveys and interviews with existing clients to find out their acceptance of Islamic microfinance	Date	Operations and Marketing department	X full time equivalent days, $xxx budget
No key industry focus for agricultural sector	Write a report to select and justify focus value chain sector	Date	Operations and Marketing Department	X full time equivalent days, $xxx budget
Lack of understanding on selected value chain	Conduct a study on selected value chain and identify business opportunities	Date	Operations and Marketing Department	X full time equivalent days, $xxx budget
Lack of clear direction	Develop a mission/vision document and circulate among staff	Date	Human Resources Department	X full time equivalent days, $xxx budget
Lack of understanding of roles/ responsibilities when interacting with farmers	Update staff manual	Date	Human Resources Department	X full time equivalent days, $xxx budget
Lack of understanding how to introduce a new Islamic financial product	Develop a business plan to introduce a new product (refer to Chapter 4 of Operations Toolkit)	Date	Operations and Marketing Department	X full time equivalent days, $xxx budget
Legal contracts are not Sharia-compliant	Use templates from IsDB Operations Toolkit. Operations Department to submit to Legal and management for approval.	Date	Operations and Legal Departments	X full time equivalent days, $xxx budget
Conduct pilot of first product	Select sectors, clients and staff to introduce and monitor the implementation of the first product (probably Murabaha or Salam)	Date	Operations and Marketing Department	X full time equivalent days, $xxx budget
Lack of MIS system to implement Sharia-compliant products	Introduce new Sharia-compatible MIS system and integrate it into the process.	Date	IT Department	X full time equivalent days, $xxx budget

Key Findings	Recommended Actions			
	Status of follow-up actions	By when	By whom	Required resources/ budget
Conduct study on first product	Derive lessons learnt and improve the product	Date	Operations and Marketing Department	X full time equivalent days, $xxx budget
Replicate pilot to other areas	Expand outreach of the product	Date	Operations and Marketing Department	X full time equivalent days, $xxx budget

responsible entity within the institution, with specific timelines to be achieved. A detailed action plan should be developed for each proposed solution identified in the gap analysis. For illustration purposes, we have taken the activity proposed in the last row of the table above (Develop a new product that meets the needs of agricultural clients) and broken it down to several tasks in the action plan below:

The action plan should be supplemented with a timeline that would clearly show the activities that need be done during the period. This would make it easier for management to monitor and track activities that are delayed, as some activities would be dependent on others. Tackling delayed activities will help ensure that the project is carried out in a timely manner. An indicative timeline is shown in the Appendix.

Once there is a commitment to implement the Economic Empowerment methodology, the management needs to develop a new strategy, analyse the market conditions and adopt the internal procedures to operate in a Sharia-compliant manner so that it will benefit the clients. Once this is part of the strategy and communicated to all staff, the MFI/FI can develop a suitable business model that would fit its strategy. This business model is described in Chapter 3 (Value Chain Analysis) and Chapter 4 (New Product Development).

Appendix – Sample of an Indicative Timeline (1-Year Project)

The report is to include an implementation report with the following deliverables and expected timeframe. Monitoring should be regular to ensure that the activities are undertaken in a timely manner.

Time (Months/ Weeks)	Month 1				Month 2				Month 3				Month 4				Month 5				Month 6				Month 7				Month 8				Month 9				Month 10				Month 11				Month 12			
	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4
Activity 1			6																																													
Activity 2								8																																								
Activity 3														8																																		
Activity 4																		8																														
Activity 5																						4																										
Activity 6																														12																		
Activity 7																																		12														
Activity 8																																			6													
Activity 9																																										4						
Activity 10																																														4		

Value Chain Analysis Tools and Approaches

There are increasing discussions around value chains in many different fields, from various business functions and industries such as sale and marketing, automotive, IT and computer, agriculture etc in developing and developed countries. The latter is our focus, as it is ideally aligned with rural microfinance and economic empowerment. However, the techniques explained below can also be applied in other sectors.

This guide to value chain approaches provides the user with actionable methods and tools to increase agricultural productivity and performance. It is intended for use by FIs with a common framework for prioritizing decisions on sector and subsector competitiveness.

The guide demonstrates how the concept of value chains, which was borrowed from the business management domain, can respond effectively to concerns related to the facilitation by MFIs/FIs of better access to markets for small-scale rural producers, particularly in developing countries.

1. OVERVIEW OF VALUE CHAINS: CONCEPTS AND DEFINITION

Value chains are a key framework for understanding how a product moves from various stages, starting from producer to ultimate customer. The value chain perspective provides an important means to understand the business-to-business relationships, mechanisms for increasing efficiency and ways to enable the business to increase productivity and add value. It provides a reference point for improvements in services and the business environment. Furthermore, it is a vehicle for pro-poor initiatives and for linking small businesses with the market.

Chains composed of companies (or individuals) that interact to supply goods and services are varyingly referred to as production chains, value chains, marketing chains, supply chains or distribution chains. These concepts vary mainly in their focus, in the activity that is emphasized and in the way in which they have been applied. However, they all describe the interactions of firms and processes that are needed to deliver products to end users, and they all aim to identify opportunities for and constraints against increasing productivity. Although it is impossible to make fine distinctions among these often-overlapping concepts, it is still worthwhile to provide some basic definitions.

For example, a value chain is the full range of activities — including design, production, marketing and distribution — businesses go through to bring a product or service from conception to delivery. For companies that produce goods, the value chain starts with the raw materials used to make their products and consists of everything that is added to it before it is sold to consumers.

A value chain is the whole series of activities that create and build value at every step. The total value delivered by the company is the sum of the value built up all throughout the company. Michael Porter developed this concept in his 1980 book 'Competitive Advantage'[1].

In terms of significance, the value chain concept separates useful activities (which allow the company to gain competitive advantage) from the wasteful activities (which hinder the company from getting a lead in the market). Focusing on the value-creating activities could give the company many advantages. For example, the ability to charge higher prices, lower cost of manufacture, better brand image and faster response to threats or opportunities.

The value chain can be described as made of primary activities and support activities. Primary involves inbound logistics (getting the material in for adding

1 https://www.albany.edu/~gs149266/Porter%20(1985)%20-%20chapter%201.pdf

value by processing it), operations (which are all the processes within the manufacturing), outbound (which involves distribution to the points of sale), marketing and sales (which go sell it, brand it and promote it) and service (which maintains the functionality of the product, post sales).

All these concepts underscore the importance of linkages to gain value and advantages to compete in global markets. The term value chain is the one primarily used in this chapter, as it is inclusive and incorporates supply, value addition, transactions and market linkages.

2. UNDERSTANDING VALUE CHAIN MANAGEMENT

The process of organizing all of the value chain activities so they can be properly analysed is called value chain management. The goal of value chain management is to ensure that those in charge of each stage of the value chain are communicating with one another to help make sure the product is getting in the hands of customers as seamlessly and quickly as possible.

Business today is tremendously interwoven and complex. Understanding this complexity is the first major challenge for any entrepreneur. An entrepreneur needs to have a deep understanding of the ecosystem and how the venture will survive in it.

The ecosystem refers to the large, loosely connected web of all stakeholders, including competitors, their partners, suppliers, customers, investors and even regulators particular to each industry. Some ecosystems are hundreds of years old; have complicated cultures, regulations and systems; and have hundreds of billions of dollars invested in them by some very large protozoans[2].

Value chain management encompasses the planning and management of all activities involved in sourcing and procurement, conversion and all logistics management activities. Importantly, it also includes coordination and collaboration with channel partners, which can be suppliers, intermediaries, third party service providers and customers. Supply chain management integrates supply and demand management within and across companies. Logistics management is that part of value chain management that plans, implements and controls the efficient, effective forward and reverse flow and storage of goods, services and related information between the point of origin and the point of consumption in order to meet customers' requirements.

3. ADVANTAGES AND USES OF VALUE CHAIN[3] ANALYSIS

Reduce Delivery Times

Any distribution channel member can benefit from reduced delivery times. A manufacturer can strengthen relationships with wholesalers or retailers by delivering orders more quickly. Resellers benefit because they can more effectively coordinate buying and selling activity. Additionally, end customers benefit from faster and more consistent on-time delivery when trade channel partners move goods efficiently.

Optimize Inventory

Closely related to faster delivery times is the ability to optimize inventory levels. Retailers can work closely with suppliers to reduce delivery times and coordinate the manufacturer's outbound processes with the retailer's inbound logistics. Many retailers use "just-in-time" (JIT) inventory processes as part of value chain management. With JIT, the retailer makes smaller, more frequent orders of goods to reduce inventory levels. Excess inventory is costly to manage and increases the potential for waste. However, the retailer also needs to trust its relationship with vendors to ensure shortages do not occur.

Improve Customer Relationships

By managing the initial value chain factors, including inbound logistics, operations and outbound logistics,

2 https://news.gcase.org/2011/02/14/what-is-the-value-chain-concept/

3 http://smallbusiness.chron.com/benefits-value-chain-management-70083.html

resellers can improve response times and minimize costs for customers. The marketing, sales and service aspects of the value chain are especially important to improving customer relationships. Many resellers use loyalty or rewards programmes to generate customer loyalty and to persuade customers to buy more products over time. Customer service is also important to help follow up on customer experiences to ensure ongoing satisfaction.

Enhance Revenue and Profit

Ultimately, the bottom-line benefits of value chain management are represented with enhanced revenue and profit. With efficient logistics and distribution, you can have products available when customers want them. Your marketing and sales efforts help to attract customers and motivate them to buy goods and relatively high price points. The combination of reduced logistics and distribution costs and optimal price points and revenue contribute to the best possible profit for your small business. Understanding the effects of the value chain and how to optimize results from operations is vital to small business success.

Long-Term Viability

Optimizing the value chain also helps companies differentiate themselves from competitors in terms of product features and benefits and branding. Product development means building solutions that are distinct and better than those offered by the competitors. Branding is use of the marketing and sales component of the value chain to convey an image of quality, high service or other pertinent messages of value to the marketplace. Strong differentiation is important to current sales and long-term viability in a competitive market.

4. WHAT IS AGRICULTURAL VALUE CHAIN?

The concept of 'agricultural value chain' includes the full range of activities and participants involved in moving agricultural products from input suppliers to farmers' fields, and ultimately, to consumers' tables. Each stakeholder or process in the chain has a link to the next for the processes to form a viable chain. At each stage, some additional transformation or enhancement is made to the product – ranging from simply moving the product from point 'a' to point 'b' (a common value addition of traders for example) to complex processing and packaging. Hence, a value chain is often defined as the sequence of value-adding activities, from production to consumption, through processing and commercialization. Each segment of a chain has one or more backward and forward linkages. A chain is only as strong as its weakest link and hence the stronger the links, the more secure the flow of products and services within the chain.[4]

The 'farm to fork' integration of a chain can increase efficiency and value through reduction of wastage, ensuring food safety, preserving freshness, decreasing consumer prices and improving farmer prices and incomes. Efficient value chains normally reduce the use of intermediaries in the chain and strengthen value-added activities because of better technology and inputs, farm gate procurement, upgraded infrastructure (such as cold chains), improved price opportunities through demand-driven production and facilitation of more secure procurement for food processing and exports.

Value chains are increasingly recognized to reduce the rural poverty prevalent in the region. For practitioners who have long been convinced of the need to look differently at agriculture – not just as a means of survival but as smaller or larger commercial businesses linked to domestic and global markets – and of the need to identify and tap into new sources of potential growth and value addition in the sector, this is a welcome development. Optimistically, renewed engagement will lead to a substantial increase in the flow of financial resources and assistance that is dedicated to supporting market sustainable agro-enterprises and agricultural value chains throughout the African continent.

Agricultural value chains encompass the flow of products, knowledge and information between smallholder farmers and consumers. They offer the opportunity to capture added value at each stage of

4 Agricultural Value Chain Finance, Tools and Lessons, Calvin Miller and Linda Jones

the production, marketing and consumption process. Smallholder farmers need to better engage with value chains in order to gain benefit for improving their livelihoods, whilst reducing their risks and increasing their resilience.

As value chains differ considerably across countries and products, MFIs/FIs need to study and identify the optimal configuration enabling smallholder farmers to gain a greater share of their value and assume fewer risks. If agricultural value chains are to offer pro-poor opportunities for growth, then those markets in which smallholders can have a 'comparative advantage' need to be identified and the producers actively assisted. Smallholders with a strong social network can draw upon their social capital to strengthen their position within a value chain. For example, an effective producer organization or cooperative can help smallholder farmers increase their bargaining power by helping them enter into high-value supply chains and provide support for acquiring information on market prices and requirements. This role can also be performed by FIs implementing the Economic Empowerment methodology.

5. AGRICULTURAL VALUE CHAIN ANALYSIS

Interest in value chains is not new. Businesses have been using value chain analysis and implementation principles for years to formulate and implement competitive strategies. Corporations use value chain analysis to answer questions such as, "Where in the value chain should my business be positioned to improve its performance?" The value chain's popularity has been reinforced by many important business strategy themes, including core competencies, comparative and competitive advantage, outsourcing, vertical and horizontal integration and best practices.

MFIs/FIs need to operate as a business. By analysing the client's value chain, they will be able to understand the business risks involved and introduce appropriate mitigation measures. Value chain approaches have been used to streamline processes that generate the goods and services that customers value and to guide product improvement and innovation. Further, there is increased awareness that procedures within a firm might not affect its own competitiveness unless other firms adopt similar or linked practices. This mode of thinking has paved the way for businesses to use collaborative value chain concepts to identify efficiencies and competitiveness both within and among firms, acting on opportunities to build win-win linkages and collaboration. Recent technological developments that permit high levels of information sharing have reinforced businesses' realization of value chain efficiencies, especially in supply management. Value chain analysis relies on the basic economic principle of advantage — companies are best served by operating in sectors where they have a relative productive advantage compared to their competitors. Simultaneously, MFI/FIs should ask themselves where they can deliver the best value to their clients? And in which sectors?

There is no "correct" way to conduct a value chain analysis; rather, the approach taken fundamentally depends on the question that is being asked. However, four aspects of value chain analysis of agriculture are particularly important (Kaplinsky, et al, 2001).

First, at its most basic level, a value chain analysis systematically maps the actors participating in the production, distribution, marketing and sales of a particular product (or products). This mapping assesses the characteristics of actors, profit and cost structures, flows of goods throughout the chain, employment characteristics and the destination and volumes of domestic and foreign sales[5]. Such details can be gathered from a combination of primary survey work, focus groups, participatory rural appraisals (PRAs), informal interviews and secondary data.

Second, value chain analysis can play a key role in identifying the distribution of benefits of actors in the chain. That is, through the analysis of margins and profits within the chain, it is possible to determine who benefits from participation in the chain and which actors could benefit from increased support or organization. This is particularly important in the context of developing countries (and agriculture in particular), given concerns that the poor are vulnerable to the process of globalization. One can supplement

5 Kaplinsky, R. and M. Morris (2001). A Handbook for Value Chain Research. Brighton, United Kingdom, Institute of Development Studies, University of Sussex.

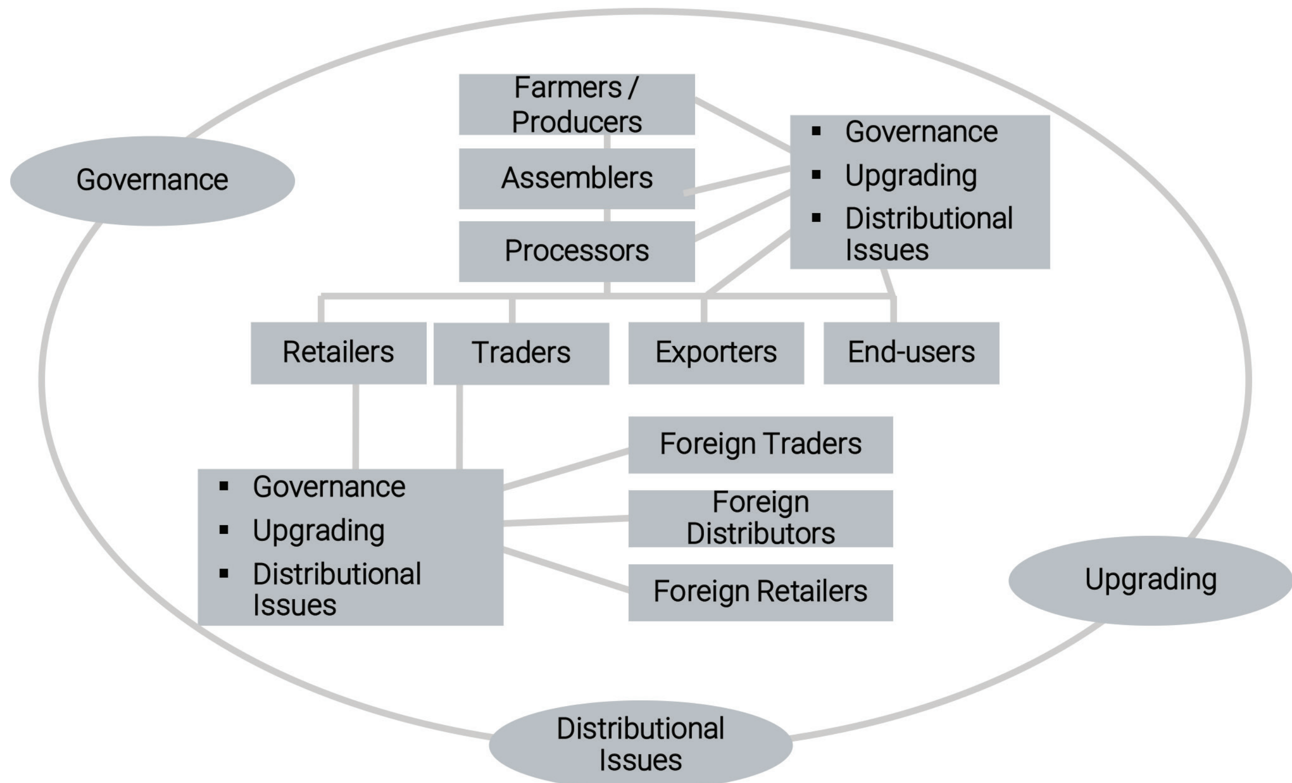
this analysis by determining the nature of participation within the chain to understand the characteristics of its participants.

Third, value chain analysis can be used to examine the role of upgrading within the chain. Upgrading can involve improvements in quality and product design or diversification in the product lines served, allowing producers to gain higher value. An analysis of the upgrading process includes an assessment of the profitability of actors within the value chain as well as information on limitations that are currently present. Governance issues play a key role in defining how such upgrading occurs. In addition, the structure of regulations, entry barriers, trade restrictions and standards can further shape and influence the environment in which upgrading can take place.

Finally, value chain analysis highlights the role of governance in the value chain, which can be internal or external. Governance within a value chain refers to the structure of relationships and coordination mechanisms that exist between actors in the value chain. Governance is a broad concept, which mainly ensures that interactions between chain participants are organized, rather than being simply random. By and large, governance within the chain occurs when some actors in the chain work to criteria set by other actors in the chain, for example quality standards or delivery times and volumes set by processing industries.

There are many ways to analyse or evaluate a value chain. Analysis can stem from research of secondary information, such as government or industry data, to interviews with industry participants. It can also be derived from participatory market assessments

Figure 3.1 A Hypothetical value chain in Agriculture^



^ Rich, K. M. (2004). A Discussion Note on Value-Chain Analysis in Agriculture: Methodology, Application and Opportunities. Ha Noi, Viet Nam, Agrifood Consulting International

and market observations. Once the information is gathered, numerous tools and processes help interpret and inform the resulting analysis. In general, an in-depth value chain analysis considers the following:

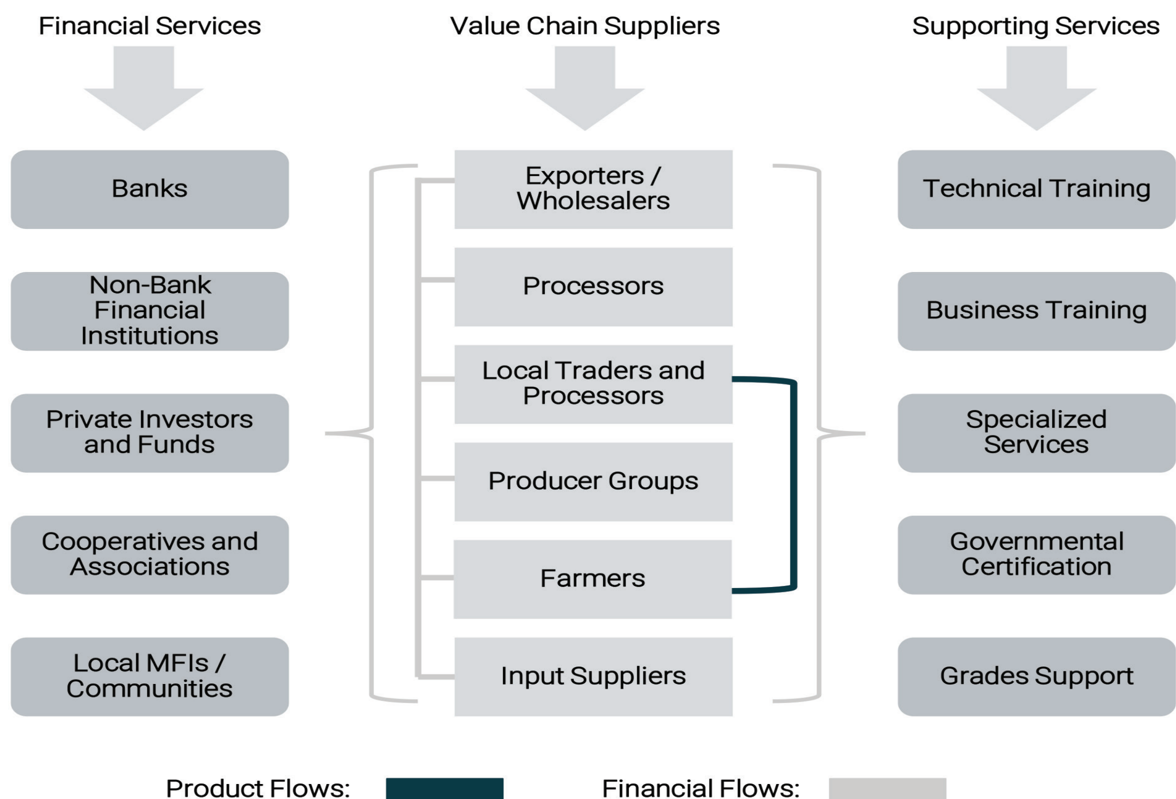
- What are the economic costs along the value chain?
- Where is the most value added to the value chain?
- Who are the most import actors within the value chain?
- What is the institutional framework of the value chain?
- Where are the bottlenecks in the value chain?
- Where is there market potential for growth?
- What is the size of the sector/chain?
- What is the potential for upgrading and what possible synergies exist?

Governments can support the development and coordination of value chains. Investments that incentivize greater productivity and the ability to capture a higher value include transport infrastructure; energy for processing, chilling, drying and packaging commodities; research and extension services in new storage, processing and packaging technologies; and education and training in product marketing. Perhaps the most critical role of governments is establishing systems of laws, regulation and governance, which set rules for fair and competitive markets for farmers, marketing agents and processors, and permit farmers to secure land and property rights. The relationship between financial services, value chain actors and support services can be seen in the diagram below.

6. LIMITATIONS OF VALUE CHAIN ANALYSIS

As mentioned, there are many ways of analysing a value chain. For example, value creation can be disaggregated between each link in the chain, as well as within each link. Some chains are merely a directional map (such as the one in Figure 3.1), which is valuable for beginning to understand the actors

Figure 3.2 Relationship of Financial and Value Chain Suppliers with Support Services#



Understanding Agriculture Value Chain Finance Approach

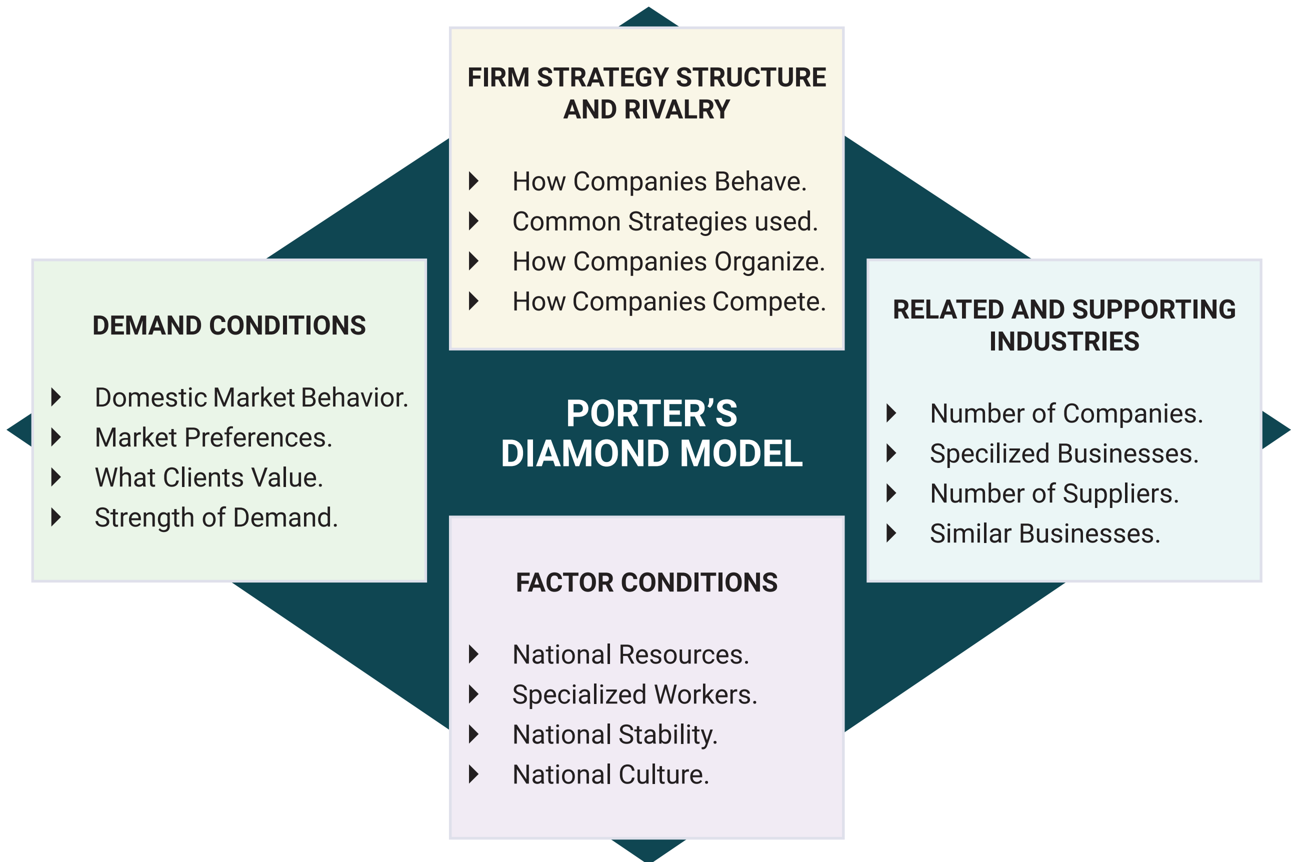
and processes that intervene to create value for consumers. However, agencies and other sponsors that commission value chain analysis often find that the analysis as implemented is insufficient and cannot be used to guide them in making informed decisions—particularly in deciding on actions that will greatly impact value added, rather than merely reducing costs.

It is important to be aware of and understand the limitations of value chain analysis. Indeed, many of these analyses have a common weakness: the tendency to focus excessively on cost efficiency or breakouts of cost components. While efficiency in production is increasingly becoming a necessary condition for penetrating global markets, it will not ultimately determine sustained participation and increased incomes for value chain participants. The following are examples of some related analytical weaknesses and challenges:

- **Value chains are not fixed or static:** It is important to recognize that value chains are not fixed in terms of composition, relationships or market positioning, and that there is a competitive need to alter and improve the value chain in light of strategic choices that businesses can make regarding the markets in which they compete. While a value chain's purpose is to link production to the target market advantageously, it is the private sector that decides which markets and where to compete – and alters the value chain accordingly. Value chain analysis too often focuses simply on improvements within the given value chain, rather than on how value chains can be shifted to target different, more attractive markets and business strategies.
- **Market dynamics matter**: Value chains can be helpful instruments for serving the needs of a market sector but focusing on a static value chain can also mask the need to segment and customize products for different markets. The key elements of building sustainable competitiveness are a solid understanding of market dynamics and a thorough analysis of the attractiveness of potential market segments and the competition. Businesses must choose which products and which markets can be served competitively and base their goals and strategy on good market analysis.
- **Quality and service are also important:** Similarly, excessive focus on delivering a product (especially a commodity) may hide opportunities to deliver a package of products and services that the market or customer will find desirable. Too often, a value chain analysis is not designed to help businesses and planners weigh choices about delivering product quality, information and service.
- **Considering the environment in which a value chain operates:** Often, value chain analysts fail to properly consider the business environment in which the value chain operates. In doing so, the analysis can fail to identify potential interventions for improved business and value chain performance. Government regulations, international standards and agreements and market forces typically shape the business environment. Michael Porter's Diamond for describing competitiveness, shown in Figure 3.3 below, is a useful framework for considering the factors that determine a value chain's business environment[6].
- **What a simple cost analysis will not do:** Certain value chain analyses merely depict a cost build-up per activity in producing a value chain without mapping the actors involved or identifying the value that is captured at each link of the chain. The cost build-up, and benchmarking it against competitors, will obviously provide ideas on areas for improvement. But the analysis will probably not shed light on which activities generate more value, whether the product can be produced at a competitive price for other markets, how well the chain is integrated or how easily information flows throughout it. More importantly, a simple cost build-up will tend to focus on interventions that improve on costs, rather than on repositioning the whole chain into more lucrative markets and products.
- **Shifting value within a value chain, rather than creating more value:** Donor agencies and governments have sometimes used value chain analysis to identify and protect threatened links

6 https://www.consuunt.com/porters-diamond-model/

Figure 3.3 Michael Porter's Diamond for Describing Competitiveness



along chains. Additionally, some stakeholders continue to look at value chain analysis as a zero-sum game focused on shifting value from one link of the chain to another. This cutthroat perspective obscures opportunities to upgrade the whole system to the benefit of all value chain participants.

7. AGRICULTURAL VALUE CHAIN ANALYSIS TOOLS

There are many ways to analyse a value chain. The purpose of analysing a value chain is to better understand the current flow of how a product is transformed from a raw state to that of a finished state through various processes undertaken by stakeholders. The value chain analysis may focus on a segmentation of the activities to understand the cost involved and value generated. The design of an Economic Empowerment initiative relies on this information and tools to generate such data. If a conventional FI relies on data that will allow it to conduct credit analysis which is then put through a credit scoring system to determine the credit risk involved, an Islamic MFI/FI practising Economic Empowerment relies on the data generated from the real economy and this can be obtained through the value chain analysis. The collection of data and decision-making process from the tools below[7] are essential for the implementation of Economic Empowerment.

Tool 1- Choosing Priority Sectors for Value Chain Interventions

In most cases, the process will start with an initial list of potential value/product chains, followed by various types of market analyses, an evaluation of the operational and strategic opportunities and their potential impact and a willingness assessment of the chains leaders and other actors to work towards improving their collective competitiveness.

7 C. Martin Webber and Patrick Labaste (2010): Building Competitiveness in Africa's Agriculture: A Guide to Value Chain Concepts and Applications https://openknowledge.worldbank.org/bitstream/handle/10986/2401/524610PUB0AFR0101Official0Use0Only1.pdf?sequence

- Start the prioritization process by compiling an initial list of products/chains the competitiveness of which could further be enhanced. Sources for an initial list include experts, previous assessments, national priorities and sectors supported by other initiatives.
- Conduct market analysis to identify if attractive opportunities to improve and upgrade a given value chain exist.
- Make the stakeholders part of the process as early as possible, especially through workshops to discuss the current conditions of the product/ value chain and to test their willingness and commitment to the process.

How MFIs/FIs can practice the tool: MFIs/FIs often finance a diverse group of clients and are not able to specialize subsegments. By understanding the various subsectors their clients and potential clients are involved in, MFIs/FIs can develop a strategy by narrowing down to certain selected value chains. While MFIs/FIs may finance many sectors, specializing in a few sectors would provide a focus and help FIs sharpen a competitive edge in the market. An explanation of the selection criteria that MFIs/FIs can use is explained in a later part of this chapter.

Tool 2- Designing Informed Strategies Across the Value Chain

This second tool offers analytical methods for understanding the value chain and integrating the information into sound strategy along various points of the chain. How to compete in each market and how to allocate resources to the most valuable production, marketing and support activities. In increasingly integrated regional and global markets, businesses do not merely compete against businesses – value chains compete against value chains. Increasing productivity and competitiveness requires a comprehensive strategy.

Since the analytical tools outlined below are point-in-time assessments, they should be updated on a continuous basis to ensure that any changes in the market dynamics or performance of the business are quickly integrated into a new strategy.

A step-by-step summary of Tool 2

- **Conduct a value chain product unit financial analysis and SWOT analysis:** First, understand the distribution and flow of resources and profits along the chain. Collect key data at each segment of the value chain, and graph the unit costs, unit revenue and unit profit for each step. To complement the financial and operational data, conduct a SWOT analysis in a participatory manner with value chain leadership to qualitatively characterize the state of the value chain.
- **Conduct a Competitiveness Diamond analysis:** For the value chain, assess the strengths and weaknesses of each of the four pillars of the competitiveness diamond: a) demand conditions; b) factor inputs; c) context for firm strategy and rivalry; and d) related and supporting industries.
- A**ssess strategic productivity of the value chain:** Use analytical tools such as market segmentation and assessment, customer profiling, customer benefit analysis and consumption chain mapping to understand the current strategic positioning of the value chain, as well as potential markets and product offerings.
- **Assess operational productivity of the value chain:** A variety of tools are available to analyse the operational productivity and performance of the value chain including per-unit economic cost-driver analysis (fixed vs. variable costs within each activity), cost trend analysis and per-unit activity cost benchmarking.
- **Assess the quality of supply chain management:** To gauge the efficiency in the flow of goods along the chain, the following tools can be useful: Farm-to-market mapping (number of transactions and time) and distribution of players across the chain, supply chain benchmarking, mapping of supporting services, mapping of information flow along the chain and supplier assessments.
- **Assess the human resources across the value chain:** To assess the quality of the value chain workforce, the following tools can be used: Demand- and supply-side analyses of the labour market for the value chain, skills segmentation and benchmarking analyses with competitor value

chains (including labour productivity, number of skilled graduates).

- **Assess the business environment:** Numerous tools are already well developed to assess the business environment of a value chain. Among the most tested are regulatory impact analyses, mapping of time and cost of bureaucratic processes at each stage of the value chain, per-unit costing of rent-seeking activities along each segment of the value chain, and total annual cost of weaknesses in infrastructure.

How MFIs/FIs can practice the tool: MFIs/FIs need to align their corporate strategies with the value chain activities. The previous chapter provides a description, illustration and tools for conducting an assessment and strategy for the FI.

Tool 3- Conducting Benchmarking and Gap Assessments

This tool describes how to measure and compare a value chain's performance (whether in relation to itself, similar value chains, or to best practices) as a means of gaining insight into appropriate strategic choices. The key components and the underlying processes can be individually benchmarked to identify relative strengths and weaknesses.

A step-by-step summary of Tool 3

- **Determine which value chain performance indicators and measures to benchmark:** Identify the elements that are important. The indicators should point to where costs, time, quality, service and value are added along the value chain to help identify bottlenecks, unnecessary costs and upgrading opportunities.
- **Determine the benchmarking target groups (comparators):** Value chains and companies that represent global best practice, as well as regional value chains, should be compared against to identify areas of operational improvement, ways to reduce transaction costs, quality and service improvements, availability and quality of supporting services and ways to improve competitiveness strategies.
- **Identify data sources:** There may be many sources, including studies and research, industry reports, trade publications and other available material. Knowledgeable experts (within the industry and within comparator value chains and organizations), buyers and service providers can be consulted. First-hand visits to observe operations may be warranted.
- **Gather and analyse the data:** A variety of tools are available to analyse and communicate benchmark data. These tools include, but are not limited to, gap analysis, spider graphs, diamond analysis and illustrative tables.
- **Convert benchmark data into strategy and action:** Accurate data from benchmarking exercises provide the private sector, practitioners and policymakers with relevant indicators highlighting the strengths and weaknesses of any value chain. These data can then be used as a springboard for discussions among stakeholders about which areas of a value chain should be priorities for intervention.

How MFIs/FIs can practice the tool: MFIs/FIs should have a clear understanding of the baseline situation of actors within the value chain in the current scenario, estimate targets on how its intervention will change the costs, revenues and interactions within the actors of the value chain and monitor the actual results.

Tool 4- Upgrading and Deepening the Value Chain

Increasing the competitiveness of the value chain by moving it in a new direction – towards a new market, market segment or customer; towards increased efficiency within the value chain; or towards adding operations within the value chain, for example – is referred to as upgrading. Actions that upgrade or increase the competitiveness of a value chain can take many forms and include improving product quality, adding more operations to the value chain, capturing a new market channel and entering a separate value chain (new market) with a similar product.

In deepening the value chain, MFI/FIs address gaps including unmet market demand and value, opportunities for vertical or horizontal integration,

greater specialization and the expansion of services to other value chain members. The gap analysis methodology (described in Tool 3) provides a mean to identify additional operations that may be added to the value chain. It also provides guidance on how best to prioritize opportunities and adjust or expand operations.

Methods for deepening the value chain

- **New entrants/entrepreneurs:** Entrepreneurship generates many new entrants, added operations and captured value in every value chain. In each market, entrepreneurs arise to take advantage of market opportunities and create links with value chains. Such new business formation can be encouraged by access to business services (such as availability of finance) and by good relationships and familiarity with the needs of the other actors in the value chain.
- **Vertical integration:** Existing firms also frequently identify opportunities to incorporate new technologies or operations into their structures. Recognizing opportunities to add value, achieve efficiencies or improve quality—for example, by adding operations through vertical integration (by a value chain or by a firm with the value chain)—enables value chain deepening. In many parts of the world, vertical integration is achieved through acquisition of another firm along the value chain.
- **Commercial joint ventures:** Sharing the risk of incorporating new operations into the value chain or investing in a new technology is an appropriate measure in some environments. Fresh produce preparation, packaging and logistics centres are frequently good candidates for a joint venture, for example.

How MFIs/FIs can practice the tool: Based on the analysis, MFIs/FIs can determine the possible business models that can be developed in accordance with the variety of Islamic modes of financing. Ideas for business development will be generated for further study on the business feasibility. MFIs/FIs may act as an aggregator and enter into a strategic buyer relationship with a supplier, lobby the government or other partners for support investments or enter into a venture capital (Musharaka) investment with a strategic actor within the value chain. A number of methods are explained later in this chapter.

Tool 5- Identifying Business Models for Replication

By analysing value chains, participants can often identify intermediation opportunities that offer increased efficiency, economies of scale, reduction of transaction cost or more value added in the chain. MFIs/FIs may be the first to identify and act on them, or government and development partners (and their consultants/practitioners) may be the ones to promote such opportunities. The defining characteristic in the context of this tool is that the opportunities offer the possibility of replication within the value chain.

A step-by-step summary of Tool 5

- Identify intermediation opportunities (business models) to increase efficiency and value added suitable for replication.
- Support and facilitate value chain stakeholders to implement a pilot enterprise.
- When an approach is successfully proven, encourage its replication through promotional campaigns, business associations, technical assistance and other available means.

How FIs can practice the tool: Once the business model is identified, FI will develop a business plan for investment. The methods of developing a business plan are elaborated in the subsequent chapter. The business model that is detailed in the business plan will be the basis for implementation and will be monitored throughout the project life cycle.

Tool 6- Capturing Value through Forward and Backward Linkages

Integration: At the firm level, vertical integration means creating forward and/or backward linkages. A firm becomes more vertically integrated when it takes on more of the activities that take place within its value chain. Vertical integration makes sense if, for example, the business is seeking to ensure supply or otherwise control inputs, capture more value, achieve economies of scale or ensure access to information. A value chain, by consequence, becomes more integrated through the decisions of firm-level actors.

Vertical integration also takes place at the value chain level when more stages are brought into the country's value chains. This means that a nation's businesses are taking on more of the activities within the global value chain, which adds value, provides more market contact and information, creates employment, etc. Value chain members must decide whether it makes sense for them to integrate – a calculation that includes profit, risk, investor wishes and other factors. Integration can also mean adding more functions to the value chain and not necessarily incorporating them from other countries. This integration may involve joint commitments or even joint investments.

The value chain understood at the firm level can be very simply illustrated (and, of course, can also be shown with much greater detail). In Figure 3.4 below, each stage represents a link in the value chain. In terms of integration, a firm operating in the production stage can assess its distribution channels and decide that it can transport its own goods more cheaply and efficiently than by using another firm. This firm has then made the decision to integrate forward and take on its value chain's distribution function.

The firm could also make decisions regarding its supply of inputs. At the production stage, a firm might recognize that its suppliers are not producing inputs that are adequate for use at the production stage. Rather than share information and work with one or a group of suppliers, the firm might simply integrate backward and develop its own ability to provide the inputs it needs.

How MFIs/FIs can practice the tool: A business that is well developed and profitable can be replicated and/or strengthened with further investments within the value chain to strengthen the ecosystem. For example, if the livestock sector is financed, related sectors such as logistics and processing may also be considered for financing. This is to ensure that risks involved in developing the sector are mitigated and that the sector realizes its full potential. Please refer to the first chapter for an example on how this was successfully carried out by Bank of Khartoum in the Wad Balal project.

Tool 7- Horizontal Collaboration - Creating and Taking Advantage of Economies of Scale

Tool 6 focused on approaches to vertical integration within a value chain. Horizontal linkages also offer excellent opportunities for value chain participants to obtain scale advantages through interfirm coordination. By combining resources and sharing information, horizontal cooperation allows participating companies and producers to achieve improved quality, service and savings through increased access to inputs, more advantage in sales negotiations and greater ability to design initiatives that emphasize upgrading the value chain.

Figure 3.4 Firm Value Chain

This tool focuses on the implementation of horizontal collaboration mechanisms and linkages among businesses to overcome problems stemming from small-scale activity by some individual producers or enterprises. This small scale prevents them, for example, from accessing inputs at optimum price, from reducing the uneconomical unit costs of extension services or from enjoying enhanced market power stemming from increased volumes of production and non-fragmented marketing.

Economies of scale do not necessarily need to be developed through producer associations or cooperatives. Horizontal linkages are in many cases recognized, instigated and organized by lead firms in the value chain.

A step-by-step summary of Tool 7

- Identify areas in which enterprises performing similar activities in the chain can operate jointly with increased efficiency and effectiveness. Typically, many will lie in marketing, procuring inputs, management and logistics.
- Promote the idea to generate enterprise buy-in.
- Give operational form to the collaboration, such as through simple agreements, cooperative creation, new associations or companies; reorient existing organizations to perform the joint activity.

How MFIs/FIs can practice the tool: FIs need not select just one actor but can also act as an aggregator of various actors within the value chain to benefit from economies of scale on the existing infrastructure and arrangements that are in place. MFIs/FIs can play the role of getting various actors to work together instead of competing among one another. Rice producer (small, medium and large) holdings can work together to have a common brand or market collectively through the MFI/FI, utilize machinery financed by the MFI/FI more effectively and obtain inputs in a more efficient manner. FIs should look at playing the catalyst role in fostering collaboration.

Tool 8- Positioning Products and Value Chains

Building on several of the tools already described, a competitiveness positioning assessment provides strategic direction to many of the actions that the value chain implements to improve its competitiveness. This assessment and collaborative decision-making inform the value chain's leadership about the value chain's product offerings, relative to competitors, in key markets. It also forms the foundation for developing a strategic vision and a clear, actionable plan for repositioning the industry in current markets and for penetrating new ones.

A step-by-step summary of Tool 8

- Assess and benchmark size and share of market. Collect net sales for each product segment and each competitor in each product segment.
- Assess and benchmark product scope (or product "offer"). Collect industry value added for each product and competitors' products. If industry value added is not available at the product level, the number and type of value-added activities taking place in-country can be substituted.
- Assess and benchmark product differentiation. Product differentiation should be measured by a combination of both the average price point at a given level of value addition, as well as specific product attributes and customer perceptions of the sources of product value. Product attributes and customer perceptions are qualitative measurements but can be assessed quantitatively through market research tools, such as consumer surveys.
- Understand the possibilities and requirements for repositioning the product and develop a repositioning strategy. Repositioning a product in a more competitive space requires a combination of activities that both enhance product differentiation and increase in-country, value-added activities.

How MFIs/FIs can practice the tool: MFIs/FIs can play the role of an industry association through helping their clients made up of various actors within the value chain towards improving the quality and standard of the sector. In Palestine, FIs that were conducting Salam transactions helped position the Maftoul (couscous) produced by their female clients by effectively packaging the product to reflect the homemade and organic nature of the product.

Tool 9- Applying Standards and Certifications

Meeting a variety of quality and performance standards is integral to the success of agricultural value chains. However, the importance of specific qualities, standard measurements, informational or other characteristics may not be readily apparent to all the actors in a value chain if they are not familiar with the target market. Aside from normal ethical, consumer health and safety requirements, the market side of the value chains pays increasing attention to standards and certifications. National and regional markets are imposing increasingly strict requirements for basic market entry (e.g., HACCP, EurepGAP). Powerful buyers and retailers, especially supermarkets, impose additional requirements on their supply chains.

As a result, the value chain must meet increasingly stringent requirements relating to product health and safety, intrinsic product qualities (shape, colour, taste, texture, etc.), packaging and labelling and accompanying information.

How MFIs/FIs can practice the tool: MFIs/FIs can play the role of an industry association by helping their clients, made up of various actors within the value chain, improve the quality and standard of the sector. In the Abu Halima Mudaraba project conducted by Bank of Khartoum in Sudan, the bank engaged in contracts with two major supermarkets and learnt about their expectations with regards to the quality of fruits and vegetables that will be supplied. The bank engaged a Turkish consultant and provided capacity building to the youth to ensure that the quality of the products produced by the Mudaraba-invested farm meets the market expectations.

Tool 10- Identifying Needed Support Services for the Value Chain

Profitable value chains are supported by services that allow the chain to grow, be more efficient and enhance its competitiveness. The overall objective is to improve the depth and breadth of services currently being provided to the value chain, enabling them to be commercially sustainable and to help those services emerge where they are not being provided. The availability of new and better services should enhance the profitability of the whole value chain. Commercially sustainable services will typically involve specialization on the part of the service delivery. Hence, there are important linkages with the deepening of the value chain, as discussed in Tool 4, Upgrading and Deepening the Value Chain.

The range of services that can add value and strength to a value chain is vast. Examples include input supply, market information and product development support, business management and consulting, transportation and logistics, quality assurance (including certifications), skills, extensions and training, veterinary services and credit and other financial services. It is absolutely in the interest of businesses, entrepreneurs and associations to ensure provision and access to services that would enhance their value chain's profitability. In many cases, demand for services can also offer opportunities for small and medium enterprises to enter the value chain market as suppliers.

A step-by-step summary of Tool 10

- Along the value chain, map services that are currently being provided, as well as those services that are potentially viable and can lead to improvements in the chain's performance. Benchmarking and analysing gaps against other value chains are particularly useful tools for identifying potential services not being provided.
- Include in the map indications of the services' sustainability, quality and location within the chain.
- Conduct feasibility studies and develop business plans to introduce services for which there is potential demand within the chain and to improve the quantity, quality and sustainability of those currently being offered. In most cases, services that are provided on a market basis will be more sustainable, as well as those provided by specialized institutions.

How MFIs/FIs can practice the tool: Help is out there if we are only willing to seek it. Once the FI demonstrates willingness to invest, it can engage partners including government, NGOs and other stakeholders needed to make the required support investments. These support investments are mutually beneficial to both parties. Governments that provide roads, markets and other forms of infrastructure will be concerned about the utilization and sustainability of such investments. MFIs/FIs will need such investments to be made to support the project feasibility. This is successfully done by Bank of Khartoum in Sudan, which actively engages stakeholders for support investments. They have been able to secure donations and contributions to their projects from donors from various ministries in the government of Sudan, Zakat Chamber, World Food Program and other stakeholders.

Tool 11- Improving the Operating Environment

The enabling environment for business is critical to the development and growth of a vibrant private sector and its firms. Constraints in the enabling environment can limit business growth, such as through:

- Increasing costs
- Decreasing competitiveness
- Decreasing product and service quality
- Increasing business and investment risk
- Decreasing foreign and domestic investment
- Constraining business' willingness to pursue long-term strategies

The value chain's ability and willingness to upgrade and make strategic choices often depends on the development of a long-term strategy. However, a burdensome regulatory, legal and policy environment can severely hinder the growth of industries and diminish competitiveness and success in global markets. A poor business environment not only limits local firms' capital investments, it also obstructs foreign investment. Reforming policies so that they are favourable to businesses can encourage dynamism and efficiency.

How FIs can practice the tool: As partners in development, FIs can effectively engage the government to help facilitate and provide necessary feedback. Governments are keen to see private sector make further investments in the microfinance space and would be willing to make the necessary policies to facilitate.

8. IMPLEMENTATION OF VALUE CHAIN ANALYSIS

As we learnt in the previous section, value chain analysis is an important means for a MFI/FI to understand the economic arrangements between its clients and their suppliers and customers. Firstly, this would enable it to make sounder decisions about their creditworthiness based on the estimated income calculated by the study. Secondly, this would also provide it with a comprehensive understanding about the issues within the sector and the risks that it should be aware of when financing clients in the sector. Thirdly, the sectorial knowledge will provide it with a better understanding of how they can intervene in the value chain with Sharia-compliant trading and investment products.

This section provides examples of how MFIs/FIs can conduct simple yet effective value chain analysis. The value chain analysis is made up of both qualitative and quantitative analyses. The qualitative analysis identifies the different actors within the value chain, the issues they face and the solutions to address those issues, and how the MFI/FI could play a role in solving some of those issues. The quantitative analysis aims to provide an accounting framework for the current situation in terms of interactions among stakeholders within the value chain. It provides a simple "income statement" for each segment of the value chain, providing an understanding of the revenues, costs and incomes generated. The incomes generated are often referred to as the value-add by the actor in the value chain. By looking into the distribution of incomes throughout the value chain, the FI can identify actors within the value chain who are taking a disproportionate share of the income generated in a value chain, and look at ways on how they may intervene.

As explained earlier in the chapter, MFIs/FIs use value chain analysis to identify the opportunities, constraints and issues facing the sector. Some of the objectives may include: (a) financing the purchase of inputs; (b) identifying better technology that would support increase in productivity; (c) identifying markets that are more profitable; and (d) identifying business opportunities to improve efficiency and profitability of the value chain. For example, a MFI/FI may realize that the costs of inputs to farmers are high. By negotiating with input suppliers and purchasing in bulk; they may develop a Murabaha product that saves costs and at the same time is profitable to the MFI/FI. The MFI/FI may also introduce new technologies such as better seeds or fertilizers that are more productive and serve as partner conduits to extension workers. It may also help farmers reduce costs by financing solutions such as solar-energy lighting or fuel-efficient stoves. Farmers may have little choice in determining the market for their crops. They have little bargaining power and may have to sell their crop at low prices to intermediaries. MFIs/FIs could develop a Salam financial product and play the role of aggregator within the value chain. Instead of selling to the intermediary, they could sell directly to upstream wholesalers or retailers in the value chain. FIs could also invest

to address a constraint within the value chain. For example, they could finance transport companies, processors and other stakeholders in the value chain, which would help increase the value of the commodity that is transacted in the value chain.

The value chain analysis provides a depiction of the 'as is' situation, providing the MFI/FI with a clear understanding of the qualitative and quantitative factors that affect the growth of the chosen value chain. The analysis will help MFIs/FIs generate ideas on how to develop customized financial products for their clients, as well as understand the risks involved in financing the value chain. The ideas on how to conduct business with actors in the value chain will be further developed with a market opportunity analysis. This analysis will provide more in-depth understanding about the market, competitors, the demand and supply requirements, price trends and much more. The market opportunity analysis will help MFIs/FIs develop a value proposition when engaging in the value chain. This value proposition will then be further developed into a full-fledged business plan to roll out the financial product, providing various scenarios and risk mitigation actions that the MFI/FI should undertake.

Islamic MFIs/IFIs are required to conduct trade and investment with their clients. This means that merely taking credit risks is not enough. They would have to take operational risks. Risks that were previously borne by the poor farmers would need to be shared with the MFIs/FIs. The value chain analysis, market opportunity analysis and business plan are done for one purpose- to help MFIs/FIs understand the overall business risks involved and help them manage and mitigate such risks. It is advisable for MFIs/FIs to develop internal capacity to conduct these studies as part of their business development function. These studies are not just meant to be conducted at the beginning of formulating a new financial product. Rather, they also provide the MFI/FI's management with a clear understanding of the assumptions that are made during that time, the changes that have occurred since the study was conducted and how to react to such changes. This could be a new paradigm for the MFI/FI. Their focus is to manage risk of the business instead of managing the credit risk of their clients. The analysis will help the MFI/FI's management monitor the performance of their product and the sector as a whole. This will help them focus on interventions in sector value chains that are more profitable.

Criteria for Selecting a Value Chain Commodity

Since many efforts will be taken in collecting data, analysis and development of a value chain, it is important that the MFI/FI make the right decision when selecting a value chain commodity. The selection criteria that can be used include:

- Commonly produced/farmed by existing clients
- Differentiating factor that makes the commodity competitive in the market
- Presence of a clear value chain
- Potential to scale up by expanding local or export markets
- Input resources are adequately available
- Presence of market failures the FI can address
- Scope for improvements in value chain efficiency

The MFI/FI should select a commodity that is already familiar to its clients. Ideally, the commodity should be competitive and easy to sell in the market with a clearly defined differentiating factor. The value chain should be easily identified with clear interaction between the actors. There should be potential to expand the production through the financing either in local or export markets. Input resources to enable the expansion should not be a factor. The MFI/FI should analyse value chains of commodities where market failure and uneven distribution of income within the value chain is present. Such a situation would enable the MFI/FI to generate a value proposition that is attractive to both its clients and its shareholders. Lastly, the MFI/FI should select commodities where improvements can be made throughout the value chain. Whether it be increasing the supply of better quality inputs, supporting the sector with better transportation or increasing the value of the commodity in the market through processing its derivatives, the MFI/FI should support the potential for improving the production quantity and quality of the selected commodity.

Why Select Commodities where Market Failure Exists?

In economics, “perfect competition” is the theoretical benchmark where there is a large number (virtually infinite) of economic agents (buyers/sellers) trading small quantities of goods and services and having no power to set the price of the traded commodity/service. In perfect competition, the price is determined by the interaction between the total demand and total supply of the good/service, with both supply and demand sides having full information so that no party has an advantage over another. The competitive market features products that are homogenous, and the absence of costs associated with the entry or exit from the market or the transactions. It also implies efficient allocation of resources among alternative uses, zero profits in the long-run and market prices reflecting resource scarcity and consumer preferences.

In reality, most market structures reflect a suboptimal allocation of resources. Imperfect competition is thought to be widespread in agriculture production, food processing and retailing, leaving smallholder farmers vulnerable to larger stakeholders who dictate the value chain. Such farmers have little means to sell their products due to, for example, lack of transport or storage facilities. These constraints force them to rely on intermediaries, who have the power to impose exploitatively low prices compared to what they could get if they had direct access to market. This scenario is common globally, especially in the developing world. By virtue of their status, MFIs/FIs have the unique opportunity to compete in such monopolistic or oligopolistic structures and develop a win-win value proposition for its clients.

Qualitative Value Chain Analysis

Scoping the value chain: The qualitative analysis aims to give the MFI/FI a clear understanding on how the selected commodity is currently produced and sold in the market. After selecting the appropriate value chain, we would need to scope it. In order to do this the following steps are required:

- Set the boundaries
- Identify the activities
- Identify the value chain actors
- Describe and quantify the interaction between the value chain actors
- Identity issues faced by the actors
- Identify possible business opportunities in the value chain

Set the boundaries

Different criteria can be used to frame a value chain. An agricultural value chain, for example, is usually identified on the basis of the primary commodity used (e.g. maize, cocoa, apples, etc.) Derivatives of the primary commodity may also be selected (e.g. olive oil, raisins, etc.) In such cases, the processed commodity is the focus of attention. The MFI/FI may prioritize the scope based on its typical client profile of farmers, hence selecting the primary commodity instead of the processed commodity. From the primary commodity, the value chain will follow the processing stages up to the end consumer. It will include all market commodities and describe various by-products and/or joint products.

When analysing a national value chain, borders are usually taken into consideration as borders of the value chain. However, the value chain analysis can be extended to actors outside the country whenever the commodity is traded abroad and exports represent an important market for the commodity.

Identify the activities

Understanding the way a value chain works implies identifying the main activities undertaken at each stage of the chain. They include:

- Primary commodity production, including different technologies
- Processing of commodity, which may determine sub-chains due to different processing methods
- Transport, handling, storage
- Wholesale and retail distribution
- Intermediation

Identify the actors

Once the operations of the value chain are identified, it is important to understand who among the actors

in the value chain are performing them. The activities have to be matched with the agents and the roles have to be examined, noting that some of them may be carrying out more than one activity. In addition, it is important to categorize the actors into homogeneous and relevant categories. For example, in one country the characteristics of rice producers may differ by farm size or in different locations. The different characteristics of the rice producers are likely to impact the cost structure and the yields. Rice producers may also be classified based on the whether their fields are rainfed, using gravitational irrigation systems or using pumping irrigation systems. Hence, FIs should look at the potential clients and determine their characteristics when conducting the classification. Figure 3.5 below shows an illustration of the activities of a value chain.

Interaction between value chain actors

Once the actors of the value chain have been identified, we would need to collect data on the interactions among them. This could include producer history, location, company size, list of products, type of technology, issues faced, input requirements, output specification, activity timeline, etc. A survey may be conducted to better understand the activities of each actor within the value chain. At the very least, the outputs of each actor in the value chain should be determined in order to better understand the supply and demand mechanisms. These data would be essential in quantifying the Cost Benefit Analysis (CBA) of each actor in the value chain. Some of the information to be obtained through a survey may include the following:

Figure 3.5 Illustration of a Value Chain and Activity Table

Actors	Input	Activity	Output
1	Paddy inputs	Supply paddy	Paddy rice
2	Paddy rice	Aggrigate supply to sell to processor	Bulk sale of paddy rice to processor
3	Bulk paddy rice (unprocessed)	Steam rice	Parboiled rice
4	Parboiled rice	Purchase in bulk and package to transport and sell to retailers	Packaged parboiled rice
5	Packaged parboiled rice	Sell Packaged parboiled rice to end consumer	Packaged parboiled rice sold in small quantities to consumer
6	Packaged parboiled rice sold in small quantities	Self-consumption of rice purchased	N/A

Output

- Wholesale price at different geographical locations (including international prices CIF-FOB, if any)
- Producer price of the commodity at various locations
- Consumer price of the commodity at various locations
- Produced and traded quantities of the commodity
- Location of the main markets in the region and/or at national level

- Numbers of the actual and potential consumers in the relevant destination area
- Seasonality in prices and quantities of the output

Primary Production Process

- Prevailing farming or other production systems in the relevant production area
- Average farm/firm size or typology of representative farms/firms
- Number of the representative farms and firms in the relevant area
- Yield per unit of activity for each representative farm/firm
- Total production from each farming system type in the relevant area
- Post-harvest losses
- Output storage capacity

Inputs and Factors for Primary Production

- Quantity of each input per unit of output (technical coefficients)
- Purchase prices of input per input type
- Seasonality in prices and quantities of the main inputs
- Stocking costs of inputs
- Packaging and stocking costs of output
- Transportation costs of inputs from various locations
- Equipment, required investment, facilities and related depreciation
- Other costs
- Tariffs and taxes
- Labour wages (agricultural, industrial skilled, non-skilled) at various locations
- Total land in the relevant area
- Total arable land in the in the relevant area
- Water resources (types, number, capacity)
- Land, water and other natural resource use rents

Collection-trade of Raw Commodity

- Typology of representative trading agents
- Type of market (competitive, monopsony etc.) and contractual arrangements
- Facilities available for collection-trade of the raw commodity (Storage capacity, specific infrastructures etc.)
- Transportation costs from the production to the processor
- Other transaction costs (informal taxes, losses etc.)
- Investment costs for collection-trade and related depreciation
- Commodity purchase price of trader
- Commodity sale price of trader
- Trade margins

Processing

- Typology of representative processing agents
- Quantity of commodity processed by type of representative processing agent
- Purchase price of raw commodities
- Processing-conversion coefficients by type of representative processing agent
- Other processing inputs and factors by type of representative processing agent (technology)
- Prices of other inputs and factors required in processing
- Losses due to processing
- Sale prices of processed commodities
- Storage capacity of processors
- Investment costs and related depreciation for processing

Wholesalers, Exporters and/or Importers of the processed commodity

- Transportation costs
- Transaction costs
- Equipment and facilities costs
- Investment costs and depreciation

- Purchased quantity
- Storage capacity
- Purchase price
- Sale prices

General and Institutional Context

- Economic and social infrastructures available (electricity roads, schools, hospitals, markets, communications, etc.)
- Distance from production sites and the closest infrastructure
- National laws, policies and/or international treaties affecting the value chain
- Market regulations and functioning
- Producers' organizations acting in support to the value chain
- NGOs acting in support to the value chain

The data listed above can be found in selected institutions and/or by searching for existing censuses, surveys and institutional databases, such as:

Institutions

- Ministry of economy and finance, ministry of agriculture and other specific ministries
- Regulatory bodies or commodity boards, if any, for the specific commodity
- National statistical offices and/or statistical branches in various ministries
- Central bank, customs services, local institutions
- Producers' and/or consumers' associations
- National research centres and thinktanks
- International organizations such as: Food and Agriculture Organization (FAO), United Nations (UN), World Bank (WB), International Monetary Fund (IMF)

Surveys and databases

- Agricultural census
- Household budget survey
- Small scale enterprises survey
- Survey of agricultural inputs and outputs
- Survey of transport services
- Labour force survey
- Institutional databases (e.g. WDI, FAOSTAT, AQUASTAT, etc.).

Identify issues faced by the actors

Each actor will provide feedback on the issues they face. The issues may stem from the lack of reliable supply, lack of financing, lack of appropriate regulation, lack of proper infrastructure for transportation, etc. Although most of the issues that will be raised are not relevant to MFI/FIs, each issue does pose a certain degree of risks, which may affect the FI directly or indirectly through its investment and involvement in the value chain. Below are two analyses of issues faced by producers, processors and traders in the frankincense and dates sectors. The analysis was conducted during the appraisal of a project conducted by the Islamic Development Bank.

Table 3.1 Issues Faced by Frankincense Producers

Issues/Risks	Risk Mitigation	Trade Support Institution Partners	MFI Possible Action
Need to protect dwindling resources ▸ Inadequate regulation for protecting trees ▸ Inadequate and loose licensing of harvesters ▸ Passive approach to reproduction of natural resources	Regulations needed to control and preserve production of frankincense. Work with tribes for clear allocations of trees and controlled harvesting.	Ministry of agriculture, ministry of environment, department of environment, ministry of interior, tribal leaders.	Monitor availability of trees to ensure uninterrupted supply.
Dispersed information, research and development on the sector -Traditional method of harvesting can be improved -No collection of information on the supply capacity and trends -No applied research concerning plant growth, productivity, etc.	Collect information from various universities to find out ways on how to improve harvest techniques and plant productivity.	Universities, ministry of agriculture, Animal and Plant Genetic Research, thinktanks.	Determine trusted quality source of supply.
Need for structured capacity building programmes for farmers -Farmers are not trained on proper methods for harvesting -Knowledge from previous generations not passed to the youth	Provide extension services to farmers and license only such farmers to harvest the frankincense trees.	Universities, ministry of agriculture, Animal and Plant Genetic Research	Link farmers with capacity building providers.
Unstructured supply chain from farmer to consumer -Too many middlemen who do not add value in the frankincense product -Processors are not paying attention to the sustainability of the supply	Organize supply chain through producer associations or a coordination body made up of the various tribal families. The institution will work with processors in determining the amount of frankincense to be harvested among them.	Ministry of agriculture, ministry of environment, department of environment. Coordinating body among producers may be established.	Finance farmers directly through Salam purchase in order to bypass the middlemen.

Table 3.2 Issues Faced by Frankincense Processors

Issues/Risks	Risk Mitigation	Trade Support Institution Partners	MFI Possible Action
Support mechanisms needed to encourage innovation in frankincense processing ▸ Inadequate funding to encourage potential frankincense processors to innovate (particularly R&D) ▸ New interesting ideas should be facilitated to translate into new products	Provide funding support to companies that are interested in developing new innovative products from frankincense derivatives.	Private funds, SMEs, development funds.	Provide funding to potential processors. Musharaka/ Diminishing and different Musharaka instruments can be explored.
Testing labs for transformation of frankincense are not available ▸ Lab facilities needed to support development of innovative products ▸ Support needed for applied research on medicinal, health benefits that can be used commercially ▸ Limited support to get or access equipment to upgrade processing methods (e.g. frankincense oil distillation process)	Collect information from various universities to find ways to improve harvest techniques and plant productivity, understand their uses and how research can be linked to develop commercial products.	Universities, ministry of agriculture, Animal and Plant Genetic Research.	Collect data on product research that can be used for marketing and promotional purposes.
Dispersed information and research on processing methods and applications of frankincense by-products	Provide extension services to farmers and license only such farmers to harvest the frankincense trees.	Universities, ministry of agriculture, Animal and Plant Genetic Research	Link farmers with capacity building providers.

Table 3.3 Issues Faced by Frankincense Traders

Issues/Risks	Risk Mitigation	Trade Support Institution Partners	MFI Possible Action
Certification process not established on product quality, grade and origin ▸ Lack of control over point of origin ▸ No proper standards are found to determine quality grading	Develop grading and quality standards. Develop geographical indicators and register them with international institutions to better trademark genuine frankincense products.	Chambers of commerce, DG for Trade, international institutions.	Ensure products undergo certification to ensure quality and to justify for higher sale prices.

Issues/Risks	Risk Mitigation	Trade Support Institution Partners	MFI Possible Action
Inadequate facilities for packaging and labelling • Packaging is basic and makes product look cheap • No proper collection and storage facilities • No defined standards for labelling to communicate product value	Establish packaging facility to ensure packaging meets proper standards defined and used to better communicate the product value of frankincense.	DG Standards and Metrology, chambers of commerce.	Finance a packaging facility to ensure quality packaging is done to improve marketing and branding of products.
Lack of well-defined brand and effective marketing strategy • Limited branding approach using potential frankincense reputation • Frankincense sold as commodity not as processed product • Logistics issues are not investigated (oil as hazardous material) • Limited marketing, positioning of various frankincense products (remedies, wellness, beauty etc.)	Develop geographical indicators and register them with international institutions in order to better trademark genuine frankincense products. This will be communicated with a logo. Advocate export of frankincense by-products instead of raw resins. Possibly consider regulations discouraging exports of raw materials to ensure processing is done in country.	Chambers of commerce.	Support companies to develop a strong brand for marketing.

Table 3.4 Issues Faced by Dates Producers

Issues/Risks	Risk Mitigation	Trade Support Institution Partners	MFI Possible Action
Fragmentation of the dates sector • Smallholder farmers do not practice proper farming methods • Low productivity • Too many varieties, not linked to market needs • Part-time farmers who also grow other agricultural products	• Create a dates association • Focus on farms that are >3 ha to have meaningful production quantity.	Ministry of agriculture, universities, etc.	Provide Salam financing to aggregate supply of dates from smallholder farmers.

Issues/Risks	Risk Mitigation	Trade Support Institution Partners	MFI Possible Action
Dispersed information, research and development on the sector ▸ Traditional method of harvesting can be improved ▸ Limited implementation of research recommendations concerning productivity and production of the right variety from market perspective ▸ Lack of interest in improving quality to expand business.	Modernization of harvesting methods by using modern irrigation systems projects to create collection centres.	Universities, ministry of agriculture, Animal and Plant Genetic Research.	Understand specification of dates that are in demand by the market and communicate this requirement to farmers. Help farmers achieve the quality standards of the market.
Inadequate Capacity building programmes for farmers ▸ Farmers are not trained on proper methods for harvesting ▸ Young farmers still practice traditional methods that should be modernized ▸ Insufficient protection from known diseases (e.g. Dubas)	-Customized training for farmers. -Improved extension services.	SMEs, universities, Agricultural and Fisheries Development Fund.	Link farmers with trade support institutions, including government and academic institutions.

Table 3.5 Issues Faced by Dates Processors

Issues/Risks	Risk Mitigation	Trade Support Institution Partners	MFI Possible Action
▸ Fragmented/non-expandable supply capacity because most businesses are home-based with limited supply capacity. ▸ No required control on home products	▸ Increase supply capacity through clustering. ▸ Encourage SMEs to get certified and to adhere to applicable standards.	Directorate General for Standards and Metrology, Ministry of agriculture, Ministry of trade.	Finance SMEs only if they cluster and ensure that the clusters commit to standards.
▸ Need to promote quality standards and quality control for processed products in order to determine shelf life ▸ Limited availability of cold storage facilities and adequate processing equipment	Support processors to comply with quality control standards that would be required for the export market.	Directorate General for Standards and Metrology, ministry of agriculture, ministry of trade, SME Development Agency.	Finance SMEs only if they cluster and ensure that the clusters commit to standards.

Issues/Risks	Risk Mitigation	Trade Support Institution Partners	MFI Possible Action
Limited innovation in dates processing ▸ Limited support to translate interesting ideas into new products, and to leverage market potential to create sustainable businesses	Coordinated approach (through one institution) to manage the sector in an integrated way and to promote pioneers as role models.	SME Development Agency, one million palm trees, etc.	Channel investment only to innovative processed dates.
Limited lab facilities for testing and upgrading products based on processed dates ▸ (e.g. sugar, syrup, coffee)	Invest in lab facilities through facilitated access to finance and by facilitating investors access to buying large piece of land.	Ministry of agriculture, national sector facilities.	Ensure lab facilities are available to ensure that products financed meet quality standards.

Table 3.6 Issues Faced by Dates Traders

Issues/Risks	Risk Mitigation	Trade Support Institution Partners	MFI Possible Action
▸ Quality control, conformity assessment and certification not being used by value chain actors, including unavailable information about origin ▸ Limited awareness and usage of available standards for quality, packaging and for labelling resulting in reduced product value	Training of SMEs, Privatization of extension services to create new lines of business and therefore new jobs	DG for Standards and Metrology, SME fund, SME Development Agency.	Ensure lab facilities are available to ensure that products financed meet quality standards.
Inadequate facilities for packaging, labelling and storage affecting product quality and marketability	Grading, packaging and labelling facilities.	Trade regulation authorities, ministry of agriculture	Finance packaging equipment for traders.

Issues/Risks	Risk Mitigation	Trade Support Institution Partners	MFI Possible Action
Need to enhance linkage with the tourism sector. Dates do not have a specific brand and are not in conformity with tourists needs ▸ Limited perspective on harnessing the geographical location and historical links as potential market for processed dates	▸ Create new approach to involve tourists in the dates experience (the dates trail, date harvesting and processing). ▸ Invest in business linkages and branding using historical commercial routes (heritage)	Ministry of tourism, SME Development Agency.	Develop a marketing project that can be promoted by the trading partners and the government.

Identify possible business opportunities

Once the issues of the value chain have been identified, MFIs/FIs can look at ways on how they can be involved in either financing solutions to these issues or supporting an initiative that has the potential to make a profit. By addressing the issues faced by various stakeholders in the dates or frankincense value chains, opportunities to meet a market need arise that can benefit the MFI/FI and their clients.

In addition, MFIs/FIs can be a catalyst for development. They can seek subsidies from the government, charities or develop partnerships with private sector stakeholders, not only in order to manage risks within the value chain, but also to turn those risks into unique value propositions that can be further developed in the market opportunity analysis and business plan.

MFIs/FIs that can identify business opportunities would generate value for their clients by extending these opportunities to them. It is this partnership approach with their clients that they should strive to achieve.

Quantitative Value Chain Analysis

In value chains, commodities can undergo several stages of collection and processing and eventually reach consumers through different distribution channels. This section aims to provide a clear picture on how the commodity physical flow streams down the value chain by quantifying the values of activities conducted in the value chain.[8]

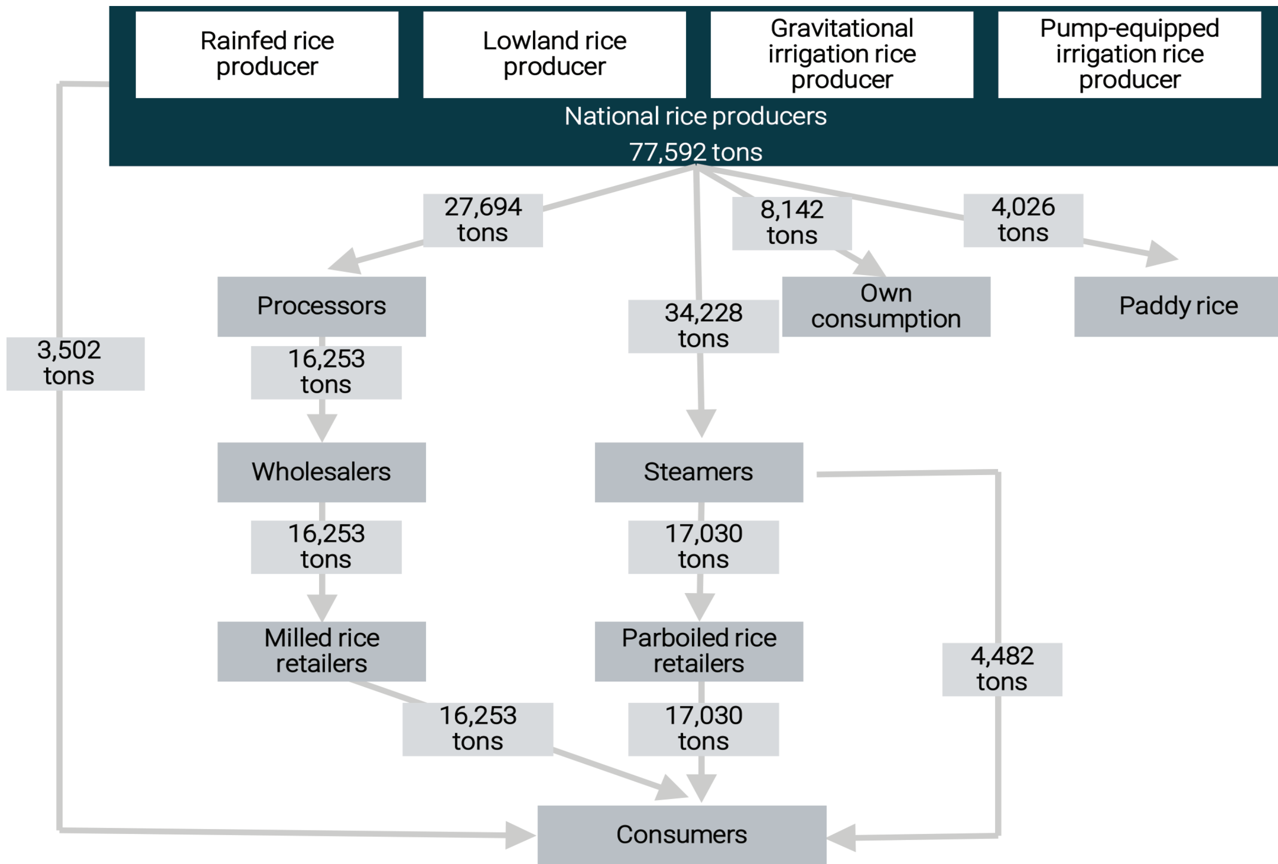
To help us understand the commodity flows, it would be helpful to develop a diagram showing the quantities of output generated by the various actors within the value chain. For example, rice farmers in a region who use various methods (i.e. rainfed, lowland, gravitational irrigation, pump-equipped irrigation, etc.). Let's suppose that 77,592 tons of paddy are produced by the farmers and distributed to processors, consumers, steamers and the farmers themselves for consumption and other uses. From that, 27,694 tons are transformed by processors into 16,253 tons of milled rice, which is then sold to wholesalers and retailers before reaching consumers. On the other hand, 34,228 tons are sold to steamers and converted to 17,030 tons of parboiled rice, which is then sold to retailers and onwards to consumers. In addition, 4,482 tons of parboiled rice are sold directly by steamers to consumers. The farmers consume 8,142 tons of the produced paddy and store 4,026 tons for other purposes. The example is depicted in Figure 3.6 below.

Based on the above a production account should be developed to understand the net value add or income generated by each actor in the value chain.

If we want to break down the production costs of rainfed producers, we can see that it takes, 0.6 tons of manure, 0.03 tons of seeds and 4 person-months of

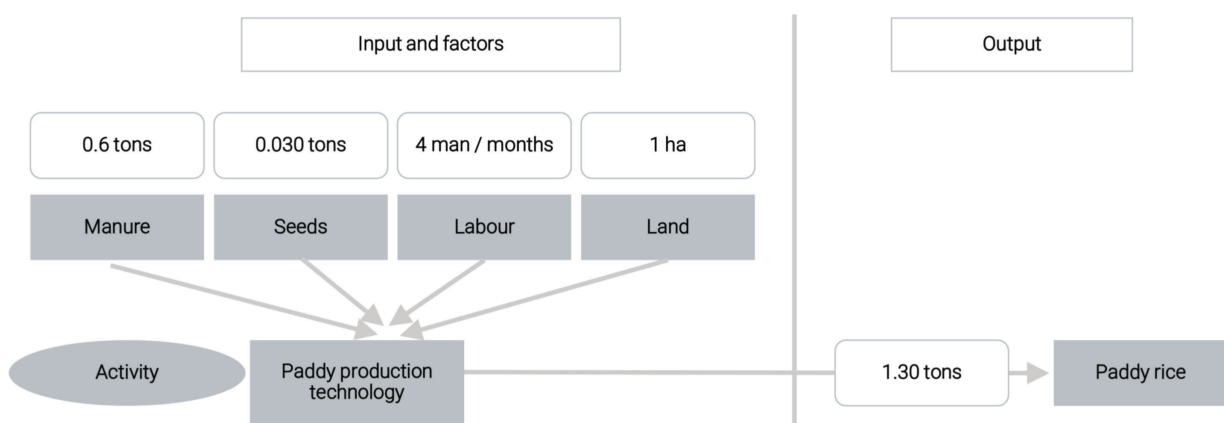
8 Lorenzo Giovanni Bellu (2013): Value Chain Analysis for Policy Making http://www.fao.org/3/at511e/at511e.pdf

Figure 3.6 Illustration of a Value Chain on Rice Production



labour for each hectare of land to produce 1.3 tons of paddy rice. These values can be taken from the ministry of agriculture based on estimations made on the productivity of each hectare of land, taking various factors that may affect productivity into consideration. In this case, we assume that the main factor that affects productivity

Figure 3.7 Rain-fed producer



among paddy farmers is the way their fields are irrigated. Based on this account, we can generate a production account table for rain-fed producers.

Based on the above, we assume that the production is 1.30 tons of paddy rice for each hectare of land. The rice produced is valued at $198.90 out of which, some is consumed and stored, leaving the remaining 1.19 tons sold for revenue for the farmer. From the revenue received, we deduct the inputs that were purchased as well as the consumption of the fixed capital. This will leave the smallholder farmer with 1 hectare of land with $57.47 of income, representing 28.89% of the total output. We should note that the total amount represented does not include expenditure on interest

Table 3.7 Production Accounts of Rainfed producers

	Price/Quantity	Quantity	Value
Output of paddy rice	$153 per ton	1.3 tons	$198.90
Own consumption	$153 per ton	0.01 tons	($1.53)
Storage of paddy rice	$153 per ton	0.10 tons	($15.30)
Amount of paddy rice sold for revenue	$153 per ton	1.19 tons	$182.07
Intermediate inputs			
Manure	$7 per ton	0.60	$4.20
Seeds	$180 per ton	0.03	$5.40
Labour	$15 per month	4 person-months	$60.00
Land rent	$50 per ha	1 ha	$50.00
Total expenses on inputs	$119.60		
Consumption of fixed capital (e.g. lease equipment of depreciation of assets)			
Total income of producer	$57.47		

payments, which the farmer may be required to pay if he obtained his capital from a bank or moneylender. Similar production accounts can be developed for other type of producers such as lowland rice producers, gravitation irrigation rice producers and pump-equipped irrigation rice producers.

Regardless of the how the paddy will be produced, the processors will be purchasing the 27,694 tons of paddy rice produced at $153 per ton in order to produce 16,253 tons of milled rice. The production account of the processors can be found below.

Wholesalers purchase 16,253 processed rice from the processors at $500 per ton and sell them to retailers at $650 per ton. The production account of the wholesalers can be found below.

Retailers purchase 16,253-processed rice from the wholesalers at $6,500 per ton and sell them to

Table 3.8 Production Accounts of Rice Milled Processors

	Price/Quantity	Quantity	Value
Output of milled rice	$500 per ton	16,253 tons	$8,126,500
Amount of milled rice sold for revenue	**$500 per ton**	**16,253 tons**	**$8,126,500**
Intermediate inputs			
Purchase of paddy rice	$153 per ton	27,694	4,237,182
Transportation	$15 per ton	27,694	415,410
Storage	$5,000 per month	2 months	10,000
Labour	$1,000 per man month	40 person-months	40,000
Total expenses on inputs	$4,702,592		
Consumption of fixed capital (e.g. lease equipment of depreciation of assets)	$200,000		
Total income of processor	$3,223,908		

retailers at $1,000 per ton. The production account of the retailer can be found below.

Table 3.9 Production Accounts of Rice Milled Wholesalers

	Price/Quantity	Quantity	Value
Output of milled rice sold at wholesale price	$650 per ton	16,253 tons	$10,564,450
Amount of milled rice sold for wholesale revenue	$650 per ton	16,253 tons	$10,564,450
Intermediate inputs			
Purchase of processed rice	$500 per ton	16,253 tons	$8,126,500
Transportation	$15 per ton	16,253	$243,795
Storage	$5,000 per month	3 months	$15,000
Labour	$1,000 per man month	40 person-months	$40,000
Total expenses on inputs	$8,425,295		
Consumption of fixed capital (e.g. lease equipment of depreciation of assets)	$200,000		
Total income of Wholesaler			**$1,939,155**

Table 3.10 Production Accounts of Rice Milled Retailers

	Price/Quantity	Quantity	Value
Output of milled rice sold at retail price to consumer	$1,000 per ton	16,253 tons	$16,253,000
Amount of milled rice sold for wholesale revenue	$1,000 per ton	16,253 tons	$16,253,000
Intermediate inputs			
Purchase of wholesale rice	$650 per ton	16,253 tons	$10,564,450
Transportation	$25 per ton	16,253	$406,325
Storage	$50,000 per month	3 months	$150,000
Labour	$1,000 per man month	400 person-months	$400,000
Total expenses on inputs	$11,520,775		
Consumption of fixed capital (e.g. lease equipment of depreciation of assets)	$1,000,000		
Total income of Retailer	$3,732,225		

Analysis of Production Accounts

The above tables show the prices and costs involved in the value chain for milled rice. Similar production accounts should also be conducted for steamed parboiled rice. Based on the milled rice process, the value chain has transformed paddy rice, which cost $153 per ton at the farm gate, to $1,000 per ton for the

end consumer purchasing the rice for consumption. Based on these prices, which can easily be obtained from farmers and retailers, the value-add process amounts to $847 per ton. The farmer, who is the primary client of the FI, only captures 15.3% of the value generated by the chain. Out of the $153 per ton revenue, only $57.47 per ton is recorded as income (excluding interest expenses).

By engaging the value chain, the FI should identify ways to compete effectively in the value chain by helping the farmer clients. Questions that the MFI/FI should ask include:

- Can the FI help reduce the cost of the inputs through bulk purchase or preferential rates from suppliers? If it could obtain a 10% discount on seeds and fertilizers, the cost for farmers would drop by $18.70 (10% of $187) for every ton of seeds and fertilizer purchased, and hence their income would grow by the same amount.
- Can the FI help obtain better selling prices for the farmers by negotiating with milled rice processors? Milled rice processors purchase paddy rice at $153 per ton from farmers, process them and sell them for $500 per ton. They generate an income of $3,223,908 out of their total output worth $8,126,500, reflecting a profit margin of 39.67%. The FI could act as the trusted aggregator of the processor and negotiate a price about 15-20% higher than what the processor is offering the farmers. By doing so, the FI could offer Salam financing at an advance price of $153 per ton, knowing that it would be able to sell it to the processor at $191.25 per ton.
- Should the FI sell more to the steamers or millers? It could make this decision based on its negotiations with both stakeholders. It may also engage in talks with other steamers or miller processors to find the best price for the farmers.
- Should the FI invest in a processor in order to capture some of the value and profits generated by the processor? Perhaps a Musharaka or diminishing Musharaka investment could be feasible.
- Should the FI help with the marketing and sale of rice to wholesalers? Instead of selling to the processors, it could pay a fee to the processors to process the rice and subsequently sell directly to the wholesalers. A wholesaler buys at $500 per ton, compared to the processor purchasing price of $153 per ton. Its profit of $1,939,155 out of a production value of $10,564,450 results in a profit margin of 18.36%. Would the FI be more efficient and profitable?
- Should the FI help with the marketing and sale of rice to retailers? Instead of selling to the processors or wholesalers, it could pay a fee to the processors to process the rice and subsequently sell directly to the retailers. A retailer buys at $650 per ton, compared to the wholesaler purchasing price of $500 per ton. Its profit of $3,732,225 out of production value of $16,253,000 results in a profit margin of 22.96%. Would the FI be more efficient and profitable?

Generating a hypothesis of what could be the next course of action for a MFI/FI: Based on the above analysis, the MFI/FI would decide on a few possible interventions where it could generate a win-win situation, generating profits for itself and for its clients. It is important that the above analysis be backed by concrete data, which may be easily obtained by interviewing farmers and other stakeholders in the value chain. Data can also be obtained from agricultural experts in the region, including extension workers or reports generated by the bureau of statistics or the ministry of agriculture.

Analyse Effects of Possible Intervention(s)

Any intervention will result in changes to the flow of rice in the value chain. To ensure consistency, we must choose a common unit of account. Therefore, values of goods and services (revenues and costs) are usually expressed in the analysis in terms of:

- Domestic currency
- Constant prices
- Present value
- Location of consumption
- Domestic users with an average income level
- All the production or consumption externalities, whether positive or negative

In addition, the MFI/FI should anticipate changes in the value chain flow and reflect relevant risks in its analysis. Risks and mitigation measures to consider may include:

Table 3.11 Risks and Possible Mitigation Measures

	Price/Quantity
Side selling of paddy	Undertake purchasing through cooperatives that can regulate supply from their members, so that if one member does not deliver, another can compensate.
Fluctuation of costs	Determine a Salam price, which is suitable based on previous years' price trend at 90-95% confidence interval. Provide a bonus payment on a revenue-sharing basis to clients if the price is much higher than the floor price.
Spoilage in transit	Estimate spoilage in the feasibility study as part of the costs incurred
Lack of quality	Link up extension workers with the farmers so that they get the assistance they need.
Lack of storage facility	Build a storage facility or finance a storage facility for cooperatives and larger clients.
Drought	Purchase insurance for drastic losses due to natural causes such as drought.
Regulation and policies	Awareness of government policies related to exports and pricing of agriculture produce.
Loss of purchaser	Distribute risks through a few purchasers who can be called upon as back up in case one is unable to accept the order.
Imported crop	Understand the regional markets and determine whether the imported crop is competitive. Should it be too competitive, the crop may undercut local producers out of the market. In that case, FIs may decide not to provide financing for that specific crop.

Examples of proposed solutions

a) Develop Murabaha product through negotiations with input suppliers

Can the MFI/FI help reduce the cost of inputs through bulk purchase or preferential rates from suppliers? If it could obtain a 10% discount on seeds and fertilizers, the cost for farmers would drop by $18.70 (10% of $187) for every ton of seeds and fertilizer purchased, and hence their income would grow by the same amount.

Based on the experience of the MFI/FI staff and through consultations with their clients, it appears to be feasible to reduce the cost of inputs though preferential agreements with suppliers. After exploratory negotiations with input suppliers, it is quite clear that suppliers are naturally willing to provide a 10% discount if the MFI/FI could generate higher volume of business through its clients. The loans may be provided to cooperatives so that the size of purchase is significant enough to provide Murabaha financings. The main risks would be side selling and default on credit repayment. The mitigation for this is (a) farmers' concern about losing a source of cheaper input supplies; (b) third party guarantees or a group guarantee through the cooperative; and (c) collateral from cooperative assets.

b) Develop Salam product through negotiations with milled rice processors

Can the MFI/FI help obtain better selling prices for the farmers by negotiating with milled rice processors? Milled rice processors purchase paddy rice at $153 per ton from farmers, process them and sell them for $500 per ton. They generate an income of $3,223,908 out of their total output worth $8,126,500, reflecting a profit margin of 39.67%. The MFI/FI could act as the trusted aggregator of the processor and negotiate a price about 15-20% higher than what the processor is offering the farmers. By doing so, the MFI/FI could offer Salam financing at an advance price of $153 per ton, knowing that it would be able to sell it to the processor at $191.25 per ton, upon a direct negotiation between MFI/FI and processor.

Milled rice processors would be willing to pay a premium if there is a guarantee for the supply of the paddy rice they need. For that certain milled rice delivery, the MFI/FI would engage in Salam contracts with several cooperatives for specific volumes of paddy rice to be delivered in a specified time period. The main risk is of crop failure or failure of the cooperative members to deliver due to side selling. The mitigation for such risks is to (a) blacklist non-compliant farmers from future Salam purchases, thus denying them access to an attractive market; (b) only generate Salam purchases for 50% to 70% of the historical capacity of the cooperative ability to produce; and (c) agree on open spot purchases with cooperatives that would mitigate supply from other cooperatives.

c) Sell more to steamers through spot purchases

Should the MFI/FI sell more to the steamers or millers? It could make this decision based on its negotiations with both stakeholders. It may also engage in talks with other steamers or miller processors to find the best price for the farmers.

If it is deemed that the MFI/FI could get a better price from steamers, it may divert some of the supply and prioritize their need, without totally neglecting the demand from rice millers. It would also better assess the qualities required by both processors and divert preferable rice types based on the demand of the processor. Besides Salam contracts provided to rice farmer cooperatives, the MFI/FI can also act as a trader and purchase on spot basis from farmers in order to sell it to the processor.

d) Increase the processing capacity of rice millers or steamer processors by providing Ijarah, Musharaka or diminishing Musharaka financing

Should the financial institution invest in a processor in order to capture some of the value and profits generated by the processor? Perhaps a Musharaka or diminishing Musharaka investment may be feasible?

While the processor may be at full capacity, the financial institution could finance the expansion of its capacity so that more paddy can be processed locally instead of being sold as raw materials. The additional equipment needed by the processing firm may be financed by the MFI/FI using Murabaha, Ijarah, Musharaka or diminishing Musharaka financing. By analysing the value chain and discussing directly with the stakeholders, the MFI/FI can address their constraints and help the sector grow so that it will benefit all stakeholders.

e) Provide Salam financing to farmers to sell to wholesalers directly or provide Salam financing to processors for sale to wholesalers

Should the MFI/FI help with the marketing and sale of rice to wholesalers? Instead of selling to the processors, it could pay a fee to the processors to process the rice and subsequently sell directly to the wholesalers. A wholesaler buys at $500 per ton, compared to the processor purchasing price of $153 per ton. Its profit of $1,939,155 out of a production value worth $10,564,450 results in a profit margin of 18.36%. Would the MFI/FI be more efficient and profitable?

In its discussions with processors, the MFI/FI could agree to pay them a fee to process the rice but decide to sell the rice directly to the wholesaler instead. The difference of $347 per ton may be worthwhile if only a fraction of that increased value is paid in the form of a processing fee. Therefore, instead of having a contract with the processor to sell the paddy, the MFI/FI would have a processing agreement on the fee for processing and a sales agreement with the

wholesaler instead. Thus, MFI/FI could have multiple hats in dealing with the processor either the seller to processor or an agent to wholesaler.

f) Provide Salam financing to farmers to sell to retailers directly or provide Salam financing to processors for sale to retailers

Should the MFI/FI help with the marketing and sale of rice to retailers? Instead of selling to the processors or wholesalers, it could pay a fee to the processors to process the rice and subsequently sell directly to the retailers. A retailer buys at $650 per ton, compared to the wholesaler purchasing price of $500 per ton. Its profit of $3,732,225 out of a production value worth $16,253,000 results in a profit margin of 22.96%. Would the MFI/FI be more efficient and profitable?

Depending on the feasibility and the risk and returns analysis, it may be possible for the MFI/FI to sell directly to retailers, which could be more profitable than selling it to wholesalers. There have been cases where an MFI/FI had agreements with supermarkets or retailer chains, which enabled it to obtain a better price for the sale of the rice. Since it is estimated that retailers are willing to pay $650 per ton, the additional $150 per ton may be sufficient benefit compared to the costs incurred to market directly to the retailer.

Value Chain Analysis – An Incremental and Practical Approach

MFI/FIs should approach value chain analysis in a practical manner, with the spirit of developing not just financial products, but also services that would produce a win-win scenario for its clients. Most FIs already recognize the need to understand the sectors that their clients are involved in. This is the reason why many FIs employ agriculture extension workers and train them to be loan officers. They believe that such staff would be able to alert them to agriculture-related risks (e.g. poor practices, weather, fluctuation of commodity prices, etc.) that should be factored into their recommendation of whether to approve loans to clients.

However, benefits gained from such knowledge are often restricted by the mandate of MFI/FIs to provide arm's length loans to clients, under the conventional interest-based approach. The separation of business and credit risks often poses a challenge to MFI/FIs who are only allowed to manage credit risks but not business risks. As a result, MFIs/FIs develop innovative measures to tackle credit risks but not business risks. Social pressure is adopted through requirements of obtaining guarantees from village leaders or group members. Regular meetings enforcing regular payments are adopted, where borrowers who delay payments are often shamed. Collateral that covers at least 150% of the loan amount is often required. High penalty fees are adopted, and rollover loans are allowed to ensure that borrowers pay the interest due to the MFI/FI.

Instead of innovation on mitigating credit risks, under the introduced Economic Empowerment approach, efforts can be made by MFIs/FIs to focus on business-related risks if they are given the mandate and freedom to engage directly with stakeholders in the value chain. Agriculture value chain financing has been gaining more prominence recently, with advocates recommending that MFIs/FIs provide financing not just to farmers, but also to other stakeholders in the value chain. In some instances, the focus of the financing would still be to facilitate access to finance for farmers, whereas in other cases such financing may be a case of mission drift, since MFIs/FIs would be providing financing to processors, traders and other middlemen instead of the farmer producers.

The advocated Economic Empowerment approach by MFIs/FIs advocate direct intervention in the value chain through trading and investing with value chain stakeholders. As shown in previous sections, by creating production accounts, the MFI/FI can analyse the situation and develop a strategy of engagement, while ensuring that the farmer producer is still kept at the centre of its interventions. Indeed, the MFI/FI could intervene in several areas in the value chain, as explained in the above section, but not all interactions need happen at the same time. A gradual process is recommended. MFIs/FIs should embark on simpler interventions while collecting data and developing feasibility studies on more complex interventions.

For example, a MFI/FI could provide Murabaha financing for assets or inputs requested by their clients.

The clients would be required to provide details of the asset that is being purchased, including specification of the asset, cost of the asset and the quantity being purchased, as well as the details of the supplier of the asset. This is one source of market data that could be used by the MFI/FI. Subsequently, the MFI/FI could analyse all the invoices provided, identify popular and inexpensive suppliers and engage in agreements to obtain lower prices for their products.

While conducting this process, the FI could collect more data from its clients by asking about the type of industry they are involved in, the type of cost involved and the fluctuation of prices that could occur. Further studies can then be undertaken to meet with other stakeholders in the value chain and understand their cost structure and their concerns to develop accurate production accounts and subsequent strategies for value chain engagement. A MFI/IFI would allow innovation to take place by freeing MFI/FIs from merely playing the role of the financial intermediary. As business partners, MFI/FIs are free to evaluate the risk and return profile of their engagement in the real economy and not just on the credit profile of their clients.

The Value Chain Analysis provides MFIs/FIs with a better understanding of the business opportunities available for them to better investigate. Once convinced with concrete data on how they can generate value for their clients, they can develop new products that would provide financial and non-financial interventions to address a market need in partnership with their clients as identified by the value chain analysis.

CHAPTER 04

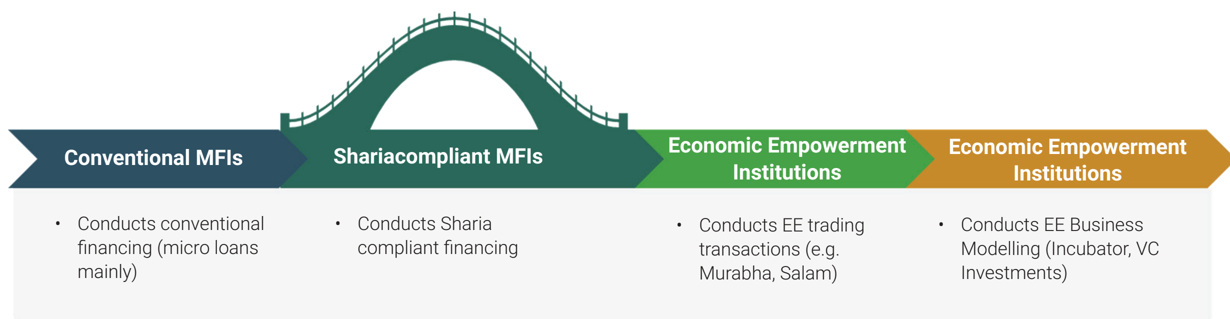
New Product Development

1. INTRODUCTION TO NEW PRODUCT DEVELOPMENT

This chapter provides the tools needed for MFIs/FIs to develop policies and a business plan to rollout a new financial product for their clients. After acquiring a clear understanding of the methodology described in Chapter I, conducting a self-diagnostic assessment and needs analysis as found in Chapter II and determining business opportunities through the value Chain analysis and market study of Chapter III, Chapter IV guides the MFI/FI on how the new financial products can be developed.

The guide found in this chapter aims to help the MFI/FI transition from an arm's length credit provider into a business-oriented trader and investor. The transition from a conventional MFI/FI to a Sharia-performing MFI/FI can be summarized as follows:

Figure 4.1 Evolution from a Conventional to an Economic Empowerment Institution



The first step would be to decide on the type of product to be rolled out. To answer this question, the MFI/FI may want to answer the following questions first.

Does my portfolio mainly comprise commercial or consumption loans?

Generally, the MFI/FI should focus on providing commercial loans rather than consumption loans. Consumption loans should generally be avoided, as they provide an avenue for the poor to spend beyond their means. Unless the loans are used for medical or educational purposes (which may be financed using social oriented financing products like Qard Hasan or interest-free loans), any loans that put an unnecessary debt burden on the client should be avoided.

Tip: Focus on restricting financing to commercial purposes and essential consumer purposes (e.g. medical, education).

Are my mission and donors mainly social-oriented?

If the conventional MFI/FI has a strong social mission backed with strong donor grants and support, it may want to adopt a Qard Hasan (interest-free loan) product. Akhuwat of Pakistan is a good example of an organization that keeps its operational cost low (below 10% of its financing portfolio) and maintains an operational fund, which enabled it to become the biggest microfinance provider in Pakistan, reaching more than 1.5 million families.

Tip: If the strategy is social-oriented, reach out for fundraising from donors and introduce Qard Hssan (interest-free loan). Otherwise, there is also a variety of asset-backed commercial instruments that can be introduced.

What are the types of assets that will be financed?

One of the principles of Islamic Finance is that it must be backed by assets. Typically, two types of assets are among the first to be considered- consumables/ inputs and capital expenditure. Ijara is a leasing contract used for assets that can be rented such as non-movable equipment and machinery. Other assets that cannot be leased could be financed through Murabaha, whereby the MFI/FI would purchase the asset on behalf of the client and sell it to the client at a marked-up price.

Table 4.1 Main Changes required for Sharia Compliance

MURABAHA	IJARA
▸ Ensure Sharia compliance on assets that will be purchased.	▸ Ensure Sharia compliance on assets that will be leased.
▸ Identify asset and ensure that the bank is taking the real ownership of the asset before transferring it to the buyer.	▸ Identify asset and ensure asset is owned fully by lessor before it gets leased to lessee under Ijarah Agreement. On maturity, the asset will be transferred from lessor.
▸ Ensure financing is used for the identified asset only.	▸ Ownership remains with the lessor, who is responsible for major repairs and maintenance. Any Takaful/insurance is to be arranged and borne by the lessor.
▸ Remove interest rates and introduce mark-up with clear declaration of the purchase price and selling price.	▸ The lease period is clearly stated in the contract.
▸ The client should not pay additional profit over and above the agreed selling price to the MFI/FI if there is a delay in payment.	▸ Ensure that a separate contract is being entered into for transfer of ownership of the asset at the end of the lease term. The price for this contract to the lessee could be either for free or against a symbolic price.
▸ As mentioned above, no penalty should be charged to the client for payment delay, however the Financial institution may introduce limited penalty fees that can only be charged to the non-poor but they cannot be accounted as revenue for the financial institution and must be given as charity as decided by the Sharia committee. The IFI should take efforts to determine whether the delay in payment is due to negligence or inability to repay. Penalties may be charged only to non-poor who are negligent.	▸ In case of default or late payment of lease rentals, ensure that any penalty received is paid as a donation to approved charity as to be decided by the Sharia committee. The IFI should take efforts to determine whether the delay in payment is due to negligence or inability to repay. Penalties may be charged only to non-poor who are negligent.

How can I create a bigger impact through Murabaha and/or Ijara financing?

By introducing the changes depicted in Table 3.1 above to the existing conventional loan product, the FI would have developed Sharia-compliant financing that mitigates the harmful effects of credit. An example of the impact and outcome of a conventional loan compared to a Sharia-compliant Murabaha loan and Murabaha financing from a Shariah-performing economic empowerment institution is shown below.

Figure 4.2 Comparison between Conventional, Sharia-Compliant and Economic Empowerment Institutions

Conventional FI

- Client needs $500 to buy fertilizer and seeds
- Borrows from FI at 30% interest per annum over 1 year
- Pays $650 after 12 months ($500 principle, $150 interest)
- If delayed by another 12 months, pays $195 additional interest ($150 additional on the principle and $45 additional interest on the interest)
- Penalty fines may be recorded as income

Sharia-Compliant FI (Murabaha Financing)

- Client needs $500 (purchase price) to buy fertilizer and seeds
- Borrows from FI at 30% profit per annum over 1 year
- Pays $650 (selling price) after 12 months ($500 principle, $150 profit)
- If delayed by another 12 months, no additional profit is due
- Penalty payments allowed but must be given to charity

Sharia-Performing Economic Empowerment Institution (Murabaha Financing)

- Client needs $500 to buy fertilizer and seeds
- FI negotiates with supplier at retailer or wholesaler level, gets 30% discount
- Negotiated purchase price $350 (purchase price)
- Client borrows from FI at 30% profit per annum over 1 year
- Pays $455 (selling price) after 12 months ($350 principle, $105 profit)
- If delayed by another 12 months, no additional profit is due
- Penalty payments allowed but must be given to charity

In summary, the net effect of the 12-month credit transaction to the client is shown below:

Method	Paid by client	
	Due After 12 months (on time)	Due After 24 months (delayed)
Conventional FI	**$650**	**$845**
Sharia-compliant FI	**$650**	**$650**
Sharia-performing FI	**$455**	**$455**

The amount paid by the client to the Sharia-compliant MFI/FI would not change whether he pays on time (12 months) or if he delays payment to 24 months, unlike the conventional MFI/FI, which would continue to accrue interest during the period of delay. The client would pay an additional $195 ($845-$650) of interest as a result. Hence, a client, who pays regularly will not see any perceived benefit from Sharia compliance. Sharia compliance protects clients who may have difficulty in making repayments due to various reasons that are not due to negligence or fraudulent practices.

It is only by embarking on practices that help clients in reducing the cost price of the asset through negotiation that the MFI/FI can help the client reduce the cost of acquisition. By getting a 30% discount, and even with the same profit rate of 30%, the cost of acquisition goes down to $455 from $650, saving the client $195 compared to the case of being financed by a conventional FI or a Sharia-compliant FI. Even if there are delays in payment, the amount due from the client remains at $455, which is also still $195 less than the Sharia-compliant FI and $390 less than the conventional interest-based FI.

Now that I have introduced policies to ensure that my products are Sharia-compliant, how can I transition into a Sharia-performing economic empowerment institution?

The first product for the transition of a conventional MFI/FI could either be Murabaha, Ijara or both, depending on the type of asset required by its clients. In undertaking this transition, the MFI/FI would collect important data such as the details of the supplier's asset, the price of the asset and the quality specifications. After some time (usually about one year), the MFI/FI would have a clear understanding of the asset-financing requirements of its clients, the quality it needs, the price of assets and the suppliers who are engaged to deliver the assets.

By analysing this data, the MFI/FI would be able to determine the quantity and quality of the assets demanded by its clients and the supplier that provides the product at the lowest price. The MFI/FI could negotiate with that supplier for exclusive prices that it could extend to its clients. The arrangements could be through a bulk purchase to be stored by the MFI/FI, or through a preferential trading agreement, whereby clients of the MFI/FI would receive exclusively lower prices compared to the case of purchasing directly from the supplier. The MFI/FI is in a better bargaining situation compared to its clients, as it can secure larger bulk purchases in exchange for lower prices. Whether the MFI/FI would like to take the storage and transportation risks is a business decision the MFI/FI should make. Otherwise, the FI could extend preferential prices to its clients, while outsourcing and transferring such risks to the supplier or third-party providers.

Besides Murabaha and Ijara, what other trading instruments could an FI offer? How can Salam be a value-add financing instrument in its portfolio?

Both Murabaha and Ijara provide financing for productive assets that clients need to acquire. The financing can also be dedicated to purchase some inputs or supplies (fertilizer, seeds, etc.) or capital needed for small machinery or equipment. These are also typical financing requirements provided by conventional MFI/FIs. Additionally, Islamic MFIs/FIs could help their clients gain access to markets for the products they produce through offering Salam.

Salam, or advance payment purchase, is a very important financing instrument that benefits clients and helps them gain access to markets. Under such arrangements, the MFI/FI could finance the marketing of products produced by its clients. Once it identifies the type of products sold by its clients, the buyers of such products and the respective selling prices of the clients and their buyers, it could purchase the products by advancing the payment to its client under the client's commitment that he/she would deliver the agreed products at the time of harvest. The MFI/FI would identify suitable buyers who are willing to purchase the products at higher prices in order to make a profit. By aggregating the products, the MFI/FI could bypass traditional intermediaries and sell the products directly to processors and/or retailers. As a bona fide trader, the MFI/FI would be able to bargain for higher prices and the benefits could be shared with its clients.

To that end, the MFI/FI would need to conduct a value chain study to understand the flow of the product, the processing it goes through, the stakeholders who are involved and the prices at each stage of the value chain. Please refer to Chapter 3 for details on how to conduct a value chain study. Once the value chain study is conducted, the MFI/FI would develop a business plan for its involvement in the value chain in a profitable manner that would also benefit its clients. As with Murabaha and Ijara products, a business decision needs to be made as to whether the MFI/FI would conduct the storage and transportation of the products or outsource the service and transfer the risk to a third party. If there is a reliable and low-cost third-party provider, outsourcing may be a good solution. Otherwise, the MFI/FI may need to dedicate internal resources to ensure safe delivery of the assets.

Following the Murabaha and Ijara products, Salam is an essential product that could help the MFI/FI's clients gain access to markets in a sustainable manner. The MFI/FI offering Salam would be able to achieve repeated business by helping to link its clients to more profitable markets that would otherwise be inaccessible.

Besides trade-oriented financing instruments, how could the MFI/FI offer equity-oriented financing instruments?

Trade-oriented financing instruments are usually the

first products developed because it is relatively easier to buy and sell familiar products. The main difference is that instead of being an arm's length financier, Islamic MFIs/FIs are actually involved in the value chain. Their direct intervention helps combine their functions of providing financing/credit and maximizing their ability to interact with other stakeholders who would help address the market failures faced by their clients. Salam transactions represent a very different business model that is excellent for providing working capital to small businesses, especially in the field of agriculture. The MFI/FI would purchase the product from a farmer (e.g. 100 tons of tomatoes to be delivered upon harvest 6 months later) at a discounted price and advance it in cash to him for purchasing inputs, labour, etc. To profit from the transaction, the MFI/FI would negotiate with a buyer for the harvest it is expecting to receive.

Such equity-oriented financing instruments are venture capital investment instruments, which are, by nature, high-risk high-return investments. Islamic MFIs/FIs that would like to introduce an equity-oriented product would need to clearly identify a business opportunity. Essentially, the opportunity would involve creating a new start-up enterprise or helping an existing one expand. In much the same manner as venture capitalists contribute not just funds, but also expertise and networks, Islamic MFIs/FIs would need to do the same to safeguard their investments. The investments would also need to be much larger in order to benefit from the economies of scale from high level involvement and generate high target returns that would justify the higher risks involved.

Based on the above criteria, MFI/FIs would have to develop financing products for value chain projects undertaken by large groups. The first requirement would be to conduct a needs assessment study for their clients to understand the dominant sectors where their clients perform business, their willingness to cooperate and their skills and expertise, as well as their financial and non-financial needs. A value chain market study would be conducted to better understand the business opportunities available in the country and the existing stakeholders in the value chain. An example of how the market value chain study is conducted is detailed in Chapter 3 of this toolkit. Subsequently, business plans would be developed to determine the feasibility of these business ideas. Some of the differences between trade-oriented Islamic finance and equity-oriented Islamic finance are shown below:

Table 4.2 Differences between Trade and Equity Oriented Islamic Finance

Features	Trade-Oriented Islamic Finance	Equity-Oriented Islamic Finance
Loan/ Investment Approval Process		
Target Beneficiary	▸ Economically active poor ▸ Mostly women ▸ Financing is given to individuals as members of a group	▸ Economically active poor with relevant skills/ talents ▸ Mostly nuclear families ▸ Investment given to a cooperative/ association having many (hundreds or thousands) family beneficiaries
Group or Individual Loan/ Investment	Separate financing given to individual members or a small group	Investments made to a group of many individual members
Collateral	Social collateral by other members of the group	No collateral provided - beneficiaries sign a letter of commitment
Risk Evaluation	Based on business profile of clients as well as history of default	Based on business risk of proposed investment

Features	Trade-Oriented Islamic Finance	Equity-Oriented Islamic Finance
Loan/ Investment Approval Process		
Loan/Investment Usage	Various (typically small trading operations) operated by the beneficiary	Specific large investments designed by the MFI/FI
Loan/ Investment Product		
Loan/Investment Size	Small (less than US$10,000)	Large (in cases more than US$1 m)
Financing Product	Murabaha, Salam, Ijara	Musharaka, Diminishing Musharaka, Mudaraba
Loan/Investment Return	Profits through trading	Profit-sharing
Loan/Investment Duration	Short (6 to 24 months)	Long (3 to 5 years)
Cost of Financing	Low (approximately one loan officer for every 20-40 clients)	High (one investment officer for each financed cooperative/association client)
Support Activities of Loan/Investment		
Bank Officer Support	Low (approximately one loan officer for every 20 clients)	High (one investment officer for each financed cooperative/ association)
Responsibility for Business Success	Depends on the ability of the client to produce and the ability of the MFI/FI to trade	Joint responsibility between the FI and association of beneficiaries. FI is required to be an active investor making business decisions
Capacity Building for Beneficiaries	Generic business management and quality of production	Specific (related to operating the business to improve project performance) – usually part of the investment expenses
Non- Financial Support	Access to markets (FI negotiates contracts with customers) Access to know-how (negotiation for lower prices)	Access to markets (FI negotiates contracts with customers) Access to management (FI helps beneficiaries make business decisions) Access to know-how (skill development specific to the business and latest technology)
Subsidy Element	Subsidy may be given to reduce operating cost, which may in turn reduce interest rates charged to end beneficiary	Subsidy is given in the form of support investments to reduce investment costs, resulting in a shorter investment period
Insurance/Takaful	Insurance obtained to mitigate risk of non-repayment	Insurance obtained to mitigate business related risks (e.g. crop failure due to drought)
Likelihood of Poverty Alleviation	Dependent on profitability of individual small business, which needs to be higher than the cost of financing charged	Dependent on the profitability of the large business managed by the FI. In the case of business loss, FI loses its investment

2. PRODUCT BUSINESS PLAN DEVELOPMENT FRAMEWORK

This section provides a template for the MFI/FI to develop a business plan for rolling out the new product. Each transaction developed by the MFI/FI should aim to ensure benefits to its clients. Hence, it is important that the product target expected returns and try to identify key factors that would ensure the client's ability to achieve the expected target returns. This would allow the MFI/FI to focus more on business-risk mitigation, rather than sheer credit-risk mitigation, and would allow a much wider reach to target customers to include the poor, women and youth.

Table 4.3 Business Plan Development Framework

Section	Areas that the section will address
1. What is the need and how will the product address this need?	▸ Problem identification ▸ Identify the gap in the market that the product is trying to meet. ▸ What is the objective that the product is trying to achieve? Please see Chapter 3 (Value Chain Analysis) for more details
2. Current market analysis, including profile of targeted client	▸ Identify demographics of target client ▸ Estimate size of market ▸ Determine key factors in reaching out to target client ▸ Comment on acceptability of target client Please see Chapter 3 (Value Chain Analysis) for more details
3. Describe the expected benefit for the targeted client	▸ Determine a simple expected minimum return to the client ▸ Determine how the financing would relate to the client's benefit ▸ Identify the key business risks faced by the client Please see section 3 for more details
4. Product design Framework - describe the 8Ps	▸ Product ▸ Pricing ▸ Place ▸ Promotion ▸ People ▸ Positioning ▸ Physical Evidence ▸ Process Please see Section 4 for more details
5. Describe similar competitive products in the market	▸ Identify similar products offered by competitors (if any) ▸ Identify similar products offered by the FI (if any) ▸ Conduct a SWOT analysis of the designed product and the competitors Please see Section 5 for more details
6. Describe specific policies of the product – Sharia-specific and others	▸ Describe the policies of the product that will be used (e.g. Murabaha, Qard Hasan, Musharaka etc) ▸ Identify the key aspects of the product for documentation. Please see Section 6 for more details

Section	Areas that the section will address
7. Financing strategy and risk analysis	▸ How will the product be financed? ▸ Matching of risk-return of product and financing ▸ Product risk analysis Please see Section 7 for more details
8. Financial and non-financial projections	▸ Projected income statements ▸ Projected balance sheet ▸ Targeted performance indicators ▸ Social performance targets ▸ Sharia impact performance Please see Section 8 for more details
9. Finalizing the trial product and timeline	▸ Developing a trial product for feedback ▸ Key feedback questions ▸ General timeline milestones Please see Section 9 for more details

3. DESCRIBE THE EXPECTED BENEFIT FOR THE CLIENT

Every product developed by the MFI/FI should attempt to strike a balance on its risk-return relationship with its clients. Hence, it is important for the MFI/FI to understand the impact of a product on its clients. All MFIs/FIs look at two aspects in evaluating a loan proposal, namely the client's (a) ability to repay and (b) willingness to repay. Most MFIs/FIs rely on guarantees and collateral as a means for checking whether their client can repay their loan. However, if they could better understand the market, the business risks involved and the expected return for the client, they would be more assured that the client would be able to generate sufficient profit needed to make the necessary repayments.

Benefit generated from trade–oriented products

Generally, there are three main Islamic financial products under this segment- Murabaha, Salam and Ijara.

Murabaha – generally used for consumable products, typically as inputs to the business. The client seeks a product to be financed, and this product undergoes a certain process in order to be sold at a higher price by the client. A sample project forecast for the client could be as follows:

Table 4.4 Client Cost-Benefit Analysis for Murabaha Financing

Cost	Explanation	Unit
C1. Cost price of Murabaha Item	Price of Murabaha item that will be purchased by the MFI/FI before negotiation.	$
C2. Negotiated price of Murabaha item	Price of Murabaha item after negotiating with the supplier. MFIs/FIs are expected to negotiate for a better price on behalf of their clients.	$
C3. Cost of financing to client (mark-up)	The mark-up estimate cost is based on the policy of the MFI/FI. It should be made up of funding cost, operational cost, cost of provisions and expected profit.	$
C4. Total selling cost of Murabaha Item (C2+C3)	The final selling price that the client will be paying over the financing tenor period.	$
C5. Other costs involved in generating output	Besides the Murabaha item, other inputs are also taken into consideration and estimated.	$
C6. Total Cost of Output (C4+C5)	This is the client's total cost of production over the financing tenor period	$

Revenue Item	Explanation	Unit
R1. Quantity of product that will be sold	Estimate amount of product that the client will sell over the financing tenor. Use recent output of the client as an indicator.	Tons/kg
R2. Price of product that will be sold	Estimate the price of the product that the client will sell. The estimated sales price should be in line with the market price expectation.	$
R3. Revenue generated by the product (R1*R2)	This is the estimated revenue that will be generated by the client's financed business.	$

Profit Estimation	Explanation	Unit
P1. Estimated profit generated by financed business (R3-C6)	This is the estimated profit.	$
P2. Conservative deduction (e.g. 20%-50%)	This measure can be put in place to ensure that the estimated profit figures remain conservative.	$
P3. Conservative profit figure (P1-P2)	This profit figure gives a conservative estimate of the profit expected to be generated by the client.	$

Benefit Estimation	Explanation	Unit
B1. Conservative profit (P3/no of days of financing tenor)	It is important to ensure that the client earns a decent profit. If their margins are too small, the profit generated may not be worthwhile for the client, with the labour and effort they put in. It is also a measure of how the intervention has helped move the client out of poverty.	$
B2. Negotiated benefit of Murabaha item (C1-C2)	Amount that the client benefits from the lower cost price negotiated by the IFI.	$
B3. Financing cost comparison (C3-(market interest rate*C1)	The benefit generated by the IFI to the client by being more efficient.	$
B4. Total direct benefit to the client (B2+B3)	Measures competitiveness of the IFI in comparison with the market. Also measures how much value add the IFI directly provides through the transaction.	$

Salam- generally used for advance purchase of agricultural products from farmers. The client receives a financing from the MFI/FI in exchange for a commitment that he would deliver the product (e.g. x tons of tomatoes) after a period of time. The MFI/FI would sell this product at a higher price for profit. A sample project forecast for the client could be as follows:

Table 4.5 Client Cost-Benefit Analysis for Salam Financing

Revenue Item	Explanation	Unit
R1. Quantity of product that is estimated to be sold during harvest	Estimate amount of product that the client will produce in the next harvest. Use recent output of the client as an indicator.	$
R2. Price of product that will be sold	Estimate the price of the product in the future during harvest. The estimated sales price should be in line with the market price expectation and current price trends.	$
R3. Revenue generated by the product (R1*R2)	This is the estimated revenue that will be generated from the product during harvest.	$

Revenue Item	Explanation	Unit
R4. Conservative discounted revenue due to poor harvest (e.g. 30% discount) (R3*70%)	Estimated revenue generated by the farmer in case of poor harvest. It is usually more prudent to have a lower estimation of the harvest output.	$
R5. Salam financing amount (R4*(1-expected return from Salam e.g. 30%))	The Salam financing amount that will be given to the farmer would be the conservative harvest with a discount on the expected return for the IFI.	$

Cost	Explanation	Unit
C1. Cost of product that will be sold during harvest	Estimate the amount of inputs that need to be purchased to produce the quantity specified in R1. The Salam financing amount should be higher than the cost price.	$
C2. Cost of producing the Salam output	The cost identified specifically for the output generated by the Salam financing (R4), which should be less than C1 (cost of all product during harvest).	$

Profit Estimation	Explanation	Unit
P1. Estimated profit generated by financed business (R4-C1)	This is the total estimated profit of the client. Conservative output value is used.	$
P2. Additional margin due to higher price.	If price of product is higher than expected return, the additional margin should be shared with the client.	$
P3. Additional margin due to better price negotiation for aggregating products	This margin compares the price that the farmer would be selling to the buyer with the price that the MFI/FI is able to obtain from the buyer. This additional profit is expected to be shared with the client.	$

Benefit Estimation	Explanation	Unit
B1. Profit generated by the transaction (P1+P2+P3)	It is important to ensure that the client earns a decent profit. If their margins are too small, the profit generated may not be worthwhile for the client, with the labour and effort they put in.	$
B2. Profit generated by the transaction per day ((P1+P2+P3)/no of days of financing tenor)	It is important to ensure that the client earns a decent profit. If their margins are too small, the profit generated may not be worthwhile for the client, with the labour and effort they put in. It is also a measure of how the intervention has helped move the client out of poverty.	$
B3. Negotiated benefit of Salam transaction item (P2 + P3)	Amount of value add generated by the IFI.	$
B4. Total benefit in comparison with conventional MFI (B2+ ((IFI expected profit rate– market interest rate) * Loan amount)	This is the value generated by the IFI in comparison with a conventional FI. Deduct the benefit gained from the difference in the Salam profit rate of the IFI and the interest rate of the conventional FI.	$

Ijara – generally used for larger assets that can be leased (e.g. machinery) to enhance the productivity of the client. The client seeks a product that would be financed by the MFI/FI, and this product undergoes a certain process in order to be sold at a higher price by the client. A sample project forecast for the client could be as follows:

Table 4.6 Client Cost-Benefit Analysis for Ijara Financing

Cost	Explanation	Unit
C1. Cost price of Ijara Item	Price of Ijara item that will be purchased by MFI/FI prior to negotiation with the supplier.	$
C2. Negotiated price of Ijara item	Price of Ijara item after negotiating with the supplier. MFIs/FIs are expected to negotiate for a better price on behalf of their clients.	$
C3. Cost of financing to client (leasing cost)	The leasing cost estimate cost is based on the policy of the MFI/FI. It should be made up of funding cost, operational cost, cost of provisions and expected profit.	$
C4. Total Ijarah amount (C2+C3)	The final Ijarah price that the client will be paying over the financing tenor period.	$
C5. Other costs involved in generating output	Besides the Ijara item, other inputs are also taken into consideration and estimated	$
C6. Total Cost of Output (C4 +C5)	This is the client's total cost of production in a given year or period.	$

Revenue Item	Explanation	Unit
R1. Quantity of product that is currently sold	Estimate amount of product that the client will sell over the financing tenor based on current productivity. Use recent output of the client as an indicator.	Ton/kg
R2. Increased output due to usage of Ijara asset	Estimate the amount of increased product that the client will sell over the financing tenor based on the increased productivity with the leasing of the Ijara asset. Use realistic figures that estimate increased productivity.	Ton/kg
R3. Total output from increased productivity with use of Ijara asset (R1+R2)	Total output due to the increased productivity.	Ton/kg
R4. Price of product that will be sold	Estimate the price of the product that the client will sell. The estimated sales price should be in line with the market price expectation.	$
R5. Revenue generated by the product (R3*R4)	This is the estimated revenue that will be generated by the client’s financed business	$

Profit Estimation	Explanation	Unit
P1. Estimated profit generated by financed business (R5- C6)	This is the estimated profit.	$
P2. Conservative deduction (e.g. P1*(20% to 50%))	This measure can be put in place to ensure that the estimated profit figures remain conservative.	$
P3. Conservative profit figure (P1-P2)	This profit figure gives a conservative estimate of the expected profit that will be generated by the client.	$

Benefit Estimation	Explanation	Unit
B1. Conservative profit (P3/no of days of financing tenor)	The earnings of the client over the financing tenor. It is important to ensure that the client earns a decent profit. If their margins are too small, the profit generated may not be worthwhile for the client, with the labour and effort they put in. It is also a measure of how the intervention has helped move the client out of poverty.	$
B2. Negotiated benefit of Ijara item (C1-C2)	Amount that the client benefits from the lower cost price negotiated by the MFI/FI.	$
B3. Financing cost comparison (C3-(market interest rate*C1)	The benefit generated by the MFI/FI to the client by being more efficient.	$
B4. Total direct benefit to the client (B2+B3)	Measures competitiveness of the MFI/FI in comparison with the market. Also measures how much value add the MFI/FI directly provides through the transaction.	$

Benefit generated from social financing product- Qard Hasan

Qard Hasan – can be used for any expense as a social financing product. This interest-free loan is provided by the MFI/FI to clients, who repay the loan at zero interest or at a service fee limited to the expenses incurred in administrating the loan. A sample project forecast for the client could be as follows:

Table 4.7 Client Cost-Benefit Analysis for Qard Hasan Financing

Cost	Explanation	Unit
C1. Cost price of Qard Hasan expense	The principal amount of money used to finance the expense, as this is an interest-free loan.	$
C2. Cost of financing to client	The service fees are limited to the administrative costs of providing the loan, i.e. the MFI/FI operational cost. It may not include cost of funds, provision cost or any profit margins. Typically these costs are borne by the financier/donor.	$
C3. Total cost of Qard Hasan Item (C1+C2)	The final amount that the client will be paying over the financing tenor period.	$

Revenue Item	Explanation	Unit
R1. Quantity of product that is produced by the client	Estimate amount of product that the client can produce and sell over the financing tenor based on current productivity. Use recent output of the client as an indicator.	Ton/kg
R2. Price of product that will be sold	Estimate the price of the product that the client will sell. The estimated sales price should be in line with the market price expectation.	$
R3. Revenue generated by the product (R2*R3)	This is the estimated revenue that will be generated by the client's financed business.	$

Profit Estimation	Explanation	Unit
P1. Estimated profit generated by financed business (R3-C3)	This is the estimated profit.	$
P2. Conservative deduction (e.g. P1*(20% to 50%))	This measure can be put in place to ensure that the estimated profit figures remain conservative.	$
P3. Conservative profit figure (P1-P2)	This profit figure gives a conservative estimate of the expected profit that will be generated by the client.	$

Benefit Estimation	Explanation	Unit
B1. Conservative profit (P3/no of days of financing tenor)	It is important to ensure that the client earns a decent profit. If their margins are too small, the profit generated may not be worthwhile for the client, with the labour and effort they put in. It is also a measure of how the intervention has helped move the client out of poverty.	$
B2. Financing cost comparison (C2- market interest rate)	The benefit generated by the MFI/FI to the client by providing an interest-free loan.	$
B3. Total direct benefit to the client (B2)	Measures competitiveness of the MFI/FI in comparison with the market. Also measures how much value add the MFI/FI directly provides through the transaction.	$

Benefit generated from equity-oriented products

Generally, there are three main Islamic financial products under this segment- Mudaraba, Musharaka, Diminishing Musharaka.

Mudaraba, Musharaka, Diminishing Musharaka generally used for venture capital investments. The client deploys the investment provided by the bank for a profit-sharing arrangement between the MFI/FI and the client. In such a situation, a full-scale project feasibility study is needed. However, general parameters of the project forecast can be shown below:

Table 4.8 Client Cost-Benefit Analysis for Equity-Oriented Financing

Expenses	Explanation	Unit
C1. Estimated expenses of the business	The feasibility study will detail the project expenses over the project period.	$
C2. Cashflow expense requirements	The investment amount should be sufficient to ensure that the business does not have negative cashflow.	$

Revenue Item	Explanation	Unit
R1. Estimated revenues of the business	The feasibility study will detail the project revenues over the project period.	$
R2. Conservative revenue shortfalls	The estimated revenues should be reduced by about 20% since no business can be in full control over their revenues.	$
R3. Conservative revenue figure (R1-R2)	This is the conservative revenue figure that would be generated by the business over the project period.	$

Profit Estimation	Explanation	Unit
P1. Total profits generated by the business (R3-C1)	Total profits generated by the business over the project period. Conservative revenue figure is used.	$
P2. Profit ratio of client	This is the profit-sharing ratio agreed with the client.	%
P2. Client profits (P2*P1)	This is the share of profits that will be distributed to the client.	$

Benefit Estimation	Explanation	Unit
B1. Profits earned by the client (P2)	This is the share of profits that will be distributed to the client and is hence the impact on the client.	$

Benefit Estimation	Explanation	Unit
B2. Profits earned by the client/ no of days of the project	The share of profits distributed to the client over the number of days of the project.	$

4. PRODUCT DESIGN FRAMEWORK

New financing products which are feasible, affordable, functional and in-demand in the targeted client areas, should be financed through Islamic financing instruments. In the design process of these new products, it is important to have Sharia compliance support, which includes the technical specifications as well as legal processes needed. An effective product design for each new financial product needs to illustrate the Islamic financing instruments, product features, launching costs and resources. This can be used to communicate the product within the MFI/ FI and to potential clients. It should be developed in collaboration with the MFI/FI experts and targeted towards specific geographic areas. The design should be clear, simple and be able to answer the following:

- What would the new financial product look like?
- How much would it cost to develop?
- Would this new product be beneficial to the clients?
- How would clients be made aware of the processes and implementation?

Designing a New Product

Academics and marketing practitioners point out that services differ from products; they are intangible, heterogeneous, perishable and inseparable from the service provider. Additional P's have evolved to help create a comprehensive framework for marketing services. Applying the 8P's in a service business is essential to developing a marketing plan[1]. The MFI/FI can be recommended to use the traditional marketing 8P's framework to guide the design of new financial products.

Table 4.9 The 8P's of New Financial Products

		Includes
1	**Product** – The features of the loan/financing	▸ Targeted client ▸ Loan amount, term and purpose ▸ Guarantees or collateral, if any ▸ Security deposit
		Includes
2	**Pricing** – Considers the market potential and profit/ sustainability objective using various strategies that include competitive, cost-plus, demand-based and break-even. It looks at behavioural attitudes and perceived values.	▸ Profit rate ▸ Profit-sharing ratio ▸ Loan fees ▸ Penalties ▸ Incentives
		Includes
3	**Place** – Where is the new financial product accessible and when is it wanted? Important lessons can be drawn from the informal sector, where access to debt is readily available but at a high price.	▸ Place of loan disbursement ▸ Place of loan distributions ▸ Place of repayment ▸ Location of operations

1 Applying the Eight P's of the Marketing Mix in the Service Industry by Scott Smith

4	**Promotion** – Refers to sales communication, which is used to inform and persuade clients.	**Includes** ▸ Advertising and marketing ▸ Public relations
5	**People** – Considers how the clients are treated during the process of obtaining the new financial product. To deliver the best customer service, IFIs need to recruit the right staff and invest in training on new financial products and their procedures.	**Includes** ▸ Employees (IFIs)
6	**Positioning** – IFIs' effort to occupy a distinct competitive position in the mind of the targeted customer; the clients' perception.	**Includes** ▸ Transaction cost ▸ Price and quality ▸ Turnaround time ▸ Professional service
7	**Physical evidence** – Presentation of the new financial product.	**Includes** ▸ Physical appearance of offices, branches, points of service, ATM stations, loan officers ▸ The appearance of the brochures and posters ▸ Transaction receipts ▸ Loan cards and passbook
8	**Process** – How the new financial product is delivered to a client.	**Includes** ▸ Financing origination ▸ Financing appraisal and approval ▸ Financing disbursal and repayment ▸ Processing and documenting of transactions

5. DESCRIBE SIMILAR PRODUCTS IN THE MARKET AND CONDUCT A SWOT ANALYSIS

Learning how to identify similar products in the market is important in developing a new product. In order to stay competitive, you need to understand who your competitors are, what they are offering and how the product fits into the competitive environment. You can identify similar products by looking at which products are currently being offered to your target customers. These are generally your direct competitors. A conventional MFI/FI offering a loan product for agriculture may be considered by your customers as an option to compare with your new product. Besides direct competition, there are also other offerings which may not be a direct competitor but may still provide similar benefits. An example is a shopkeeper who is willing to sell fertilizer or seeds on credit terms.

The next step is to conduct a market segmentation and divide the market into different groups consisting of people who have relatively similar product needs. The purpose is to better understand the needs of targeted customers in selected market segments. With this understanding, the product can be better adjusted to meet their needs and concerns. In order to get a profile of your targeted customers and segment them, questions you may ask may include the following:

- What are the problems of this type of client?
- Where do they turn to for information to solve their problems?
- Do they have a preference for cash or direct financing?
- Do they have a preference for Sharia-compliant financing?
- How poor are your clients?
- Do they have assets?

- What are this client's hopes and dreams?
- What benefits can this client get from your product?
- What product attributes do they want?
- How did they learn about your MFI/FI?
- What are they really using your services for?
- What benefits do they get from your services?
- What do and don't they like about your services?

A diagrammatic illustration can be used to analyse the response and feedback.

The below table is an example that attempts to categorize the targeted customers based on their attributes. Different competitive products may be developed for different market segments. Competitor A may design a product that primarily caters for segment 2a), while Competitor B may offer a product that caters for segment 3c). Products could be offered to more than one segment or tailored more closely to appeal to one segment. This matrix can be developed with various combinations of attributes in order to better understand the customer's perception of the product attributes and how the product may be better marketed to appeal to the targeted customer.

Table 4.10 Market segmentation of products

1a) Requires assets only/below poverty line Poor smallholder livestock herders	1b) Requires assets only/close to poverty line Irrigated smaller farmers that require seeds and fertilizer Livestock farmers	1c) Requires assets only/above poverty line Livestock large herders
2a) Requires both assets and working capital/ below poverty line Rainfed farms that require irrigation systems Poor smallholder farmers that run trading businesses	2b) Requires both assets and working capital/close to poverty line Farmers with medium sized farms who hire workers Farmers who lease land for development	2c) Requires both assets and working capital/above poverty line Farms with small machinery
3a) Requires working capital only/ below poverty line Poor smallholder farmers Poor unemployed families that require emergency funds	3b) Requires working capital only/ close to poverty line Farmers involved in fisheries Small retail businesses	3c) Requires working capital only/ above poverty line Large farms that hire workers Large retail owners

A SWOT analysis should be done for competitive products. Such analysis would help highlight aspects of the product that require improvement in order to be competitive in the market. Below is an example of a SWOT analysis.

The below analysis could also be done quantitatively. Each category of factors is given weights that sum up to 1, with the different weights being determined according to the importance of the respective factors and the impact they can have on the competitiveness of the product in general. Each strength or opportunity

Table 4.11 Qualitative SWOT Analysis

Internal	**Strengths** - Low pricing - Flexible - Good distribution channels	**Weaknesses** - High collateral requirement - Complex repayment structure

External	**Opportunities** • Growing demand for agricultural inputs • Growing demand for Sharia-compliant products	**Threats** • Reduced donor appetite in grant financing • Inconsistent regulatory policies that may affect product acceptance

factor is then graded from 1 (the lowest score) to 5 (the highest score), while factors in the weaknesses and threats categories are conversely graded from -1 (the lowest level of negative effects on microfinance) to -5 (the highest endangering effect on the factor). An example of the calculation of the scores can be seen in the table below.

Based on the below table, it appears that the product that is being developed scored an overall strength of 3.5 and an overall weakness of -2.6. This means that it has intrinsic factors with a combined value of 0.9 (3.5-

Table 4.12 Quantitative SWOT Analysis

Strengths	Weight	Score	Total Score
Low pricing	0.5	4	2.0
Flexible	0.2	3	0.6
Good distribution channels	0.3	3	0.9
Subtotal	**1.0**		**3.5**
Weaknesses	**Weight**	**Score**	**Total Score**
High collateral requirement	0.4	-2	-0.8
Complex repayment structure	0.6	-3	-1.8
Subtotal	**1.0**		**-2.6**
Opportunities	**Weight**	**Score**	**Total Score**
Growing demand for agricultural. inputs	0.5	4	2.0
Growing demand for Sharia-compliant products	0.5	4	2.0
Subtotal	**1.0**		**4.0**
Threats	**Weight**	**Score**	**Total Score**
• Reduced donor appetite in grant financing	0.7	-3	-2.1
• Inconsistent regulatory policies that may affect product acceptance	0.3	-4	-1.2
Sub- total	**1.0**		**-3.3**
Grand Total			**1.6**

2.6), reflecting higher strengths than weaknesses. Similarly, in terms of external factors the opportunities have a score of 4.0 while threats have an overall score of -3.3. This means that the overall external outlook is positive with a value of 0.7 (4.0-3.3).

6. SHARIA-SPECIFIC PRODUCT GUIDELINES FOR VARIOUS ISLAMIC MODES OF FINANCING

Murabaha Guidelines

Murabaha financing is a purchase and sale contract in which the seller declares his/her cost and profit. Murabaha is commonly implemented by many Islamic MFIs/FIs. Under this mode, the MFI/FI provides the requested amount of funds as available within a preapproved limit for a specific period under the Murabaha financing facility. As a financing technique, it involves a request by the client to the MFI/FI to purchase a certain item for the client, thus facilitating the purchase of goods or raw materials for business needs. The MFI/IFI does that in consideration of a definite mark-up above the cost. The Murabaha transaction could be either a cash sale (spot Murabaha) or a credit sale (deferred payment Murabaha) or a combination of both; payment can be in the form of a lumpsum amount, in instalments or a combination of both.

Murabaha contract is a type of purchase and sale contract under Sharia, where the purchaser relies upon the honesty of the vendor to obtain the preferred Sharia-compliant asset at a rational cost. Hence, the seller in the Murabaha contract is required to disclose the breakdown of the selling price, which comprises the cost and the mark-up, to the purchaser.

In the context of Islamic financial transactions, an MFI/FI performs both the roles of a trader and a financier under the Murabaha contract. As a financier, the MFI/FI provides a line of finance to its clients to cover the cost of establishing the business (i.e. assests). While as a trader, the MFI/FI undertakes to get a specific asset from the provider based on the buyer's requirements and then sells the asset to the buyer with full disclosure of the asset's acquisition cost and profit margin. Murabaha is often referred to as 'cost-plus financing' and frequently appears as a form of trade finance.

MFIs/FIs may deal with the supplier directly or appoint the client as an agent to acquire the asset on its behalf for the purpose of the Murabaha transaction. Sharia underlines the prerequisite for the supplier to assume possession of the asset and undertake the risk associated with its control prior to the execution of the Murabaha contract, irrespective of the previous responsibility delivered by the buyer. MFIs/FIs are free to attach any necessary annexes and supporting documents pertinent to the country's legal framework.

Objectives and scope of the Guidelines

- These guidelines aims to encourage end-to-end compliance with Sharia requirements as well as to ensure that sound Islamic finance practices and client protection are implemented throughout the life cycle of the Murabaha contract.
- It describes the operational requirements that any IFI needs to consider while carrying out the Murabaha contract.

The policy section must be read in conjunction with the other toolkits, especially the "Islamic Financial Products Implementation Toolkit", which relates to the implementation of Murabaha.

Sharia prerequisites and components of Murabaha

Murabaha refers to the sale and purchase of an asset where the acquisition cost and the mark-up are disclosed to the purchaser.

Murabaha is a binding sale and purchase contract. Thus, the contract may not be unilaterally terminated by either party. Additionally, the sale contract must explicitly stipulate the transfer of ownership of the asset from the seller to the purchaser.

The parties to a Murabaha contract are a seller and a buyer, with both parties having legal capacity to enter a contract. Either party to a Murabaha contract may

be a natural person or a legal person.

Assets, prices and operational requirements and oversight functions

The asset to be traded in a Murabaha contract must meet the following conditions:

- Sharia-compliant (acknowledged by Sharia, valuable, identifiable and deliverable).
- Already in existence or possessed by the vendor.
- Tangible

Possession of the asset pursuant to the Murabaha transaction must be effectively moved from the seller to the buyer through a valid sale and purchase contract.

Any Murabaha asset must have only one contract. Multiple Murabaha contracts on the same asset may not be entered into concurrently. The contracting parties may mutually agree, at the time of entering the contract, on a validity period for the rescind-on-defect option.

The price and currency used in the transaction shall be determined and jointly granted at the time of entering the Murabaha contract. The price shall be based on the disclosed acquisition cost and added mark-up at the time of entering the contract.

The contracting parties may agree to make payment of the instalments or full settlement in a currency different from the currency identified in the contract at the agreed prevailing exchange rate on the payment or settlement date, respectively. The contracting parties may agree to prolong or rearrange the payment period of the outstanding debt without any increase in the amount of the remaining debt. In the event of default, the seller may purchase the same asset or part thereof from the defaulting purchaser in cash at a mutually agreed price. The seller may claim from the defaulting buyer all costs incurred to recover the defaulted payment, including but not limited to the costs of legal expenses and fees that the seller incurs to recover the outstanding payment. The seller however, may not levy any form of penalties over and above the actual costs incurred.

Under the section on operational requirements and oversight functions, regulatory prospects come into place for better and more effective policies and procedures to carry out oversight functions, conduct Murabaha transactions, disclose information and manage risks. The policy intends to provide sufficient protection of the parties' interests, promote interconnected business and risk management strategies and drive control measures, while preserving Sharia compliance.

In terms of oversight, the MFI/FI must establish inclusive internal policies and procedures to ensure that all Murabaha transactions are Sharia-compliant, based on sound practices and within proper cooperative oversight arrangements.

Documentation, internal policies and procedures

The MFI/FI must generate legal documentation, policies and procedures to ensure the transaction is valid and carried out in accordance with Sharia.

Figure 4.3 Oversight Process for Murabaha

a. Documentary requirements

The MFI/FI must develop a comprehensive set of legal documentation that shall specify the agreed terms on asset acquisition, asset sale and financing arrangements.

b. Information disclosure

The MFI/FI should provide relevant information to enable potential investors to understand Murabaha transactions. The MFI/FI should make available comprehensive and precise information to its client about the application of Murabaha contracts. The information in the product disclosure sheet or marketing material may include the following:

Table 4.13 Documentation of the Murabaha Transactions

Acquisition of Asset	Sale of Asset	Inventory Management
MFI/FI must undertake asset acquisition process based on approved policies	MFI/FI must ensure it has se-cured ownership of the asset prior to entering a Murabaha contract or sale of asset agreement with the client	Acquired asset is securely kept and properly maintained by the IFI (based on the project or size of the credit)
MFI/FI must ensure the asset acquisition transaction under-taken for the purpose of Mu-rabaha contract is genuine and verified by proper and suffi-cient documentation	Agreed selling price and de-ferred settlement terms or fi-nancing terms must be in ac-cordance with the approved policies governing the financing and pricing of Murabaha trans-actions	MFI/FI assesses the condition of the asset
MFI/FI must implement appro-priate mechanisms to ensure the asset acquired by the agent satisfies the client's needs	Agreed currency of settlement associated with the sale of as-set must be clearly stipulated in the Murabaha contract	MFI/FI forms a system which monitors assets that are main-tained by the appointed agent
MFI/FI may require the client to place security deposits as a control measure to affirm the latter's commitment to enter a Murabaha contract	Ownership of the asset sold under Murabaha contract shall be effectively transferred to the client in accordance with the terms agreed in the sale document	MFI/FI establishes a mecha-nism on asset valuation, which includes the applicable valua-tion methodology

- Objective of the financial product
- Analysis of the Murabaha transaction and its structure
- Roles, responsibilities, rights and duties of the contracting parties
- Key terms and conditions of the contract
- Description of asset to be financed under the Murabaha contract
- Fees and charges, including compensation charges in case of customer's failure to fulfil the promise to purchase the asset

Qard Hasan Guidelines

Qard Hasan is basically an "interest-free loan" that is made either for welfare purposes or for fulfilling short-term funding requirements. Ultimately, the borrower is only obligated to repay back the principal amount of the loan.

This policy document aims to provide reference on the Sharia rulings applicable to Qard Hasan, elaborate

key operational necessities for the execution of Qard Hasan and promote Sharia compliance.

This section must be read in conjunction with the other toolkits, especially the "Islamic Financial Products Implementation Toolkit", which relates to the implementation of Qard Hasan.

Sharia compliance elements and components of Qard Hasan

An MFI/FI must ensure that its Qard Hasan contracts are in line with the basic Sharia principles. In the contract, Qard refers to an amount of money[2] that is loaned/given to a borrower, who is bound to repay the principle loan to the lender.

Qard Hasan contract is established when ownership of an amount of money belonging to the lender is transferred to the borrower and the borrower is obliged to repay the lender. It is the responsibility of the borrower to repay the money borrowed. Terms and conditions of the Qard Hasan contract need to be mutually agreed by both contracting parties.

A Qard Hasan contract comprises (a) the contracting parties (a lender and a borrower); (b) offer and acceptance[3] ; and (c) the money. The lender must be the possessor of the money to be lent to the borrower under the contract. In addition, the contracting parties could be natural persons or legal persons and must have the legal capacity to enter the contract.

If the borrower failed to repay the lender timely due to his inability to repay as a poor client, the MFI/FI may consider extending the repayment deadline for this client. Non-poor clients that fail to repay due to negligence may be charged penalty fees as decided by the Sharia committee if they do so out of negligence and not due to their inability to repay.

Qard Hasan with fee and the completion of the Qard contract

A lender in a Qard contract may levy charges to cover only the direct costs of providing the identified services, benefits, facilities or privileges. Such charges must be fixed and mutually agreed by the contracting parties. In addition, the amount of charges may vary according to the importance of different types of identified services, benefits, facilities or privileges.

A Qard contract ends by the completion of all obligations of the contracting parties under it, which includes settlement of the Qard amount in any of the following ways:

- Settlement of the entire Qard amount at maturity
- Early settlement through mutual agreement of the contracting parties
- Transfer of the whole obligation of the borrower to pay the Qard amount to a third party
- Full waiver by the lender of his right to receive the Qard amount

After the completion of the Qard contract, the contracting parties become free of any contractual obligations under such Qard contract.

Salam Policy

Salam is an advance purchase contract whereby the MFI/FI purchases goods (typically agricultural) and advances the price to the client. The client utilizes the funds as working capital to produce the product. The future price is a discount of the expected spot price and the MFI/FI will earn the profit upon selling the product to a buyer.

2 Money may include cash in any currency, gold or silver.

3 A valid contract in Sharia requires an offer (Ijab) and an acceptance (Qabul). Here, offer means a specific action that represents a declaration of willingness by its maker to enter into a binding contract, and acceptance is the counter-declaration indicating consent to the offer.

Table 4.14 Salient Aspects of Qard Contracts

Contractual Benefits	Granting Hibah[4]	Repayment of Qard
Must not contain any contractual benefit to the lender	The borrower under a Qard con-tract must not grant the lender a Hibah that is conditional to the Qard contract, whether it be in the form of cash, in kind or bene-fit	The money borrowed un-der the Qard contract must be repaid according to the agreed term of the Qard contract or, in the event that there is no such term, at the request of the lender
Contractual benefit that is ge-neric in nature, not dependent on the Qard contract and not exclusive to the lender is al-lowed	The granting of a Hibah to the lender that is solely based on the borrower's discretion is allowed	Repayment must be based on the prevailing exchange rate on the payment date or any rate agreed by the parties on the payment date

4 Hibah: A transfer of ownership of an asset from a donor to a recipient without any consideration

The financing received from advance purchase of manufactured or agricultural goods can be used to support the expenses incurred for the manufacturing and production. Some of the features of Salam include the following:

- Salam is a forward sale. Delivery of the purchased good is deferred; the price is paid in advance.
- The objective is to advance payment and effect an actual sale. The price has to be fully paid in advance.
- Salam is an advance purchase sale. This contract helps clients gain access to markets.
- MFI/FI takes risk of client not delivering the purchased product.
- Salam cannot be applied in respect of commodities that are required to be delivered on the spot (e.g. gold and silver).

Objectives and scope of the guidelines

- This policy encourages end-to-end compliance with Sharia requirements as well as to ensure that sound Islamic finance practices and client protection are implemented throughout the life cycle of the Salam contract.
- It describes the operational requirements that any IFI needs to consider while carrying out the Murabaha contract

This section must be read in conjunction with the other toolkits, especially the "Islamic Financial Products Implementation Toolkit", which relates to the implementation of Salam.

Sharia prerequisites and components of Salam

Salam is beneficial to the seller, because he/she receives the price in advance. It is also beneficial to the buyer as, normally, the price in Salam is lower than the price in spot sale (at the time of delivery). Since the permissibility of Salam is an exception to the general rule that prohibits forward sales, it is subjected to some strict conditions, as summarized below:

- The buyer must pay the price in full to the seller at the time of sale.
- Salam can only be used to finance commodities that allow for exact specification of quality and quantity.
- Salam cannot be used to finance a particular commodity or on a product of a particular field or farm (origin), since supply of such commodities cannot be guaranteed.

- Salam sale is impermissible on existing commodities or on land and real estate because the description of the land or the real estate entails the location.
- The commodities must not be unique, i.e. if the commodity is lost or destroyed, a similar commodity could be acquired from another source (e.g. wheat, rice, sugar, etc.)
- Standardized production of companies can also be transacted under Salam (sugar, fertilizer, poultry feed, etc.).
- The period specified for delivery of the commodity should be sufficient to allow convenient use of the Salam capital, with a resulting impact on the prices of Salam commodities.
- The exact date and place of delivery must be specified in the contract.
- A Salam contract can be rescinded with the consent of both parties, provided that the original price paid is returned.
- Before delivery, the goods remain at the risk of seller. After delivery, the risk is transferred to the purchaser.

Assets, prices and operational requirements and oversight functions

Salam is primarily a mode of financing for small farmers and traders. However, it can also be used efficiently in the industrial sector, particularly the agro-based industries, subject to the basic principles of Salam. The price in Salam is normally fixed at a lower rate than the price at spot (when the commodity is delivered). In this way, the difference between the two prices becomes a legitimate profit for the MFI/FI.

In order to ensure that seller shall deliver the commodity on the agreed date, the MFI/FI can also ask the client to furnish a security, which may be in the form of promissory note, a guarantee, a mortgage or hypothecation, for example. In the case of default by the client in delivering goods, the guarantees may be invoked or the original price can be returned by the client if so agreed between the parties. If, due to any unforeseen reason, it is not possible to deliver the commodity on the due date, it is permissible to replace the commodity with another by mutual consent. The market value of such substituted goods at the time of delivery may not be higher than the market value of the originally agreed commodity. Salam cannot be exercised on a commodity that is considered a medium of exchange, i.e. currency, gold or silver. Moreover, Sharia does not allow the MFI/FI to sell the commodity before it is actually delivered.

As it would be impractical for the MFI/FI to receive different commodities from different clients and sell them on the market, it may resort to any of the following solutions:

1. Once the commodity is received by the MFI/FI, while actually being kept in the warehouse/store of the client against payment of rent, the client or any third party can be appointed as agent to sell the commodity on the market and deposit the sale proceeds with the MFI/FI. This is the most common practice and is convenient for MFI/FIs.

2. Alternatively, after purchasing a commodity on Salam basis, the MFI/FI may sell it through a parallel contract of Salam for the same date of delivery agreed in the first Salam contract. This could also be used by the MFI/FI as a liquidity management tool. However, the two Salam contracts must be kept separate and non-contingent, i.e. delivery of the commodity in the first Salam may not be set as a condition for delivery in the second Salam.

3. The MFI/FI may also obtain from a third party a promise (undertaking) of purchase.

Documentation, internal policies and procedures

The MFI/FI must legal documentation, policies and procedures to make sure the transaction is valid and carried out in accordance with Sharia.

a. Documentary requirements

The MFI/FI must develop a comprehensive set of legal documentation for Sharia-compliant Salam transactions. Such documentation shall specify the agreed terms on asset acquisition, asset sale and financing arrangements.

Table 4.15 Documentation of Salam Transactions

Advance purchase of product	Sale of product during harvest
IFI must undertake a future goods acquisition process based on approved policies	IFI must ensure that it has secured beneficial ownership of the goods prior to entering a sepa-rate sale of the product with a buyer
IFI must ensure the future product purchase transaction undertaken for the purpose of Salam contract is genuine and that the client has the ability to produce the goods	Transportation and specification of the product must be agreed with the buyer separately from the Salam contract.
IFI may require the client to place security de-posits as a control measure to affirm the latter's commitment to enter a Salam contract.	MFI/FI will accept the goods from the client if they meet the requested specifications

Mudaraba Guidelines

In Mudaraba, one party supplies the capital and the other party provides the implementation capability to undertake a specific investment. All these operations need to be predefined under a Sharia-compliant contract. In this contract, the party supplying the capital would be called capital provider. The other party is referred to as a manager or entrepreneur and is the party who actually runs the business.

Sharia compliance is the first criterion for certifying the acceptability and reliability of Islamic financial products and services. Mudaraba contracts are mainly based on an investment relationship between a capital provider and an entrepreneur (Mudarib). In Mudaraba, all realized income/earnings from investing the capital are distributed, while financial losses are borne solely by the capital provider.

In the Mudaraba policy, three elements are important for better management:

- Full Sharia compliance, follow the best practices in financial management as well as protects client rights
- Performing the role as an investor to grow the business of the investee similar to that of a Venture Capital investor.

This section must be read in conjunction with the other toolkits, especially the "Islamic Financial Products Implementation Toolkit", which relates to the implementation of Mudaraba.

Islamic finance requirements

As it is based on a investment relationship, under Mudaraba contracts a manager/entrepreneur (Mudarib) carries out the businesses basically in trust. If any loss is incurred due to misconduct, negligence or breach of contract on the part of the entrepreneur, he/she shall be responsible for the impairment.

Either party may unilaterally terminate the contract at any time except in the following cases:

- The manager has begun the work relating to the management of the assets of the capital provider
- The parties entered into a Mudaraba contract for a designated period of time
- The parties agreed not to terminate the Mudaraba contract within a specified period of time

Mudaraba contracts can be in either of two possible

Figure 4.4 Forms of Mudaraba

Restricted Mudarabah	Unrestricted Mudarabah
• A contract in which the capital provider imposes specific restrictions on the Mudaraba terms, such as the determination of location, period for investment, type of project and commingling of funds	• A contract in which the capital provider permits the Mudarib to manage the Mudaraba capital without any specific restriction

forms, based on mutual agreement:

Components of Mudaraba

The capital provider and Mudarib are the contracting parties and each may be a natural person or a legal person with the legal capacity to enter into the Mudaraba contract, including, the capacity to enter into an agency contract, either as a principal or as an agent.

End of the business partnership

The MFI/FI must clearly specify the terms and conditions of exit from a Mudaraba project, including the following:

- Tenure of the Mudaraba venture
- Time or intervals permitted for the purpose of withdrawal or redemption
- Qualifying criteria for an exit before maturity
- Methodology for an asset assessment and calculation of profit and loss upon exit
- Prospective payables, including compensation or damages incurred
- Operational procedures for the exit, including

Table 4.16 Main Components of the Mudaraba Contracts

Management	Capital	Profit	Loss
The Mudarib may assign the Mudaraba capital under his management to another Mudarib	The capital of Mudaraba shall be provided by the capi-tal provider and man-aged by the Mudarib	The profit shall not be fixed in the form of a certain percentage of the capital	Loss shall be borne by the capital provider up to the capital value
The Mudarib is responsi-ble to ensure proper management of the Mudaraba venture and must act in the best in-terests of the capital provider	The capital shall be identifiable, readily available and accessi-ble for the Mudarib to commence busi-ness activities[5]	The capital provider may get lower or no profit payment if the capital is withdrawn before the maturity of the Mudaraba ven-ture	In case of multiple cap-ital providers in a single Mudaraba, the loss shall be borne by each capital provider in pro-portion to his capital contribution
The capital provider shall not be involved in man-aging the Mudaraba ven-ture, but shall have a right of access to reason-able information regard-ing the Mudaraba ven-ture	The Mudarib may in-ject his own funds into the capital with consent of the capital provider and the Mudaraba expendi-ture may be charged to the capital	The Mudarib shall not guarantee any profit on the capital provid-ed and Mudarib shall share the profit based on a ratio mutually agreed between them	The Mudarib shall not be liable for any im-pairment of asset un-less such loss is due to his misconduct, negli-gence or breach of specified terms of the contract

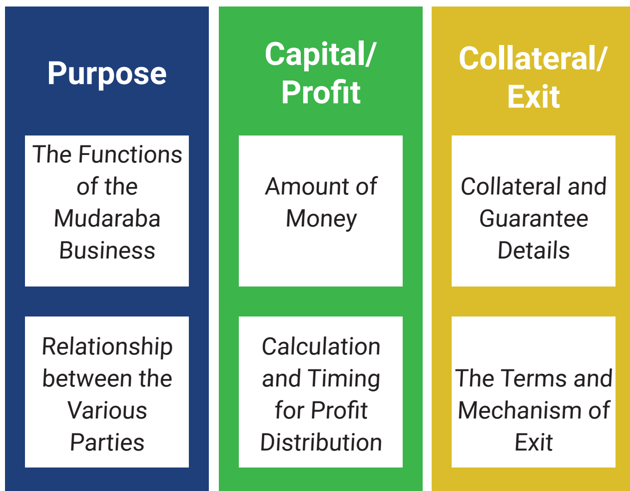
5 The capital may be in the form of cash or in-kind, including intangible assets.

submission of relevant documents, notice period, number of days taken to process the transaction and settlement period

Documentation

The MFI/FI must develop inclusive and legally binding documentation for any Mudaraba venture in compliance with Sharia principles and regulatory frameworks. At a minimum, the legal documentation shall clearly specify the following:

Figure 4.5 Subjects of the Legal Documentation in Mudaraba



Musharaka/Diminishing Musharaka Guidelines

Compliance with Sharia requirements is a prerequisite for ensuring the legitimacy and integrity of any Islamic financial products and services. In meeting this expectation, it is essential for an MFI/FI to establish the necessary operational framework and infrastructure to ensure that the conduct of Islamic financial transactions.

The Sharia contract-based regulatory policy is intended to promote transparency and consistency of Sharia contract application, which would enhance the contract certainty and strengthen Sharia compliance by IFIs.

The Sharia contract-based regulatory guidelines consists of two components, namely the Sharia requirements and operational requirements. The Sharia requirements highlight the salient features and essential conditions of a specific contract, while the operational requirements outline the core principles underpinning good governance and oversight, proper product structuring, effective risk management, sound financial disclosure and fair business and market conduct. The operational requirements aim to complement and promote sound application of Sharia principles. Musharaka is a partnership between two or more parties, whereby all contracting parties contribute capital to the Musharaka venture and share the profit and loss from the partnership.

The guidelines aims to:

- Provide reference on the Sharia rulings associated with Musharaka
- Set out key operational requirements with regard to the implementation of Musharaka

The policy document is also applicable to:

- IFIs, as defined in related Laws
- All financial products and services structured on Musharaka, (exceptions are defined by the local regulatory)

The policy document must be read together with, but not limited to, such Sharia rulings and policy documents as specified in the relevant laws and regulations.

This section must be read in conjunction with the other toolkits, especially the "Islamic Financial Products Implementation Toolkit", which relates to the implementation of Musharaka.

Islamic finance requirements

Musharaka refers to a partnership between two or more parties, whereby all parties share the profit and bear the loss from the partnership.

In general, there are two types of Musharaka (partnership), namely:

1. Partnership in joint ownership: refers to possession of an asset by two or more persons with or without prior arrangement to enter into a sharing in joint ownership. Under this type, each partner's ownership is exclusive, i.e. no partner

may deal with assets of another partner without the latter's consent.

2. Contractual Partnership: refers to a contract executed between two or more partners to venture into business activities to generate profit. Under this type, one partner acts as an agent for the other partners, i.e. the actions of one partner in the ordinary course of business represents the partnership as a whole.

Components of Musharaka/Diminishing Musharaka

Contracting parties: Each party to a Musharaka contract (partner) must be a natural person or a legal person with the legal capacity to enter into the Musharaka contract. A partner in a Musharaka contract may enter into the contract through an agent. Any terms or conditions in the Musharaka contract that are mutually agreed between the partners and do not contravene Sharia shall be binding on the partners.

Offer (Ijab) and acceptance (Qabul): A Musharaka contract shall be entered into by an offer and acceptance between the partners. The offer and acceptance may be expressed verbally, in writing or any other method that could be evidenced by appropriate documentation or record.

Management: A Musharaka venture may be managed by:

- A single partner, certain partners or all partners in the Musharaka contract (managing partner); or
- A third party appointed by the Musharaka (third party manager)

The appointment of a third party as the manager must be executed in a separate contract.

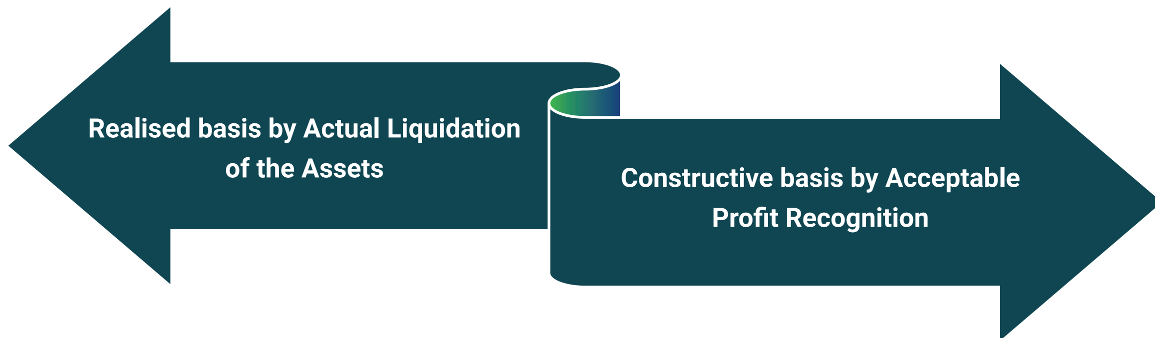
The appointment of a manager may be based on an agency arrangement (Wakala), employment contract or profit sharing (Mudaraba). A managing partner may be entitled to an agreed remuneration and/or any incentive as agreed by the partners for his services as manager. This is in addition to his share in profit as a partner, provided that the appointment of the manager is effected in a separate contract. A managing partner is liable for any loss incurred by the Musharaka because of his misconduct, negligence or breach of specified contractual terms. Amendments and variations to the Musharaka contract may be made at any time throughout the tenure of the contract. The Musharaka contract may provide that any amendment to the contract would be valid through a specified and agreed approval process such as a majority vote.

Capital: The capital of a Musharaka must be identifiable, readily available and accessible. The capital may be in the form of cash or in-kind, including intangible assets. Where the capital is in-kind, it shall be valued in monetary terms either by agreement between the partners or by a third party, which may include experts or any other qualified person, at the time of entering into the Musharaka contract. Where the capital is denominated in a different currency, it shall be valued based on a specific currency as agreed by the partners at the time of entering into the Musharaka contract. Not all forms of contribution may qualify as capital, including all account receivables and payments due from other partners or third parties. An asset with an integral financial liability attached to it may be contributed as a Musharaka capital and the Musharaka may assume the liability associated in such capital. Where an asset is contributed as capital, the Musharaka shall assume the risk associated with such asset. The total amount of capital to be contributed by each partner must be known and determined at the time of entering into the Musharaka contract. The partners' rights and liabilities with regard to the Musharaka is based on their respective contributions to its capital.

The capital may be fully or partially contributed as per the terms of the contract. Additional capital may be contributed to the Musharaka subject to mutual agreement of all partners, and the partners may vary or revise the profit-sharing ratio. The capital invested is not indemnified by any of the partners and/or the managers. A share of the capital may be transferred to existing partners or a third party, subject to the terms of the Musharaka contract. A Musharaka contract may impose a condition that a partner who wishes to sell his share of the capital would be obliged to offer it to existing partners, subject to the terms of the Musharaka contract. Any gain or loss in the value of the capital arising from the transfer of share capital

shall be enjoyed or borne, as the case may be, by the partner who disposes of such share. The Musharaka contract may provide for the withdrawal of capital by a partner during the tenure of the Musharaka contract, unless stated otherwise. Where the Musharaka contract provides for the withdrawal of capital, the loss-sharing ratio of the Musharaka shall be revised accordingly consequent to such capital withdrawal. The profit-sharing ratio in the Musharaka shall be proportionate to the capital contribution of each partner unless mutually agreed otherwise at the time of entering the Musharaka contract. The Musharaka contract shall not stipulate a predetermined fixed amount of profit to any partners that may deprive other partners of their profit shares. The expected return in the form of a percentage which is attributed to the capital amount is only permissible in the form of indicative profit rate.

Figure 4.6 Possible Profit Share Methodologies[6]



Loss: Any loss incurred by the Musharaka shall be borne by the partners in proportion to their respective capital contributions to the Musharaka. Partners may agree that the liability of the partnership is limited to the value of capital contributed. Any loss incurred by the Musharaka due to misconduct, negligence or breach of specified terms by a partner shall be borne by that partner.

End of the business partnership

A Musharaka contract is dissolved under any of the following circumstances:

- Mutual agreement to terminate
- Contract expires upon the maturity date agreed by the partners
- Demise or dissolution of partners
- Loss of legal capacity
- The total acquisition by one partner of the other partners' shares of the Musharaka
- Invalidity of the Musharaka

Remaining partners may agree to continue according to the terms of the Musharaka contract. Upon the termination of the Musharaka contract, Musharaka assets may be subjected to the liquidation process. Musharaka assets may be liquidated by disposing of them on the market.

Furthermore, earnings of the asset disposal shall be used as follows:

- **Payment of liquidation expenses**
- **Payment of financial liabilities of the partnership**
- **Distribution of the remaining assets, if any, among the partners in proportion to their respective capital contributions.**

In a Diminishing Musharkah arrangement, the IFI agrees to relinquish its share of the Musharaka in a gradual manner to the other partners. This arrangement is agreed between all partners of the business.

Documentation

An MFI/FI shall develop comprehensive and legally enforceable documentation for the Musharaka venture in compliance with Sharia and regulatory requirements.

6 **Constructive basis by Acceptable Profit Recognition:** Constructive basis according to an acceptable profit recognition method, which may include valuation according to acceptable market methodology, independent valuation or valuation based on estimated figures

At minimum, the legal documentation must clearly stipulate the following:

- Purpose of the Musharaka venture
- Contractual relationships between the various parties
- Rights, roles and responsibilities of parties to the Musharaka venture
- Amount of capital contributed by the partners
- Loss that shall be borne by the relevant contracting parties
- Calculation methodologies and timing for profit distribution
- Tenure of Musharaka venture
- Pricing or valuation method of underlying assets or shares
- Requirements on the reporting of the Musharaka venture's performance, which includes the frequency and the information to be reported
- Details on the collateral and guarantees, including rights over assets
- Terms and mechanism of exit
- Terms, fees and charges to be borne by the relevant contracting parties, where applicable

The use of Arabic terms in the documents must be adequately clarified and translated to facilitate their understanding by the contracting parties. An MFI/FI may include imposing conditions on any dilution of rights or shareholding e.g. rights issuance and any transactions that may be harmful.

7. FINANCING STRATEGY AND RISK ANALYSIS

Financing Strategy

The financing strategy is key to mitigating any liquidity risks and ensuring that the expected returns of the MFI/FI's funds match the expected risk of their financing to clients. The cost of funds of the MFI/FI is a combination of the equity and debt portfolio and is a key component in determining the types of products to introduce and the pricing of such products.

The types of possible liabilities of an MFI/FI include the following:

- Owner/founder's equity- this is the equity that is put up by the owner of the MFI/FI. Also, the MFI/FI cooperative may require their members to make an annual payment which would make up the equity. The cost of this type of funds depends on the profile of investors and their risk-return appetite. Some investors may have low risk appetite and would be expecting a lower return, while other investors are looking for a higher return despite being exposed to higher risks.
- Loans – these are loans from commercial banks or wholesale FIs who provide lines of credit to MFI/FIs at a determined cost. Typically, MFIs/FIs will use these funds as a last resort measure if they do not have sufficient liquidity to meet the high demand for credit.
- Client savings- MFIs/FIs that have a license from the regulatory authority will be able to obtain funds through client savings. While these client savings come at a low cost, ensuring sufficient capital adequacy is essential to prevent any reputational loss as a result of not being able to fulfil clients' demand for withdrawals.
- Grant financing- donors may be willing to support MFIs/FIs through grants. Grant financing may be used to provide capacity building to clients or to upgrade the capacity of the FI (MIS systems, advisory services, manuals etc.). Although grant financing is especially useful during the initial stages of operations, such funds are usually limited and should not be relied upon in the long run, unless there is a successful long-term fundraising strategy.
- Restricted funds – MFI/FIs may be required to ensure that donors' wishes are fulfilled. This may be in the form of ensuring that the funds entrusted by donors or investors are deployed in line with the mandate given by the donors. Whether the funds are used for youth or women clients or for specific

sectors like agriculture, health or education, the MFI/FI would be liable for mismanagement if these wishes are not carried out.

In order to match the liabilities with the right assets, new products developed need to be funded with the right liability class. In developing the financing product, several aspects need to be considered, including:

- Social –oriented loans- the only social oriented loan is Qard Hasan. This interest-free loan may be feasible if the cost of transaction is charged to the client or subsidized through donor grant financing. As Qard Hasan loans are interest-free, the funds used should also be of zero cost.
- Debt-oriented trading loans- products include Murabaha, Salam and Ijara. Typically, these products have lower risk compared to equity-oriented financing. Profits are generated through mark-ups on the purchase price and would need to match sources where there is low cost of funds.
- Equity-oriented investment- products such as Mudaraba, Musharaka and Diminishing Musharaka may be of high risk but they can also generate high returns. Such investments are typically for a longer tenor (e.g. 3 to 5 years) compared to debt-oriented trading loans, where the tenors are much shorter (e.g. 6 to 24 months). Such financing should be matched with either the owners' equity or third-party investors who would want to invest in such a risk profile.
- Variable vs. fixed return structure- different products have different return structures. Generally, if the MFI/FI is reliant on funds derived from the market, such funds are usually variable in nature, while many of the products have a fixed return profile. This mismatch may cause the MFI/FI to borrow at a higher variable cost (which can go up over time), which would not be covered by a lower priced fixed return product.
- Long vs. short term tenors- savings are usually short-term commitments from savers who are likely to withdraw the funds after a short period of time. Such funds would not be appropriate if used to fund equity-oriented investments, where the tenors are about 5 years. Home and vehicle financing, which are financed with Ijara, may also require longer term fund sources with longer tenors.

Risk Analysis

During the conceptual product design stage, it would be helpful to conduct a product risk analysis on new financial product ideas to highlight the potential risks associated with each product. The market research will help identify some of the risk areas and can inform the risk analysis. The risk areas may be adapted to the MFI/FI's context. Some risk areas to assess are:

Institutional Risk Areas

- Is the staff supportive of a new financial product?
- Does the MFI/FI have sufficient expertise for the new financial product?
- Are there any staff concerns with launching a new financial product (capacity, training, etc.)?
- Does the MFI/FI have a standard protocol in place for launching new products?
- Will the new financial product require special processes?
- What will the relationship be between the staff and contractors/vendors?
- What are the policies, procedures and internal controls like? Will the MFI/FI be able to adapt them to product needs? For example, would the MFI/FI be able to create a new procedure for the new product?

Risk Areas through External Factors

- Are the local economy, seasonal patterns, cultural norms, government regulations and programmes giving any advantage to the product? For example, does the MFI/FI consider creating an innovative product that is totally new to the market?
- Is there competition from other MFIs/FIs offering the same product?

Viability of the Risk Areas

- What is the potential for client default? Will

the clients be able to afford the cost of the improvement?

- Are the terms of the new financial product manageable for the targeted clients?
- Will the product be demanded by the targeted clients?
- Is Islamic finance awareness or Sharia compliance capacity building required to create demand? If so, what are those costs?

Table 4.17 Sample Product Risk Analysis - Operational Risk - Internal

Risk	Strategy to mitigate risk(s)
Resistance to change by employees	▸ Capacity building and motivation through incentives ▸ Carry out training needs assessment
Human resource capacity — no proper estab-lishment of the personnel required to deliver the new products	▸ Engage enough qualified staff to handle the new products ▸ Assess employment for the new products
Compliance/regulatory risk	▸ Adhere to necessary acts required by central bank
Lack of in-house new product technical exper-tise	▸ Engage third parties/consultants with sufficient new product expertise
Reliance on low-cost wholesale funds	▸ Design the product for sustainability at market rates
Diversion of new product by clients	▸ Direct loan disbursement to contractors and suppliers ▸ Close client monitoring
Non-payment of loan due to client relocation	▸ Use group guarantees, personal guarantees, collateral, credit history reporting, mitigate real economy risks
Political will and commitment and regulatory changes	▸ Local partners offer insider knowledge and con-nections to mitigate the political risk ▸ Knowing what local partners/agents are doing to exercise influence
Low market share	▸ Create brand, product loyalty and awareness through advertising (television, newspapers, etc.)
Low quality items and materials supplied	▸ Create agreements with manufactures and dealers to ensure adequate warranty periods and quality guarantees on items delivered
Foreign exchange risk—price fluctuations of new products and provisions	▸ Enter into a memorandum of understanding (MOU) with clients or dealers at the country/regional levels

- Will the cost of managing the new financial product be more than the revenue earned?
- Is there sufficient cash flow to launch the new product?

Besides the above risk factors, factors pertaining to the target sector and client business should also be considered. The most important key success factor is for the client to have the ability to generate the expected business, and this can be demonstrated

Table 4.18 Risks and Corresponding Mitigation Strategies

Risk	Strategy to mitigate risk(s)
Inputs	
Changes in price of inputs	▸ Ensure adequate storage capacity for inputs
Difficulty in obtaining inputs	▸ Secure supply of inputs through contracts ▸ Diversify supply channels
Labour does not have the capacity or is not relia-ble	▸ Ensure business operators have sufficient capac-ity by looking at their track record
Processing	
Inability for client to generate the expected pro-ductive output	▸ Avoid doing business with individual clients, but rather with cooperative and associations that are able to compensate
Poor agriculture or trade practices	▸ Work only with farmers who have demonstrated good agriculture or trade practices
Inconsistent quality of output	▸ Help businesses develop operational systems to maintain quality standards
Output	
Inability to generate target sales	▸ Set reasonable targets, especially for initial en-gagement. Financing can increase as the busi-ness demonstrates its ability to expand
Price fluctuations of new products and provi-sions	▸ Storage facilities could be used to ensure stock is sold at the right price
Lack of marketing channels	▸ Help clients expand their marketing channels

through his recent track record. At the same time, the MFI/FI should also consider some factors that are common in the performance of the value chain such as:

8. FINANCIAL AND NON-FINANCIAL PROJECTIONS

In developing a product, the FI needs to have an appropriate financial model for the product it is launching. As part of the business plan, it has to prepare financial and non-financial projections on how the product will achieve the objective of the IFI. Below is a simple template:

Financial projection of the new product of the IFI

Income Statement (of new product)

Revenue

1. Financial revenue from new product (includes profit mark-up revenue or profit-sharing revenue received).
2. Revenues from advisory or other fees
3. Total revenue (1 +2)

Expenses

4. Financial expense from financing new product (if funds are derived from external sources, including profit sharing distribution)

5. Personnel expenses

6. Administrative expenses

7. Provision for losses

8. Total operating expenses (4+5+6+7)

Net Income

9. Net Operating Income (3- 8)

10. Non-operating grants and donations

11. Net income (9 – 10)

Balance Sheet (of new product)

Assets

1. Cash that will be used as reserves (if financed through savings)

2. Financing provided through new product

3. Expected loan loss reserve for new product (negative)

4. Total assets (1 +2+3)

Liabilities

5. Financial liabilities from financing new product (if funds are derived from external sources, including profit-sharing distribution)

6. Savings liabilities used for the new product

7. Total liabilities (5+6)

Equity

8. Share capital

9. Reserves

10. Retained earnings

Note: Financing portfolio

1. Financing outstanding

2. Portfolio at risk > 90 days (PAR 90)

3. Portfolio at risk > 180 days (PAR 180)

4. Portfolio write-off > 360 days

5. Allowance for loan loss

6. Net loan portfolio (11 +12+13+14 -15)

Financial projections/appraisal on clients- Besides deriving a financing plan for the IFI, each transaction should also have targeted benefits for the clients to ensure that the client is better off and has the ability to repay the financing. This analysis, which is shown in Section 2, should be part of the appraisal conducted by the FI on its clients.

Non-Financial projections of the new product on the MFI/FI- Every product should include a set of non-financial indicators so that it measures not only the financial performance, but also non-financial performance. Some of the targets it should measure, which are detailed in the Monitoring and Evaluations Toolkit, are as follows:

Capacity Building of partners, sector institutions and beneficiaries of the product

- Number of personnel trained
- Number of FI personnel trained and equipped
- Number of partner institutions trained and equipped
- Number of beneficiaries trained

Implementation of the Islamic finance product

- Number of locations/branches where the new financial product is made available
- Number of clients receiving financing
- Number of poor clients receiving financing
- Profits earned from the financing

- Portfolio at risk >90 days (PAR 90)
- Write-off ratio

Project management

- Processes for managing the rollout of the product in place
- Baseline survey conducted
- Monitoring and evaluation system in place
- Management information system is configured

In addition to the above general indicators, the MFI/FI should measure financial and social performance indicators as detailed in the Monitoring and Evaluation Toolkit.

Non-Financial projections of the new product on the client- The MFI/FI should also make projections on how the new product will benefit the client. The projections can be in the form of qualitative and

Table 4.19 Murabaha Qualitative Indicators

Indicator	Non-financial value to address business risks provided	Economic empowerment impact points
Pays directly to supplier and takes ownership of the product prior to selling to client (i.e. FI ensures bona fide supplier and asset).	▸ Mitigates payment receipt risk ▸ Ensures the existence of the seller and asset	1
Conducts quality check on behalf of the client. MFI checks that the asset meets the required quality specifica-tion.	▸ Ensures the quality of the asset based on the needs of the client ▸ Mitigates non-performance risk of the supplier	1
Ascertains that asset purchased by client is transferred by arranging for asset transportation to the client or ensuring that timely delivery is made.	▸ Ensures the asset is safely transferred and is in the possession of the client ▸ Mitigates transportation risks of the client	1
MFI analyses contractual data to bet-ter understand the value chain and be able to propose alternative suppli-ers and/or better products and help the clients make better decisions.	▸ Promotes price transparency with clients ▸ Helps clients make informed decisions with available historical data on similar previous transactions	1

Indicator	Non-financial value to address business risks provided	Economic empowerment impact points
Sources alternative suppliers or nego-tiates on behalf of the client. The spot rate of the asset is lower than the spot rate quoted by the client and the overall selling price is lower than the overall costs (including the average market interest rate) if financed by a conventional MFI.	▸ Helps client negotiate with suppliers for lower prices and, hence, save money. ▸ For example, client provides invoice for fertilizer amounting to $1,000. MFI negotiates for a lower price (e.g. 5% discount- $950). In addition, the selling price (after 30% profit, i.e. $1,235) is lower than the overall costs (after 30% interest, i.e. $1,300).	1
Sources alternative suppliers or nego-tiates on behalf of the client. The spot rate of the asset is lower than the spot rate quoted by the client by at least 10% of the overall selling price and is at least 10% lower than the overall costs (including the average market interest rate) if financed by a conventional MFI.	▸ Helps client negotiate suppliers for lower prices and, hence, save money. ▸ For example, client provides invoice for fertilizer amounting to $,1,000. MFI negotiates for a lower price (e.g. 15% discount - $850). In addition, the selling price (after 30%*$850 profit, i.e. $1,105) is lower than the overall costs (after 30%*$1,000 interest, i.e. $1,300).	1
Sources alternative suppliers or nego-tiates on behalf of the client. The spot rate of the asset is lower than the spot rate quoted by the client by at least 20% and the overall selling price is at least 20% lower than the overall costs (including the average market interest rate) if financed by a conven-tional MFI.	▸ Helps client negotiate with suppliers for lower prices and, hence, save money. ▸ For example, client provides invoice for fertilizer amounting to $1,000. MFI negotiates for a lower price (e.g. 25% discount - $750). In addition, the selling price (after 30%*$750 profit, i.e. $975) is at least 20% lower than the overall costs (after 30%*$1,000 interest, i.e. $1,300).	1
Sources alternative suppliers or nego-tiates on behalf of the client. The spot rate of the asset is lower than the spot rate quoted by the client by at least 30% and the overall selling price is at least 30% lower than the overall costs (including the average market interest rate) if financed by a conven-tional MFI.	▸ Helps client negotiate with suppliers for lower prices and, hence, save money. ▸ For example, client provides invoice for fertilizer amounting to $1,000. MFI negotiates for a lower price (e.g. 35% discount - $650). In addition, the selling price (after 30%*$650 profit, i.e. $845) is at least 30% lower than the overall costs (after 30%*$1,000 interest, i.e. $1,300).	1

Table 4.20 Murabaha Quantitative Indicators

Type of products/ interventions	Quantitative indicators
Murabaha	Example: Client needs $1,000 to buy fertilizer and seeds. MFI negotiates with supplier at retailer or wholesaler level, gets 30% discount Negotiated purchase price $700 (purchase price). Client borrows from MFI at 30% profit per annum over 1 year. Pays $910 (selling price) after 12 months ($700 principle, $210 profit). The market interest rate is 30%. The poverty line is set at $2.50 per day.

Impact of choosing Islamic loan compared to conventional loan

Savings or benefit generated from choosing Islamic loan compared to conventional loan

= Cost of conventional loan (principle + interest)- Murabaha selling price
= $1,300 - $910
= $390

Percentage of savings or benefit generated from choosing Murabaha compared to conventional loan

= (Cost of conventional loan (principle + interest)- Murabaha selling price)/ cost of conventional loan (principle + interest) *100%
= ($1,300 - $910)/ $1,300 * 100%
= 30.00%

Savings or benefit generated from choosing Islamic loan compared to conventional loan contributing to poverty alleviation

= (Cost of conventional loan (principle + interest)- Murabaha selling price)/ financing tenor in number of days) / Poverty Line (income per day)*100%
= ($1,300 - $910) /365 /2.5 *100%
= 42.74%

Impact of negotiation with supplier

Savings or benefit generated due to negotiation conducted by microfinance institution

= Initial spot purchase price – negotiated purchase price of MFI
= $1,000 - $700
= $300

Percentage of savings or benefit generated due to negotiation conducted by MFI

= (Initial spot purchase price – negotiated purchase price of MFI)/ initial spot purchase price *100%
= ($1,000 - $700) / $1,000 *100%
= $300/ $1,000 * 100%
= 30%

Percentage contribution of savings or benefit generated that is directly contributing to poverty alleviation as a result of direct negotiation

= (Initial spot purchase price – negotiated purchase price of MFI)/financing tenor in number of days) / poverty line (income per day)
= ($1,000 - $700) / 365/2.50 *100%
= $300/ 365/2.50 * 100%
= 32.88%

Type of products/ interventions	Quantitative indicators
Combined indicator- impact of negotiation by MFI less any additional cost Savings or benefit generated due to negotiation less any additional cost incurred = Benefit of negotiation – cost of negotiation = Initial spot purchase price – negotiated purchase price of MFI – (Profit rate of Murabaha*initial spot purchase price – market interest rate * loan principle) = $1,000 - $700 – (30% (profit rate) * $1,000 – 30% (interest rate) * $1,000) = $300 – 0 = $300 Percentage of savings or benefit generated due to negotiation less the possible additional cost incurred = (Benefit of negotiation – cost of negotiation)/ initial spot purchase price = (Initial spot purchase price – negotiated purchase price of MFI – (Profit rate of Murabaha*initial spot purchase price – market interest rate * loan principle))/initial spot purchase price = ($1,000 - $700 – (30% (profit rate) * $1,000 – 30% (interest rate))/$1,000 *100% = ($300-0)/ $1,000 * 100% = 30% Percentage of savings or benefit generated due to negotiation less the possible additional cost incurred that is directly contributing to poverty alleviation = (Benefit of negotiation – cost of negotiation)/financing tenor in number of days/poverty line (income per day) = Initial spot purchase price – negotiated purchase price of MFI – (profit rate of Murabaha*initial spot purchase price – market interest rate * loan principle) / financing tenor in number of days / poverty line (income per day) = ($1,000 - $700– (30% (profit rate) * $1,000 – 30% (interest rate)) / 365/2.50 *100% = ($300-0)/365/2.50 * 100% = 32.88%	

quantitative indicators that measure the value add of the product offered by the MFI/FI. The MFI/FI should include relevant economic empowerment impact performance indicators as specified in the Monitoring and Evaluation Toolkit.

For more details on the above indicators and for other indicators related to other products (e.g. Salam, Ijara, Qard Hasan, Musharaka, Mudaraba, Diminishing Musharaka), please refer to the third toolkit on the Monitoring and Evaluation.

9. FINALIZING THE TRIAL PRODUCT AND TIMELINE

Client Concept Evaluation[7]

The most valuable information for an MFI/FI developing a new product comes from its clients. Once the preliminary product notions are developed based on the market research results, it would be prudent to solicit feedback from clients on the product concept and further adapt the financial product design prior to the pilot. This process of client concept evaluation would also contribute to streamlining and purifying the language in which the product concept is described.

7 https://water.org/documents/54/Water.org_Toolkit_2_-_WASH_Financial_Product_Development.pdf

Below is a four-step procedure for concept appraisal to be followed with customers:

Step 1– Introduce Concept to Clients

The client focus groups should be presented with the concept statement of the new financial product and a detailed discussion should take place regarding the product's features/capabilities. The product development team should write each feature on a separate card to present during the discussion.

Step 2– Assess Client Feedbacks

There are three aspects that need to be evaluated:

- **Product Features:** The product development team should solicit reactions, feature by feature (review each of the 8P's in the previous section, Designing a New Product) and continuously probe participants to identify the reasons for their reactions. Ask the group to rank the most attractive to least attractive features.

Table 4.21 Obtaining Client Feedback on a New Product

Product concept	Client reaction during concept testing	Product prototype
Loan term: **1 year**	Clients felt the 1-year loan term was too short and that, as a result, the monthly payment was too large; a 2-year loan term would be more convenient and better suit household cash flows	The loan term was increased to 2 years
Loan amount: **Between US$100 and US$300**	Clients felt that the loan amount was adequate	The loan amounts remained unchanged
Security/collateral: **15% of the loan amount**	Clients felt this was too high, since most of the existing products require only 10%	Cash collateral requirements were set at 10% for loans ≤US$200 and 15% for loans >US$200

- **Price:** Either suggest the price to the group or have the group suggest the price. The product development team should understand the reasoning provided by the clients for recommending a price.
- **Product Extensions:** The product development team should determine if options could enhance product features. For example, a flexible grace period for the new loan product.

Step 3– Refine Concept

Based on the feedback gathered, the product development team should brainstorm possible revisions and make suitable changes to the product concept (8P's).

Step 4– Introduce Concept to Clients

If the product development team is not confident in the revised changes, it should repeat steps 1-3 until confidence in the product concept is attained. The concept evaluation could take one week or less to complete. The sample size is generally very small as compared to the market research and the respondents may be selected from among the same respondents who were chosen during the market research phase. The advantage of this method is that it yields immediate feedback, allows for intense discussions with customers and enables the MFI/FI to apply real-world customer opinions to inform product refinements. The refined product, after the client concept evaluation, is called the "product prototype." The product prototype is pilot tested with clients before the launch.

A well-conducted prototype test will allow the new product development team to find out the level of appeal of the prototype. This information will allow the team to improve the idea or the marketing of the product, if necessary, so that it is targeted specifically to the most appropriate population. The more the prototype incorporates known consumer preferences, the more useful the pilot test results will be. Either way, valuable insights will come from the pilot test when the product prototype is offered in a real-market setting. Once the idea is developed qualitatively, it is important for the IFI to find out:

- The proportion of its target customers who find the idea attractive
- Who is most, and least, likely to buy the product
- How different the product is from the competition's, if any
- If the appeal of the prototype is limited, why this is the case

The decision to carry out the prototype test must be based on cost and risk. If the proposed product would cost a great deal to of deliver (necessitating changing systems or large-scale investment) and/or is considered high risk for the IFI (such as client or revenue loss if misunderstood), a prototype test is necessary. Larger organizations are more likely to need to prototype test products before pilot testing.

Timeline of Milestones for Product Rollout

As part of the business plan, an action or implementation plan should be developed with milestones, responsible parties, start date and end date. Each milestone will include activities that will be carried out by a responsible party in the MFI/FI to ensure that the product rollout is conducted smoothly.

Milestones:

1. **Team formation-** Any product rollout requires a team to be identified and manage the complete rollout process. The team should include the product champion and the product development team. However, leadership should be shifted to the person to be in charge for the product after the launch. Members of the team may include branch managers, marketing, legal, training and other members.
2. **Examine internal capacities**- The formed team will then review the business plan in line with the internal capacities of the MFI/FI. Some of the areas would include the institutional acceptance and capacity, financial and liquidity viability, organizational culture in adopting the new product, aligned human resources policies and incentives, delivery networks and links with the clients, as well as the readiness of the management information systems.
3. **Train staff–** Training is essential for the product rollout. Staff members, especially those on the frontline, should have a clear understanding of the product. Feedback from the staff prior to the rollout may also be beneficial in tweaking the marketing of the product. If the MFI/FI is large, a training of trainers approach may be the most effective. It may also be more effective for branch staff to train their own colleagues.
4. **Update marketing plan-** Based on the feedback from frontline staff, the marketing plan should be updated to incorporate the most effective means of reaching to the client. Marketing and advertising should be localized to the scope of the rollout and should include development of communication materials on the product.
5. **Product launch and rollout-** Once the MFI/FI has all the preparations in place, the product would be ready to be rolled out. The timing of the launch must coincide with availability of adequate resources that may be needed in meeting the expected initial demand from the clients.
6. **Monitor rollout and obtain feedback–** When rolling out a product, the MFI/FI needs to quickly communicate any changes with the customers. The MFI/FI must always comply with contractual agreements. While minor changes may be made to enhance the product offering, changing major aspects of the product should be avoided, as that could have detrimental effects to the product.

A sample implementation plan is summarized in Table 4.22 below. Each milestone can be further subdivided to detail the activities that should be undertaken to achieve the milestone.

Table 4.22 Sample Implementation Plan

Milestone/step	Responsible party	Deadline
Team formation		
Examine internal capacities		
Organize product rollout		
Conduct a product cost and benefit analysis		
Train staff		
Update marketing plan		
Product launch and rollout		
Monitor rollout and obtain feedback		

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