

# ECONOMIC EMPOWERMENT FOR FINANCIAL INSTITUTIONS



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## MONITORING AND EVALUATION TOOLKIT

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ECONOMIC EMPOWERMENT DEPARTMENT (EED)

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## Foreword from HE 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.

The road to economic empowerment is a journey of continuous improvement. This Monitoring and Evaluation Toolkit is a comprehensive guide for financial institutions to monitor their progress and self-evaluate their performance. Measuring and communicating their contribution to poverty alleviation will enhance their ability to demonstrate their success and raise impact funds from donors.

Donors are interested in supporting financial institutions that are (i) financially sustainable, (ii) treat their clients in a socially responsible manner, and (iii) have an impact on poverty alleviation. The Monitoring and Evaluation Toolkit measures the performance of financial institutions in all these three dimensions. It provides them with a clear understanding of where they stand under each dimension and how they can be more competitive for the benefit of their clients and their long-term sustainability.

This Monitoring and Evaluation Toolkit and the other two complementing toolkits – the Economic Empowerment Design 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 Monitoring and Evaluation Toolkit is an essential resource for how the financial institution's performance can be measured from the financial and social perspectives. The toolkit also presents an innovative way to measure the impact of the value-added generated by trading and investment activities of financial institutions. These qualitative and quantitative indicators measure the client-centricity of the financial institutions as the support they provide to their clients goes beyond financial services.

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. This toolkit presents a standard on the performance indicators that should be monitored for the continuous improvement of the Islamic financial institution.

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<sup>1</sup>, with invaluable contributions from Mohamed Mazen Dakhli<sup>2</sup> and Mehmet Fehmi Eken<sup>3</sup>, as well as the critical support provided by Smail Haddad<sup>4</sup> and Hazem Hamdy Hassan<sup>5</sup> for the editorial review and Aboubacar Kante<sup>6</sup> and Elhadi Elnahoui<sup>7</sup> for the Sharia review.

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**Dr. Nabil Ghaleb**

**Director, Economic Empowerment Department**

1 Lead Economic Empowerment Programs Specialist, Economic Empowerment Department.

2 Economic Empowerment Programs Specialist, Economic Empowerment Department

3 Islamic Finance Specialist, Islamic Finance Sector Development Department

4 Manager, Language Services Division

5 Senior Interpreter and Translator, Language Services Division

6 Lead Islamic Finance Expert, Shariah Compliance Unit

7 Senior Islamic Finance Expert, Shariah Compliance Unit





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# Abbreviations

<b>ATM</b>	Automated Teller Machines	<b>MIS</b>	Management Information System
<b>BDS</b>	Business Development Services	<b>MOU</b>	Memorandum of Understanding
<b>BOK</b>	Bank of Khartoum	<b>MSE</b>	Micro and Small Enterprises
<b>CBA</b>	Cost Benefit Analysis	<b>MSME</b>	Micro Small and Medium Enterprise
<b>CGAP</b>	Consultative Group to Assist the Poor	<b>MSMEDA</b>	Micro Small and Medium Enterprise Development Agency
<b>DEEP</b>	Deprived Families Economic Empowerment Program	<b>PAPP</b>	Program of Assistance to the Palestinian People
<b>DFI</b>	Development Financial Institution	<b>PESTLE</b>	Political, Economic, Social, Technological, Legal and Environmental
<b>EE</b>	Economic Empowerment	<b>PPD</b>	Public Private Dialogue
<b>MFI/FI</b>	Economic Empowerment Institution	<b>PSR</b>	Profit-Sharing Ratio
<b>EGY</b>	Egyptian Pounds	<b>SDG</b>	Sudanese Guinea
<b>FAO</b>	Food and Agriculture Organization of the United Nations	<b>SME</b>	Small and Medium Enterprises
<b>FI</b>	Financial Institution	<b>SWOT</b>	Strengths Weaknesses Opportunities and Threats
<b>G20</b>	Group of 20 Nations	<b>UFA</b>	Universal Financial Access
<b>GDP</b>	Gross Domestic Product	<b>UNDP</b>	United Nations Development Program
<b>GNP</b>	Gross National Product	<b>VAT</b>	Value Added Taxes
<b>IF</b>	Islamic Finance	<b>VC</b>	Value Chain
<b>IFC</b>	International Finance Cooperation	<b>VCM</b>	Value Chain Management
<b>IMF</b>	International Monetary Fund	<b>WB</b>	World Bank
<b>IsDB</b>	Islamic Development Bank	<b>YES</b>	Youth Employment Support Program
<b>M&amp;E</b>	Monitoring and Evaluation	<b>ZTM</b>	Zitouna Tamkeen
<b>MFI</b>	Microfinance Institution		

# Introduction and Overview

Monitoring and Evaluation (M&E) are key tools in project management and implementation. Monitoring informs stakeholders of progress and outcomes and shows where corrective action is needed to adjust implementation plans. Evaluation, on the other hand, assesses outcomes and impacts of the project relative to expectations, tries to explain variations and helps formulate lessons for consideration in future projects. Taken together, monitoring and evaluation are critical for assessing the achievement of project objectives as well as their relevance, effectiveness, efficiency and sustainability.

The Islamic Development Bank (IsDB) has a significant portfolio of microfinance projects and components implemented in its member countries and has developed considerable expertise in the practice of Islamic microfinance and Economic Empowerment initiatives. With a view to better assessing the impact of its interventions in member countries and to better informing future projects, it is fundamental for IsDB to have a sound M&E system in place. To that end, IsDB undertook the preparation of this toolkit.

## 1. PURPOSE OF THE TOOLKIT

The purpose of this toolkit is to monitor and evaluate Economic Empowerment interventions at the institution, project and donor levels. The toolkit will help users -

- ▶ Identify the outcomes and impacts of an Economic Empowerment project
- ▶ Develop a framework to monitor the performance and evaluate the outcomes of MFIs/FIs

## 2. USERS OF THE TOOLKIT

The toolkit was developed for the following groups of users -

- ▶ IsDB staff and task teams
- ▶ Member country agencies
- ▶ Project management teams
- ▶ Management teams of MFIs/FIs
- ▶ Donors and funders of Microfinance and Economic Empowerment initiatives

## 3. APPLICATION OF THE TOOLKIT

The toolkit should be used throughout the project cycle. It is particularly useful at the early identification and preparation stages, because good M&E design can contribute to improved project design in several ways. Preparing the Logical and Results Framework requires a clear analysis of the expected developmental impact of a project and of the causal chain linking initial investments to outcomes and objectives. Thinking about the project development objective obliges project designers to establish and understand the causal model through which the project is expected to achieve the desired aims, which enhances the quality of project design. This is further enhanced by smart indicators, which can be used to measure the achievement of objectives and ensure that project objectives are realistic, achievable and measurable, and that they are consistent with the resources provided, activities planned and outputs expected. During project implementation, the toolkit remains a useful source of reference for project managers and M&E staff. It assists them in running the M&E system, refining indicators where necessary and planning and implementing data collection to meet the information needs of management.



# The Nature of Islamic Microfinance and Economic Empowerment

## 1. DEFINITION AND CHARACTERISTICS OF ISLAMIC MICROFINANCE

Islamic Microfinance follows the principles of Sharia; with no interest paid on deposits or charged on financing. It operates through interest-free, mark-up-based and profit-and-loss-sharing contracts. Rather than lending money, Islamic finance often uses an underlying asset as the basis of transaction. Islamic microfinance allows a return on capital, provided that the capital contributes to a productive process and is exposed to business risk. Because of its link to a real asset and exposure to real business risks, Islamic Microfinance has a direct impact on the real economy.

Based on its inherent values, Islamic Microfinance can be used as a tool for Economic Empowerment, as it mitigates harmful effects such as over-indebtedness and Gharar (ambiguity). There are many Islamic modes of finance that can provide, when properly applied, benefits to the poor, not only by providing them with funds, but also by helping them in their businesses through non-financial support, such as market linkages and better prices. Properly applying these modes of finance and extending non-financial support and partnership that value add to the client's business is how Economic Empowerment of the client is achieved.

## 2. ATTRIBUTES OF A CONVENTIONAL, SHARIA-COMPLIANT AND ECONOMIC EMPOWERMENT INSTITUTION

MFIs/FIs that implement the Economic Empowerment approach properly apply the Sharia compliant principles of Islamic Microfinance in a way that realizes the full potential of creating value to the client. Firstly, the MFI/

FI does not invest in non-Sharia-compliant activities such as alcohol, gambling, tobacco, etc. Secondly, any financing provided must be free of interest, which is any benefit gained from a financing by a lender over a period of time. The first requirement is easily complied with, as most MFIs/FIs invest in productive activities that benefit the society.

To comply with the second requirement, MFIs/FIs have two options. The first is to act as a financial intermediary and provide interest-free loans only. The challenge under this option would be to raise the necessary resources from charity or volunteer manpower in order to operationalize the lending activities in a sustainable manner.

The second option would be to generate revenues to cover their operational costs by conducting business with their clients through trade and investment activities. Under this option, the MFI/FI would expand its role from merely being a financial intermediary to that of active involvement in trading activities.

The MFI/FI would earn profits by buying and selling on behalf of its clients and/or by investing with its clients and sharing the profits generated from the investment. Profits earned through such transactions are justified by the efforts made by the institution in engaging with stakeholders within the value chain and the risks it takes in conducting those real economic transactions. The efforts and risks undertaken are non-financial activities that add value to their clients' businesses.

The following diagram depicts the transformation from conventional MFI/FI to an MFI/FI -

**Figure 1- Transformation from Conventional to Economic Empowerment Institutions**



**Table 1 - Comparison between conventional, Shariah compliant MFI/FIs and Economic Empowerment Institution**

Attributes of a conventional MFI/FI (possibly harmful)	Attributes of a Sharia-compliant MFI/FI (do no harm)
<ul style="list-style-type: none"> <li>▶ May invest in non-Sharia-compliant sectors (e.g. tobacco, alcohol, etc.)</li> <li>▶ Invests only in debt instruments</li> <li>▶ Not required to ensure that financing is tied to any assets or productive activity</li> <li>▶ Funds typically disbursed in cash to customer. MFI/FI does not have full knowledge on how funds are actually used</li> <li>▶ Charges interest as a price to 'rent' money</li> <li>▶ Strictly performs the role of financial intermediary</li> <li>▶ May cause harm from over-indebtedness by encouraging clients to take financing (which are its main source of income)</li> <li>▶ Clients who delay repayments are required to pay additional interest on the delayed payments</li> <li>▶ Focus on financial inclusion</li> <li>▶ Purpose is to compete with traditional 'moneylenders'. Interest charged by moneylenders is taken as a benchmark for the interest charged by the MFI/FI</li> </ul>	<ul style="list-style-type: none"> <li>▶ May only invest in Sharia-compliant sectors</li> <li>▶ Invests in mostly debt-oriented instruments (mainly Murabaha)</li> <li>▶ Asset or productive activity must be identified for the financing. This avoids funds being used for daily consumption purposes that may not benefit the client</li> <li>▶ Funds are disbursed directly to supplier/activity in order to ensure that the funds are not diverted for unintended purposes. Otherwise, proof of transaction must be provided. This also mitigates the risks of vulnerable beneficiaries, e.g. women being demanded by their husbands to borrow on their behalf</li> <li>▶ Participation in the value chain is kept to a minimum to minimize risk exposure</li> <li>▶ Mainly buys on behalf of the client at spot rate and charges profit when selling on deferred basis to clients. Benchmark profit rate is the sector interest rate</li> <li>▶ Since the selling price is fixed, clients who delay repayments do not pay additional interest over and above the selling price due, even if there is a delay. This mitigates the risk of over-indebting the poor</li> <li>▶ Focus also on financial inclusion</li> </ul>

- ▶ Since involvement in the value chain is kept to a minimum, the purpose is to compete with conventional MFIs. The interest rates charged

by conventional MFIs/FIs are still used as the benchmark. However, the Sharia safeguards in place mitigate the harmful effects of the debt caused by the financing

**Attributes of an Economic Empowerment MFI/FI (do good)**

- ▶ May only invest in Sharia-compliant sectors
- ▶ Invests in a variety of debt-oriented and equity instruments
- ▶ An asset or productive activity must be identified for the financing. This avoids funds being used for consumption and non-productive purposes that may not benefit the client
- ▶ Funds are disbursed directly to supplier/activity in order to ensure that the funds are not diverted for unintended purposes. Otherwise, proof of transaction must be provided. This also mitigates the risks of vulnerable beneficiaries, e.g. women being demanded by their husbands to borrow on their behalf
- ▶ Active participation in the value chain is practiced. Risks are managed, not avoided. The aim is to add value to business transactions with clients through cost savings, price negotiation, market linkages, etc.

- ▶ Conducts business with clients. Benchmark profit rates are based on benefits that can be gained by clients through other informal middlemen, in addition to other market factors
- ▶ Since the selling price is fixed, clients who delay repayments do not pay additional mark-up over and above the selling price due, even if there is a delay. This mitigates the risk of over-indebting the poor
- ▶ Focus not only on financial inclusion, but also Economic Empowerment. Besides providing access to finance, the MFI/FI also provides access to markets, technical knowhow, access to management, etc.
- ▶ Actively involved in value chain through transactions with its stakeholders. The purpose is still to compete with the traditional 'moneylender', and with the traditional middleman

Sharia compliance refers to the minimum requirements an MFI/FI must comply with to be deemed Sharia-compliant. In much the same way as the legal code in any country is a "system of rules which a particular country or community recognizes as regulating the actions of its members and which it may enforce by the imposition of penalties", Sharia specifies a code to ensure that FIs do no harm to the society. The basis of Islamic finance is to encourage trade/business that is allowed under Sharia and to forbid interest as a result of pure money lending. By doing so, Sharia encourages and promotes a finance-plus approach, requiring that the financing provided to clients generate a positive benefit instead of creating a debt that would be a burden on the client. Hence, MFIs/FIs are encouraged to not only be Sharia-compliant, but also practice Economic Empowerment.

An MFI/FI practising Economic Empowerment not only provides Sharia-compliant credit, but also engages directly in the value chain to ensure benefits are generated for its clients, thus creating a direct impact for its typically poor clients. This is done by going beyond its role as financial intermediary to an active economic value-adding agent.

In doing so, the MFI/FIs not only justifies its service by competing with money lenders, but also competes with value chain middlemen. Through such competition, it helps make the value chain more efficient to the benefit of its clients, instead of just adding the cost of financing as further burden on its clients over and above all the business risks they are already exposed to. As such, there will be better co-relation between the performance of the MFI/FI and the level of graduation out of poverty of the client.

### 3. IS IMPACT OF ECONOMIC EMPOWERMENT INTERVENTIONS MEASURABLE?

Performance is measured based on the outputs, outcomes and impact generated by the intervention. An MFI/FI is provided with resources from the government, donors or investors and uses them to generate measurable outputs. The measurements include the number of clients provided with financing, the number of clients provided with financial literacy training, audits conducted, etc. Outcomes are estimated benefits generated in the short to medium run following the intervention. Usually, the achievement of outcomes depends, at least partially, on the actions of beneficiaries in response to project outputs. The indicators used will depend on the data collected from beneficiaries. Outcomes are often measured using client surveys to determine whether the client is better off and is satisfied with the service. Through evaluation(s), comparisons are conducted on the situation of the beneficiaries before and after receiving the financial service.

Impact is the measurable benefit that is directly attributable to the intervention of the MFI. In conventional microcredit, like many developmental activities, it was found difficult to measure whether the target beneficiary has improved welfare and to attribute any improved welfare to the intervention, not other factors.

Since microcredit institutions are merely financial intermediaries and are not concerned with understanding how well the loans are directly benefitting their clients, it is difficult to measure the contribution of loans to poverty alleviation. Hence, although microcredit was launched with a lot of hyped hope that it would address the problem of poverty, various crises and several impact evaluations later showed a mixed picture on the promise of microcredit to alleviate poverty.

The best means to measure the impact of conventional microcredit or any other developmental intervention is to conduct a randomized control trial. In such an evaluation study, which is very expensive to conduct, evaluators conduct a household survey on a random sample of people who previously obtained microcredit

(treatment group) and another random sample of people who did not receive such microcredit (control group). This baseline survey would then be compared with another household survey conducted several years later the same two groups of people (treatment and control groups). Through analysis of the difference between the two surveys, the impact would be measured.

Randomized control trials are selectively conducted, due to the difficulty in ensuring their accuracy (which means that not all projects or interventions can be evaluated this way, and it is difficult to measure profit or benefit that is attributable to the credit provided). In addition, the cost of conducting two household surveys over a period on statistically significant sample sizes is an expensive undertaking that may cost around a million dollars.

Unlike their conventional counterparts, MFIs/FI practising Economic Empowerment can measure the impact of their financing to clients if they intervene effectively in the value chain. Instead of conducting a household survey, which may include other factors, knowledge of the value chain would provide it with a clear understanding of the income generated from the economic activities conducted by its clients as a result of the financing provided.

This knowledge is also apparent for middlemen and investors. For example, a middleman meets with the farmer and is interested to purchase the farmer produce (tomatoes, apples, etc). The farmer would like to sell 1,000kg of the produce. The middleman will inspect the farm and will be able to tell how productive it is, and the cost of inputs needed to produce 1,000kg. By doing a simple calculation, the middleman would know how much profit would be earned by the farmer based on the price that he is intending to offer. In addition, he would also know the cost of operations and transportation to his buyer, as well as the market price that he would probably obtain from the buyer, which would determine his expected profit. He may also know the market price paid by the end consumer, which would determine the revenue earned by the buyer and, with estimations made on the operating costs of the retailer, he may even be able to estimate the income earned by the retailer. This is the type of



analysis done by the middleman. Such value chain analysis in determining the production accounts or income statements of each value chain actor is detailed in Chapter 3 of the Economic Empowerment Design Toolkit.

By performing the role of a middleman, the MFI/FI would not only know its own profit, but also the profit earned by its clients. This profit or benefit earned can be measured as the impact of the financing. In addition, by improving the efficiency of the value chain through playing an effective role as the wholesaler or aggregator, it could negotiate prices with other stakeholders in the value chain and generate measurable value add for its clients.

Similarly, an investor would have a clear forecast of the business revenue and expenses. Based on the agreed profit-sharing agreement with the client, both the investor and client would clearly know how much revenue is earned by both parties. If a forecast of \$1,000 is expected that month and the agreed profit-sharing ratio between the investor and client is 60:40, the investor would expect to earn \$600 that month, knowing that its client would earn \$400. In order to generate the expected profits, the investor would be actively involved in the management of the project, providing it with the relevant expertise, markets and know-how, over and above the financial investment he made.



# Building an Operations Performance Framework

## 1. INTERNAL PROCEDURES AND OPERATIONS SYSTEM MONITORING

It is very important to monitor the overall operational performance of the MFI/FI to ensure that it remains a viable institution operating in an efficient manner and providing quality services to its clients. Similarly, monitoring operations serves as a check and balance on its adherence to its own mission or the intended objectives of its funders. It also measures the MFI/FI's business performance, as well as its impact on the businesses and individuals who are its business partners or recipients of its financing.

In order to be viable and efficient in the long term, it is very important for the MFI/FI to take stock of its internal procedures, assess them during the course of its activities and look for ways and means to improve them. The following subcomponents highlight areas which the MFI/FI needs to look into and monitor over the course of its activities to remain competitive and relevant to its own defined vision, mission and objectives.

### The mission

The vision and purpose of the MFI/FI are defined by basic principles and beliefs that should emanate from, and respond to, the local market needs. They should also reflect the social and ethical principles that guide the implementation of Economic Empowerment. It is important that the MFI/FI not deviate from its vision and objectives.

### Guidelines on mission monitoring

1. Is there clarity among staff regarding the mission and objectives?
2. Are there awareness sessions for new staff regarding the mission and objectives?
3. Are there strategy plans to monitor the progress towards achieving its mission and objectives?
4. Are there occasional reviews of the strengths and

weaknesses and is there flexibility to adapt to new circumstances?

### Organizational structure and management

Here, the role of the monitoring unit is to focus on the influence of the institutional structure on the services offered by the MFI/FI and vice versa. Monitoring staff must identify and propose relevant changes to the institutional structure and management of the financial activities to eliminate any existing constraints for these activities.

### Guidelines on organizational structure and management monitoring

1. Does the legal structure permit carrying out Islamic financing transactions?
2. Does the MFI/FI use intermediaries for its financing activities?
3. What is the control and rewarding mechanism for the intermediaries?
4. Are the financing appraisal functions separate from the financing approval functions?
5. Is there a Risk Management framework?
6. Is there a code of conduct and governance framework?
7. Are members of the board selected based on their technical expertise?
8. Are board meetings held frequently?
9. Are the management staff technically competent?
10. Are there annual plans, goals and budgets prepared?
11. Is the decision-making centralized or decentralized?
12. Are field staff allowed a degree of autonomy to fulfil their objectives?
13. Are branches judged on their performance and financial position?
14. Are there uniform standards and procedures across branches and similar functional units?

15. How many staff does the MFI/FI have compared to what is needed?
16. Is there high staff turnover?
17. Is there regular training for the staff?
18. Have the staff efficiency and knowledge improved as a result of training conducted?
19. Are staff knowledgeable about the mechanisms of Islamic finance instruments?
20. Is there a staff technical expertise development plan?
21. Is there regular maintenance of office buildings and equipment?
22. Is there a proper MIS with reporting capabilities?
23. Are the reports generated by the MIS used by management for decision-making?
24. Are there regular backups of financing and client data?
10. Is financing disbursed in an efficient manner?
11. Does the MFI/FI respect the criteria set by its funders/donors for financing?
12. Does client repayment match the seasonality of its business/cash flow?
13. Does the have digital payment platforms for quick and efficient disbursement and repayment?
14. Does the MFI/FI have in place repayment and late repayment guidelines?
15. Are fees for late payments channelled to charity?
16. What pressures are applied to motivate repayment?
17. Are these pressures ethical/Sharia-compliant?
18. If assets are seized, where will they be stored, and how will they be disposed of?
19. Who decides on rescheduling if it is necessary?
20. At what point are loans written off?
21. What legal means of enforcing repayment are used?
22. What collateral is required for financing?
23. Are clients receiving any positive incentive to repay on time?
24. What rate of write-offs is expected?
25. How often do field officers make visits on average (weekly, bi-weekly)? How often is a typical client visited during the life of the financing?
26. How often are delinquent clients visited, on average?
27. Are there reports submitted by field officers and what use is made of them?

## Financing procedures

Well-defined financing procedures help enhance the efficient delivery of services to clients. These have a bearing on the financing approval process and the time it takes for financing to be approved.

### Guidelines on financing procedures monitoring

1. Are financing procedures clearly spelt out in a manual?
2. Do field officers have access to this manual?
3. Are financing officers assessed on their knowledge of financing criteria and institutional objectives?
4. Are financing procedures adapted to the context of the target clients?
5. Is financing appraisal carried out in a rigorous manner, with cost calculations, cash flow projections and adequate risk analysis?
6. Are there guidelines and methods for staff to determine feasible financing amounts and repayment capacity of clients?
7. Are there records of the time taken to approve each financing?
8. Is there a technically competent committee to assess financing proposals?
9. Does management have a say on who receives financing?

## SAVINGS PROCEDURES

Savings procedures are another important element in running an MFI/FI, as they determine the types of Islamic finance contracts used by the MFI/FI for saving services, the payment or absence of fee/return, the ease of deposits/withdrawals, the protection of depositors and the use of the deposit money for investment purposes. The MFI/FI should be able to maintain sufficient liquidity to pay out future withdrawals while earning an adequate return on investments to cover its costs of funds and operations.

### Guidelines on saving procedures monitoring

1. Are saving procedures clearly spelt out in a manual?
  2. Do field officers have access to this manual?
  3. Does the MFI/FI policy on savings comply with the country's regulations on mobilization of savings deposits, reserve requirements and other regulations for protecting depositors from dealing with questionable institutions that could endanger their assets?
  4. Are clients aware of their rights and understand the savings/investment contracts used? Are savings mobilized on a voluntary basis? Or is the mobilization of savings compulsory and directly tied to financing so that every time clients receive financing they must deposit a specific amount in savings?
  5. If savings mobilization is tied to financing, what is the ratio of savings to financing applied by the MFI/FI?
  6. Is savings mobilization stimulated through solidarity and self-help groups?
  7. Is the MFI/FI able to reach the prospective clients and collect their savings? Do the location and opening hours of the MFI/FI meet the needs and preferences of the clients? Is the MFI/FI applying innovative forms of savings mobilization such as mobile savings collectors who visit marketplaces on a daily or weekly basis to mobilize savings?
  8. Are the procedures to open an account simple and efficient, and is the withdrawal of funds easy and prompt?
- of financings, number of different businesses and by branch?
2. What is the amount and number of total outstanding financing? Compare these figures with the stated goals of the institution, and indicate for variables such as gender, location, income status and economic sector.
  3. What are the growth rates of clients served and financing distributed?
  4. How many savings were mobilized during each year and since initiation of savings mobilization, by amount of savings and number of savings accounts. Compare these figures with the stated goals of the institution.
  5. What is the ratio of savings to financing? And, by branch?
  6. What are the growth rates of mobilized savings?
  7. What is the percentage of the target clientele served in the region or market covered by the MFI/FI?
  8. What is the geographic area covered? Is the MFI/FI increasing its geographic zone?
  9. The number of financing or savings deposits handled by the MFI/FI staff, the administrative costs per financing or savings account, and the number of days it takes average financings or savings deposits to be processed.
  10. What is the financing processing time overall? Number of days between giving the client the financing application and receiving all required documents; between receiving the financing application and completion of analysis; between completion of analysis and approval; and between approval and disbursement.
  11. To what degree do clients believe the MFI/FI services are responding to their needs?

### EFFICIENCY INDICATORS

The cost of operations and transactions have an important bearing on the ability of the MFI/FI to reach more clients, to break even and to be profitable. It is important for the monitoring staff to keep track of the efficiency indicators/elements in order to convey this pertinent information to the management.

### Guidelines on saving procedures monitoring

1. How many financings were extended each year broken down by the amount of financing, number

## 2. BUSINESS PERFORMANCE MONITORING

### Client profile monitoring

It is important to monitor whether the MFI/FI is reaching the target group it was established or mandated to serve. Maybe it is giving financing or doing business only with clients who are more attractive to the institution from a profitability standpoint. It is important to monitor the client profile and the financing portfolio of the MFI/FI to avoid digression from its objectives.

#### Guidelines on Client profile monitoring

To allow monitoring of the profile and situation of the clients it is serving, the MFI/FI should formulate a clear definition of the socioeconomic characteristics of the client group it intends to serve and compare it with the basic information it collects from its clients at the financing application stage.

#### **Stage 1 - Definition of socioeconomic characteristics of the client groups the MFI/FI is mandated to serve**

Non-exhaustive examples -

Gender, age bracket, level of education, number of members in household, poverty status, ability to afford three meals a day, school attendance of children, type of house, number of bed sets, toilet facility, source of energy used, ownership of land and livestock/poultry, means of transport, affordability of health care, type of activity, etc.

#### **Stage 2 - Collection of data through the financing application form**

Non-exhaustive examples -

- ▶ Basic data of the client such as - name, ID, address, contact number, type of business, references, financing history, gender, age, etc.
- ▶ Basic data of the client's business, e.g. seasonality, cash flow, ROI.
- ▶ General socioeconomic data of the client.
- ▶ Purpose and amount of financing required.
- ▶ Client's present sources of income?
- ▶ Does the client have a bank account, and if so where and of what type?

- ▶ Does the client currently have debts? How much and to whom?
- ▶ What (informal) collateral can the client provide?
- ▶ Is the client financially literate?
- ▶ Does the client require training and capacity building?

#### **Stage 3 - Comparison between initial characteristics of client group and actual clients in portfolio**

- ▶ Number of clients per geographic region/income level/socioeconomic characteristics/gender
- ▶ Number of repeat financing granted to clients
- ▶ Underserved regions
- ▶ Types of businesses financed. Sector and activity?
- ▶ Concentration of MFI/FI portfolio by activity, geographic zone, type of clients

### Financing performance monitoring

An important component is the financing performance monitoring, which allows the MFI/FI to ensure that financing repayment is on schedule and to review the financing appraisal mechanism of the MFI/FI, as well as its risk prevention and management systems.

#### Guidelines for proper field supervision

1. Plan a geographic route that enables the field officer to visit a maximum number of clients in a given period
2. Ensure that all new clients receive a follow-up visit within days of the disbursement
3. Visit clients at times that are critical for preventing delinquency, such as several days before payments are due
4. Visit clients quickly after a payment becomes past due to assess and solve problems
5. Process different strategies for different delinquent clients depending upon their credit histories and how far behind they are on their payments
6. Detect trends in the portfolio (such as high delinquency among clients with certain activities) that might help identify strategies for reducing delinquency

**Guidelines for financing performance monitoring**

1. Has the client invested the financing fully into the business?
2. Can the client generate sufficient cash in order to meet his repayments?
3. Has the client requested rescheduling?
4. Has the client received financing from other institutions?
5. Has the client been living above his means?
6. Is the client interested in other types of financial services?

**Savings performance monitoring**

This component allows the MFI/FI to assess the rate of savings mobilization and better understand the savings behaviour of its clients. Savings mobilization can be a useful indicator of repayment capacity by demonstrating whether their businesses are generating enough profits to be able to repay. This will also allow the MFI/FI to better understand the capacity of its clients for more financing.

**Guidelines for savings performance monitoring**

1. What is the percentage of income clients are able to deposit each month?
2. What is the amount saved by the client - obligatory and voluntary?
3. What is the regularity of savings deposits?

**Monitoring of effect of financing on partners and clients**

The MFI/FI can assess whether the financial services have benefited their clients, the employees and their families. The assessment focuses on the effects and impacts of the financial services and should verify whether the client-service relationship and the social and economic situation of the businesses have been improved.

**Guidelines for monitoring of effect of financing on partners and clients**

1. How has the MFI/FI impacted the profitability and sales of the partner/client?
2. What are the prospects of the business?
3. What are the lessons to be drawn and types of corrective actions to be taken?
4. How many people are now working in the businesses and what is the increase in their average wage rate? Indicate for gender.
5. Is the MFI/FI continuing to listen and respond to the changing needs of micro and small entrepreneurs in creating access to financial services, information and markets?



# Economic Empowerment Impact Performance

## 1. MOVING FROM CONVENTIONAL MICROFINANCE TO ECONOMIC EMPOWERMENT - THE PROCESS

A conventional MFI/FI that is interested to practice Economic Empowerment should first take steps to be Sharia-compliant. But it should not stop there, further steps should be undertaken to make it an MFI/FI.

The transformation from a financial intermediary providing arm's length interest-based loans into an active business partner that is participating in the value chain is not an easy one. It would require a gradual

**Figure 2 - Transformation from Conventional to Economic Empowerment Institutions**



process of transformation that should be in line with the institution's mission. While the manuals and guidelines would help in ensuring Sharia compliance, the MFI/FI would need time to conduct various market studies to be aware of the business risks involved and how to mitigate such risks. The mindset of a lender/creditor is quite different from that of a business trader/investor, and this paradigm shift is bound to take time based on the experience and the capacity gained in engaging with the value chain.

### Step 1 - Transforming from a conventional to a Sharia-compliant MFI

Introduce Murabaha to replace the conventional loan. When a client requires a financing, request that the client identify an asset for which the financing will be used to purchase. A client may approach the MFI/FI with a price quotation/pro forma invoice specifying the asset, vendor details and price. After undertaking a financing appraisal, the MFI/FI would approve the Murabaha financing. The MFI/FI would make direct payment to the supplier upon proof of delivery with the supplier. The MFI/FI would then sell the asset to the client on a deferred basis at a profit rate similar to the interest rates previously charged. However, the contract would clearly specify the buying price and selling price of the asset. Once the transaction takes place, the selling price is fixed moving forward; any delay would not imply additional charges for the client. The client may an undertaking to pay fees as a result of delay of payments, but they must be capped so that the amount would not be unreasonable and should not cause further burden to the client. It is important to emphasize that charging late fees would be the last resort with clients ignoring their payments, not clients who are actually insolvent. In addition, all such penalty

In order to facilitate this process of transformation, we suggest the following steps for the MFIs/FIs to undertake.

<b>Step 1</b>	<b>Step 2</b>	<b>Step 3</b>
<b>Transforming from a conventional to a Sharia - compliant MFI</b>	<b>Collecting Market Data</b>	<b>Analysing Market Data</b>
<b>Step 4</b>	<b>Step 5</b>	<b>Step 6</b>
<b>Determine course of value chain intervention and negotiate with the supplier</b>	<b>Introduce various other debt - oriented financing products such as Salam and Ijara</b>	<b>Introduce equity - oriented financing products</b>



fees must be directed to charity causes approved by the board and not be absorbed as revenue for the MFI/ FI.

## Step 2 - Collecting Market Data

Although from a consumer standpoint no difference may be noticed other than rescheduling payments, the process specified in Step 1 puts in place measures that would mitigate any harm that might be caused by the financing. However, in order to benefit fully from the Sharia-compliant process, the MFI/FI should collect market data on the assets that it is procuring, the type of sectors it is involved in, the stakeholders (suppliers) involved, specification of the assets and the price of the assets. Such market data would be too valuable than to be ignored and casually filed away to fulfil a procedural requirement. The market data should be compiled in a database for further analysis.

## Step 3 - Analysing Market Data

By compiling market data in a database, the MFI/FI could identify the type of assets that are in demand for their clients (irrigation, fertilizer, seeds, etc). Some assets might be purchased repeatedly by their clients. On the other hand, the clients may approach several suppliers, each of whom may sell the same product at a different price. The feedback received from the clients on the quality of the assets that are being purchased may also be factored in. Based on the data that is being received, the MFI/FI may explore several issues -

- a) Is there a common generic good/asset that is being purchased by its clients? For example, clients may purchase seeds or fertilizers on a regular basis.
- b) Which suppliers offer the lowest price for the same asset? Is it possible to obtain the asset from a regional or national supplier at a lower price? The MFI/FI may identify a prospective supplier of the identified asset that is in demand.
- c) The MFI/FI may conduct a value chain analysis to determine, or at least estimate, the profit earned by the supplier. This would help it understand the supplier's cost and profit structure and prepare for negotiations with the supplier accordingly.

## Step 4 - Determine course of value chain intervention and negotiate with the supplier

Based on the asset and the supplier identified, the MFI/ FI may decide to be a wholesaler, purchasing items from the supplier in advance and storing them in a warehouse to ensure availability whenever the asset is in demand. Alternatively, the MFI/FI may decide to have a preferential price agreement with the supplier, providing a promise to purchase in bulk over a period in exchange for a discounted price, without the need for a storage facility. The decision of which alternative to take will be based on the business risks, the storage vs. unavailability risk and the risk of expected price increases due to inflation compared to the risk and costs of storage. Regardless of which alternative the MFI/FI opts for, the discounted price gained as a result of negotiations will benefit its clients directly.

It is very important to note that the MFI/FI should ensure that the client maximize the benefit for the MFI/ FI's client, based on the price negotiations, in terms of discounts for the client. The MFI/FI should refrain from maximizing its own profit margin. Additionally, the MFI/ FI should consider upgrading its internal capabilities through staff training and strategic hires, as this would help it grow from the limited financial intermediation mindset to be an active economic agent.

## Step 5 - Introduce various other debt-oriented financing products such as Salam and Ijara

Once the MFI/FI gains confidence and develops a better understanding of the value chain, it may develop other debt-oriented financing products such as Salam and Ijara to meet other needs of its clients.

## Step 6 - Introduce equity-oriented financing products

After gaining experience in transactions with various value chain actors, the MFI/FI may realize business opportunities through investment in farms, processing facilities or transportation services that would complement and strengthen the value chain flow. Such investments would not only generate profits in their own right, but would further grow the sector to the benefit of the MFI/FI financing the sector and its clients.

## 2. SHARIA COMPLIANCE CHECKLIST- GUIDANCE FOR SHARIA CONTROLLER/ AUDITOR

For each financial instrument, certain conditions must be met to ensure that the MFI/FI is Sharia-compliant. The following checklists can be used to help validate such conditions.

**Table 2 - Shariah Compliant Checklist for Islamic Financial Instruments**

### Murabaha

S. No.	Control	Remarks
<b>General</b>		
1	Obtain a list of all the Murabaha transactions entered into by the institution during the period under review.	
2	Select a sample of the transactions and obtain their respective agreements/supporting documents and amounts disbursed from the books of accounts.	
3	Compare the sampled agreements with the standard agreements as approved by the Sharia controller.	
4	Document the flow of transactions.	
5	Ensure that the documented flow of transactions is in agreement with the standard flow of Murabaha transactions.	
<b>Internal Controls</b>		
6	Does the institution ensure that the price of the asset and the institution's profit are fixed and known to both parties?	
7	Does the institution ensure that the subject matter of the transaction is of a permissible type?	
8	Are there adequate controls to ensure that each step of the standard Murabaha transaction is followed by the next step in the prescribed sequence?	
9	Ensure that the terms of the agreement are not amended except with the specific approval of the Sharia controller.	
10	Does the institution ensure that the subject matter of the Murabaha was not in the possession of the client at the time of entering into the Murabaha agreement?	
11	Are there controls to ensure that the institution or the agent acquire physical or constructive possession of the subject matter before offering it for sale to the client?	
12	Ensure that in case of default on payment by the client, any penalty levied by the institution is collected in a charity account and donated to a charitable institution approved by the Sharia controller.	
13	Ensure that the Murabaha transaction is not used as a buyback facility by the client.	
<b>Legal Rules</b>		
14	Ensure that the goods to be traded are real goods and not credit instruments.	
15	Ensure that the assets to be traded can be properly quantified and specified.	

S. No.	Control	Remarks
16	Ensure that the subject matter is in the ownership of the seller at the time of sale by inspecting possession report, delivery report, physical verification and certificate of the institution.	
17	Ensure that the sale is instant and unrestricted.	
18	Ensure that the subject of sale is specifically known and identified to the buyer and seller.	
<b>Price and delivery</b>		
19	Ensure that the delivery of the commodity sold to the buyer is certain and is not contingent on any event.	
20	Ensure that the price of commodity sold is definite and not fluctuating.	
<b>Agency agreement</b>		
21	Check whether the institution has appointed the client/third party as agent. If yes, then ensure that there is an agency agreement whereby the institution appoints the client/third party as its agent for purchasing the commodity on its behalf.	
22	In case the client is appointed as agent of the institution, ensure that the client purchases the commodity on behalf of the institution and takes possession as an agent of the Institution.	
23	Ensure that the Client does not use or consume the commodity in his possession as an agent.	
<b>Risk and ownership</b>		
24	Ensure that the institution retains all risks and rewards of ownership during the period from the time the client buys the commodity as an agent until the institution transfers the title of the goods to the client upon acceptance of the offer. This includes the risk of any damage to the commodity.	
<b>Documentation</b>		
25	Ensure that the invoices/delivery orders issued by the suppliers are in the name of the institution. If not, ensure that the client has provided an affidavit that he has purchased such commodity on behalf of the institution.	
26	Ensure that the date on the invoices/delivery orders is not later than the date of declaration of financing provided.	
27	In case of consumable goods, ensure that there is no significant delay between the dispatch of goods and the signing of the declaration.	
28	Ensure that, in case the client has been appointed as agent, he informs the institution in writing that he has purchased the commodity and then makes an offer to purchase the same from the institution.	
29	Ensure that institution accepts the offer and that the sale is thus concluded, whereby the ownership as well as risk is transferred to the client.	
30	Ensure that the agreement specifies the maximum limit up to which the facility may be availed by the client and that the facility availed by the client is within that specified limit.	
31	Ensure that the agreement is properly signed and witnessed.	

S. No.	Control	Remarks
<b>Penalty (Undertaking made by client in case of delay of payments)</b>		
32	Inquire about the client, if any, where the client defaults on paying instalments.	
33	Obtain a list of those clients.	
34	Obtain list of charitable institutions approved by the Sharia controller.	
35	Ensure that the institution channels any penalty levied to the approved charitable institution as a donation.	

## Salam

S. No.	Control	Remarks
<b>General</b>		
1	Obtain a list of all the Salam transactions entered by the institution during the period under review.	
2	Select sample of transactions and obtain their respective agreements.	
3	Obtain and review the standard agreement approved by the Sharia controller and compare the sampled agreements with the standard agreement.	
4	Ensure that all the transactions entered and the substance are in accordance with the Sharia rules.	
5	Document actual flow of the transactions.	
6	Perform walkthrough test to check that the actual flow of transactions is in line with the documented flow of transactions.	
<b>Internal Controls</b>		
7	Ensure that subject matter of transaction is of permissible type and the commodity specified meets the criteria for Salam sale.	
8	Are there adequate controls to ensure proper flow of transactions?	
9	Are there adequate controls to ensure that each step of standard Salam transaction is followed by the next step?	
10	Ensure that the terms of the agreement are not amended except with the specific approval of the Sharia controller.	
11	Ensure proper documentation of the transactions.	
12	Has the institution implemented controls to ensure that the commodity purchased by the institution on Salam basis is not sold before receiving the commodity?	
13	Ensure that Salam contract is not on specific things (e.g. this car).	
<b>Legal Rules</b>		
14	Ensure that the subject matter of the transaction is of permissible type.	

S. No.	Control	Remarks
15	Ensure that the price is paid in full to the seller at the time of effecting the sale (i.e. entering the Salam contract).	
16	Ensure that the commodity is known to both contracting parties and meets the criteria applicable for commodities in the Salam sale.	
17	Ensure that the commodity under consideration will be available for delivery when it is due. Ensure that the commodity in the Salam contract is not seasonal. It must be available in the market from date of the contract to the date of delivery.	
18	Ensure that the Salam sale contract is not made on existing commodities already owned by the seller/client.	
19	Ensure that the Salam sale is not effected on gold, silver or cash.	
20	Ensure that the quality and quantity of assets traded in the Salam contract can be specified precisely.	
21	Ensure that Salam is not effected on a particular commodity or on a product of particular origin.	
22	Ensure that the exact date and place of delivery are specified in the contract.	
23	Ensure that the subject of sale is in physical or constructive possession of the buyer when he sells it to another person.	
24	Ensure that the institution does not sell the commodity for cash before receiving it from client	
25	Ensure that the delivery of the commodity is certain and not contingent on any another event.	
26	Ensure that the price and other conditions, once agreed between the institution and the client, are not amended without explicit approval of the Sharia controller.	
27	Review and document any kind of mortgage or security obtained by the institution from the client/seller.	

## Qard Hasan

S. No.	Control	Remarks
<b>General</b>		
1	Obtain a list of all the Qard Hasan transactions entered by the institution during the period under review.	
2	Select a sample of the transactions and obtain their respective agreements/supporting documents and amounts disbursed from the books of accounts.	
3	Compare the sampled agreements with the standard agreements as approved by the Sharia controller.	
4	Document the flow of transactions.	
5	Ensure that the documented flow of transactions is in agreement with the standard flow of Qard Hasan transactions.	

S. No.	Control	Remarks
<b>Internal Controls</b>		
6	Does the institution ensure that there are no charges or fees of any form incurred by the client?	
7	If there are any costs that are transferred to the client in administration of the Qard, do the charges/fees reflect the true costs incurred? Any charges incurred by the client may not be higher than the true cost of administration of the loan.	
8	Does the institution ensure that the subject matter of the transaction is of a permissible type?	
9	Are there adequate measures to ensure that the Qard(loan) provided is for the wellbeing of the client?	
10	Ensure that the terms of the agreement are not amended except with the specific approval of the Sharia controller?	
11	Ensure that in case of default on payment by the client, any penalty levied by the institution is collected in a charity account and donated to a charitable institution approved by the Sharia controller.	
12	Ensure that the agreement is duly signed and witnessed.	
<b>Penalty (undertaking made by the client to pay fees due to late payments)</b>		
13	Inquire about the client, if any, where the client defaults on paying instalments.	
14	Obtain a list of those clients.	
15	Obtain a list of charitable institutions approved by the Sharia controller.	

## Ijara

S. No.	Control	Remarks
<b>General</b>		
1	Obtain a list of all the Ijara transactions entered by the institution during the period under inspection.	
2	Select a sample of the transactions and obtain their respective agreements to check their Sharia compliance.	
3	Review the standard agreement approved by the Sharia controller and compare the sample agreements for correctness.	
4	Document actual flow of the transactions.	
5	Perform walkthrough test to check that the actual flow of transactions is in line with the documented flow of transactions.	
6	Ensure that the institution has properly classified the Ijara as per the modes approved by the Sharia controller.	

S. No.	Control	Remarks
<b>Internal Controls</b>		
7	Does the institution ensure that the subject matter of the transaction is held on permissible items?	
8	Are there adequate controls implemented to ensure proper flow of transactions?	
9	Are there adequate controls implemented to ensure that each step of standard Ijara transaction is followed by the next step?	
10	Ensure that the terms of the agreement are not amended except with the specific approval of the Sharia controller.	
11	Ensure proper documentation of the transactions.	
12	Ensure that the agreements are duly signed and witnessed.	
<b>Legal Rules</b>		
13	Ensure the leased assets are/were not perishable or consumable items.	
14	Check that the subject of the contract is legally attainable.	
15	Ensure that the Ijara agreement provides that the lessor will be responsible for the major repair and maintenance of the leased asset and will bear any loss thereto. Moreover, if Takaful/insurance is considered necessary, its cost is borne by the lessor.	
16	Ensure that the lease contract specifies that the responsibility for damage is to be borne by the one who causes it.	
17	Check that the lease period is clearly and unambiguously stated in the contract.	
18	Ensure that the rental charges start after the date of the contract and after delivery of the asset.	
19	Ensure that any Urboun (earnest money) taken in respect of lease at the execution of the contract is treated as advance payment. Also ensure that only actual damages are settled with Urboun in case of default.	
20	Subject to the approval of the Sharia controller, advance rent may also be taken but not credited to income of the institution until the asset is delivered to the client.	
21	Check whether any security deposit has been obtained by the institution as a guarantee for accepting the lease and also ensure that no amount has been deducted from this sum except expenses that are in proportion to the actual damage suffered by the institution in case the client defaults.	
22	Document the amount of security deposit and cross-reference it with the agreement.	
23	In case of floating rentals, ensure that rentals for the first period are specified and then a certain benchmark applied for the determination of future rentals.	
24	In case of default or late payment of lease rentals, ensure that penalty received is paid as a donation to approved charity.	
25	Ensure that a separate contract is being entered into for transfer of ownership of the asset at end of the lease term.	



## Diminishing Musharaka

S. No.	Control	Remarks
<b>General</b>		
1	Obtain a list of all the Diminishing Musharaka transactions entered by the institution during the period under review.	
2	Select a sample of the transactions and obtain their respective agreements to check their Sharia compliance.	
3	Obtain and review the sampled agreement prepared by the institution and duly approved by the Sharia controller for compliance with Sharia.	
4	Ensure that all the transactions entered are in accordance with the contracts.	
5	Document the actual flow of the transactions.	
6	Perform walkthrough test to check the actual flow of transactions is in line with the documented flow of transactions.	
<b>Internal Controls</b>		
7	Does the institution ensure that the subject matter of the transaction is held on permissible items?	
8	Are adequate controls implemented to ensure proper flow of transactions?	
9	Are there adequate controls implemented to ensure that each step of standard Diminishing Musharaka transaction is followed by the next step?	
10	Does the institution ensure that the terms of the agreement are not changed except with the specific approval of the Sharia controller?	
11	Does the institution ensure that losses are shared in proportion to the capital contributions?	
12	Has the institution ensured proper documentation of the transaction?	
<b>Legal Rules</b>		
13	Ensure that the Diminishing Musharaka contract is a proper partnership arrangement, not a mere financing operation.	
14	Document the nature of the Diminishing Musharaka arrangement.	
15	Ensure that the buying and selling of equity is not stipulated in the Diminishing Musharaka contract. Only a promise to buy the equity may be given by the buyer irrespective of the contract.	
16	Ensure that there exists a binding promise from one of the partners to acquire the equity shares gradually according to the market value or price agreed at the time of acquisition or at the time of contract.	
17	Ensure that the cost of Takaful/insurance and maintenance of the Diminishing Musharaka is borne jointly by the partners of the Diminishing Musharaka in proportion to the partnership in the asset held, not by one partner.	

S. No.	Control	Remarks
18	Review and ensure that no guarantee or security is sought by the institution for losses incurred during the normal course of business in any capacity, as this would be against the principles of Diminishing Musharaka. A partner is a trustee of the funds in his hand from the Diminishing Musharaka and is not required to indemnify except in case of fraud, misconduct or negligence. In order to avoid any loss due to negligence or wilful misconduct, security or guarantee from a third-party guarantor may be taken.	
19	In case of more than one partner on one side/either side, inquire from the institution any cases where the Diminishing Musharaka arrangement is terminated/rescinded. In such cases ensure that the same is done with consent of all other partners and not unilaterally.	

## Musharaka

S. No.	Control	Remarks
<b>General</b>		
1	Obtain a list of all the Musharaka transactions entered by the institution during the period under review.	
2	Select a sample of the transactions and obtain their respective agreements to check their Sharia compliance.	
3	Obtain and review the sampled agreements prepared by the institution and duly approved by the Sharia controller.	
4	Ensure that all the agreements follow the sample agreement as approved by the Sharia controller.	
5	Ensure that all the transactions entered and their substances are in accordance with the contracts.	
6	Document the actual flow of the transaction.	
7	Perform walkthrough test to check that the actual flow of transactions is in line with the documented flow of transactions.	
<b>Internal Controls</b>		
8	Does the institution ensure that the subject matter of the transaction is held on permissible items and, particularly, that the nature of business is Sharia-compliant?	
9	Are there adequate controls implemented to ensure proper flow of transactions?	
10	Are there adequate controls implemented by the institution to ensure that each step of standard Musharaka transaction is followed by the next step?	
11	Ensure that the terms of the agreement are not amended except with the specific approval of the Sharia controller.	
12	Ensure proper documentation of the transaction.	
13	Ensure that the terms of Musharakah agreement do not change except with the approval of Sharia controller	

S. No.	Control	Remarks
<b>Legal Rules</b>		
14	Ensure that the capital is specific and existent such as in cash, gold or trading assets.	
15	Ensure that the Musharaka is not established on a non-existent fund or debt.	
16	Review the selected Musharaka agreement and ensure that the capital is invested in terms of money and is of valuable nature. Capital may consist of merchandise, provided that the value of such merchandise has been agreed at the time of entering the agreement.	
17	Ensure that the profit-sharing ratio is agreed between the institution and the client at the time of contract	
18	Ensure that the profit is quantifiable.	
19	Ensure that the profit-sharing ratio is specific (in defined terms) and not stipulated as a lumpsum profit.	
20	Ensure that the Musharaka agreement contains a clause providing that the loss is divided in proportion to the respective contributions of the partners in the capital of the Musharaka.	
21	Ensure that the Musharaka agreement does not forbid any partner to be active in the business of Musharaka.	
22	Review the agreement and ensure that no partner provides indemnification for the other partner's capital.	

## Mudaraba

S. No.	Control	Remarks
<b>General</b>		
1	Obtain a list of all the Mudaraba transactions entered by the institution during the period under review.	
2	Select a sample of the transactions and obtain their respective agreements to check their Sharia compliance.	
3	Ensure that all the agreements are in compliance with the standard agreement as approved by the Sharia controller.	
4	Ensure that all the transactions entered and the substance is in accordance with the Sharia.	
5	Document the actual flow of transactions.	
6	Perform walkthrough test to check that the actual flow of transactions is in line with the documented flow of transactions.	
<b>Internal Controls</b>		
7	Ensure that the subject matter of the transaction is held on permissible items.	
8	Ensure that the institution has properly evaluated the financial position of the client before entering the Mudaraba contract.	

S. No.	Control	Remarks
9	Are there adequate controls implemented to ensure proper flow of transactions?	
10	Are there adequate controls implemented to ensure that each step of standard Mudaraba transaction is followed by the next step?	
11	Ensure that the terms of the agreement are not changed except with the specific approval of the Sharia controller.	
12	Ensure proper documentation of the transaction.	
13	Does the institution maintain proper feasibility and evaluation of the projects?	
<b>Legal Rules</b>		
<b>Capital Specification</b>		
	Ensure that the Mudaraba agreement meets the following conditions -	
14	<ul style="list-style-type: none"> <li>▶ Capital of Mudaraba is specific</li> <li>▶ Capital has been delivered to the client or agent of the client</li> <li>▶ Profit-sharing ratio is specific for both the institution (Rab ul Maal/ capital provider) and the client (entrepreneur/Mudarib)</li> </ul>	
<b>Profit-Sharing and Distribution</b>		
15	Ensure that the Mudaraba does not make the client liable to secure the payment of capital or profit.	
16	Ensure that the profit-sharing ratio is specific (in defined terms) and not stipulated as a lumpsum profit.	
17	Ensure that, in case the contract is not renewed, the institution recovers the cash or cash equivalent value of the capital as agreed in the contract.	
18	Inquire from the institution about cases of loss (if any). Ensure that in case of loss, only the institution bears the loss and not the client, unless it is proven that the loss was due to negligence of the client, in which case the loss shall be borne by the client as per agreement.	
19	Ensure that there are particular projects underlying the contract. Ensure that the institution has made arrangements for regularly visiting and monitoring the projects.	
20	Ensure that institution does not arrange with the client two accounts of capital based on the condition that the profit earned from one amount would be taken by the client and that earned on the other amount would be taken by the institution.	
21	Ensure that the Mudaraba agreement does not specify any condition that the profit of one financial period shall be taken by client and that of the other financial period shall be taken by the institution.	
22	Ensure that the Mudaraba arrangement does not assign any profit from a particular transaction to the client or the institution.	
23	Ensure that any restrictions imposed on the client to attain the profit are beneficial and do not constitute a restriction on the client, making it counterproductive to the purpose of the Mudaraba.	

S. No.	Control	Remarks
24	Ensure that the institution does not stipulate that it has a right to work with the client and be involved in operations of the Mudaraba.	
25	Ensure that the client does not make any loan, gift or charitable donation out of the Mudaraba funds.	

### 3. MEASURING ECONOMIC EMPOWERMENT PERFORMANCE QUALITATIVELY AND QUANTITATIVELY

The MFI/FI is required to be an active participant within the value chain to conduct trade and investment with its clients. As mentioned earlier, while Sharia compliance is a requirement, taking on and managing various business risks (e.g. ownership, transportation, marketing, etc) is a business decision that the management of any MFI/FI needs to be prepared for and allocate the required time to develop into a fully mature MFI/FI with the capacity to practise Economic Empowerment. The section below aims to measure this development using qualitative and quantitative performance indicators.

The qualitative indicators measure the extent to which the institution is involved and helps support its client’s business. Since it is well recognized that access to finance is only one among several aspects that determine the success of the client (other success factors include access to markets, access to technology, access to information, etc), qualitative indicators measure the non-financial services provided by the MFI/FI.

To complement qualitative indicators, quantitative indicators measure the impact of the services

(including non-financial) provided by the MFI/FI. Unlike conventional MFIs, institutions adopting Economic Empowerment can measure impact without the need of conducting a randomized control trial. By measuring the actual benefit generated by the microfinance intervention (treatment) compared to the alternative (control), MFI/FIs able to measure the impact of the intervention in a quantitative manner.

#### Qualitative Indicators

Qualitative indicators reflect how involved an MFI/FI is in conducting business (trade and investment) with its clients. They reflect the benefits of the financing provided. Practicing Economic Empowerment is a journey rather than a destination. The goal of an MFI/FI as a social business is to support its clients through partnering with their businesses, actively engaging in the value chain to find win-win solutions for themselves and their clients. The first step of a conventional MFI/FI interested in practicing Economic Empowerment is to be Sharia-compliant. The checklists provided in the previous section provide the needed guidance for an MFI/FI to be Sharia-compliant. Typically, the first Sharia-compliant product to be introduced is Murabaha. It is the easiest to introduce and requires minimal changes to the existing conventional products. By adopting these changes, the MFI/FI would be at less risk of doing any harm to its clients.

**Figure 3 - Transformation from Conventional to Economic Empowerment Institutions**



However, as explained earlier, the MFI/FI remaining at the Sharia compliance stage would not be unleashing its full potential to do good and help its clients. To be an MFI/FI practising Economic Empowerment, it needs to provide non-financial services complementing the credit provided. To estimate the value provided, points are accorded to estimate the impact as shown below -

**Table 3 - Qualitative Economic Empowerment Impact of Murabaha**

Indicators	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).	<ul style="list-style-type: none"> <li>▶ Mitigates payment receipt risk</li> <li>▶ Ensures the existence of the seller and asset.</li> </ul>	1 point
Conducts quality check on behalf of the client. MFI/FI checks that the asset meets the required quality specification.	<ul style="list-style-type: none"> <li>▶ Ensures the quality of the asset based on the needs of the client</li> <li>▶ Mitigates non-performance risk of the supplier</li> </ul>	1 point
Ascertain that asset purchased by client is transferred by arranging for asset transportation to the client or ensuring that timely delivery is made.	<ul style="list-style-type: none"> <li>▶ Ensures the asset is safely transferred and is in the possession of the client.</li> <li>▶ Mitigates transportation risks of the client</li> </ul>	1 point
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.	<ul style="list-style-type: none"> <li>▶ Promotes price transparency with clients</li> <li>▶ Helps clients make informed decisions with available historical data on similar previous transactions</li> </ul>	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 is lower than the overall costs (including the average market interest rate) if financed by a conventional MFI/FI.	<ul style="list-style-type: none"> <li>▶ Helps client negotiate with suppliers for lower prices and, hence, save money.</li> <li>▶ For example, client provides invoice for fertilizer amounting to \$1,000. MFI/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).</li> </ul>	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 and is at least 10% lower than the overall costs (including the average market interest rate) if financed by a conventional MFI.	<ul style="list-style-type: none"> <li>▶ Helps client negotiate with suppliers for lower prices and, hence, save money.</li> <li>▶ 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).</li> </ul>	1 point

Indicators	Non-financial value to address business risks provided	Economic Empowerment Impact points
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.	<ul style="list-style-type: none"> <li>▶ Helps client negotiate with suppliers for lower prices and, hence, save money.</li> <li>▶ 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%*\$1,000 interest, i.e. \$1,300) if financed by a conventional MFI/FI.</li> </ul>	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.	<ul style="list-style-type: none"> <li>▶ Helps client negotiate with suppliers for lower prices and, hence, save money.</li> <li>▶ For example, client provides invoice for fertilizer amounting to \$1,000. MFI/FI negotiates for a lower price (e.g. 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%*\$1,000 interest, i.e. \$1,300).</li> </ul>	1 point
<b>Total possible Economic Empowerment Impact points for Murabaha</b>		<b>8 points</b>

An institution that would like to undertake Murabaha will be required to adapt the terms of its financing product to be Sharia-compliant. However, this is only to meet the minimum requirements of Sharia. The institution can also take additional measures to create impact for its clients by mitigating their risks and helping them generate more benefit from the transactions.

To score an additional point, the institution would take stronger measures to ensure that the funds are used for the assets that are to be purchased. Hence, instead of appointing the client as an agent and disbursing cash to the client, it would provide the service to make direct payments to the supplier. In making direct payment, it would be the MFI/FI's prerogative to ensure that the supplier is genuine and that the asset exists by checking the credibility of the supplier.

To score an additional point, the institution would mitigate the non-performance risks of the supplier by ensuring that the quality of the assets that are transacted meets the specifications that have been promised.

To score an additional point, the institution would ensure that the asset is transferred to the client by either transporting the asset to the client itself or by arranging the transportation of the asset to the client. The liability of the asset remains with the institution until the client has physical custody of the asset. This can be verified by obtaining the delivery order of the asset, signed by the client. At this stage, the institution would have the asset specification, details of the supplier as well as the order quantity and asset price.

To score an additional point, these data should not just be taken and stored. Rather, the institution should analyse the data and identify strategic suppliers to negotiate and enter into strategic trading agreements with. For example, over the period of one year, the institution may transact with several fertilizer suppliers. It would know the estimated annual demand for fertilizers of its clients and would be able to discuss with either the supplier with the lowest price or other suppliers at the regional or national level to make a bulk purchase for their clients or enter into an agreement for a preferential rate for its clients.



To score an additional point, the institution would negotiate or get an alternative supplier so that it is able to purchase the asset from the supplier at a price lower than the normal price. Hence, if the spot price for fertilizer is \$1,000, the institution would be able to purchase it at \$950 (i.e. 5% discounted price), and it would sell the asset at \$1,235 (at 30% profit rate). This is in contrast to the overall cost incurred by the client if the financing were to come from a conventional MFI/ FI (at 30% interest rate), which would cost the client \$1,300.

To score an additional point, the institution would negotiate or get an alternative supplier so that it is able to purchase the asset for discounts of at least 10%. If the spot price for fertilizer is \$1,000, the institution would negotiate to purchase from the supplier at a price at least 10% lower than the normal price. Hence, if the institution is able to purchase at \$850 (i.e. 15% discounted price), it would sell the asset at \$1,105 (at 30% profit rate). This is at least 10% lower than the overall cost incurred by the client if the financing were to come from a conventional MFI/ FI (at 30% interest rate), which would cost the client \$1,300.

To score an additional point, the institution would negotiate for discounts of at least 20%. If the spot price for fertilizer is \$1,000, the institution would negotiate to purchase from the supplier at a lower price of 20% to 30% off the normal price. Hence, if the institution is able to purchase at \$750 (i.e. 25% discounted price), it would sell the asset at \$975 (at 30% profit rate). This is at least 20% lower than the overall cost incurred by the client if the financing were to come from a conventional MFI/ FI (at 30% interest rate) which would cost the client \$1,300.

To score an additional point, the institution would negotiate for discounts of at least 30%. If the spot price for fertilizer is \$1,000, the institution would negotiate to purchase from the supplier at a lower price of up to 30% off the normal price. Hence, if the institution is able to purchase at \$650 (i.e. 35% discounted price), it would sell the asset at \$845 (at 30% profit rate). This is at least 30% lower than the overall cost incurred by the client if the financing were to come from a conventional MFI/ FI (at 30% interest rate), which would cost the client \$1,300.

**Table 4 - Qualitative Economic Empowerment Impact of Salam**

Indicators	Non-financial value to address business risks provided	Economic Empowerment Impact points
Conducts quality check and helps client fulfil quality specification required by buyer by providing capacity building.	<ul style="list-style-type: none"> <li>▶ Ensures the quality of the asset based on the needs of the buyer/ market.</li> <li>▶ Mitigates non-performance of the client.</li> </ul>	1 point
Markets the product by linking it to a buyer or platform of buyers	<ul style="list-style-type: none"> <li>▶ Provides access to markets as MFI/ FI may sell the products for profit.</li> </ul>	1 point
Helps with the packaging to ensure than the product is of high quality.	<ul style="list-style-type: none"> <li>▶ Supports the packaging of the product for market.</li> </ul>	1 point
Ascertain that asset sold by client is transferred by arranging for the produce's transportation to the buyer.	<ul style="list-style-type: none"> <li>▶ Ensures the asset is safely transferred and is in the possession of the buyer.</li> <li>▶ Mitigates transportation risks of the client.</li> </ul>	1 point

Indicators	Non-financial value to address business risks provided	Economic Empowerment Impact points
<p>Markets produce or finds an alternative buyer for client by negotiating with the buyer so that the clients get a higher price for their product. The sale price of the product is higher than the expected sale price that the clients can sell on their own. In addition, the clients earn more than if they were to borrow from a conventional MFI/FI.</p>	<ul style="list-style-type: none"> <li>▶ Helps clients negotiate with buyer for higher prices and, hence, earn more money.</li> <li>▶ For example, the clients sell tomatoes using Salam amounting to \$1,000. At the time of delivery, price of tomatoes is \$1,300. MFI/FI negotiates for a higher price (\$100 more). MFI/FI shares 50% of the negotiated amount with the clients in the form of a bonus of \$50 more, representing 5% of the Salam price of tomatoes. If the clients borrowed \$1,000 from a conventional MFI/FI at 30% interest, the cost would have been \$300, which is \$50 more than the cost of the Salam financing of \$250 or 5% of the Salam price</li> </ul>	<p>1 point</p>
<p>Markets product or finds an alternative buyer for clients by negotiating with the buyer so that the clients earn a bonus of at least 10% of the Salam price. The sale price of the product is higher than the expected sale price that the clients can sell on their own. The clients earn at least 10% more than if they were to borrow from a conventional MFI/FI.</p>	<ul style="list-style-type: none"> <li>▶ Helps clients negotiate with buyer for higher prices in and, hence, earn more money.</li> <li>▶ For example, the clients sell tomatoes using Salam amounting to \$1,000. At the time of delivery, price of tomatoes is \$1,300. MFI/FI negotiates for a higher price (\$300 more). MFI/FI shares 50% of the negotiated amount with the clients in the form of a bonus of \$150 more, representing 15% of the Salam price of tomatoes. If the client borrowed \$1,000 from a conventional MFI/FI at 30% interest, the cost would have been \$300, which is \$150 more than the cost of the Salam financing of \$150 or 15% of the Salam price.</li> </ul>	<p>1 point</p>
<p>Markets product or finds an alternative buyer for clients by negotiating with the buyer so that the clients earn a bonus of at least 20% of the Salam price. The sale price of the product is higher than the expected sale price that the clients can sell on their own. The clients earn at least 20% more than if he were to borrow from a conventional MFI/FI.</p>	<ul style="list-style-type: none"> <li>▶ Helps clients negotiate with buyer for higher prices and, hence, earn more money.</li> <li>▶ For example, the clients sell tomatoes using Salam amounting to \$1,000. At the time of delivery, price of tomatoes is \$1,500. MFI/FI negotiates for a higher price (\$500 more). MFI/FI shares 50% of the negotiated amount with the clients in the form of a bonus of \$250 more, representing 25% of the Salam price of tomatoes. If the clients borrowed \$1,000 from a conventional MFI/FI at 30% interest, the cost would have been \$300, which is \$250 more than the cost of the Salam financing of \$50 or 25% of the Salam price.</li> </ul>	<p>1 point</p>

Indicators	Non-financial value to address business risks provided	Economic Empowerment Impact points
<p>Markets product or finds an alternative buyer for client by negotiating with the buyer so that the client earns a bonus of at least 30% of the Salam price. The sale price of the produce is higher than the expected sale price that the client can sell on his own. The client earns at least 30% more if he were to borrow from a conventional MFI.</p>	<ul style="list-style-type: none"> <li>▶ Helps client negotiate with buyer for higher prices and, hence, earn more money.</li> <li>▶ For example, the client sells tomatoes using Salam amounting to \$1,000. At the time of delivery, price of tomatoes is \$1,300. MFI/FI negotiates for a higher price (\$700 more). MFI/FI shares 50% of the negotiated amount with the client in the form of a bonus of \$350 more, representing 35% of the Salam price of tomatoes. If the client borrowed \$1,000 from a conventional MFI/FI at 30% interest, the cost would have been \$300, which is \$350 more or 35% of the Salam price since the client actually earns an additional \$50 by obtaining the Salam financing.</li> </ul>	<p>1 point</p>
<p><b>Total possible Economic Empowerment Impact points for Salam</b></p>		<p><b>8 points</b></p>
<p>Besides Murabaha, an MFI/FI may want to introduce Salam, especially if many of its clients are involved in agriculture-related activities, since Salam helps mitigate price volatility for the client and ensures that the client is able to sell the product. The MFI/FI ensures that all Sharia requirements for Salam are followed. The client conducts the forward purchase in exchange for produce that is to be delivered after an agreed period. In order to make profit, the MFI/FI appoints the client as an agent to arrange for a buyer to purchase the goods that it is expected to receive. By selling the product upfront, the MFI/FI would have helped the client mitigate the risk of price volatility.</p> <p>To score an additional point, the MFI/FI would mitigate non-performance risks by ensuring that the quality of the produce that is transacted meets the specifications that have been promised to, or are expected by, the buyer. This can be done by providing or arranging for capacity building.</p> <p>To score an additional point, the MFI/FI would help the clients find a buyer or link them to an e-commerce platform for a buyer. The MFI/FI would have thus helped the clients gain access to the market.</p> <p>To score an additional point, the MFI/FI would help with the packaging to ensure that the product is of high quality, which would help it gain a higher price and better markets.</p>	<p>To score an additional point, the MFI/FI would ensure that the asset is transferred to the buyer by either transporting the asset to the client itself or by arranging the transportation of the asset to the client. Upon acceptance of the produce, the liability of the asset remains with the MFI/FI until the client acquires physical custody of the asset. This can be verified by obtaining the delivery order of the asset, signed by the buyer.</p> <p>To score an additional point, the MFI/FI would help the clients negotiate with the buyer for higher prices and, hence, earn more money. The sale price of the product would be higher than the expected sale price that the clients would have sold at on their own. In addition, the clients earn more than if they were to borrow from a conventional MFI/FI. For example, if the client sells tomatoes with Salam amounting to \$1,000, the MFI/FI expects to sell the tomatoes in the future at an estimated price of \$1,300 based on a 30% profit rate. The MFI/FI would negotiate with the buyer for a higher price (e.g. \$100 more). In the spirit of profit-sharing, the MFI/FI shares 50% of the negotiated increase with the client in the form of a bonus of \$50 more, representing 5% of the Salam price of tomatoes. If the client had borrowed \$1,000 from a conventional MFI/FI at 30% interest, the cost would have been \$300, which is \$50 more than the cost of the Salam financing of \$250 or 5% of the Salam price.</p>	

To score an additional point, the MFI/FI would help the clients negotiate with the buyer for higher prices and, hence, earn more money (at least 10% bonus of the Salam financing value). In addition, the client earns at least 10% more than if he were to borrow from a conventional MFI/FI. For example, if the client sells tomatoes with Salam amounting to \$1,000, the MFI/FI expects to sell the tomatoes in the future at an estimated price of \$1,300 based on a 30% profit rate. The MFI/FI would negotiate with the buyer for a higher price (e.g. \$300 more). In the spirit of profit-sharing, the MFI/FI shares 50% of the negotiated increase with the clients in the form of a bonus of \$150 more, representing 15% of the Salam price of tomatoes. If the clients had borrowed \$1,000 from a conventional MFI/FI at 30% interest, the cost would have been \$300, which is \$150 more than the cost of the Salam financing of \$150 or 15% of the Salam price.

To score an additional point, the MFI/FI would help the clients negotiate with the buyer for higher prices and, hence, earn more money (at least 20% bonus of the Salam financing value). For example, if the client sells tomatoes with Salam amounting to \$1,000, the MFI/FI expects to sell the tomatoes in the future at an estimated price of \$1,300 based on a 30% profit rate. The MFI/FI would negotiate with the buyer for a higher

price (e.g. \$500 more). In the spirit of profit-sharing, the MFI/FI shares 50% of the negotiated increase with the clients in the form of a bonus of \$250 more, representing 25% of the Salam price of tomatoes. If the client had borrowed \$1,000 from a conventional MFI/FI at 30% interest, the cost would have been \$300, which is \$250 more than the cost of the Salam financing of \$50 or 25% of the Salam price.

To score an additional point, the MFI/FI would help the client negotiate with the buyer for higher prices and, hence, earn more money (at least 30% bonus of the Salam financing value). For example, if the client sells tomatoes with Salam amounting to \$1,000, the MFI/FI expects to sell the tomatoes in the future at an estimated price of \$1,300 based on a 30% profit rate. The MFI/FI would negotiate with the buyer for a higher price (e.g. \$700 more). In the spirit of profit-sharing, the MFI/FI shares 50% of the negotiated increase with the client in the form of a bonus of \$350 more, representing 35% of the Salam price of tomatoes. If the client had borrowed \$1,000 from a conventional MFI/FI at 30% interest, the cost would have been \$300, which is \$350 more or 35% of the Salam price.

**Table 5 - Qualitative Economic Empowerment Impact of Qard Hasan**

Indicators	Non-financial value to address business risks provided	Economic Empowerment Impact points
Provides Qard Hasan at the true cost of administration of the loan, which is less than the market interest rate of the financing.	▶ Low cost of financing. Hence, if the market interest rate is 30%, service charges should be lower than 30%.	1 point
Provides Qard Hasan at the true cost of administration of the loan, which is at least 20% less than the market interest rate of the financing.	▶ Low cost of financing. Hence, if the market interest rate is 30%, service charges should be 24% or lower.	1 point
Provides Qard Hasan at the true cost of administration of the loan, which is at least 50% less than the market interest rate of the financing.	▶ Low cost of financing. Hence, if the market interest rate is 30%, service charges should be 15% or lower.	1 point
Provides Qard Hasan at the true cost of administration of the loan, which is at least 80% less than the market interest rate of the financing.	▶ Low cost of financing. Hence, if the market interest rate is 30%, service charges should be 6% or lower.	1 point
Provides Qard Hasan at zero cost for the loan.	▶ Zero cost of financing.	1 point

Indicators	Non-financial value to address business risks provided	Economic Empowerment Impact points
Provides non-financing support in the form of capacity building.	▶ Capacity building provided to clients in addition to zero-cost of financing.	1 point
Provides non-financing support in the form of access to markets.	▶ Access to markets support provided.	1 point
Poor client is relieved of Qard Hasan loan should he have difficulty in repaying the loan. MFI/FI may have alternative means of obtaining guarantees or Zakat funds.	▶ Protects poor client from the burden of debt.	1 point
<b>Total possible Economic Empowerment Impact points for Qard Hasan</b>		<b>8 points</b>

Qard Hasan is meant to provide low or zero cost loans for clients, especially the poor and needy. Although this is often known as interest-free loans, MFIs/FIs are allowed to charge up to the true cost of administration of the loans. Service charges include all forms of expenses incurred for administering the Qard Hasan loan. Hence, an MFI/FI that lacks efficiency may charge administration costs of the loan, which may be higher than the market interest rates charged by conventional MFIs. Hence, although such an MFI/FI would technically be Sharia-compliant, it may have to charge more than a conventional MFI.

To score an additional point, the MFI/FI would charge loan administrative costs lower than the market interest rate of the financing. Hence, if the market interest rate is 30%, service charges are expected to be lower than 30%.

To score an additional point, the MFI/FI would charge loan administrative costs at least 20% less than the market interest rate of the financing. Hence, if the market interest rate is 30%, service charges are expected to be 24% or less.

To score an additional point, the MFI/FI would charge loan administrative costs at least 50% less than the market interest rate of the financing. Hence, if the market interest rate is 30%, service charges are expected to be 15% or lower.

To score an additional point, the MFI/FI would charge loan administrative costs at least 80% less than

the market interest rate of the financing. Hence, if the market interest rate is 30%, service charges are expected to be 6% or lower.

To score an additional point, the MFI/FI would charge no loan administrative costs and truly fulfil its role of providing a 'benevolent loan', as its Arabic name means, at zero service charges, expect nothing from the client but repayment of the principle.

To score an additional point, the MFI/FI would not only provide zero-cost financing, but also non-financial support in the form of capacity building. This could be, for example, financial literacy training, technical training, business advisory, linking with better suppliers, etc.

To score an additional point, the MFI/FI would not only provide zero-cost financing, but also non-financial support in the form of access to markets. This could be, for example, by linking with a buyer, providing access to an e-commerce platform, etc.

To score an additional point, the MFI/FI would have a policy to waive the debt owed by the client. Since most Qard Hasan clients are poor, the MFI/FI may decide to write-off the principle for clients who are not able to repay their loans for good reasons. The MFI/FI would write-off the loan from its own books or make a claim from other sources of funds such as Zakat funds, guarantee funds or other grant funding.

**Table 6 - Qualitative Economic Empowerment Impact of Ijara**

Indicators	Non-financial value to address business risks provided	Economic Empowerment Impact points
<p>MFI/FI validates that the supplier is genuine and the asset is genuine and makes direct payment to the supplier. Takes ownership of asset upon purchase and it remains with MFI/FI throughout lease period.</p>	<ul style="list-style-type: none"> <li>▶ Mitigates payment risk.</li> <li>▶ Ensures the existence of the seller and asset.</li> <li>▶ Mitigates ownership risks of asset.</li> </ul>	<p>1 point</p>
<p>Arranges for adequate protection of asset in the form of Takaful. Ensures that the quality and value of the asset are preserved through regular maintenance and checks.</p>	<ul style="list-style-type: none"> <li>▶ Ensures appropriate Takaful to avoid risks related to damage and theft of the asset.</li> <li>▶ Ensures that the asset remains productive throughout lease period.</li> </ul>	<p>1 point</p>
<p>Provides options to client to return, renew lease or purchase asset at the end of the lease period.</p>	<ul style="list-style-type: none"> <li>▶ Provides flexibility for client to maximize his benefit at the end of the lease period.</li> </ul>	<p>1 point</p>
<p>Provides capacity building to client on how to maximize the benefits of the leased asset.</p>	<ul style="list-style-type: none"> <li>▶ Helps the client maximize the income that can be generated by the asset by ensuring that the asset is operated and managed properly.</li> </ul>	<p>1 point</p>
<p>Negotiates for a lower price for the asset. The spot rate of the asset is less 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.</p>	<ul style="list-style-type: none"> <li>▶ Helps client negotiate with suppliers for lower prices and, hence, save money.</li> <li>▶ For example, client provides invoice for a tractor amounting to \$10,000; MFI/FI negotiates for a lower price (e.g. 5% discount- \$9,500). In addition, the selling price (after 30% profit, i.e. \$12,350) is lower than the overall costs (after 30% interest, i.e. \$13,000).</li> </ul>	<p>1 point</p>
<p>Negotiates for a lower price for the asset. The spot rate of the asset is at least 10% lower and the overall selling price is at least 10% lower than the overall costs (including the average market interest rate) if financed by a conventional MFI.</p>	<ul style="list-style-type: none"> <li>▶ Helps client negotiate with suppliers for lower prices and, hence, save money.</li> <li>▶ For example, client provides invoice for tractor amounting to \$10,000; MFI/FI negotiates for a lower price (e.g. 15% discount - \$8,500). In addition, the selling price (after 30%*\$8,500 profit, i.e. \$11,050) is at least 10% lower than the overall costs (after 30%*\$10,000 interest, i.e. \$13,000).</li> </ul>	<p>1 point</p>
<p>Negotiates for a lower price for the asset. 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.</p>	<ul style="list-style-type: none"> <li>▶ Helps client negotiate with suppliers for lower prices and, hence, save money.</li> <li>▶ For example, client provides invoice for tractor amounting to \$10,000; MFI/FI negotiates for a lower price (e.g. 25% discount - \$7,500). In addition, the selling price (after 30%*\$7,500 profit, i.e. \$9,750) is lower than the overall costs (after 30%*\$10,000 interest, i.e. \$13,000).</li> </ul>	<p>1 point</p>



Indicators	Non-financial value to address business risks provided	Economic Empowerment Impact points
Negotiates for a lower price for the asset. 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.	<ul style="list-style-type: none"> <li>▶ Helps client negotiate with suppliers for lower prices and, hence, save money.</li> <li>▶ For example, client provides invoice for fertilizer amounting to \$10,000; MFI/FI negotiates for a lower price (e.g. 35% discount - \$6,500). In addition, the selling price (after 30%*\$6,500 profit, i.e. \$8,450) is lower than the overall costs (after 30%*\$10,000 interest, i.e. \$13,000).</li> </ul>	1 point
<b>Total possible Economic Empowerment Impact points for Ijara</b>		<b>8 points</b>

Besides Murabaha, an MFI/FI may want to introduce Ijara, especially if many of its clients require high priced assets such as vehicles, which are more appropriate to be financed through a leasing arrangement.

To score an additional point, the MFI/FI would ensure that all Sharia requirements for Ijara are followed. It would ensure that the funds are used for the asset that is to be purchased and make direct payment to the supplier. After purchase from the seller, the MFI/FI remains the owner of the asset throughout the lease period. The MFI/FI will mitigate risks relating to payment and ownership risk of the asset.

To score an additional point, the MFI/FI would ensure that the asset is well protected from damage and theft. In addition, regular maintenance procedures are put into place to ensure that the asset is well maintained and remains productive.

To score an additional point, the MFI/FI would provide the client with a range of options on what they would like to do with the asset at the end of the lease period, including renewing the lease, returning the asset to the MFI/FI or purchasing the asset from it at a nominal fee. The range of options will allow the client flexibility on what to do with the asset at the end of the lease period.

To score an additional point, the MFI/FI would help the client negotiate for a lower price for the asset. If the spot price for tractor is \$10,000, the MFI/FI would negotiate to purchase from the supplier at a lower price of up to 10% off the normal price. Hence, if the MFI/FI could purchase at \$9,500 (i.e. 5% discounted price), it

would sell the asset at \$12,350 (at 30% profit rate). This is lower than the overall cost incurred by the client if the financing were to come from a conventional MFI/FI (at 30% interest rate), which would cost the client \$1,300.

To score an additional point, the MFI/FI would negotiate for discounts of at least 10%. If the spot price for the tractor is \$10,000, the MFI/FI would negotiate to purchase from the supplier at a lower price of 10% to 20% off the normal price. Hence, if the MFI/FI could purchase at \$8,500 (i.e. 15% discounted price), it would sell the asset at \$11,050 (at 30% profit rate). This is at least 10% lower than the overall cost incurred by the client if the financing were to come from a conventional MFI/FI (at 30% interest rate), which would cost the client \$1,300.

To score an additional point, the MFI/FI would negotiate for discounts of at least 20%. If the spot price for the tractor is \$10,000, the MFI/FI would negotiate to purchase from the supplier at a lower price of at least 20% off the normal price. Hence, if the MFI/FI could purchase at \$7,500 (i.e. 25% discounted price), it would sell the asset at \$9,750 (at 30% profit rate). This is at least 20% lower than the overall cost incurred by the client if the financing were to come from a conventional MFI/FI (at 30% interest rate), which would cost the client \$1,300.

To score an additional point, the MFI/FI would negotiate for discounts of above 30%. If the spot price for the tractor is \$10,000, the MFI/FI would negotiate to purchase from the supplier at a lower price of up to 30% off the normal price. Hence, if the MFI/FI could



purchase at \$6,500 (i.e. 35% discounted price), it would sell the asset at \$8,450 (at 30% profit rate). This is at least 30% lower than the overall cost incurred by the client if the financing were to come from a conventional MFI/FI (at 30% interest rate), which would cost the client \$1,300.

**Table 7 - Qualitative Economic Empowerment Impact Indicators for Musharakah/Mudaraba/Diminishing Musharakah**

Indicators	Non-financial value to address business risks provided	Economic Empowerment Impact points
Sharia-compliant partnership agreement between the MFI/FI and client that reflects a fair arrangement between the parties. The client's share of profits is at least the portion of capital injected by the client.	<ul style="list-style-type: none"> <li>▶ Fair partnership arrangement with client that recognizes the contributions between the parties equitably.</li> </ul>	1 point
MFI/FI is involved in the business planning of the venture. Market studies are conducted to determine the feasibility of the venture in ensuring a win-win situation for both MFI/FI and client.	<ul style="list-style-type: none"> <li>▶ Helps client plan for setting up the business by determining stakeholders involved, budget, risks, etc.</li> </ul>	1 point
Provides the know-how needed to run the company, including introducing innovation or technology.	<ul style="list-style-type: none"> <li>▶ Provides access to information in order to help client make key decisions.</li> <li>▶ Provides technology and/or innovation to improve productivity.</li> </ul>	1 point
MFI/FI provides relevant capacity building to its clients so that they can run the venture in an efficient and profitable manner.	<ul style="list-style-type: none"> <li>▶ Provides clients with technical or managerial capacity building to enhance the sustainability of the venture even after the MFI/FI exit.</li> </ul>	1 point
MFI/FI is involved in providing access to markets through introducing and negotiating with buyers.	<ul style="list-style-type: none"> <li>▶ Supports client by providing access to markets.</li> </ul>	1 point
MFI/FI is involved in supporting the venture in its management through mentoring, consulting or as a board member.	<ul style="list-style-type: none"> <li>▶ Helps client in the management of the company through capacity building and mentoring.</li> <li>▶ May be actively involved in the management of the venture, if required.</li> </ul>	1 point
MFI/FI has a clear exit plan, including how clients could continue operating the venture.	<ul style="list-style-type: none"> <li>▶ The exit plan in case of success or failure is clear with a clear understanding of both scenarios by both the MFI/FI and the client.</li> <li>▶ Clients are protected</li> </ul>	1 point
Client is able to make early instalments to purchase equity so the MFI/FI would exit earlier than expected (for diminishing Musharaka).	<ul style="list-style-type: none"> <li>▶ Clients are incentivised to enhance productivity so that they can take full ownership of the venture earlier than expected.</li> </ul>	1 point
<b>Total possible Economic Empowerment Impact points for Musharka/ Mudaraba/Diminishing Musharka (for SME investments)</b>		<b>8 points</b>

Musharaka or Mudaraba is a transaction where the MFI/FI makes a venture capital investment. These equity-oriented investments are unique and are often seen as representing the true essence of Islamic finance due to their clear profit-and-risk-sharing structure. The depth of the MFI/FI's involvement and how it cooperates with its clients depend on its relative expertise and agreement on who would be in a better position to conduct the task.

To score an additional point, the MFI/FI would enter into a Sharia-compliant partnership agreement that is fair and equitable. In addition, the client's share of profits is at least equal to the portion of capital injected by the client. While the loss sharing ratio is automatically decided based on the share of capital invested, the profit-sharing ratio, which is negotiable, should be a fair reflection whereby the client earns at least the share of profits that he has invested.

For an additional point, the MFI/FI would be involved in the planning and designing of the transaction. Market studies are carefully conducted in order to determine the feasibility of the venture, which will be sustainable only if both parties understand the risks involved and the responsibilities to be shared in exchange for the expected profits. This will ensure that both parties are clear on the roles and responsibilities in the partnership and are motivated to work towards realizing the expected profits.

To score an additional point, the MFI/FI would collect the required information and know-how, which is shared with the client so that he is well informed on the decisions to be made. Know-how also includes introduction of innovative practices, processes or technology that would improve productivity and enhance profits.

To score an additional point, the MFI/FI would provide the needed capacity building by either engaging a third party or providing its own expertise. This would ensure that the client has the technical and managerial expertise needed to operate and manage the venture in the most efficient manner.

To score an additional point, the MFI/FI would be involved in providing access to markets, introducing the venture with buyers and helping with negotiations

for higher prices so that both parties would benefit.

To score an additional point, the MFI/FI would be actively involved in supporting and monitoring the venture in its management through mentoring or consulting or as a board member. Such an arrangement will help develop the capacity of the client.

To score an additional point, there would be a clear exit plan in case of success or failure, and the exit plan for both scenarios would be clearly understood by both the MFI/FI and the client. In such a situation, clients should not be compelled to fulfil their promise to purchase the equity if the amount of profits is not sufficient for them to meet their daily needs.

To score an additional point, the intervention should be sustainable in the long term and the MFI/FI should exit the transaction after a period of time, while ensuring that the client does not remain dependent. To incentivise the client to exceed planned targets, the client should be allowed to make early instalments so that the MFI/FI would exit earlier than expected.

### **Diminishing Musharaka (for real estate/physical assets)**

Diminishing partnership investments on real estate assets are a combination of Musharaka and Ijara. As the contract is a combination of the two separate contracts, the elements of both types of contracts are evaluated separately and the combined evaluation of the Diminishing Musharaka contract will be the average of the two evaluation outcomes (i.e. if Ijara is evaluated at 5 points and Musharaka is evaluated at 3 points, the Diminishing Musharkah would score 4 points  $((5 \text{ points} + 3 \text{ points})/2)$  on average as a whole). Detailed explanation of Ijara and Musharaka can be found in the respective sections above.

### **Quantitative indicators**

Quantitative indicators measure the impact of the MFI/FI's intervention when conducting business (trade and investment) with its clients. They measure how smart the financing provided is. A Sharia-performing institution aims to deliver positive impact to its clients. To achieve this mission of helping clients earn more and come out of poverty, it is important to be able to

measure the extent to which the MFI/FI contributed to improving the incomes of its clients in a quantitative manner. As mentioned earlier, although randomized control trials are one recognized way of measuring impact, their prohibitive costs and difficulty in accurately isolating treatment and control samples are problematic and are the reason why such studies are rarely conducted.

Unlike their conventional counterparts, MFI/FIs can measure the impact of their financing to clients if they intervene effectively in the value chain. Instead of conducting a household survey, which may include

other factors, knowledge of the value chain would provide it with a clear understanding of the income generated by the economic activities conducted by its clients as a result of the financing provided.

The impact of the microfinance intervention is the benefit gained by the client that is directly attributable to such intervention. Since MFI/FI provides non-financial value add in addition to access to finance, the overall benefit from the combined intervention needs to be measured. Some of the quantitative indicators are given in the table below -

**Table 8 - Quantitative Economic Empowerment Impact for Various Islamic Financial Instruments**

Type of products/ interventions	Quantitative indicators
<b>Murabaha</b>	Example - Client needs \$1,000 to buy fertilizer and seeds. MFI/FI negotiates with supplier at retailer or wholesaler level, gets 30% discount Negotiated purchase price \$700 (purchase price). Client borrows from MFI/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.
<b>Impact of choosing Islamic financing compared to conventional loan</b>	
Savings or benefit generated from choosing Islamic financing 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 financing 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 financing 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 /\$2.50 *100%	
= 42.74%	
<b>Impact of negotiation with supplier</b>	
Savings or benefit generated due to negotiation conducted by MFI	
= Initial spot purchase price – negotiated purchase price of MFI	
= \$1,000 - \$ 700	
= \$300	

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

Type of products/ interventions	Quantitative indicators
<b>Salam</b>	<p>Clients needs to buy fertilizer and seeds. The MFI/FI makes an advance contract to purchase their produce at \$1,000. Since the target profit rate is 30%, it expects to sell the produce for \$1,300. MFI/FI negotiates with a buyer for a 30% higher price, selling at \$1,690 (1.3*\$1,300). MFI/FI receives the 100kg of produce during the harvest after 6 months (180 days) from the client and sells to the buyer at the expected price of \$1,690. It returns 50% of the additional profit of \$390 to the client (i.e. \$195) as a bonus. The market interest rate is 30%. The poverty line is set at \$2.50 per day. The end consumer price of the product is \$16 per kg.</p>
	<p><b>Impact of choosing Salam compared to conventional loan</b></p> <p>Savings or benefit generated from choosing Salam compared to conventional loan</p> $= (\text{Market interest rate} * \text{discounted Salam advance price}) - (\text{discount rate} * \text{expected market price} + \text{share of additional profits due to higher prices})$ $= (30\% * \$1,000) - (30\% * \$1,000) + \$195$ $= \$195$ <p>Percentage of savings or benefit generated from choosing Salam compared to conventional loan.</p> $= ((\text{Market interest rate} * \text{discounted Salam advance price}) - (\text{discount rate} * \text{expected market price} + \text{share of additional profits due to higher prices})) / \text{cost of conventional loan (principle + interest)} * 100\%$ $= ((30\% * \$1,000) - (30\% * \$1,000) + \$195) / \$1,000 * 100\%$ $= 19.50\%$ <p>Savings or benefit generated from choosing Salam compared to conventional loan contributing to poverty alleviation</p> $= ((\text{Market interest rate} * \text{discounted Salam advance price}) - (\text{discount rate} * \text{expected market price} + \text{share of additional profits due to higher prices})) / \text{financing tenor in number of days} / \text{poverty line (income per day)} * 100\%$ $= ((30\% * \$1,000) - (30\% * \$1,000) + \$195) / 180 / \$2.50 * 100\%$ $= 19.50\%$ <p><b>Impact of negotiation with the buyer/market</b></p> <p>Savings or benefit generated due to negotiation conducted by MFI/FI</p> $= \text{Share of profits due to negotiation received by client} * (\text{actual revenue from sales to the buyer} - \text{expected price before discount to the client})$ $= 50\% * (\$1,690 - \$1,300)$ $= 50\% * \$390$ $= \$195$ <p>Percentage of savings or benefit generated due to negotiation conducted by MFI/FI</p> $= \text{Share of profits due to negotiation received by client} * (\text{actual revenue from sales to the buyer} - \text{expected price before discount to the client}) / \text{expected sales price before discount to the client} * 100\%$ $= 50\% * (\$1,690 - \$1,300) / \$1,000 * 100\%$ $= 50\% * \$390 / \$1,000 * 100\%$ $= \$195 / \$1,000 * 100\%$ $= 19.50\%$

Type of products/ interventions	Quantitative indicators
	<p>Percentage contribution of savings or benefit generated that is directly contributing to poverty alleviation as a result of direct negotiation</p> <ul style="list-style-type: none"> <li>= Share of profits due to negotiation received by client * (actual revenue from sales to the buyer – expected price before discount to the client) / financing tenor in number of days / poverty line (income per day)</li> <li>= <math>50\% * (\\$1,690 - \\$1,300) / 180 \text{ days} / 2.5</math></li> <li>= <math>50\% * \\$390 / 180 \text{ days} / 2.5</math></li> <li>= <math>\\$195 / 180 \text{ days} / 2.5</math></li> <li>= 43.33%</li> </ul> <p>Increase in proportion (in %) of price from the end consumer benefitted by the client</p> <ul style="list-style-type: none"> <li>= (Negotiated product price of product benefitted by client- usual product price of product benefitted by client) / end consumer price *100%</li> <li>= <math>((\\$1,000 + \\$195) / 100\text{kg}) - (\\$1,000 / 100\text{kg}) / \\$16 * 100\%</math></li> <li>= <math>(\\$11.95 - \\$10) / \\$16 * 100\%</math></li> <li>= <math>\\$1.95 / \\$16 * 100\%</math></li> <li>= 12.19%</li> </ul>
	<p><b>Combined indicator- impact of negotiation done by MFI/FI less any additional cost</b></p> <p>Savings or benefit generated due to negotiation conducted by MFI</p> <ul style="list-style-type: none"> <li>= Share of profits due to negotiation received by client * (actual revenue from sales to the buyer – expected price before discount to the client) – (discount rate of Salam * expected sales price before discount to client – market interest rate * advance Salam revenue)</li> <li>= <math>50\% * (\\$1,690 - \\$1,300) - (30\% * \\$1,300 - 30\% * \\$1,000)</math></li> <li>= <math>50\% * \\$390 - (\\$390 - \\$300)</math></li> <li>= <math>\\$195 - \\$90</math></li> <li>= <math>\\$105</math></li> </ul> <p>Percentage of savings or benefit generated due to negotiation less the possible additional cost incurred</p> <ul style="list-style-type: none"> <li>= (Share of profits due to negotiation received by client * (actual revenue from sales to the buyer – expected price before discount to the client) – (discount rate of Salam * expected sales price before discount to client – market interest rate * advance Salam revenue)) / advance Salam revenue *100%</li> <li>= <math>(50\% * (\\$1,690 - \\$1,300) - (30\% * \\$1,300 - 30\% * \\$1,000)) / \\$1,000 * 100\%</math></li> <li>= <math>(50\% * \\$390 - (\\$390 - \\$300)) / \\$1,000 * 100\%</math></li> <li>= <math>(\\$195 - \\$90) / \\$1,000 * 100\%</math></li> <li>= <math>\\$105 / \\$1,000 * 100\%</math></li> <li>= 10.50%</li> </ul> <p>Percentage of savings or benefit generated due to negotiation less the possible additional cost incurred that is directly contributing to poverty alleviation</p> <ul style="list-style-type: none"> <li>= (Share of profits due to negotiation received by client * (actual revenue from sales to the buyer – expected price before discount to the client) – (discount rate of Salam * expected sales price before discount to client – market interest rate * advance Salam revenue)) financing tenor in number of days / poverty line (income per day)</li> <li>= <math>(50\% * (\\$1,690 - \\$1,300) - (30\% * \\$1,300 - 30\% * \\$1,000)) / 180 \text{ days} / 2.50 * 100\%</math></li> <li>= <math>(50\% * \\$390 - (\\$390 - \\$300)) / 180 \text{ days} / 2.50 * 100\%</math></li> <li>= <math>(\\$195 - \\$90) / 180 \text{ days} / 2.50 * 100\%</math></li> <li>= <math>\\$105 / 180 / 2.50 * 100\%</math></li> <li>= 23.33%</li> </ul>

Type of products/ interventions	Quantitative indicators
	<p>Increase in proportion (in %) of price (including costs) from the end consumer benefitted by the client</p> $= ((\text{Negotiated product price of product benefitted by client} - \text{pricing of Salam financing}) - (\text{usual product price of product benefitted by client} - \text{pricing of conventional financing})) / \text{end consumer price} * 100\%$ $= ((\$1,000 + \$195) / 100\text{kg}) - (\$1,000 / 100\text{kg}) - (30\% * \$1,300 - 30\% * \$1,000 / 100\text{kg}) / \$16 * 100\%$ $= (\$11.95 - \$10 - \$0.90) / \$16 * 100\%$ $= \$1.05 / \$16 * 100\%$ $= 6.56\%$
<p><b>Ijara</b></p>	<p>Client needs \$10,000 to buy equipment. MFI/FI negotiates with supplier and gets a 30% discount. Negotiated purchase price \$7,000 (purchase price).</p> <p>He borrows from the MFI/FI at 30% profit per annum over 1 year. Pays \$9,100 (selling price) after 12 months (\$7,000 principle, \$2,100 profit). The market interest rate is 30%. If delayed by another 12 months, no additional profit is due. Penalty payments allowed but must be given to charity. The poverty line is set at \$2.50 per day.</p>
<p><b>Impact of choosing Islamic financing compared to conventional loan</b></p>	
	<p>Savings generated from choosing Ijara compared to conventional leasing loan</p> $= \text{Total repayment amount from conventional financing (principle + interest)} - \text{Ijara total leasing price (principle + Ijara profit)}$ $= \$13,000 - \$9,100$ $= \$ 3,900$
	<p>Percentage of savings generated from choosing Ijara compared to conventional loan</p> $= (\text{Total repayment amount from conventional financing (principle + interest)} - \text{Ijara selling price}) / \text{Total repayment amount from conventional financing (principle + interest)} * 100\%$ $= (\$13,000 - \$9,100) / \$13,000 * 100\%$ $= 30.00\%$
	<p>Savings or benefit generated from choosing Islamic financing compared to conventional loan contributing to poverty alleviation</p> $= (\text{Total repayment amount from conventional financing (principle + interest)} - \text{Ijara selling price}) / (\text{lease period (in number of days)} / \text{poverty line (income per day)}) * 100\%$ $= (\$13,000 - \$9,100) / (365 / 2.50) * 100\%$ $= 427.40\%$
<p><b>Impact of Negotiation with the Supplier</b></p>	
	<p>Savings generated due to negotiation conducted by MFI/FI</p> $= \text{Initial spot purchase price} - \text{negotiated purchase price of MFI}$ $= \$10,000 - \$ 7,000$ $= \$3,000$



Type of products/ interventions	Quantitative indicators
	<p>Percentage of savings generated due to negotiation conducted by MFI/FI</p> $= (\text{Initial spot purchase price} - \text{negotiated purchase price of MFI}) / \text{initial spot purchase price}$ $= (\$10,000 - \$ 7,000) / \$10,000 * 100\%$ $= \$3,000 / \$10,000 * 100\%$ $= 30\%$
	<p>Savings generated as a result of negotiation that is contributing to poverty alleviation</p> $= (\text{Initial spot purchase price} - \text{negotiated purchase price of MFI}) / \text{financing tenor in number of days} / \text{poverty line (income per day)}$ $= (\$10,000 - \$ 7,000) / 365/2.50 * 100\%$ $= \$3,000 / 365/2.50 * 100\%$ $= 328.77\%$
	<p><b>Combined indicator- impact of negotiation done by MFI/FI less any additional cost</b></p>
	<p>Savings or benefit generated due to negotiation less any additional cost incurred</p> $= \text{Benefit of negotiation} - \text{cost of negotiation}$ $= \text{Initial spot purchase price} - \text{negotiated purchase price of MFI/FI} - (\text{profit rate of Ijara} * \text{initial spot purchase price} - \text{market interest rate} * \text{loan principle})$ $= \$10,000 - \$ 7,000 - (30\% (\text{profit rate}) * \$10,000 - 30\% (\text{interest rate}) * \$10,000)$ $= \$3,000 - 0$ $= \$3,000$
	<p>Percentage of savings or benefit generated due to negotiation less the possible additional cost incurred</p> $= (\text{Benefit of negotiation} - \text{cost of negotiation}) / \text{initial spot purchase price}$ $= (\text{Initial spot purchase price} - \text{negotiated purchase price of MFI/FI} - (\text{profit rate of Ijara} * \text{initial spot purchase price} - \text{market interest rate} * \text{loan principle})) / \text{initial spot purchase price}$ $= (\$10,000 - \$ 7,000 - (30\% (\text{profit rate}) * \$10,000 - 30\% (\text{interest rate})) / \$10,000 * 100\%$ $= (\$3,000 - 0) / \$10,000 * 100\%$ $= 30\%$
	<p>Percentage of savings or benefit generated due to negotiation less the possible additional cost incurred that is directly contributing to poverty alleviation</p> $= (\text{Benefit of negotiation} - \text{cost of negotiation}) / \text{lease period in number of days} / \text{poverty line (income per day)}$ $= \text{Initial spot purchase price} - \text{negotiated purchase price of MFI/FI} - (\text{profit rate of Ijara} * \text{initial spot purchase price} - \text{market interest rate} * \text{loan principle}) / \text{lease period in number of days} / \text{Poverty Line (income per day)}$ $= (\$10,000 - \$ 7,000 - (30\% (\text{profit rate}) * \$10,000 - 30\% (\text{interest rate})) / 365/2.50 * 100\%$ $= (\$3,000 - 0) / 365/2.50 * 100\%$ $= 328.77\%$

Type of products/ interventions	Quantitative indicators
<b>Qard Hasan</b>	Client needs \$1,000 to pay for her children's medical expenses. The client borrows from MFI/FI an interest-free loan (0%) over 1 year. The market interest rate is 30%. The poverty line is set at \$2.50 per day.
<p><b>Impact of choosing Qard Hasan loan compared to conventional loan</b></p> <p>Savings generated from obtaining a Qard Hasan instead of a conventional loan</p> <ul style="list-style-type: none"> <li>= Interest costs of the loan – service fees of Qard Hasan (typically zero)</li> <li>= <math>30\% * \\$1,000 - 0\% * \\$1,000</math></li> <li>= <math>\\$300 - \\$0</math></li> <li>= <math>\\$300</math></li> </ul> <p>Percentage of savings generated from choosing Qard Hasan compared to conventional loan</p> <ul style="list-style-type: none"> <li>= (Interest costs of the loan – service fees of Qard Hasan (typically zero))/ interest cost of the loan *100%</li> <li>= <math>(\\$300 - \\$0) / \\$300 * 100\%</math></li> <li>= 100%</li> </ul> <p>Percentage of savings generated from choosing Qard Hasan compared to conventional loan contributing to poverty alleviation</p> <ul style="list-style-type: none"> <li>= (Interest costs of the loan – service fees of Qard Hasan (typically zero))/ financing tenor in number of days / poverty line (income per day)</li> <li>= <math>(\\$300 - \\$0) / 365 / \\$2.50 * 100\%</math></li> <li>= 32.88%</li> </ul>	
<b>Musharaka/ Mudaraba/ Diminishing Musharaka (SME)</b>	A client approaches the MFI/FI for an equity-oriented investment. The MFI/FI invests \$10,000 into the venture based on a profit-sharing agreement of 60:40 where 60% of the profits will be received by the MFI/FI and the remaining 40% will be shared with the client. The venture is expected to earn \$1,000 a month. The market interest rate is 30%. The poverty line is set at \$2.50 per day. The GDP per capita in the region is \$3,650 or \$10 per day.
<p><b>Impact of profits generated by the client</b></p> <p>Profits earned by client from Musharaka/Mudaraba transaction</p> <ul style="list-style-type: none"> <li>= Share of profits earned by clients per annum * declared profit</li> <li>= <math>40\% * \\$1,000</math> per month</li> <li>= <math>\\$400</math> per month</li> </ul> <p>Profits earned by client from Musharaka/Mudaraba transaction compared to opportunity cost</p> <ul style="list-style-type: none"> <li>= Share of profits earned by clients per annum*declared profit/ GDP per capita (in the location or sector) *100%</li> <li>= <math>40\% * \\$1,000 \text{ per month} / (\\$10 * 30 \text{ days}) * 100\%</math></li> <li>= <math>\\$400 \text{ per month} / \\$300 \text{ per month} * 100\%</math></li> <li>= 133.33%</li> </ul> <p>Percentage of profits generated by client from Musharaka/Mudaraba transaction contributing to poverty alleviation</p> <ul style="list-style-type: none"> <li>= Share of profits earned by clients per annum*declared profit/period of earnings in number of days / poverty line (income per day)</li> <li>= <math>40\% * \\$1,000 \text{ per month} / 30 \text{ days} / \\$2.50 * 100\%</math></li> <li>= <math>\\$400 \text{ per month} / 30 \text{ days} / \\$2.50 * 100\%</math></li> <li>= 533.33%</li> </ul>	

Type of products/ interventions	Quantitative indicators																																																							
<p><b>Diminishing Musharaka (Productive Asset)</b></p> <p>Client wants to purchase a tractor that costs \$142,857. After negotiating for a 30% discount, the price of the tractor is \$100,000. Under Diminishing Musharaka arrangement the equity of the MFI/FI is divided into eight equal units, which the client is to acquire annually over a period of eight years at an expected return of 10% per annum. A certain portion (e.g. 20%) of the total price is to be contributed by the client and the rest (80%) is provided by the MFI/FI at the time of acquisition. The tractor is the joint property of the MFI/FI and the client. After acquisition, the tractor is handed over to the client and MFI/FI is renting its share in the asset to the client.</p> <p>Suppose the annual rent of the tractor is \$10,000 net of repair and insurance, etc. For the first year, the MFI/FI's share of the rent is \$8,000, being the owner of 80% of the tractor. The first instalment is \$18,000, consisting of the purchase price of an equity unit and the annual rent. For every subsequent year, as the share of the MFI/FI in the tractor diminishes, its share of the rent is also decreasing, as shown in the table below. The market interest rate is 10% per annum. The poverty line is set at \$2.50 per day.</p>																																																								
	<table border="1"> <thead> <tr> <th>End of Years</th> <th>Principal Payment</th> <th>Rental Payment</th> <th>Instalment Amount</th> <th>Balance</th> </tr> </thead> <tbody> <tr> <td>0</td> <td>0</td> <td>0</td> <td>0</td> <td>80,000</td> </tr> <tr> <td>1</td> <td>10,000</td> <td>8,000</td> <td>18,000</td> <td>70,000</td> </tr> <tr> <td>2</td> <td>10,000</td> <td>7,000</td> <td>17,000</td> <td>60,000</td> </tr> <tr> <td>3</td> <td>10,000</td> <td>6,000</td> <td>16,000</td> <td>50,000</td> </tr> <tr> <td>4</td> <td>10,000</td> <td>5,000</td> <td>15,000</td> <td>40,000</td> </tr> <tr> <td>5</td> <td>10,000</td> <td>4,000</td> <td>14,000</td> <td>30,000</td> </tr> <tr> <td>6</td> <td>10,000</td> <td>3,000</td> <td>13,000</td> <td>20,000</td> </tr> <tr> <td>7</td> <td>10,000</td> <td>2,000</td> <td>12,000</td> <td>10,000</td> </tr> <tr> <td>8</td> <td>10,000</td> <td>1,000</td> <td>11,000</td> <td>0</td> </tr> <tr> <td><b>Total</b></td> <td><b>80,000</b></td> <td><b>0</b></td> <td><b>116,000</b></td> <td></td> </tr> </tbody> </table>	End of Years	Principal Payment	Rental Payment	Instalment Amount	Balance	0	0	0	0	80,000	1	10,000	8,000	18,000	70,000	2	10,000	7,000	17,000	60,000	3	10,000	6,000	16,000	50,000	4	10,000	5,000	15,000	40,000	5	10,000	4,000	14,000	30,000	6	10,000	3,000	13,000	20,000	7	10,000	2,000	12,000	10,000	8	10,000	1,000	11,000	0	<b>Total</b>	<b>80,000</b>	<b>0</b>	<b>116,000</b>	
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<p><b>Impact of choosing Diminishing Musharaka compared to conventional loan</b></p> <p>Savings generated from choosing Diminishing Musharaka compared to conventional leasing loan</p> <ul style="list-style-type: none"> <li>= Total repayment amount from conventional financing (principle + interest)- total repayment from Diminishing Musharaka financing (principle + profits generated from DM financing)</li> <li>= 80%* 142,857 *1.1 - \$116,000</li> <li>= \$125,714.16 - \$116,000</li> <li>= \$9,714.16</li> </ul>																																																								

Type of products/ interventions	Quantitative indicators
	<p>Percentage of savings generated from choosing Diminishing Musharaka compared to conventional loan</p> $= (\text{Total repayment amount from conventional financing (principle + interest)} - \text{total repayment from Diminishing Musharaka financing}) / \text{total repayment amount from conventional financing (principle + interest)} * 100\%$ $= (80\% * 142,857 * 1.1 - \$116,000) / \$125,714 * 100\%$ $= (\$125,714.16 - \$116,000) / \$125,714 * 100\%$ $= \$9,714.16 / \$125,714 * 100\%$ $= 7.73\%$ <p>Percentage of savings generated from choosing Diminishing Musharaka in contribution to poverty alleviation</p> $= (\text{Total repayment amount from conventional financing (principle + interest)} - \text{total repayment from Diminishing Musharaka financing}) / \text{financing tenor in number of days} / \text{poverty line (income per day)}$ $= (80\% * 142,857 * 1.1 - \$116,000) / 8 / 365 / \$2.50 * 100\%$ $= (\$125,714.16 - \$116,000) / 8 / 365 / \$2.50 * 100\%$ $= \$9,714.16 / 8 / 365 / \$2.50 * 100\%$ $= 133.07\%$
	<p><b>Impact of negotiation with the supplier</b></p>
	<p>Savings generated benefitted by the client due to negotiation conducted by MFI/FI</p> $= \text{Initial spot purchase price} - \text{negotiated purchase price of MFI}$ $= 80\% * (\$125,714.16 - \$100,000)$ $= \$20,571.33$
	<p>Percentage of savings or profits benefitted by the client generated due to negotiation conducted by IFI</p> $= (\text{Initial spot purchase price} - \text{negotiated purchase price of MFI}) / \text{Initial Spot Purchase Price} * 100\%$ $= (80\% * \$125,714.16 - 80\% * \$100,000) / 80\% * \$100,000 * 100\%$ $= \$20,571.33 / \$80,000$ $= 25.71\%$
	<p>Savings generated as a result of negotiation that is contributing to poverty alleviation</p> $= (\text{Initial spot purchase price} - \text{negotiated purchase price of MFI}) / \text{financing tenor in number of days} / \text{poverty line (income per day)} * 100\%$ $= 80\% * (\$125,714.16 - \$100,000) / 8 / 365 / \$2.50 * 100\%$ $= \$20,571.33 / 8 / 365 / \$2.50 * 100\%$ $= 281.80\%$

Type of products/ interventions	Quantitative indicators
<b>Combined indicator- impact of negotiation done by MFI/FI less any additional cost</b>	
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 – (Total cost of DM financing above principle cost – market interest rate * financing principle)	
= 80%* (\$125,714.16 - \$100,000- 0)	
= \$20,571.33	
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/FI – (Total Cost of DM financing above principle cost – market interest rate * financing principle)) / initial spot purchase price* 100%	
= (80%* \$125,714.16 – 80%* \$100,000) - 0 / 80%* \$100,000 * 100%	
= \$20,571.33- 0 / \$80,000	
= 25.71%	
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) * 100%	
= Initial spot purchase price – negotiated purchase price of MFI/FI – (total cost of DM financing above principle cost – market interest rate * financing principle) / financing tenor in number of days / Poverty Line (income per day) * 100%	
= (80%* \$125,714.16 – 80%* \$100,000) - 0 / / 8/ 365/ \$2.50 * 100%	
= \$20,571.33- 0 / 8/ 365/ \$2.50 *100%	
= 281.80%	



## Social Performance

### 1. WHAT IS SOCIAL PERFORMANCE OF AN MFI?

Social performance, as defined by the Social Performance Task Force (SPTF), is “the effective translation of an institution’s mission into practice in line with accepted social values.”

An MFI/FI’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.

### 2. WHY IS SOCIAL PERFORMANCE IMPORTANT?

Social performance is important because it puts clients at the centre of strategic and operational decisions, making it more likely that financial services will be safe and beneficial for clients. For many years, the industry has been emphasizing financial sustainability, but we have learned that strong financial performance alone does not necessarily translate into benefits for clients.

Hence, having a social strategy is just as important as a financial strategy. Both strategies should complement each other with appropriate goals in mind. Although having a double bottom line is often perceived to be unmanageable, it is not the case with microfinance. Common financial problems (e.g. client exit, high PAR, and employee turnover) can be addressed with SPM interventions such as understanding the needs of different client segments, designing products and services that meet specific needs and creating human resources policies that protect employees.

A double bottom line provider can and should use data on both financial and social performance to guide its decisions about prices, products, service delivery systems, and strategies, as success for social providers requires sustainability and the creation of benefits for clients. Without attention to social performance, financial service providers and funders will make decisions based on short-term financial goals. In such cases, financial services can cause harm to clients. The benefits of promoting social performance for long-term sustainability of an MFI/FI include -

- ▶ Develop client-centric products and services
- ▶ Strong client retention as a long-term business partner
- ▶ Enhance reputation in the market as a value-added business partner
- ▶ Protection from mission drift
- ▶ Able to capture needed information for reporting to investors/donors in order to generate and sustain funding
- ▶ Differentiation and value addition in competitive markets
- ▶ Staff satisfaction and retention

### 3. JOURNEY AND BASIS OF SOCIAL PERFORMANCE STANDARDS

The SPTF was created in 2005, a few years before the first microfinance initial public offering (IPO) and before the onset of the over-indebtedness crisis in many countries. The first IPO remains controversial and is still a major cause of debate, which demonstrates the major emphasis of the profit motive of microfinance rather than its social purpose. Although the IPO incident is the extreme case often cited for the loss of direction of the microfinance industry, many MFIs/FIs experienced the lesser extent of “mission drift” too. They may have started off serving rural areas, but the attraction of higher profits led many to move to urban centres, where they could provide larger financing at lower costs. The SPTF, in consultation with various

stakeholders, developed universal standards that provide a practical path to deliver client- centric and responsible microfinance.

The Smart Campaign was founded in 2009, putting more emphasis on client protection. The Smart Campaign brings people together across the industry to develop and implement standards that focus on protecting clients through common codes of conduct. Since its founding, the campaign has been endorsed by more than 1,674 MFIs, 186 networks and associations and 187 investors and donors. As of 2020, the Smart Campaign has developed a framework and certified 115 organizations serving 45 million clients worldwide.

#### 4. CORRELATION BETWEEN FINANCIAL AND SOCIAL PERFORMANCE

The expanded dataset that the Microfinance Information Exchange (MIX) market has gathered on social performance enabled the emergence of a large number of positive and statically significant

correlations between social and financial performance. In a MIX market report published on 15 August 2016 by Meraj Husain and Micol Pistelli, several interesting findings were observed, including -

- ▶ MFIs/FIs with a board of directors that monitors social performance and with a specific focus on targeting women consistently show better portfolio quality, efficiency and productivity
- ▶ The presence of more progressive human resources policies is associated with better staff productivity and portfolio quality
- ▶ Exclusively targeting poorer clients is associated with higher operating costs but also with lower costs per borrower. The lack of a poverty strategy for market segmentation is associated with higher cost per borrower.
- ▶ Borrower retention is positively correlated to higher staff retention, productivity and lower costs per borrower.

A summary of the findings can be found in the table below -

**Figure 4 - Correlation between Financial and Social Performance**

	Board with SPM Expertise	Progressive HR Policies	Poor Clients Target	Female Clients Targets	Borrower Retention
Borrowers Per Staff	↑	↑↑	↑	↑	↑↑
PAR 30 / Write Offs	↓	↓	X	↓	X
Operating Expenses as % of GLP	↓	X	↑↑	↓	X
Cost Per Borrower as % of GNIPC	↓	X	↓	↓	↓

↑↑	Strong Positive Correlation	↑	Moderate Positive Correlation	↓	Moderate Negative Correlation	X	Inconclusive
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**Synergies**

**Trade-Offs**

**No Correlations**



The above findings not only show that social and financial performance can mutually reinforce each other, but also demonstrate that the correlation between the two factors is more probable than possible.

## 5. ECONOMIC EMPOWERMENT AND SOCIAL PERFORMANCE MANAGEMENT

As an alternative point of view, IsDB champions the principles of Economic Empowerment that promote fair and equitable relationships between both business partners (MFI/FI and client). It is important that the MFI/FI not take advantage of their obvious advantage in this relationship so that both the MFI/FI and client are trustworthy partners. By going beyond the traditional financial intermediary relationship, MFI/FIs can have a stronger influence and can impact the livelihoods of their clients in a more significant manner.

The adoption of the key dimensions of client protection and SPM are inherent in Economic Empowerment as an approach for poverty reduction. One of the guiding principles of Economic Empowerment vis-à-vis SPM is that Economic Empowerment is concerned with how to generate benefits with the poor as partners rather than generating profit from them as clients.

Moreover, the minimum standard for Economic Empowerment is “do no harm”, which contrasts with the concept promoting financial inclusion which has proven that it may cause harm to overindebted financing clients. Moreover, while the microfinance industry has emphasized financial sustainability for many years, we have learned that strong financial performance alone does not necessarily translate into benefits for clients, not to mention the negative outcomes that some microfinance services may cause. MFI/FIs aim to be financially sustainable as they go beyond financial intermediation to being actively engaged in trade and the real economy, where operational losses are not a taboo.

## 6. SIX UNIVERSAL STANDARDS OF SPM

The universal standards for SPM clarify and standardize SPM practices and bring together good practices implemented successfully in the field. The

universal standards include standards that are simple statements of what the financial services provider should achieve, along with essential management practices that the provider should implement in order to meet the standards.

The practices contained in the universal standards are field-tested. These describe policies and operational practices that experts working in the field have seen in action and agree are essential for any provider seeking to achieve its social goals. The practices have been revised and adjusted based on the application of Economic Empowerment.

In light of the similarities and differences between Economic Empowerment and SPM, we reviewed the social performance practices, as promoted by the SPTF, and found that while being in line with the principles of Economic Empowerment, these practices have been adapted to the different perspective through which MFI/FIs relate to the poor, who are their business clients and partners in trade and investment.

### Universal Social Performance Standard 1 - Define and monitor social goals

#### Universal Social Performance Standard 1A - The provider has a strategy to achieve its social goals

Essential practices (as specified by the SPTF) -

- ▶ The provider’s strategy includes a formal mission statement, which specifies increasing access to financial services for vulnerable or excluded target groups and creating benefits for these clients.
- ▶ The provider’s strategy defines the specific characteristics of its target clients.
- ▶ The provider’s strategy defines social goals, targets, and indicators to measure progress.
- ▶ The provider’s strategy articulates how its products, services and delivery channels will achieve its social goals.

Application of the essential practices in Economic Empowerment -

- ▶ The provider’s strategy includes a formal mission statement, which specifies not just access to

financial services but also access to economic opportunities for vulnerable or excluded target groups through engagement and value creation in the value chain.

- ▶ The provider's strategy defines specific characteristics of its target clients within the productive sectors of the economy.
- ▶ The provider's strategy defines social goals, targets and indicators to measure progress. It specifies a clear approach on how engagement in the value chain will benefit its clients.
- ▶ The provider's strategy articulates how its products, services and delivery channels will achieve its social goals. It segments products into productive and consumption purposes. It also restricts the provision of financing to purposes of uplifting clients from poverty or near poverty to the exclusion of consumption loans that do not contribute to the Sustainable Development Goals.

The provider will endeavour to provide consumption loans through social finance instruments (i.e. Qard Hasan) within a cost structure financed by supporting resources.

### **Universal Social Performance Standard 1B - The provider collects and discloses accurate client data specific to its social goals**

Essential practices (as specified by the SPTF) -

- ▶ The provider has an MIS and protocols for social performance data.
- ▶ If the provider states poverty reduction as one of its social goals, it monitors the poverty levels of its clients using a poverty assessment tool.
- ▶ If the provider states responsibility to the environment as one of its social goals, it defines and implements an environmental strategy.
- ▶ The provider analyses and reports social performance data internally and externally.

Application of the essential practices in Economic Empowerment -

- ▶ The provider has an MIS that captures value chain data, including commodity price movements. It also captures social performance data on target benefits to be shared with the client.

- ▶ If the provider states poverty reduction or inclusive economic growth as part of its social goals, it monitors the poverty levels of its clients using a poverty assessment tool and the numbers of jobs created
- ▶ If the provider states responsibility to the environment as one of its social goals, it defines and implements an environmental strategy.
- ▶ The provider analyses and reports social performance data internally and externally.

### **Universal Social Performance Standard 2 - Ensure board, management and employee commitment to social goals**

#### **Universal Social Performance Standard 2A - Members of the board of directors hold the provider accountable to its mission and social goals**

Essential practices (as specified by the SPTF) -

- ▶ The provider orients board members on the social mission and goals, and the board's social performance management responsibilities.
- ▶ The board uses social performance data to provide strategic direction, taking into account both social and financial goals.
- ▶ The board holds the CEO/managing director accountable for making progress toward the provider's social goals.
- ▶ The board is responsible for preserving the provider's social mission during times of institutional change.

Application of the essential practices in Economic Empowerment -

- ▶ The provider orients board members on the social mission and goals, and the board's social performance management responsibilities. The board understands the methodology of Economic Empowerment and supports the institution's engagement in the value chain.
- ▶ The board uses social performance data to provide strategic direction, taking into account both social and financial goals.
- ▶ The board monitors management's efforts to differentiate and develop value-added products and services through value chain engagement.

- ▶ The board holds the CEO/managing director accountable for making progress toward the provider's social goals.
- ▶ The board is responsible for preserving the provider's social mission during times of institutional change.
- ▶ The board designates a trained member to review each financial product to ensure its Sharia compliance and that it continuously strives to enhance its impact by creating value for its poor clients.

**Universal Social Performance Standard 2B - Senior management oversees implementation of the provider's strategy for achieving social goals**

Essential practices (as specified by the SPTF) -

- ▶ Senior management operationalizes the provider's social strategy.
- ▶ Senior management analyses and addresses social performance-related risks.
- ▶ The CEO/Managing Director holds senior managers accountable for making progress toward the provider's social goals.

Application of the essential practices in Economic Empowerment -

- ▶ Senior management operationalizes the provider's social strategy.
- ▶ Senior management analyses and addresses social performance-related risks.
- ▶ The CEO/Managing Director holds senior managers accountable for making progress toward the provider's social goals.
- ▶ CEO/Managing Director designates an internal trained Sharia auditor to review and monitor Sharia compliance and social and client protection measures.

**Universal Social Performance Standard 2C - Employee recruitment and evaluation are based on both social and financial performance criteria**

Essential practices (as specified by the SPTF) -

- ▶ Employee job candidates are screened and hired for their commitment to the provider's social goals, and their ability to carry out social performance related job responsibilities.

- ▶ The provider trains and evaluates employees on both social and financial performance responsibilities related to their position.
- ▶ Employee incentives promote progress toward the provider's social goals.
- ▶ The provider incentivizes staff to approve quality loans. (Client Protection standard 2.5)

Application of the essential practices in Economic Empowerment -

- ▶ Employee job candidates are screened and hired for their commitment to the provider's social goals and their ability to carry out social performance-related job responsibilities.
- ▶ The provider trains and evaluates employees on the Economic Empowerment impact, social and financial performance responsibilities related to their position.
- ▶ Employee incentives promote progress toward the provider's social goals.
- ▶ Employee understands the poverty situation of the clients and strives to support efforts to improve their livelihoods. The employee understands the business activities of their clients and looks for ways to ensure value-adding financing is availed.
- ▶ The provider incentivizes staff to approve quality and value-adding financing. (Client Protection standard 2.5)

**Universal Social Performance Standard 3 - Design products, services and delivery channels that meet client's needs and preferences**

**Universal Social Performance Standard 3A - The provider understands the needs and preferences of clients**

Essential practices (as specified by the SPTF) -

- ▶ The provider seeks information on clients' needs, preferences and experiences for product design and delivery.
- ▶ The provider monitors the suitability of products, services and delivery channels. (Client Protection standard 1.2)

Application of the essential practices in Economic Empowerment -

- ▶ The provider seeks information not only on the financial needs, but also the non-financial support required, preferences and experiences for product design and delivery.
- ▶ The provider monitors the suitability of products, services and delivery channels. (Client Protection standard 1.2) The provider provides the non-financial support needed by the client.

**Universal Social Performance Standard 3B - The Provider's products, services and delivery channels are designed to benefit clients, in line with the provider's social goals**

Essential practices (as specified by the SPTF) -

- ▶ The provider offers products and services that are suited to clients' needs. (Client Protection standard 1.1).
- ▶ The provider's products and services are designed to reduce barriers to financial inclusion for target clients.
- ▶ The provider's products and services are designed to reduce client risks.
- ▶ The provider creates benefits for clients by enabling them to invest in economic opportunities and address anticipated household needs.
- ▶ A policy and documented process are in place to prevent aggressive sales techniques and forced signing of contracts. (Client Protection Standard 1.3)
- ▶ The provider monitors the risks associated with agents and networks and addresses problems.

**Application of the essential practices in Economic Empowerment -**

- ▶ The provider offers products and services that are suited to clients' needs. (Client Protection standard 1.1). The products and services are designed with the objective of improving the client's livelihood.
- ▶ The provider's products and services are designed to reduce barriers to financial inclusion for target clients.
- ▶ The provider's products and services are also

designed to provide economic opportunities to clients through the provider's interventions in the value chain.

- ▶ The provider's products and services are designed to reduce client risks. Risks are shared throughout the value chain and are not left to the client alone. The profits generated by the provider are based on the success of the client.
- ▶ The provider creates benefits for clients by enabling them to invest in economic opportunities and address anticipated household needs. The provider actively seeks synergies with different service providers and ongoing programmes to cater for household needs beyond the provider's scope of work.
- ▶ A policy and documented process are in place to prevent aggressive sales techniques and forced signing of contracts. (Client Protection Standard 1.3)
- ▶ The provider monitors the risks associated with agents and networks and addresses problems.

**Universal Social Performance Standard 4 - Treats clients responsibly**

**Universal Social Performance Standard 4A - Prevention of over-indebtedness**

Essential practices (as specified by the SPTF) -

- ▶ The provider has a sound policy and well-documented process for loan approvals and makes decisions using appropriate information and criteria. (Client Protection standard 2.1).
- ▶ The provider uses credit reporting information, when feasible in the local context. (Client Protection standard 2.2).
- ▶ The provider's senior management and board monitor the market and respond to heightened over-indebtedness risk. (Client Protection standard 2.3).
- ▶ The provider maintains sound portfolio quality. (Client Protection standard 2.4).

Application of the essential practices in Economic Empowerment -

- ▶ The provider has a sound policy and well-documented process for financing approvals and makes decisions using appropriate information and criteria. (Client Protection standard 2.1).
- ▶ The provider employs direct payment means, where possible, instead of providing cash to clients.
- ▶ The provider does not consider any late fees or charges as income. All late fees or charges are directed to charity.
- ▶ No late fees or charges of the outstanding repayment due are taken as income. It is important to note that charging late fees would be the last resort with clients ignoring their payments, not clients who are factually insolvent.
- ▶ The provider uses credit-reporting information, when feasible in the local context. (Client Protection standard 2.2).
- ▶ The provider's senior management and board monitor the market and respond to heightened over-indebtedness risk. (Client Protection standard 2.3).
- ▶ The provider maintains sound portfolio quality. (Client Protection standard 2.4).

**Universal Social Performance Standard 4B - Transparency**

Essential practices (as specified by the SPTF) -

- ▶ Policy and documented process are in place to require transparency on product terms, conditions and pricing. (Client Protection standard 3.1)
- ▶ The provider communicates with clients at an appropriate time and through appropriate channels. (Client Protection standard 3.2)
- ▶ The provider takes adequate steps to ensure client understanding and support client decision-making. (Client Protection standard 3.3)

**Application of the essential practices in Economic Empowerment -**

- ▶ Policy and documented process are in place to require transparency on product terms, conditions and pricing. (Client Protection standard 3.1). The

cost price, selling price and profit margins must be clearly specified for debt-oriented products.

- ▶ The details of the quantity and quality of an asset, vendor supplier details & roles, risks and responsibilities of both the client and provider should be clearly specified.
- ▶ The provider communicates with clients at an appropriate time and through appropriate channels. (Client Protection standard 3.2). The details of the quantity and quality of an asset, vendor supplier details & roles, risks and responsibilities of both the client and provider should be clearly specified.
- ▶ The provider takes adequate steps to ensure client understanding and support client decision-making. (Client Protection standard 3.3)

**Universal Social Performance Standard 4C - Fair and respectful treatment of clients**

Essential practices (as specified by the SPTF) -

- ▶ The provider promotes and enforces fair and respectful treatment of clients in line with a code of conduct. (Client Protection standard 5.1)
- ▶ The provider has policy and documented processes to avoid discriminating against Protected Categories in selecting clients and setting terms and conditions. (Client Protection standard 5.2)
- ▶ Loans are collected by staff and collection agents in an appropriate manner. (Client Protection standard 5.3)
- ▶ The provider has effective systems to prevent and detect fraud. (Client Protection standard 5.4)
- ▶ The provider management and oversight support fair and respectful treatment of clients. (Client Protection standard 5.6)
- ▶ Insurance claims are processed in a fair and timely manner. (Client Protection standard 5.5)

Application of the essential practices in Economic Empowerment -

- ▶ The provider promotes and enforces fair and respectful treatment of clients in line with a code of conduct. (Client Protection standard 5.1) The provider treats clients as business partners, not as debtors.

- ▶ The provider has policy and documented processes to avoid discriminating against Protected Categories in selecting clients and setting terms and conditions. (Client Protection standard 5.2). The provider should not charge poorer clients a higher price for the financing provided.
- ▶ Provider does not discriminate against non-Muslims in terms of fair and respectful treatment and of the financing terms and conditions.
- ▶ Loans are collected by staff and collection agents in an appropriate manner. (Client Protection standard 5.3). Staff and collection agents should explore ways to ensure that the client's basic needs are being assessed and prioritized during debt collection.
- ▶ The provider has effective systems to prevent and detect fraud. (Client Protection standard 5.4)
- ▶ The provider management and oversight support fair and respectful treatment of clients. (Client Protection standard 5.6)
- ▶ Takaful insurance claims are processed in a fair and timely manner. (Client Protection standard 5.5)

#### **Universal Social Performance Standard 4D - Privacy of client data**

Essential practices (as specified by the SPTF) -

- ▶ Client data is kept secure and confidential. (Client Protection standard 6.1)
- ▶ Clients are informed about data privacy and consent to the use of their data. (Client Protection standard 6.2)

Application of the essential practices in Economic Empowerment -

- ▶ Client data is kept secure and confidential. (Client Protection standard 6.1)
- ▶ Clients are informed about data privacy and consent to the use of their data. (Client Protection standard 6.2)

#### **Universal Social Performance Standard 4E - Mechanisms for complaint resolution**

Essential practices (as specified by the SPTF) -

- ▶ The provider has an effective system in place to receive and resolve client complaints. (Client Protection standard 7.1)
- ▶ The provider informs clients about their right to complain and how to submit a complaint. (Client Protection standard 7.2)
- ▶ The provider uses information from complaints to manage operations and improve product and service quality. (Client Protection standard 7.3)

Application of the essential practices in Economic Empowerment -

- ▶ The provider has an effective system in place to receive and resolve client complaints. (Client Protection standard 7.1)
- ▶ The provider informs clients about their right to complain and how to submit a complaint. (Client Protection standard 7.2).
- ▶ The provider uses information from complaints to manage operations and improve product and service quality. (Client Protection standard 7.3)
- ▶ Complaints should be made accessible to the Sharia trained staff and/or internal auditor

#### **Universal Social Performance Standard 5 - Treats employees responsibly**

##### **Universal Social Performance Standard 5A - The provider follows a written human resources policy that protects employees and creates a supportive working environment**

Essential practices (as specified by the SPTF) -

- ▶ A written human resources policy compliant with national law is available to all employees and explains their rights.
- ▶ Employee compensation levels reflect competitive market rates, or at least the national or local sector minimum wage
- ▶ The provider accepts and responds to employee grievances through a formal and confidential grievance system



- ▶ The provider assesses employees' health and safety risks and takes steps to mitigate them before they occur. The provider investigates, documents, and reports all occupational incidents (i.e., accidents, injuries, and diseases) that occur.

Application of the essential practices in Economic Empowerment -

- ▶ A written human resources policy compliant with national law is available to all employees and explains their rights.
- ▶ Employee compensation levels reflect competitive market rates.
- ▶ The provider accepts and responds to employee grievances through a formal and confidential grievance system
- ▶ The provider assesses employees' health and safety risks and takes steps to mitigate them before they occur. The provider investigates, documents and reports all occupational incidents (i.e., accidents, injuries, and diseases) that occur.

**Universal Social Performance Standard 5B - The provider communicates to all employees the terms of their employment and provides training for essential job functions**

Essential practices (as specified by the SPTF) -

- ▶ Employees receive clear documentation related to their job responsibilities and performance evaluation.
- ▶ Employees receive job-specific training and/or skill development.

Application of the essential practices in Economic Empowerment -

- ▶ Employees receive clear documentation related to their job responsibilities and performance evaluation.
- ▶ Employees are provided with a clear understanding of how to implement the Economic Empowerment Approach with their clients. Employees well understand the related policies to be effective agents of the provider.
- ▶ Employees receive job-specific training and/or skill development

**Universal Social Performance Standard 5C - The provider monitors employee satisfaction and turnover**

Essential practices (as specified by the SPTF) -

- ▶ The provider analyses employee satisfaction.
- ▶ The provider monitors the rate of employee turnover and understands the reasons for employee exit.
- ▶ The provider takes action to correct institutional problems leading to employee turnover and dissatisfaction.

Application of the essential practices in Economic Empowerment -

- ▶ The provider analyses employee satisfaction.
- ▶ The provider monitors the rate of employee turnover and understands the reasons for employee exit.
- ▶ The provider takes action to correct institutional problems leading to employee turnover and dissatisfaction.

**Universal Social Performance Standard 6 - Balance financial and social performance**

**Universal Social Performance Standard 6A - The provider sets and monitors growth rates that promote both institutional sustainability and social goals**

Essential practices (as specified by the SPTF) -

- ▶ The provider has a policy on sustainable target growth rates that considers the provider's growth capacity, institutional sustainability and social goals.
- ▶ The provider monitors growth and enhances internal capacity as needed.

Application of the essential practices in Economic Empowerment -

- ▶ The provider has a policy on sustainable target growth rates that considers the provider's growth capacity, institutional sustainability and social goals.
- ▶ The provider monitors growth and enhances internal capacity as needed.
- ▶ The targets include value add to clients and other poverty reduction measurement targets.



**Universal Social Performance Standard 6B - Equity investors, lenders, board and management are aligned on the provider's social goals and implement appropriate financial structure in its mix of sources, terms and desired returns**

Essential practices (as specified by the SPTF) -

- ▶ The provider has clear policies, consistent with its social goals, on its desired level of returns and on how profits will be used.
- ▶ The provider engages with funders whose expectations for financial returns, timeframe and exit strategies are aligned with the provider's social goals and stage of development.
- ▶ The provider protects the liabilities it has to clients.
- ▶ The provider has a transparent financial structure, as reflected in its annual audited financial statements.

Application of the essential practices in Economic Empowerment -

- ▶ The provider has clear policies, consistent with its social goals, on its desired level of returns and on how profits will be used.
- ▶ The provider engages with funders whose expectations for financial returns, timeframe and exit strategies are aligned with the provider's social goals and stage of development.
- ▶ In cases where the provider is a Mudarib (agent) of the financier, they agree on the social goals (including impact generated by Economic Empowerment interventions) and use of the capital.
- ▶ The provider protects the liabilities it has to clients.
- ▶ The provider has a transparent financial structure, as reflected in its annual audited financial statements.
- ▶ Board and senior management continuously monitor any negative correlation between financial return and social indicators.

**Universal Social Performance Standard 6C - The provider sets prices responsibly**

Essential practices (as specified by the SPTF) -

- ▶ The provider is managed sustainably to provide services in the long term. (Client Protection standard 4.1).

- ▶ The provider's pricing policy is aligned with the interest of clients. (Client Protection standard 4.2).
- ▶ The provider's financial ratios do not signal pricing issues. (Client Protection standard 4.3).

Application of the essential practices in Economic Empowerment -

- ▶ The provider is managed sustainably to provide services in the long term. (Client Protection standard 4.1).
- ▶ The provider's pricing is based on the cost of funds, cost of operations, cost of provision and profit margin. The provider understands and continuously monitors its cost structure and takes steps to be efficient.
- ▶ The provider's pricing policy is aligned with the interest of clients. (Client Protection standard 4.2). A policy for Salam financing is in place to ensure that the provider shares the benefit of price increase of the commodity with the client.
- ▶ The provider takes steps to negotiate with value chain stakeholders and shares these benefits with the client.
- ▶ The provider's financial ratios do not signal pricing issues. (Client Protection standard 4.3).

**Universal Social Performance Standard 6D - The provider compensates senior managers in a way that is appropriate to a provider with stated social goals**

Essential practices (as specified by the SPTF) -

- ▶ The provider ensures that compensation of the CEO/Managing Director and other senior staff is in line with the provider's social goals.
- ▶ Upon request, the provider transparently discloses compensation to regulators, auditors, raters, donors, lenders, and investors.
- ▶ The provider calculates the difference between the average compensation of its top-level executives and its field employees, and analyses whether this spread is consistent with the provider's mission.

Application of the essential practices in Economic Empowerment -

- ▶ The provider ensures that compensation of the CEO/Managing Director and other senior staff is in line with the provider's social goals.

- ▶ Upon request, the provider transparently discloses compensation to regulators, auditors, raters, donors, lenders, and investors.
- ▶ The provider calculates the difference between the average compensation of its top-level executives and its field employees, and analyses whether this spread is consistent with the provider's mission.
- ▶ The board continuously monitors any negative correlation between financial return and social indicators.

## 7. SEVEN CLIENT PROTECTION PRINCIPLES

### What are the Client Protection Principles (CPPs)?

The CPPs are the minimum standards that clients should expect to receive when doing business with an FI. They were distilled from work by providers, international networks and national microfinance associations to develop pro-client codes of conduct and practices. FIs must involve employees from every operational area in an effort to achieve adequate client protection. Rather than designating client protection as a "special project" to select employees, FIs should ensure that each department has specific client protection responsibilities. Some of the operational areas discussed include -

- a. **Executive Management-** Executive management's role is to communicate the importance and advantages of protecting clients to motivate employees and to ensure the design and implementation of sound policies and procedures. Executive management also sets the tone for the institution's organizational culture and values. The board and top management's commitment to client protection is a pre-condition for strong practices among other employees.
- b. **Product Research and Development-** The product research and development team designs products that meet clients' needs. Through market research and client satisfaction assessments, the product research and development team contribute vital information that enables the institution to design appropriate products and services for clients.
- c. **Product/Operations Management-** Product/operations management oversees the delivery of products and services to clients. This team ensures that the client protection policies and procedures defined at the executive management level are respected at the operational level.
- d. **Human Resources-** Human resource management is essential for creating a culture of high standards of ethical behaviour throughout the organization. The code of ethics developed by HR and policies on recruitment, training, and performance evaluation help determine whether employees treat clients with fairness and respect.
- e. **Marketing and Promotions-** Marketing and promotions ensures that employees are truthful and transparent with clients and are in line with any existing consumer protection legislation. The marketing team designs materials that help clients understand their products and rights. Marketing and promotions can also play a role in protecting privacy by ensuring client consent to use client photos or information in marketing materials.
- f. **Sales Team and Frontline Employees-** As the employees with the most frequent contact with clients, frontline employees execute the client protection policies established by other departments. Loan/financing officers are central to preventing over-indebtedness, while all frontline employees play a major role in promoting transparency, upholding high ethical standards, listening to clients and safeguarding their privacy.
- g. **Finance-** The finance department ensures responsible, competitive, affordable and sustainable pricing policies. Finance may also contribute to defining profitability targets and helping define profit allocation policies that bring value for clients.
- h. **Risk Management-** Risk management verifies compliance with policies and procedures. These employees monitor risk factors for over-indebtedness, verify client files and conduct client visits to ensure employees are communicating transparently and respecting the institution's ethical standards. Risk management also verifies the proper functioning of complaints mechanisms and client privacy procedures.
- i. **Legal-** Many countries have laws that influence client protection such as legislation on interest rates, transparency, professional codes of

conduct, collateral seizure, truth-in-advertising, discrimination and data privacy. The legal department is responsible for ensuring compliance with any existing consumer protection legislation, and for assisting the institution in establishing sound legal policies concerning client and employee rights.

**j. Information Technology and Communication (ICT)**- ICT is critical to safeguarding client data and keeping IT systems secure. ICT can also contribute to defining appropriate products and monitoring over-indebtedness by providing platforms that facilitate analysis of client-level data, product portfolios and tracking client complaints.

**k. Complaints /Customer Service**- The complaints or customer service department ensures that clients' voices are heard. Complaints mechanisms give clients a way to express their discontent, feedback and suggestions and provide an opportunity for institutions to improve their products and detect any unethical treatment of clients. Regular analysis of complaints allows the institution to evaluate overall trends and identify systemic problems.

FIs can use this tool to assign client protection responsibilities to each operational department and to understand how responsibilities are shared among operational departments. The Client Protection Principles were documented by the Smart Campaign, a global campaign committed to embedding client protection practices into the institutional culture and operations of the microfinance industry. In this document, IsDB revised the CPPs to take into account Economic Empowerment practices.

### Why are the Client Protection Principles important?

The Client Protection Principles promote ways for service providers to take practical steps to treat clients fairly and respectfully while avoiding practices that might harm them. While the Principles are universal, meaningful and effective, implementation requires careful attention to the diversity within the provider community and conditions in different markets and country contexts. The seven Client Protection Principles are listed below.

- 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.
- 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).
- 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.
- 4. Responsible pricing** - Pricing, terms and conditions will be set in a way that is affordable to clients while allowing for FIs to be sustainable. Providers will strive to provide positive real returns on deposits.
- 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 financing and debt collection processes.
- 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.
- 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.

**Table 9 - Client Protection Principle 1 - Appropriate product design and delivery**

Recommended Practice	Responsibility
<p>Request and analyse regular market studies and client surveys— including client satisfaction and dropout surveys—from Product Research and Development. Analyse these data regularly to understand information on client needs and constraints.</p>	<p>Executive Management, Product Research and Development</p>
<p>Based on this analysis, provide guidance to Product Research and Development on how to design/improve products and services so that they more closely match clients’ needs and constraints.</p>	<p>Executive Management, Product Research and Development</p>
<p><b>Offer financing products that match the identified business and family needs of diverse segments of the institution’s target population. This means -</b></p> <ul style="list-style-type: none"> <li>▶ The institution offers an acceptable variety of financing products, designed to match the main business and family needs of the target segment.</li> <li>▶ The financing size matches the target clients’ main financial needs.</li> <li>▶ The repayment schedule (grace period, repayment frequency, and term) is tailored to the business activity and the cash flow of the business and household.</li> <li>▶ Prepayment is not subject to any penalties or unjustified fees or charges.</li> <li>▶ The institution does not continue to accrue penalties/fees on non-performing financing that causes poor clients to go further in debt. It is important to emphasize that charging late fees would be the last resort with clients ignoring their payments, not clients who are factually insolvent.</li> <li>▶ All fees/penalties are not to be accounted as income for the institution and must be given to charity.</li> </ul>	<p>Executive Management, Product Research and Development, Finance</p>
<p><b>Design savings products that are appropriate for clients (where permitted by the regulator).</b></p> <ul style="list-style-type: none"> <li>▶ Offer minimum account balances appropriate to small savers.</li> <li>▶ Calculate profit-sharing based on average daily balance.</li> <li>▶ Do not charge excessive fees for closing a client savings account.</li> <li>▶ Compulsory savings should not be made mandatory</li> </ul>	<p>Executive Management, Product Research and Development, Finance</p>
<p><b>Offer Takaful insurance products that are appropriate for clients.</b></p> <ul style="list-style-type: none"> <li>▶ Only charge clients for the insurance premium passed on to the insurance company or premium as per actuarial (if in-house); the institution should absorb the operational cost.</li> <li>▶ Ensure that the need for Takaful insurance is clear and not a blanket replacement for collateral/guarantees.</li> <li>▶ Minimize the number of exclusions and rejections.</li> <li>▶ Keep the claims procedure as simple as possible.</li> <li>▶ Ensure claims are processed in a timely way.</li> </ul>	

Recommended Practice	Responsibility
<ul style="list-style-type: none"> <li>▶ Ensure the coverage amount and costs are affordable to the client and sustainable for the institution.</li> <li>▶ Set prices according to clients' willingness and ability to pay for Takaful insurance (verified by market studies or surveys).</li> <li>▶ Make sure products do not have premiums that are significantly higher than expected payouts.</li> <li>▶ Ensure frequency of premium collection is appropriate to clients' cash flows and collection methods are convenient for clients.</li> </ul>	Executive Management, Product Research and Development
<p><b>Offer payments products that are appropriate for clients.</b></p> <ul style="list-style-type: none"> <li>▶ Offer affordable exchange rates to clients.</li> <li>▶ Offer the possibility to cancel the payment within a short window of time after sending the payment.</li> <li>▶ Consider how linking payments products to other financial products might create benefits for clients.</li> <li>▶ Provide different options for receiving payments, such as home delivery and direct deposit into a savings account.</li> </ul>	Executive Management, Product Research and Development
<p>Consider client needs and characteristics to offer clients the most appropriate product or service. Understand the client's business needs and discuss ways how client can best generate more income.</p>	Sales force and frontline employees
<p>During client orientation sessions, make clients aware of the range of products offered, and their characteristics, so that clients can select the products and services that are appropriate to their needs and means. Clients should be made aware of the roles and responsibilities of both client and institution for each product offered.</p>	Sales force and frontline employees
<p>Do not use aggressive sales techniques. Provide clients with information about products, but do not exaggerate the benefits of the products, or pressure clients to buy them. Emphasize the different manner in which the institution intervenes in the value chain.</p>	Sales force and frontline employees
<p>Provide a platform for the collection and analysis of client-level data and market research information. The collection of data will include feedback on various product features as well as poverty improvement data.</p>	ICT, Executive Management
<p>Provide a platform and capabilities for reporting client-level information to the product development team, the board of directors, and other executive managers.</p>	ICT, Executive Management

**Table 10 - Client Protection Principle 2 - Prevention of over - indebtedness**

Recommended Practice	Responsibility
<p><b>Regularly monitor the risk and level of client over-indebtedness.</b></p> <ul style="list-style-type: none"> <li>▶ Require regular reporting (at least annually) on the level and risk of client over-indebtedness and multiple borrowing. These reports should present information on -               <ul style="list-style-type: none"> <li>– Non-performing financing, rescheduled financing, and financing write-offs.</li> <li>– Multiple borrowing within the institution and between institutions.</li> <li>– Credit bureau information analysed at the aggregate level in order to inform decisions about product mix, geographical expansion and targeting of specific populations.</li> <li>– The results of client visits by Risk Management, to look at financing use and monitor the risk of over-indebtedness.</li> </ul> </li> <li>▶ Direct payment to suppliers preferred to providing cash to clients.</li> <li>▶ Scrutinize institutional policies to look for those that may contribute to over-indebtedness, like zero tolerance for delinquency and employee incentive schemes that prioritize growth and productivity over portfolio quality.</li> <li>▶ Scrutinize institutional weaknesses to look for those that may contribute to over-indebtedness, such as inexperienced or undertrained financing officers, in addition to misaligned employee KPIs.</li> <li>▶ Define the scope of “high risk” segments in the local market and increase monitoring if the institution is in high risk. Use at least the following factors to determine risk - multiple borrowings, lack of effective credit bureau, high penetration rates and high competition..</li> </ul>	<p>Risk Management, Executive Management</p>
<p>In addition to the monitoring mechanisms listed above, also require specific reports on over-indebtedness with the opinions and recommendations made by independent areas from the institution’s operations side (i.e. Risk Management).</p>	<p>Risk Management, Executive Management</p>
<p><b>For individual financing, develop an assessment process that requires rigorous evaluation of financing client repayment capacity. The process should -</b></p> <ul style="list-style-type: none"> <li>▶ Ensure individual financing assessments include a cash flow analysis of the business and the household, and takes into account liabilities from other sources, including indirect loans (as guarantor).</li> <li>▶ The cash flow analysis should cover the entire financing period for households with seasonal cash flows. Analysis should emphasize additional cash flow anticipated as a result of the financing and should consider the volatility of the income source due to business risks.</li> <li>▶ Financing should be provided mainly for productive purposes. However, should financing be provided for essential consumption purposes (e.g., durable goods), due consideration should be given to the household cash flows.</li> <li>▶ Follow prudential criteria (e.g., cash flow before financing, moderate/pessimistic scenario) during the assessment.</li> </ul>	

Recommended Practice	Responsibility
<ul style="list-style-type: none"> <li>▶ Require analysis at each financing cycle or at minimum once a year, even if simplified for secondary aspects at financing renewal.</li> <li>▶ For clients with informal revenues and/or non-consumption financing (most cases), base the repayment capacity analysis on a client visit (performed by the financing officer through client visit or delegated to the group/village members). Verify the information consistency through cross checks. For clients with a salary asking for a consumption financing, a client visit is not required.</li> <li>▶ Require that financing approval is not based solely on guarantees (whether peer guarantees, co-signers or collateral). Verify that client has the capacity to operationalize the income generating activity.</li> <li>▶ Require that the credit team check the credit registry or credit bureau for financing client's current debt levels and repayment history (when available). Establish a supervisory system to ensure that credit bureau information is used to inform credit analysis and decisions. When a credit bureau is not available, require that employees check internal records before processing the financing further.</li> <li>▶ Ensure that credit staff limit client debt thresholds to a level deemed acceptable by the institution.</li> <li>▶ Include all the above policies regarding financing evaluation, credit bureau reporting and financing rescheduling/restructuring in a written credit manual.</li> </ul>	Product Management, Executive Management
<p><b>For group financing, develop a pre-financing process that requires evaluation of financing client repayment capacity and group preparation. The process should -</b></p> <ul style="list-style-type: none"> <li>▶ Include training of group members on how to assess their own, and their group members' repayment capacity.</li> <li>▶ Include training on the concepts of solidarity payments, the dangers of over-indebtedness and the risks associated with multiple borrowing.</li> <li>▶ When available, provide group members with access to up-to-date credit bureau information on their fellow group members. Inform group members about the level of over-indebtedness of any group member that surpasses the established limit in the credit/financing policy.</li> </ul>	Product Management, Executive Management
<p>Develop a policy describing how and when to consolidate or reschedule financing for clients who are willing but unable to repay. Describe specific cases under which clients can be granted rescheduling or refinancing, and considerations for clients who have demonstrated good history of repayment. Rescheduled payments should not impose any costs/fees over and above the due outstanding amount.</p>	Product Management, Finance, Executive Management
<p>Develop a policy that the institution will systematically report to the credit bureau about its clients (where a credit bureau is available).</p>	Product Management, Executive Management



Recommended Practice	Responsibility
<p>Require that a credit bureau check is conducted regularly on the whole client database (e.g. check 25% of the database each month, completing a check of 100% of the database quarterly) in order to identify the level of cross-indebtedness, and the potential patterns of clients that borrow from other sources immediately after contracting financing with the institution. Analyse the reports that are produced from these checks.</p>	<p>Product Management, Executive Management</p>
<p><b>Establish productivity targets and employee incentives that are reasonable compared to the industry benchmark (parameters and proportion of fixed/variable remuneration). Ensure that -</b></p> <ul style="list-style-type: none"> <li>▶ The incentive structure rewards the quality of the portfolio at least as highly as growth.</li> <li>▶ The FI does not issue bonuses/incentives unless PAR is under control (i.e., PAR30&lt;10%).</li> <li>▶ The incentive structure does not incentivize the over-selling or mis-selling of products (e.g., incentivizing portfolio growth over portfolio quality), or overly aggressive collections practices due to a “zero delinquency” policy or an incentive scheme based on very short delays (for example, judging financing officer’s PAR on the basis of PAR 1).</li> <li>▶ Productivity targets and incentive schemes are differentiated among employees and are adjusted according to the market potential, infrastructure and other factors.</li> <li>▶ Productivity targets and incentive schemes are periodically reviewed for changing market conditions and Risk Management investigates cases where risk is higher related to the incentive scheme and productivity targets.</li> </ul>	<p>Human Resources, Executive Management</p>
<p>Develop and execute employee training on credit and business procedures. Ensure junior financing officers receive adequate field mentoring from senior employee.</p>	<p>Human Resources, Executive Management</p>
<p>Provide a platform for monitoring of portfolio quality by different parameters, such as product type, financing cycle, region, etc.</p>	<p>ICT, Executive Management</p>
<p>Provide a platform for credit employees to enter client financing and personal information into an institution-wide database in which clients have unique identifying numbers.</p>	<p>ICT, Executive Management</p>
<p>Provide a platform for financing employees to quickly and easily check internal client records for client repayment history, current financing and other credit information.</p>	<p>ICT, Executive Management</p>
<p>Provide a platform for the institution to draw information from, and contribute to, a credit information sharing system (if applicable). The platform should facilitate regular reporting on the risks of client’s over-indebtedness</p>	<p>ICT, Executive Management</p>
<p>Provide a platform to monitor employee/financing officer incentive calculations.</p>	<p>ICT, Executive Management</p>

**Table 11- Client Protection Principle 3 - Transparency**

Recommended Practice	Responsibility
<p>For all products, present to clients the total amount that the client pays for the product, regardless of local regulations (including in the absence of industry-wide requirements). Include cost price, profit margins and selling price for trade transactions (i.e., Murabaha, Ijara) clearly in the contracts. For Salam transactions, clearly mention the quality and quantity of products to be purchased. For equity-oriented transactions (i.e., Mudaraba, Musharaka), profit-sharing ratios should be clearly mentioned.</p>	<p>Legal, Product Management, Executive Management</p>
<p><b>Develop a policy that requires sales and frontline employees to communicate to clients all the prices, terms and conditions of all financial products, including any possible changes to these over time, prior to signing a contract. The policy should -</b></p> <ul style="list-style-type: none"> <li>▶ Require that financing documentation include - <ul style="list-style-type: none"> <li>– charges and fees, including 3rd party fees</li> <li>– terms/maturity</li> <li>– conditions</li> <li>– information on compulsory savings</li> <li>– information on Takaful insurance premiums</li> <li>– penalties for late payment</li> <li>– conditions for early repayment</li> </ul> </li> <li>▶ Require that clients receive a copy of documentation at beginning of the financing process.</li> <li>▶ Require that the financing contract be handed to clients (both group and individual financing clients) at the time of signing the contract.</li> <li>▶ Require that debt collection practices be revealed to the client at the time of sale.</li> <li>▶ If applicable, require that savings documentation lists eligibility criteria, profit rates, fees for withdrawal, withdrawal limits, minimum and maximum balance and use of savings in case of credit default (if applicable).</li> <li>▶ If applicable, require that payment/money transfer service documentation lists - the amount to be paid by the sender in the sender's currency and the amount to be received in the recipient's currency; all fees; taxes; estimated exchange rate; possible changes; conditions for collecting money; cancellation conditions; and linked product requirements (e.g., having to open a savings account).</li> <li>▶ If applicable, require that Takaful insurance product documentation lists eligibility criteria; cost of and how premiums are collected; specific events covered by product and amount of loss covered; length and term of coverage and premium due dates; all exclusions; any expiry conditions; waiting periods, if used; how to file a claim; contact information for making a claim; reimbursement conditions; and whether and how insurance is regulated by a third party. Require that clients receive written proof of their insurance coverage.</li> <li>▶ For all product contracts (financing, savings, insurance, payments/ money transfer), include a privacy clause that describes how the institution will use and share client data.</li> </ul>	<p>Product Management, Sales Force and Frontline Employees, Executive Management</p>

Recommended Practice	Responsibility
<p><b>Develop a policy that employees communicate with clients in a way that helps clients make informed decisions about purchasing a product. The policy should require -</b></p> <ul style="list-style-type: none"> <li>▶ Employees use multiple channels for disclosing information, such as brochures, orientation sessions, meetings, branch postings and websites.</li> <li>▶ All written and verbal communication with clients is in the local language and that plain language and terms are used to describe products, prices, terms and conditions.</li> <li>▶ Employees read contracts aloud to illiterate or low-literate clients.</li> <li>▶ Employees check client understanding by asking follow-up questions</li> </ul>	<p>Product Management, Sales Force and Frontline Employees, Executive Management</p>
<p>Develop a policy to provide clients with proof of payments for all products, and provide information on accounts (e.g., financing balance, savings balance) either upon request from clients, or on a regular basis (e.g., account statements)</p>	<p>Product Management, Sales Force and Frontline Employees, Executive Management</p>
<p><b>Enforce the institution's policy to give clients adequate time to review the terms and conditions and have an opportunity to ask questions prior to signing contracts. Require that -</b></p> <ul style="list-style-type: none"> <li>▶ Employees communicate product information and conditions upfront, including debt collection procedures.</li> <li>▶ Employees take time to answer all the client's questions.</li> <li>▶ Employees inform clients of how to contact the institution if they have further questions or want to make a complaint</li> </ul>	<p>Product Management, Executive Management</p>
<p>Include all institutional policies on communicating with clients, providing clients with full and accurate information and ensuring client understanding in a manual that is easy for employees to understand. Follow the institution's guidelines for providing all necessary product information to clients.</p>	<p>Product Management, Executive Management</p>
<p><b>Develop and execute training for frontline employees on effective communication with clients.</b></p> <ul style="list-style-type: none"> <li>▶ Ensure employees are trained to disclose key information prior to transaction. Include practical examples and techniques for verifying clients understand key elements.</li> <li>▶ Train frontline employees to communicate with different groups of clients, from different market segments, in a way that will help the clients make informed decisions about purchasing a product.</li> <li>▶ Train frontline employees to help clients make informed decisions about products.</li> </ul>	<p>Product Management, Executive Management</p>
<p>Ensure marketing materials respect any existing consumer protection legislation on advertising and transparent communication of prices.</p>	<p>Marketing and promotions, Legal</p>
<p>Ensure marketing materials do not oversell the benefits of credit or make guarantees/offers that may change based on the individual client (e.g., "You are pre-approved for a financing").</p>	<p>Marketing and promotions, Legal</p>

Recommended Practice	Responsibility
<p><b>Ensure marketing materials do not include deceptive pricing. information that is likely to change depending on the characteristics of the individual client. In particular -.</b></p> <ul style="list-style-type: none"> <li>▶ Do not make incorrect or deceptive price comparisons with other institutions or with the institution's own "regular" prices.</li> <li>▶ Do not advertise a product or service as "free" if the client will bear any associated cost.</li> </ul>	Marketing and promotions, Legal
Check that clients understand financing terms and conditions. Interview a sample of clients, including delinquent clients and dropout clients.	Risk Management
Check that employee methods for explaining product terms and conditions to clients are effective and information is accurate. Check that clients are given sufficient time to review and understand information.	Risk Management
Check that employees follow institutional policy on providing clients with documentation (financing agreement, "Key Fact" document, copies of any signed documentation, etc.)	Risk Management
Check that employees inform clients of their right to complain and how to make complaints. For each of the checks above, conduct more frequent checks on new employees.	Risk Management

**Table 12 - Client Protection Principle 4 - Responsible pricing**

Recommended Practice	Responsibility
<p><b>Establish formal, internal pricing procedures for each product. When establishing prices -</b></p> <ul style="list-style-type: none"> <li>▶ Offer market-based, non-discriminatory prices.</li> <li>▶ Ensure that efficiency ratios are aligned with peers.</li> <li>▶ Calculate profit according to the exact date of payment.</li> <li>▶ If takaful and/or savings are compulsory, take these into account in the EIR calculation.</li> </ul>	Product Research and Development, Finance, Executive Management
Have a clear understanding on the pricing structure of the institution, including the cost of funds, cost of operations, cost of provision and profit margin.	Product Research and Development, Finance, Executive Management
Have a policy for how generated profits will be used as reserve or for expansion. As a rule of thumb, no more than 20% of the profits should be disbursed in the form of bonuses to management of shareholders.	Finance, Executive Management
Have a clear profit-sharing policy to share benefits generated by negotiation and value-addition with stakeholders in the value chain for specific products (i.e. Murabaha, Salam etc). As a rule of thumb, at least 50% of the value generated should be shared with the clients.	Product Research and Development, Finance, Executive Management

**Table 13 - Client Protection Principle 5 - Fair and respectful treatment of clients**

Recommended Practice	Responsibility
<p><b>Establish a code of ethics/code of conduct that spells out organizational values and the standards of professional conduct expected of all employees.</b></p> <ul style="list-style-type: none"> <li>▶ Ask the board to review and approve the code.</li> <li>▶ Review the code for updates at least every three years, in order to reflect changes in societal or international norms on ethics or disability.</li> <li>▶ Provide employees with opportunities to offer amendments or changes to the code and submit them to the board for consideration.</li> </ul>	Legal, Human Resources, Executive Management
<p>Establish a non-discrimination policy, including a policy on the treatment of people with disabilities that applies to employees and clients.</p>	Legal, Human Resources, Executive Management
<p>Establish and execute efficient and fair procedures and sanctions to deal with violations of the code of conduct and the non-discrimination policy, and to protect employees who report violations by other employees (“whistleblowing”). In the event of misconduct, inform staff of the case and sanctions that were taken, and allow employees to ask questions about the case.</p>	Legal, Human Resources, Executive Management
<p>Establish a designated committee at the board or senior management level or designate a board member or senior manager to deal with issues related to ethics. The committee or board member should handle serious cases of employee misconduct and investigate cases of whistleblowing.</p>	Product Management, Sales force and Frontline employees, Executive Management
<p>Establish a policy that clients must be informed of the main aspects of the code of conduct, particularly those related to clients’ rights and how they can make complaints to the institution. This information should be presented in a format that clients, including illiterate clients, can understand (e.g. posters, illustrations).</p>	Product Management, Sales force and Frontline employees, Executive Management
<p><b>Establish acceptable and unacceptable debt collection practices, and provide them to employees in writing, in a code of conduct, book of employee rules, debt collection or credit procedures manual. The policy should include -</b></p> <ul style="list-style-type: none"> <li>▶ Precise standard steps to follow in case of repayment delays.</li> <li>▶ Different strategies to be used in case of inability to repay and unwillingness to repay.</li> <li>▶ Actions and behaviours considered to violate the financing client’s rights.</li> <li>▶ Actions that would support client’s ability to pay.</li> <li>▶ In the case of group financing, actions group members are expected to take and are prohibited from taking when group members are delinquent.</li> </ul>	Product Management, Human Resources, Executive Management

Recommended Practice	Responsibility
<p>Compensate employees at a level that constitutes a living wage, and do not rely heavily on incentive schemes, such as bonus pay. Under-compensation and high bonus pay can incentivize fraud, mistreatment of clients, inappropriate financing sizes and other unethical behaviour.</p>	<p>Human Resources, Executive Management</p>
<p>Ensure that performance evaluation procedures and employee incentives incorporate the values and standards spelled out in the code of conduct. Use the institution's incentive system to reward ethical behaviour and good customer service—especially for those employees who are in direct contact with clients.</p>	<p>Human Resources, Executive Management</p>
<p>During the institution's annual evaluation, review and discuss whether employee incentives are aligned with the institution's corporate values and business ethics.</p>	<p>Human Resources, Executive Management</p>
<p><b>Establish a policy describing acceptable collateral. The policy should include -</b></p> <ul style="list-style-type: none"> <li>▶ Guidelines for how collateral is registered and valued.</li> <li>▶ Guidelines to ensure clients receive a fair price for their confiscated assets.</li> <li>▶ Guidelines that ensure that procedures for confiscation respect clients' rights and follow local laws.</li> <li>▶ Guidelines for the safe storage of client collateral, if kept on the institution's premises.</li> </ul>	<p>Legal, Finance, Executive Management</p>
<p><b>Maintain respectful treatment of clients even in difficult situations (e.g., client misconduct, client delinquency).</b></p>	<p>Sales force and frontline employees</p>
<p>Report misconduct by other employees, including fraud, abusive or discriminatory behaviour toward clients, theft, etc.</p>	<p>Sales force and frontline employees</p>
<p>Follow the institution's guidelines for acceptable and unacceptable debt collection practices.</p>	<p>Sales force and frontline employees</p>
<p>Follow the institution's policy on non-discrimination. Treat clients without discrimination. Do not treat clients differently and less favourably because of characteristics that are not related to their ability and willingness to meet the requirements of the financial institution. Client selection and treatment should not involve discrimination based on personal characteristics or personal affiliations.</p>	<p>Sales force and frontline employees</p>
<p>Check that employees abide by a code of conduct that spells out organizational values and the standards of professional conduct expected of all employees.</p>	<p>Risk Management</p>

Recommended Practice	Responsibility
Check that Human Resources performs employee background checks designed to identify previous instances of misconduct by the potential employee.	Risk Management
Check that employees abide by the institution's collections guidelines.	Risk Management
Check that employees abide by the institution's non-discrimination policy that applies to employees and clients	Risk Management
Check that employees abide by the institution's collateral policy.	Risk Management
Check that employees apply the institution's rescheduling policies in a consistent and fair way.	Risk Management
<p><b>Visit clients to check the following regarding employee treatment of clients -</b></p> <ul style="list-style-type: none"> <li>▶ Clients are not abused, disrespected, or mistreated in any way.</li> <li>▶ Employees do not solicit bribes, kickbacks, or favours of any kind.</li> <li>▶ Employees respect acceptable and unacceptable debt collection practices.</li> </ul>	Risk Management
Check that clients understand their rights, including the right to respectful treatment from employees, and the right to complain. Select a sample of clients to check understanding through client visits.	Risk Management
Provide a platform for the institution to produce regular reports on rescheduled financing, in order to help monitor whether employees are following the institution's policies on financing rescheduling.	Information Technology and Communication, Human Resources, Executive Management
Provide input into the training for employees on the importance of data privacy and how to protect the confidentiality, security, accuracy and integrity of clients' personal and financial information. The training should instruct employees to inform clients of their responsibilities for keeping data private, such as storing any records in a secure location and not sharing personal identification codes. It should also instruct employees on how to train group leaders to safeguard group member information, including savings balances, dates of financing disbursement and information on repayment problems.	Information Technology and Communication



**Table 14 - Client Protection Principle 6 - Privacy of client data**

Recommended Practice	Responsibility
<p><b>Participate in the design of an institutional policy on security and privacy of client data. The policy should specify -</b></p> <ul style="list-style-type: none"> <li>▶ Which client data is covered by the policy.</li> <li>▶ Procedures for ensuring information security, including - <ul style="list-style-type: none"> <li>– Which employees have access to different types of client data.</li> <li>– How client data should be collected.</li> <li>– Where and how client data should be stored.</li> </ul> </li> <li>▶ Procedures for ensuring information privacy, including - <ul style="list-style-type: none"> <li>– How to advise clients about legal requirements for collecting, sharing and using information.</li> <li>– How to safely share information with third-party providers such as credit bureaus, marketing companies, data processing companies, collections agencies, etc.</li> <li>– How to for ensure third parties follow appropriate data privacy procedures.</li> <li>– How to share information within the same financial institution or corporate group for purposes of cross-selling.</li> <li>– How to treat data when clients have voluntarily waived their right to data privacy.</li> <li>– What to do in the event of a privacy breach or complaint.</li> </ul> </li> </ul>	ICT, Executive Management
<p>Ensure procedures are in place for frontline employees to obtain written consent from clients to use information or photos or to share their personal data with any external audience, including credit bureaus, insurance agents, collections companies, etc. Institute penalties for exposing or revealing client data to third parties without prior client consent.</p>	Marketing and Promotions, Legal, Product Management, Executive Management
<p>Establish a policy that clients must be instructed on their responsibilities for keeping data private, such as storing any records in a secure location and not sharing personal identification codes. Group leaders should be trained to safeguard group member information, including saving balances, dates of financing disbursement and information on repayment problems.</p>	Product Management, Human Resources, Sales force and frontline employees, Executive Management
<p>Establish a policy that employees should hold group meetings in locations that allow discussions among group members to remain private, whether the locations are chosen by the group or the institution</p>	Human Resources, Executive Management
<p>Ensure that the employee book of rules and code of conduct penalize misuse or misappropriation of client data, including revealing data to third parties without client consent.</p>	Executive Management

Recommended Practice	Responsibility
<p>Ensure that ICT systems have different password protection systems that are changed periodically with different access levels according to the position of the staff member accessing the data.</p>	<p>ICT, Executive Management</p>
<p>Participate in the design of the manual/handbook and employee training curriculum on the institution's data-handling policies and procedures.</p>	<p>ICT, Human Resources</p>
<p>Provide training to employees on the importance of data privacy and how to protect the confidentiality, security, accuracy and integrity of clients' personal and financial information. The training should instruct employees to inform clients of their responsibilities for keeping data private, such as storing any records in a secure location and not sharing personal identification codes. It should also instruct employees on how to train group leaders to safeguard group member information, including saving balances, dates of financing disbursement and information on repayment problems.</p>	<p>Human Resources, Product Management, Executive Management</p>
<p>Provide input on any other client data privacy agreements, including any documents that require client signatures.</p>	<p>Legal</p>
<p>Ensure that the institution's privacy policy covers current employees, as well as those who leave the organization.</p>	<p>Legal</p>

**Table 15 - Client Protection Principle 7 - Mechanism for compliant resolution**

Recommended Practice	Responsibility
<p>Use the institution's analysis of client complaints to consider whether complaints and client dissatisfaction stem from product design weaknesses. Use the information to make product changes when appropriate.</p>	<p>Risk Management, Product Management, Product Research and Development, Complaints/Customer service, Executive Management</p>
<p>Assist in the development and dissemination of a training manual that includes policies on how to inform clients about the institution's complaint mechanism and how to handle complaints.</p> <p><b>Train employees on how to -</b></p> <ul style="list-style-type: none"> <li>▶ Use the complaints mechanism.</li> <li>▶ Talk to clients about their right to ask questions and make complaints.</li> <li>▶ Direct clients to use the institution's complaints mechanism.</li> </ul> <p>Handle the most common complaints and when to refer complaints to the employees in charge of complaints.</p>	<p>Human Resources, Complaints/ Customer service</p>

Recommended Practice	Responsibility
All marketing materials should include the institution's contact information and instructions on how to ask a question or make a complaint.	Marketing and Promotions, Complaints and Customer Service
<p><b>Learn how to handle client questions and complaints. Specifically, understand how to -</b></p> <ul style="list-style-type: none"> <li>▶ Use the complaints mechanism.</li> <li>▶ Talk to clients about their right to ask questions and make complaints.</li> <li>▶ Direct clients to use the institution's complaints mechanism.</li> <li>▶ Handle the most common complaints and when to refer complaints to the employees in charge of complaints.</li> </ul> <p>Do not punish clients for asking questions or making complaints.</p>	Human Resources, Complaints and Customer Service, Sales force and Frontline Employees
Check that the institution's complaints mechanism is actively used by clients (e.g. check number of complaints per month, use of various mechanisms for making complaints, etc.).	Risk Management, Complaints and Customer Service, Product Management, Product Research and Development, Executive Management
<p><b>Check that employees dedicated to the complaint's mechanism follow institutional procedures for collecting, recording, analysing and reporting client questions and complaints -</b></p> <ul style="list-style-type: none"> <li>▶ Check that frontline employees understand how to explain the mechanism to clients.</li> <li>▶ Check that frontline employees understand how to answer frequently asked questions and complaints.</li> <li>▶ Check that frontline employees accurately and regularly report complaints information to the concerned department or the appropriate managers.</li> </ul> <p>Check that clients receive a timely response to their issues, within a month of complaint submission or earlier, based on institutional policy.</p>	Risk Management, Complaints and Customer Service, Product Management, Product Research and Development, Executive Management
Check that clients understand how to use the institution's complaints mechanism (e.g. ask clients if they have been informed how to use it, whether they have used it, etc.)	Risk Management
Check that client complaints are resolved satisfactorily (e.g. survey a sample of clients registered in the complaints system).	Risk Management
Use complaints data to identify and investigate cases of employee fraud, mistreatment of clients or other unethical behaviour identified by clients or other employees.	Risk Management

Recommended Practice	Responsibility
Evaluate overall trends in client complaints to identify any systemic problems that go beyond individual grievances. Follow up on these problems with further checks.	Risk Management
Provide input on how the institution should handle client complaints, particularly how to handle alleged employee misconduct and how to apply local law when necessary	Legal, Complaints and Customer Service, Risk Management, Executive Management
Provide necessary technology for the smooth functioning of the complaints system (e.g. phone lines, answering service, text messaging capabilities, email address, etc.)	ICT
<p><b>Develop a policy for managing client complaints. The policy should -</b></p> <ul style="list-style-type: none"> <li>▶ Ensure clients' rights, including the right to - <ul style="list-style-type: none"> <li>– complain to the institution</li> <li>– receive a quick response to the complaint</li> <li>– complain anonymously</li> <li>– complain without negative consequences</li> </ul> </li> <li>▶ Establish a mechanism for resolving client complaints, including - <ul style="list-style-type: none"> <li>– an organizational position in charge of overseeing complaints resolution</li> <li>– procedures for collecting, tracking and responding to complaints</li> <li>– a timeline for responding to and resolving complaints</li> <li>– a process for handling serious complaints (e.g. alleged abuse, fraud)</li> <li>– a process for providing responses directly to clients who complain</li> </ul> </li> </ul>	Legal, Risk Management, ICT, Executive Management, Complaints and Customer Satisfaction
Accept client questions and complaints on an ongoing basis, using a mechanism or mechanisms that are accessible and free for clients. Check that the mechanism is actively used by clients.	Risk Management, Complaints and Customer Satisfaction
Establish a clear reporting system to ensure that complaints from the field (e.g. branches, point of sale) reach employees that handle complaints.	Risk Management, Complaints and Customer Satisfaction
Ensure that clients receive a timely response to their questions and complaints. Complex problems should be resolved within a month, and less complex issues should be resolved more quickly.	Complaints and Customer Satisfaction
Develop and disseminate a training manual that includes policies on how employees should inform clients about the institution's complaint mechanism, and how to handle complaints.	Human Resources, Complaints and Customer Satisfaction

Recommended Practice	Responsibility
<p><b>Train employees on how to -</b></p> <ul style="list-style-type: none"> <li>▶ Use the complaints mechanism.</li> <li>▶ Talk to clients about their right to ask questions and make complaints.</li> <li>▶ Direct clients to use the institution's complaints mechanism.</li> </ul> <p>Handle the most common complaints and when to refer complaints to the employees in charge of complaints.</p>	ICT
<p><b>Evaluate overall trends in client complaints to identify any systemic problems that go beyond individual grievances.</b></p> <ul style="list-style-type: none"> <li>▶ Use complaints data to correct mistakes, omissions and activities that may be harmful to the client (e.g., recurring complaints about "hidden" fees, multiple complaints about a particular branch office).</li> <li>▶ Use complaints to guide operational improvements related to the institution's interactions with its clients, including changes to products and services</li> </ul>	Product Management, Risk Management, Executive Management, Complaints and Customer Service
<p>Ensure that complaints information (e.g. hotline number) is included on all marketing materials, product documents (e.g. financing agreement) and other materials provided to clients.</p>	Marketing and Promotions, Complaints and Customer Service
<p>Ensure that the institution has the necessary technology in place to manage the complaints mechanism (e.g. designated phone line, database for recording and analysing complaints).</p>	ICT, Complaints and Customer Service

## 8. SOCIAL PERFORMANCE SELF-ASSESSMENT

Based on the above, MFIs/FIs should conduct a regular self-assessment to see whether it is conducting the required best practices on social performance. It also includes questions that aim to ensure a good balance between financial and social performance. Below are some questions that would guide MFIs/FIs in its self-assessment.

### Mission, Governance, and Strategy

- ▶ Is the mission statement clear and updated?
- ▶ Does it reflect institutional intention for positive and holistic change?
- ▶ Any reference to targeting vulnerable populations?
- ▶ Any reference to expanding breadth and depth of outreach?
- ▶ Does management have a clear understanding of the social mission?
- ▶ Has management set clear targets in their social performance plan or business plan?
- ▶ Is there proper governance? Does the board play an effective role?
- ▶ Is there a formal conflict-of-interest policy?
- ▶ Does the board have a social orientation? Have they attended training on social performance or client protection?
- ▶ Is there any social consideration in the decision-making process?
- ▶ Are social performance indicators included as part of regular reporting by management to the board?
- ▶ Has the CEO received a formal performance appraisal, including social performance?
- ▶ Is there a risk of mission drift to move away from rural areas (if that is the mission of the MFI/FI)?
- ▶ Any risk assessment conducted on the risk of mission drift?
- ▶ Is there alignment to the product strategy and the mission?

- ▶ Is the current portfolio aligned with the mission?
- ▶ Is there awareness of real returns at the governance level for effective balance between financial and social returns?

### Financial performance indicators measured

- ▶ Growth in active financing clients
- ▶ Growth in outstanding portfolio
- ▶ Growth in number of staff
- ▶ Growth in number of branches
- ▶ PAR30
- ▶ Write off ratio
- ▶ Restructured financing
- ▶ Return on equity
- ▶ Return on assets
- ▶ Adjusted return on equity
- ▶ Adjusted return on assets
- ▶ Operational self-sustainability
- ▶ Financial self-sustainability
- ▶ Staff productivity (financing client)
- ▶ Loan officer's productivity (financing client)
- ▶ Operating expense ratio
- ▶ Provision expense ratio
- ▶ Portfolio yield
- ▶ Risk coverage ratio
- ▶ Cost of funds ratio
- ▶ Debt/Equity ratio

### Analyse financial ratios to ensure balance between financial and social performance

- ▶ Are growth rates overambitious? Would they stretch the internal systems?
- ▶ Is the growth supported by adequate liquidity, staff and other resources?
- ▶ Is there regular growth monitoring?
- ▶ Is there analysis on competition and market saturation?
- ▶ Is there improvement in productivity of staff and financing officers?
- ▶ Have operating expense ratios increased?
- ▶ Is senior management compensation fair?
- ▶ Have there been there any recent policy changes that may affect financial or social performance?

### Tracking and monitoring system

- ▶ Is there an MIS system that supports financial and social performance monitoring?
- ▶ Does the MIS monitor the client segment profile?
- ▶ Does the MIS monitor the client poverty profile?
- ▶ Is the quality of services monitored through regular feedback channels?
- ▶ Are the client dropout and retention rates monitored?
- ▶ Any tracking of impact due to the services provided by the MFI/FI?

### HR and alignment with the mission

- ▶ Is there alignment of HR management with the mission?
- ▶ Does the recruitment process align skill needs with the mission?
- ▶ Are the MFI/FI vision and mission clearly communicated to new hires during induction?
- ▶ Are new hires provided training on social performance and client protection?
- ▶ Is the appraisal system in line with the financial and social performance of the MFI/FI?
- ▶ Is the incentive scheme in line with the financial and social performance of the MFI/FI?
- ▶ Is there a push towards higher sized financing that might exclude the poor?
- ▶ Is there any committee or focal person to support the mainstreaming of social performance?

### Social responsibility towards personnel

- ▶ Is there a risk of staff discrimination?
- ▶ Is there a policy promoting meritocracy?
- ▶ Is there a code of conduct for staff?
- ▶ Is the rate of staff turnover stable and acceptable?
- ▶ What are the reasons for staff leaving the MFI/FI?
- ▶ What is the labour climate and staff satisfaction levels?
- ▶ Are HR policies formalized?
- ▶ Are staff safety issues considered and managed?
- ▶ Are staff officially contracted?
- ▶ Are staff fairly compensated?
- ▶ Do staff have good development opportunities?

## Client protection

- ▶ Is there regular market research and does analysis of client feedback inform product design?
- ▶ Does the MFI/FI offer a variety of financial products?
- ▶ Do the products on offer meet the needs of the target population?
- ▶ Does the repayment schedule match regular and seasonal cash flows?
- ▶ Does the repayment schedule allow for early repayment?
- ▶ Is the financing size appropriate for the repayment capacity?
- ▶ Does the way the funds are to be utilized (in a productive manner) influence the appraisal of the ability to repay?
- ▶ Does the financing methodology impose unnecessary restrictions on clients?
- ▶ Is the delivery of financing convenient to clients?
- ▶ Are clients subjected to pressure to take up financing through marketing or selling techniques?
- ▶ Are compulsory savings enforced? Are they protected?
- ▶ Are appropriate Takaful insurance products provided to clients? Do they provide value for money?

## Prevention of over-indebtedness

- ▶ Is there a risk of client over-indebtedness due to the lack of a credit bureau and/or poor exchange data?
- ▶ Are there surveys to determine whether clients have used financing to pay off their credit?
- ▶ Is there a policy to mitigate over-indebtedness?
- ▶ Does the MFI/FI provide non-Sharia-compliant refinancing products?
- ▶ Are financing products targeted to productive or consumption purposes?
- ▶ Are financing products for the productive sector prioritized?
- ▶ Are policies relating to prevention of over-indebtedness followed by financing officers?
- ▶ Is there a rescheduling policy in place?
- ▶ Is financing use monitored? Is direct payment to

suppliers favoured over payment to clients?

- ▶ Is the incentive scheme in line with the balance of portfolio growth, outreach and portfolio quality?

## Transparency

- ▶ Does the MFI/FI use declining balance calculation in pricing its financing products?
- ▶ Are all terms and conditions, including cost and selling price, clearly reflected in the appropriate financial products?
- ▶ Are the cost structure and payment schedule simple and easy to understand?
- ▶ Are all additional charges and fees clearly reflected and communicated to the client?
- ▶ Do marketing materials include cost information and other terms and conditions?
- ▶ Do clients clearly sign off on all the cost, fees and other terms and conditions?
- ▶ Is there feedback or complaints that clients are unaware of the terms and conditions?
- ▶ Does audit verify the transparency to clients and awareness about product features?
- ▶ For savings products, are clients made clear on any restrictions or fees on withdrawal?
- ▶ Are clients made aware of Takaful insurance requirements and their terms for taking up any financial products?

## Responsible pricing

- ▶ Does the MFI/FI use declining balance basis in their pricing calculation?
- ▶ Does the MFI/FI understand its cost structure and is its pricing in line with the cost structure?
- ▶ Is the pricing competitive in the market?
- ▶ Are the profits generated by the MFI/FI attributable to undue high pricing?
- ▶ Are clients overcharged for services provided by the MFI/FI?
- ▶ Are the costs charged by the MFI/FI affordable to the target population?
- ▶ Is the income generated by the MFI/FI distributed to the client savings in a fair manner?
- ▶ Are clients required to contribute in the form of membership fees? Are they inclined to make



such contributions and are the contributions affordable?

### Fair and respectful treatment of clients

- ▶ Does the MFI/FI have a code of conduct or policies that specify professional conduct expected of all staff?
- ▶ Are there any disciplinary measures in place for cases of violation by staff?
- ▶ Is there any training provided to ensure that staff treat clients fairly and with respect?
- ▶ Does the audit make efforts to detect client mistreatment and fraud?
- ▶ Are there measures in place to conduct investigative audits in response to complaints?
- ▶ Are collection practices clearly specified and are staff trained on them appropriately?
- ▶ Are staff subject to termination in cases of fraud, bribery or threatening or humiliating behaviour towards clients?

### Mechanism for complaint resolution

- ▶ Does the MFI/FI have appropriate channels for clients to provide feedback and complaints?
- ▶ Is there is a customer care policy with guidelines on how to handle client complaints, specific levels of responsibilities, timeframes and controls to ensure follow up?
- ▶ Is client feedback consolidated and reported to management and the board as appropriate?

### Social responsibility towards community and the environment

- ▶ Is there outreach on community development programmes that the MFI/FI is involved in?
- ▶ Are there policies for an exclusion list of activities that cannot be financed if they are not Sharia-compliant or they may cause harm to the community? Does internal audit or Sharia audit verify this?
- ▶ Is there an environmental policy or is the MFI/FI involved in any environmental activities?

### Area of operation

- ▶ Is there a high level of poverty in the area that the MFI/FI is serving?
- ▶ Is there an alignment between geographical outreach and the target population?

### Client reached

- ▶ What is the breadth (number of clients) of the client outreach?
- ▶ Is there positive growth in terms of number of active clients, gross outstanding portfolio, number of branches, outstanding portfolio and inactive clients?

### Social vulnerability and household profile

- ▶ Is there a gender focus for the clientele?
  - Does the MFI/FI capture household indicators such as -
    - Household size
    - Age dependency ratio
    - Education levels compared to national average
    - School attendance of primary, secondary and tertiary aged youth
    - Are remittances a significant source of income?
    - Clients who are head of household
    - Clients with fixed sources of household income
    - Clients who have decision-making ability and have control over the household resources
- ▶ Has there been an improvement in the client's ownership of assets in terms of -
  - Ownership of dwelling
  - Improved water source
  - Improved sanitation
  - Source of electricity
  - Land ownership
  - Ownership of essential home appliances such as refrigerator and washing machine
  - Ownership of farm animals

### Financed activities

- ▶ Does the MFI/FI focus on financing the productive sector to generate income for clients?
- ▶ Does the MFI/FI have a clear understanding of the sectors that it is financing?
- ▶ Do the financed activities generate jobs? What is the average employment generated for each financed business activity?
- ▶ Does the MFI/FI support its clients through value-addition activities (non-financing)?
- ▶ Does the MFI/FI help its clients grow their businesses?
- ▶ Some of the indicators to track include -
  - Ratio of self-employed clients
  - Number of family and non-family employees
  - Ratio of financed business in the informal sector
  - Ratio of use of financing for productive sector
  - Ratio of use of financing for social purposes (e.g. education, health)
  - Ratio of use of financing for consumption purposes

### Economic poverty

- ▶ Has the depth or breadth of poverty changed over the past years in the locations where the MFI/FI has operated?

### Access to financial services

- ▶ Is there data on the MFI/FI's impact on financial inclusion? Such data may include -
  - Clients not receiving financing from other MFIs/FIs
  - Clients who stopped borrowing from moneylenders
  - Clients who started borrowing from moneylenders

### Financing size

- ▶ Is the average and median financing to the client in line with the MFI/FI mission? Indicators to note include -
  - Average financing size

- Average balance per financing client/GNI per capita
- Annual growth in average financing balance

### Quality of services

- ▶ Is there a large variety of financing products?
- ▶ Is there a large variety of savings products?
- ▶ Are there suitable Takaful insurance products?
- ▶ Is value chain financing provided?
- ▶ Does it take a long time to process a financing application?
- ▶ What is the level of client satisfaction with the MFI/FI?
- ▶ Is there a record on the aspects of services of the MFI/FI appreciated by its clients?
  - Overall
  - Amount of financing
  - Time and procedure
  - Cost
  - Tenor of financing
  - Guarantee
  - Centre meetings
  - Mandatory savings
  - Takaful insurance
  - Non-financial services
  - Loan officers
  - Information

### Client dropout

- ▶ Does the MFI/FI know the client dropout rate and the reasons for dropout? Indicators that can be measured include -
  - Client dropout ratio (financing clients)
  - Client dropout ratio (active clients)
  - PAR30
  - Financing in the first cycle
  - Financing in the second cycle
  - Financing in the third cycle
  - Financing after the third cycle



# Financial Performance

## 1. THE IMPORTANCE OF FINANCIAL PERFORMANCE OF MFI/FIS- THE EVOLUTION

The history of microfinance is often associated with the rise of nongovernmental organizations (NGOs) providing microcredit services to the poor and the development of a handful of microfinance banks. In the early 1990s, standards began to emerge calling for stronger financial management of microcredit providers, particularly in their delinquency management and reporting. At the same time, credit unions and banks involved in microlending developed stronger monitoring techniques for their microcredit portfolios.

In 1995, The SEEP Network produced a monograph called Financial Ratio Analysis of Microfinance Institutions or Blue Book for short. Its primary objective was to introduce managers of microfinance organizations to the calculation and interpretation of financial ratios. Since 1995, MFIs/FIs have grown in size, type, number and complexity. At the same time, more emphasis has been placed on financial accountability, management and viability.

The 2002 SEEP Financial Definitions Guidelines have helped minimize much of the ambiguity by defining nearly 50 financial terms and providing calculation guidelines for 20 ratios. The ratios were later reduced and grouped into four main categories -

- ▶ Category 1 - Portfolio quality
- ▶ Category 2 - Efficiency and productivity
- ▶ Category 3 - Financial management
- ▶ Category 4 - Profitability and sustainability

### Are these indicators relevant for Economic Empowerment?

MFIs/FIs practising Economic Empowerment are not just financial institutions but also business institutions that conduct trade and investment with clients. The ratios that are described and explained below are not exclusively used for MFIs/FIs; they can also be applied

to determine the financial viability and profitability of non-financial institutions firms.

Islamic MFIs/FIs do not charge interest as income, but to be a going concern, they would need to realize revenue through profit-generation and fees. The asset-oriented nature of Islamic MFI/FIs means that the assets are capitalized and depreciated over time based on AAOIFI accounting standards. Here, we will explain the likely variances on how these ratios are calculated.

The financial performance of an MFI/FI is very relevant, as all stakeholders (donors, regulators, etc.) are keen to ensure the sustainability of its interventions. MFI/FIs with good financial performance demonstrate prudent management and good profitability that ensures its sustainability, good financial management, good portfolio quality and efficiency and productivity in its operations. An MFI/FI with good financial and social performance will gain an improved reputation in the market, which would enable it to obtain more funding.

## 2. ANALYSING FINANCIAL PERFORMANCE

Financial performance is a snapshot of the current situation of an MFI/FI. It should be read in its entirety to provide a good understanding on how it is performing from various perspectives. A 3-5 year trend analysis would also help determine the changes in focus and the direction in which the MFI/FI is heading. It would also help to have a benchmark or market analysis conducted in order to make comparisons with other MFI/FI peers in the sector. In addition, financial performance ratios should be read together with the social performance indicators in order to have a clearer understanding of the on-the-ground reality and context of why the numbers are as they are reported.

### Averaging/Annualizing

In comparing a figure from the income statement with a balance sheet item, the latter, which is in the denominator should be averaged and annualized. For

example, an MFI/FI that provides financial reports periodically should annualize its figures in order to compare appropriately. The more frequent the reports provided in a year are, the more accurate the average figure would be. The formula for annualizing/averaging a balance sheet figure is as follows -

$$P^{avg} = [(P^0 + P^1 + \dots + P^t)/t]$$

### Collection of data

As any financial manager would confirm, financial statements can be used to conceal as much as to reveal. If financial statements are to be used as a management tool, each statement should tell the manager, analyst or other reviewer the true financial performance or financial condition of the MFI/FI.

For MFI/FIs, financial statements are imperative, as they are the primary means for an institution to express its financial activities. Some statements contain stock data, which “take stock” or present data at a moment in time. Other statements contain flow data, which report on the flow or summary of transactions over a defined period. Because an MFI/FI’s core business is the provision of financial services, the financial statements and reports are very similar to those of traditional financial institutions. MFI/FI financial statements and reports include the following -

- ▶ Income Statements (or profit and loss statements),
- ▶ Balance Sheets (or statements of financial position),
- ▶ Cash Flow Statements (or sources and uses of funds statements)
- ▶ Portfolio Reports.

When reporting data, MFI/FIs should disclose how the average is calculated and comment, if applicable, on potential distortions that result from the calculation method. The more granular the data, the more accurate and detailed picture of the financial health of the MFI/FI. For this reason, it is important that reports be segregated on various business lines and

Islamic financial instruments. Appropriate cost and revenue matching to the respective products should be conducted to enable a better understanding of the operational and financial sustainability, areas that require improvement and how to address them.

## 3. CATEGORY 1 - PORTFOLIO QUALITY

The portfolio quality is an essential area that measures the credit risk of the MFI/FI’s main asset- its portfolio. It is the probability that the MFI/FI may not be able to recover its assets. It enables management to supervise the quality of the portfolio during the period of the financing by measuring the current risk profile in order to take preventive measures for improvement in order to protect the equity of the institution.

### Portfolio quality considerations

Portfolio quality indicators demonstrate a snapshot of the current portfolio. An analysis of the numbers generated should be accompanied by rationale for various factors, including the following -

- ▶ **Growth and evolution** - An aggressive growth policy may result in a young portfolio that is unlikely to be in default. Hence, a low PAR30 ratio may not necessarily be due to good portfolio quality.
- ▶ **Seasonality** - A high PAR30 may be due to poor structuring of payment plans that are not in line with the seasonality of income earned by their clients. This is especially true for farmers, who generally earn their income during the seasonal harvest period.
- ▶ **Structure and diversification** - The portfolio quality may be due to the poor structuring of financial products. The products may not have the appropriate tenor, pricing, grace period, frequency of payments, etc.
- ▶ **Concentration** - There may be a concentration of certain clients based on geography or other characteristics such as sector focus. For example,

a drop in cocoa prices would greatly affect the portfolio quality of an MFI/FI whose main clients are cocoa farmers.

- ▶ **Outreach and dropout** - The manner in which the financing officers obtain deal flow for financing

and the reasons for dropout may also give a clearer understanding of the underlying factors of portfolio quality.

The following sections discuss the main portfolio quality indicators to measure.

### Portfolio at risk more than 30 days (PAR30)

$$\text{PAR30} = \text{Outstanding balance of loans that is due more than 30 days} / \text{Outstanding balance of all loans}$$

***This ratio measures the portion of the portfolio affected by delinquency and, therefore, at risk of not being repaid.***

In microfinance, 30 days is a common breakpoint. However, there are MFIs/FIs that may use a different period of measurement (eg. PAR 60 or PAR 90). If the repayment schedule is other than monthly, then one repayment period—e.g., week, fortnight, or quarter—could be used as an alternative. This is especially important for agriculture financing that may be expected to be cyclical in nature. When any full or partial payment is past due, the whole outstanding balance of the loan is at higher than normal risk of non-repayment. PAR should not be confused with arrears or past due payments, which measure the value of the past due amount, rather than the full loan amount that remains outstanding. It is important to understand the financing provided by the MFI/FI to better understand the significance of the PAR. PAR can be manipulated

not only by excluding renegotiated loans, but also by the aggressive use of write-offs, which remove past due loans from the books. When an MFI/FI writes off a delinquent loan, that loan disappears from the MFI/FI's books and hence is no longer outstanding. This makes the ratio look better than the actual situation. Therefore, the PAR should also be viewed together with the restructured portfolio ratio and the write off ratio.

***How to calculate PAR*** -First calculate the denominator, which is the outstanding balance of all loans, i.e. the amount of loan receivables due from the client. This includes the amount that is due but not paid and the amount that is not due and is expected to be in the future. Second, calculate the numerator, which is the outstanding balance of loans that has been in arrears for more than 30 days. This figure should not just include the amount that is actually in arrears, but also the loan balance that is currently declared to be in arrears.

### Revised Islamic microfinance indicator (for debt-oriented instruments- Murabaha, Salam, Ijara, Istisna)

$$\text{PAR30} = \text{Outstanding balance of financing that is due more than 30 days} / \text{Outstanding balance of all loans}$$

The main difference is that the financing that is measured is mainly the assets at historical cost. Special attention should be given to Salam financing,

which is seasonal in nature. In such circumstances, a separate PAR policy should be in place (e.g. PAR90 to PAR180) based on the appropriate date that the farmers are expected to deliver their harvest.

### Revised Islamic microfinance indicator (for equity-oriented instruments- Mudaraba, Musharkah, Diminishing Musharkah)

$$\text{Unrealized Portfolio Revenue (UPR)} = (\text{Expected ROI of investment} - \text{Actual ROI of investment})$$

For equity-oriented products such as Musharaka and Mudaraba, the product should be measured separately. A better measure for such an indicator would be the unrealized portfolio revenue. Here, the MFI/FI measures the actual return against expected returns of

the investment. If the feasibility study during appraisal represents a 30% IRR but the actual current return is only 22% IRR, ceteris paribus, the MFI/FI would lose 8% of the outstanding balance of financing as potential revenue over the period of financing.

### Restructuring ratio

$$\text{Restructured portfolio} = \frac{\text{Outstanding restructured portfolio}}{\text{outstanding balance of all loans}}$$

***This ratio measures the restructured portfolio, which may be missing from the PAR.***

Restructuring is common to allow clients to have a longer tenor to make their repayments. This is especially encouraged for clients that are distressed and are unable to make repayment due to unforeseen circumstances. However, restructured portfolio is often riskier and should be monitored closely. An aggressive restructuring policy may also not be healthy, as it may lead to moral hazard on the part of the MFI/FI to earn

more interest and penalty fees from existing clients for conventional institutions. However, for Islamic MFIs/FIs, restructuring is actually carried out with no additional income generated but rather to give the client a realistic and fair opportunity to repay their outstanding balance without losing their collateral. MFI/FIs may also be motivated to restructure the financings so that they can reflect a much lower PAR30. It is important to note that the restructured portfolio would include financing that have been reprogrammed (increased tenor).

### Revised Islamic microfinance Indicator (only relevant for debt-oriented instruments- Murabaha, Salam, Ijara, Istisna)

$$\text{Restructured portfolio} = \frac{\text{Outstanding restructured portfolio that was in arrears/}}{\text{outstanding balance of all financing}}$$

In Islamic MFIs/FIs, restructured portfolio refers to financings that have been increased in tenor (i.e. reprogrammed). Refinancing of financing is generally not allowed, as it would be a form of purchasing debt. In the case of reprogrammed debt, Islamic microfinance

principles do not allow any increase in the outstanding balance of the debt that was in arrears, unlike in conventional microfinance where the numerator includes the accrued mark-up generated as a result of the restructuring

### Write off ratio

$$\text{Write off ratio} = \text{Loans written off during the period} / \text{average outstanding balance of all loans}$$

**Measures the write off ratio of the portfolio, which may be missing from the PAR.**

It is important to analyse the write off ratio to ensure that the cases for write off were genuine. In addition,

written off portfolio does not mean the loans are forgotten. Generally, loans may be considered for write-off if they are due for over 120 days, unless the payments are of a seasonal nature.

### Revised Islamic microfinance indicator

$$\text{Write off ratio} = \text{Financing written off during the period} / \text{average outstanding balance of all financing}$$

The financing in this case includes investments that have been made and are not expected to be recovered,

having passed the expected investment period.

## 4. CATEGORY 2 - EFFICIENCY AND PRODUCTIVITY

Efficiency and productivity indicators reflect how well an MFI/FI uses its resources, particularly its assets and personnel. MFI/FIs use many different efficiency and productivity indicators, tailoring them to reflect their own organizational structure, product lines and monitoring priorities.

MFI/FIs should use both number of personnel and number of financing officers as their benchmark for human resources in their productivity measures. The purpose for considering financing officers as a separate category is that they are client-facing and are

usually directly involved in revenue-generating tasks (that is, making and collecting loans), whereas other personnel are not. A trend toward using total personnel in productivity calculations exists, however, because financing officers' tasks may overlap with the tasks of administrative staff.

Looking at the ratios together can give a more comprehensive and significant description of the current efficiency and productivity of an institution, which is a good indicator of how well the MFI/FI is managed. For these reasons, readers should thoroughly understand the components of these indicators.

### Operating Expense Ratio (OER)

$$\text{Operating expense ratio} = \text{Operating expenses during the period} / \text{gross loan portfolio}$$

**Measures the operating costs of the MFI/FI to offer their services.**

OER is the most widely used indicator of efficiency. It gives a comparison between the MFI/FI's portfolio yield and its personnel and administrative expenses. It measures how much it earns on loans versus how

much it spends to make them and monitor them. The operating expense ratio is also referred to as the efficiency ratio. Monitoring this trend is important as it tracks the MFI/FI's efficiency as it grows its loan portfolio. The lower the ratio, the more efficient the MFI/FI is.



MFI/FIs should strive for a downward trend in this ratio, even when portfolio growth is flat, until they are convinced that no more efficiencies can be found while ensuring that it remains true to its mission. It should decline from year to year. Although commercial MFI/FIs and credit unions should have higher operating costs due to the savings services, they have proven themselves extraordinarily efficient in maintaining low

operating costs. Its substantial drawback is that it will make an MFI/FI doing small loans look worse than an MFI/FI doing large loans, even if both are efficiently managed. Therefore, like other ratios, the indicator should be read with other ratios under the category while having a proper understanding of the MFI/FI's business.

### Revised Islamic microfinance indicator

**Operating expense ratio = operating expenses during the period/gross financing portfolio**

Operating expense ratio is also applicable to MFI/FIs practicing Economic Empowerment. The operating expenses of the portfolio are derived from salaries and

other expenses. The gross financing portfolio includes all debt-oriented financing as well as equity-oriented investments made by the MFI/FI.

### Cost per borrower

**Cost per borrower = operating expenses during the period/average number of active borrowers**

#### ***Indicates the average cost of maintaining a borrower.***

This indicator shows how much it costs the retail financial service provider to serve each client. Because it does not penalize MFI/FIs making smaller loans, cost per borrower/client is a better efficiency ratio for comparing institutions. If one wishes to benchmark an MFI/FI's cost per borrower/client against similar MFI/FIs in other countries, the ratio should be expressed as a percentage of per capita GNI, which is used as a rough proxy for local labour costs.

As mentioned earlier, OER tilts the scales against MFI/FIs making smaller loans - six \$50 loans cost more to make than one \$300 loan. Measured this way, an MFI/FI can become more "efficient" by simply dropping its smaller borrowers, even without making any improvements in operating systems. Cost per client avoids this perverse result. Young or fast-growing MFI/FIs will look less efficient by either of these measures, because those MFI/FIs are paying for staff, infrastructure and overhead that are not yet producing at full capacity.

### Revised Islamic microfinance indicator

**Cost per financing client = operating expenses during the period/average number of active financing client**

There are no changes to the formula to be used. The data taken for both numerator and denominator would be the same. Typically, Islamic MFIs/FIs that conduct venture capital investments (Musharaka, Mudaraba) will experience a higher cost per financing client, since

the depth of support would incur higher expenses compared to the average number of active clients. Similarly, it is important to understand the rationale behind the ratios when performing an analysis of its performance.

### Loan officer productivity

$$\text{Loan officer productivity} = \text{number of active borrowers} / \text{number of loan officers}$$

**Indicates the number of borrowers served by each loan officer of the MFI/FI.**

The borrowers or financing clients per loan officer ratio, often used by MFI/FIs, helps measure personnel productivity of loan staff. Creating caseload targets for loan officers is useful in planning, and this ratio is an easy and effective way to measure progress against such targets.

This ratio will increase until it reaches the optimal range. Managers should monitor it on a monthly basis. Barriers to improving this ratio can be surpassed through structural or technological changes, such as streamlining the methodology or introducing technology. Improvements may also be made by introducing staff incentives for efficiency, such as

loan officer bonuses. The borrowers per loan officer ratio helps managers monitor the gains realized from implementing these changes.

This ratio depends on the local environment, such as population density and ease of access to clients. It can also vary drastically due to product terms and conditions (for example, individual versus group loans) and methodology (frequency of meetings). MFI/FIs should monitor gains with an eye on the portfolio at risk to ensure that productivity gains are not achieved at the expense of asset quality. The borrowers per loan officer ratio may be distorted if an MFI/FI adds a group of new loan officers near the end of the period. If the MFI/FI is growing quickly, adding both borrowers and loan officers, managers may want to use period averages for the numerator and denominator.

### Revised Islamic microfinance indicator

$$\text{Financing officer productivity} = \text{Number of active financing clients} / \text{number of financing officers}$$

There are no changes to the formula to be used. The data taken for both numerator and denominator would be the same. Typically, Islamic MFIs/FIs that conduct venture capital investments (Musharaka, Mudaraba)

will experience a higher productivity for each financing officer, as the number of activities under each venture is likely to be high compared to trade-oriented activities.

### Staff productivity

$$\text{Staff productivity} = \text{Number of active borrowers} / \text{number of staff}$$

**Indicates the number of borrowers served by each employee of the MFI/FI.**

Measuring the overall productivity of staff is vital and requires examining the ability of the MFI/FI's personnel to manage all its clients, including borrowers, voluntary savers and other clients. As MFI/FIs offer more

products to meet their clients' diverse financial needs, active clients per staff member is more relevant than borrowers per loan officer as the primary productivity ratio for personnel.

A low ratio does not mean that staff members are not working hard. Internal issues, such as excess

paperwork or procedures, or external factors, such as remote service locations, contribute to lower

productivity. Each MFI/FI will have its own optimal number of clients per staff person and should set this target in its business plan and monitor it closely.

### Revised Islamic microfinance indicator

$$\text{Staff productivity} = \text{Number of active financing clients/number of staff}$$

There are no changes to the formula to be used. The data taken for both numerator and denominator would be the same. Typically, Islamic MFIs/FIs that conduct venture capital investments (Musharaka, Mudaraba)

will experience a higher productivity for each staff, as the number of activities under each venture is likely to be high compared to trade-oriented activities.

## 5. CATEGORY 3 - FINANCIAL MANAGEMENT

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 several levels -

- ▶ **Rate of return of financing management** - 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 (are 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 cost of funds and fee expense on those borrowings. It must also be wary of borrowing more than it can repay in times of trouble.
- ▶ **Liquidity Management** - The MFI/FI must also make sure that it has sufficient funds available ("liquid") to meet any short-term obligations.

Although the next five indicators are important for any MFI/FI, they are particularly important to MFI/FIs that take deposits and borrow funds.

### Debt/Equity ratio

$$\text{Debt/Equity ratio} = \text{Total liabilities/total equity}$$

**Indicates the MFI/FI's level of protection to absorb potential losses before they pose a risk to its creditors.**

Debt/Equity, a common measurement of an MFI/FI's capital adequacy, indicates the safety cushion the institution has to absorb losses before creditors are at risk. It also shows how well the MFI/FI leverages its equity to increase assets through borrowing and is frequently called the leverage ratio. This ratio is usually

important for investors and lenders.

The Debt/Equity ratio is a stock ratio, capturing a single moment in time. It can fluctuate daily and should be monitored as frequently as possible by MFI/FIs that are highly leveraged. Managers may also consider looking at the average Debt/Equity over a period to get a clearer picture of the risk. Deposit-taking MFI/FIs and saving-based organizations will usually have higher ratios than non-commercial MFI/FIs such as NGOs. In

many environments, Debt/Equity levels may be limited by local regulations or indirectly controlled through borrowing restrictions. As a means of comparison, while the leverage of an MFI/FI is typically about 5, a commercial bank's leverage is about 8 to 12. The lower leverage is due to the MFI/FI's perceived higher risk due to lack of collateral.

Monitoring Debt/Equity alone is insufficient for MFI/FI managers. Other common indicators include Equity/Assets or Equity/Risk-adjusted Assets, which are

common banking measures of capital adequacy. The Equity Multiplier (Assets/Equity) is an easy ratio to assess the MFI/FI's leverage because it shows how the MFI/FI has used its equity to grow its assets by taking on debt. None of these Debt/Equity ratios reveal, however, whether the terms and conditions of the MFI/FI's debt are appropriate for the institution's asset base. For management purposes, a manager may also construct tables to monitor the maturities and cost of its debt and monitor any significant difference between the maturity and yield of its assets.

### Revised Islamic microfinance indicator

$$\text{Financing/equity ratio} = \text{Wadia account/total equity (Wadia equity ratio)} + \text{financing from other party/total equity (external financing ratio)} + \text{Mudaraba fund/total equity (Mudaraba financing equity ratio)}$$

The total financing represented in the accounts of an Islamic MFI/FI are slightly various, as the different financing obligations are treated differently. Wadia accounts are safekeeping accounts, while external financing from other banks is also accounted separately. Lastly, venture capital Mudaraba investments by

investors in the bank are placed in between the liabilities and the owners' equity of the MFI/FI. If there are other restricted Mudaraba accounts that are for specific purposes, they have to be tracked separately as a different line item on the balance sheet.

### Cost of Funds Ratio

$$\text{Cost of funds ratio} = \frac{\text{Expenses on funding liabilities (interest and fees) during the period}}{\text{average funding liabilities}}$$

#### ***Measures average cost of the MFI/FI's financial resources to finance its financial activities***

This ratio gives a blended rate for all the MFI/FI's average funding liabilities, deposits and financing. The denominator does not include other liabilities, such as Accounts Payable or a mortgage loan. When compared to the Portfolio Yield, it reveals how the cost of funding the Gross Loan Portfolio with borrowings relates to the Yield on the Gross Loan Portfolio. The aim is to maintain a sufficient financial spread between the Cost of Funds and Yield. This relationship is the key element of successful pricing management.

MFI/FIs strive to minimize Cost of Funds and maximize Yield. Ideally, a low Cost of Funds results from an MFI/FI gaining access to deposits and/or borrowings at a reasonable cost because depositors and lenders considered it creditworthy. The more creditworthy the MFI/FI, the lower the cost will be. Several reasons exist for why an institution may achieve a low Cost of Funds, however, not all of which are healthy for the institution's long-term growth. For others, Cost of Funds could be quite low because the MFI/FI has access to subsidized borrowings.

**Revised Islamic microfinance indicator**

$$\text{Cost of funds ratio} = \frac{\text{Expenses on funding liabilities during the period}}{(\text{Average Wadia Account} + \text{Average Financing From Other Party} + \text{Average Mudaraba Fund})}$$

MFI/FIs are also affected by the cost of funds, which represents a factor of their cost structure. The total financing represented in the accounts of an MFI/FI are slightly various, as financing obligations are treated differently. Wadia accounts are safekeeping accounts, while financing from other banks is also accounted separately. Lastly, venture capital Mudaraba investments by investors in the MFI/FI are placed in

between the liabilities and the owners' equity of the bank. If there are other restricted Mudaraba accounts that are for specific purposes, they have to be tracked separately as a different line item on the balance sheet. This ratio gives a blended rate for all the MFI/FI's average funding liabilities, deposits and financing. The denominator does not include other liabilities, such as Accounts Payable or a mortgage loan.

**Financial Expenses Ratio**

$$\text{Financial expenses ratio} = \frac{\text{Expenses on funding liabilities (interest and fees) during the period}}{\text{average gross loan portfolio}}$$

***Measures financial expenses incurred by the MFI/FI on its financial obligations to finance its loan portfolio.***

The ratio gives a blended cost of financing when compared to the average loan portfolio. This ratio is not to be confused with the cost of funds ratio which is the average interest rate at which the MFI borrows. The difference is the denominator where the expenses reflect the asset loans made by the MFI/FI. Reading it with the cost of funds ratio will give an understanding

on how the expenses are compared with the portfolio of the MFI/FI. A cost of funds ratio which is significantly lower than the Financial Expense Ratio means that the interest cost of the funding has not efficiently been translated into financing.

The ratio tends to increase when the MFI becomes less and less dependent on subsidies. But this is not a sign of poor performance. The indicator is largely determined by how well the MFI/FI is able to leverage the amount of loans generated by the MFI/FI. It informs the levarging cost of providing the financing.

**Revised Islamic microfinance indicator**

$$\text{Financial expenses ratio} = \frac{\text{Expenses on funding liabilities during the period}}{\text{average gross financing portfolio}}$$

MFI/FIs are also affected by the cost of funds that represent a factor of their cost structure. For the numerator, the funding liabilities include costs relating to wadia accounts, external financing and Mudaraba accounts which are placed in between the liabilities

and the owners' equity of the MFI/FI. The denominator in this case includes all financing products under the MFI/FI's portfolio. The above ratio includes not just debt financing but also equity-oriented financing (eg. Mudaraba, Musharakah etc).

## Liquidity Ratio

$$\text{Liquidity ratio} = \frac{\text{Cash and bank deposits} + \text{short-term financial investments (<3 months)}}{\text{Total Current Liabilities}}$$

**Measures the MFI/FI's liquidity level to meet its financial obligations with third parties and its growth objectives.**

The Liquidity or Liquid Ratio is one measurement of the sufficiency of cash resources to pay the short-term obligations to depositors, lenders and other creditors. MFIs/FIs are particularly vulnerable to cash shortages since their survival is determined on the proper management of cash inflows and outflows. For MFI/FIs, maintaining sufficient cash is important not only to pay bills, salaries or creditors, but also to uphold their promise to provide repeat loans to clients, which is a major incentive for clients to repay loans. Their reputation to keep their client's cash safely and to return to them on demand is vital. Any MFI/FI that fails to repay client deposits on time is likely to lose client confidence and access to future funding.

The Liquidity Ratio can help managers monitor the sufficiency of cash to meet the most immediate obligations, namely short-term deposits and borrowings and other short-term payables and liabilities. In this framework, short-term refers to assets and liabilities that can be turned into cash within three months from the date of the statement or report, not from the date of disbursement, issuance or purchase.

If credit is the main source of funds, the MFI/FI needs to ensure that there is enough cash to pay the loans when they are due. If the MFI/FI offers savings, liquidity needs to be well managed to ensure that its loan payments and savings withdrawals are honoured.

No single liquidity ratio is adequate to monitor cash. Cash management policies must be in place to ensure that cash is available on time to all branches and agencies.

### Revised Islamic microfinance indicator

$$\text{Liquidity ratio} = \frac{\text{Cash and bank deposits} + \text{short-term financial investments (<3 months)}}{\text{Wadia account} + \text{short-term financing from other party} + \text{Mudaraba Fund (short-term)}}$$

The short-term liabilities for an MFI/FI include Wadia safekeeping savings account, short-term financing and short-term Mudaraba funds. This ratio looks at the short-term requirements need by the MFI/FI. The

short-term refers to assets and liabilities that can be turned into cash within three months from the date of the statement or report, not from the date of disbursement, issuance or purchase.

## Portfolio Yield

$$\text{Portfolio yield} = \frac{\text{Income from loan portfolio (interest and fees) during the period}}{\text{average gross loan portfolio}}$$

**Measures the MFI/FI's ability to cover its operating, financial and provision expenses to generate a positive margin.**

Yield on Gross Portfolio measures how much the MFI/FI received in cash interest/profit payments and Fees and Commissions from its clients during the period.

This ratio is the initial indicator of an MFI/FI's ability to generate cash for operations from the Gross Loan Portfolio. Cash receipts from the Gross Loan Portfolio are vital for an MFI/FI's survival.

Portfolio yield should be analysed with the prevailing pricing in the local market. Yields should not fluctuate significantly unless the MFI/FI frequently changes its pricing terms. MFI/FI managers should compare frequently the portfolio yield with the effective pricing of their loans or the contractual yield of the portfolio to determine whether a "yield gap" exists. If the Yield

is significantly and/or consistently lower than the effective pricing rate, it may indicate problems with loan collections.

Managers should be careful when averaging or annualizing for the purposes of calculating the Yield. If an MFI/FI's Gross Loan Portfolio is growing quickly, averaging may distort the calculation of the Yield. Similarly, distortion may also result from looking at the Yield for a short period. Managers should look at this ratio on a monthly or quarterly basis and recognize any distortions due to averaging or annualizing.

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### Breakdown of Portfolio Yield

**Portfolio Yield = Operating Expense ratio + Financial Expense ratio + provision expense ratio + Net profit margin**

### Revised Islamic microfinance indicator

**Portfolio Yield = Income from financing portfolio (profits and fees) during the period/  
Average Gross Financing portfolio**

Income generated from financing portfolio includes all profits and fees charged by the MFI/FIs. Similarly,

the gross financing portfolio also includes investment-oriented financing instruments.

**Portfolio Yield = Operating Expense ratio + Financial Expense ratio + provision expense ratio + Net profit margin**

There is no difference, since the breakdown of the portfolio yield is the same structure as in Islamic finance. Refer to the above calculation for the Financial

Expense Ratio. All the denominators of the ratios are based on average gross financing portfolio which includes investment-oriented instruments



## 6. CATEGORY 4 - PROFITABILITY AND SUSTAINABILITY

Profitability and sustainability ratios reflect the MFI/FI's ability to continue operating and grow in the future. Most reputable MFI/FIs are striving for sustainability, regardless of their non-profit or for-profit status;

### Return on Equity

$$\text{Return on equity} = \text{Net income before grants received and after taxes} / \text{average total equity}$$

**Measures the capacity of the MFI/FI to remunerate its shareholders. For a non-profit MFI/FI, measures its commercial viability and ability to increase equity through profits.**

In a for-profit MFI/FI, return on equity (ROE) is the most important profitability indicator; it measures an MFI/FI's ability to reward its shareholders' investment, build its equity base through retained earnings and raise additional equity investment. For a non-profit MFI/FI, ROE indicates its ability to build equity through retained earnings, and increased equity enables the MFI/FI to leverage more financing to grow its portfolio. By excluding donations and non-operating revenues, this ratio demonstrates an institution's ability to generate income from its core financial service activity.

Mature MFI/FIs can and have achieved remarkably high ROE, exceeding those of banks. However, this must be viewed together with the results of the social indicators. Young organizations may take several years to achieve this, and even a mature MFI/FI's ROE can be temporarily depressed due to unplanned events (such as natural disasters) or planned undertakings (such as expansion). ROE tends to fluctuate more than Return on Assets (ROA). Monthly measurements of ROE can be misleading because many MFI/FI costs may not be recorded until the end of the fiscal year. Managers should look for a positive trend over several years and a ratio similar or better than competitors. As the market becomes saturated and competition increases, ROE may plateau. MFI/FIs that are financed solely through equity donations will find this ratio less meaningful

donors and investors alike look to fund sustainable institutions. Several factors can affect profitability and sustainability. Although new MFIs/FIs may have low profitability, they are building the basis for a sustainable future. The ratios recommended in this section are the most widely accepted in the industry.

because donors rarely base their future investment decisions on ROE. ROE is, however, a good indicator of how well the MFI/FI has used retained earnings and donor money to become sustainable. MFI/FIs that are generating most of their income through debt instead of equity will demonstrate higher ROE, which may distort the financial performance view. In such a situation, profitability can be measured better using ROA. Other possible reasons for ROE to be impacted include (a) strong competition that depresses pricing; (b) presence of subsidies; and (c) interest/profit rate ceilings imposed by central banks.

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### Revised Islamic microfinance indicator

$$\text{Return on equity} = \frac{\text{Net income before grants received and after taxes}}{\text{average total equity}}$$

Income generated from financing portfolio includes all profits and fees charged by the MFI/FI that are Sharia-compliant. The total equity measured is

the shareholders equity, not venture capital equity investments from clients.

### Return on assets

$$\text{Return on assets} = \frac{\text{Net income before grants received and after taxes}}{\text{average total assets}}$$

***Measures the capacity of the MFI/FI to generate profits through its assets.***

ROA indicates how well an MFI/FI is managing its assets to optimize its profitability. The ROA can be used to forecast earnings in future periods if the ratio proves to be consistent over several periods. The ratio measures the return on the portfolio as well as all other revenue generated from operating activities and investments. Unlike ROE, this ratio measures profitability regardless of the institution's underlying funding structure. It does not matter whether MFI/FIs that are funded primarily

through equity. Therefore, ROA is a good measurement to compare commercial and non-commercial MFI/FIs. In fact, non-commercial MFI/FIs with low debt/equity ratios can often achieve higher ROA than their commercial counterparts because they have low financial expenses and pay fewer taxes.

ROA should be positive. A positive correlation exists between this ratio and Portfolio to Assets. Institutions that maintain a large percentage of assets in the Gross Loan Portfolio will have a higher ratio.

**Revised Islamic microfinance indicator**

$$\text{Return on assets} = \text{Net income before grants received and after taxes} / \text{average total assets}$$

The calculation is the same. Income generated from financing portfolio includes all profits and fees charged by the MFI/FI that are Sharia-compliant.

**Operational Self-Sufficiency**

$$\text{Operating self-sufficiency} = \text{operating income during the period} / (\text{financial expenses} + \text{provision expenses} + \text{operating expenses during the period})$$

***Measures the ability of the MFI/FI to cover all its costs with its operating income.***

Operational Self-Sufficiency (OSS) measures whether revenues from operations are sufficient to cover all operating expenses. Similar to the previous ratios that measures income generation, OSS focuses on revenues and expenses from the MFI/FI's core business, excluding non-operating revenues and donations. Financial Expense and Impairment Losses on Loans are included in this calculation because they are normal (and significant) costs of operating. By measuring cost coverage, OSS reflects the MFI/FI's ability to continue its operations if it receives no further subsidies.

The breakeven point of an MFI/FI's operations is 100%. Young MFI/FIs may take several years to break even, and when they do, they should never return to an OSS of less than 100%. OSS does not tend to fluctuate as much as other ratios and the positive trend can be achieved through growth and increased efficiency. OSS is the a profitability measurement that should be followed on a monthly basis. Managers should consider the drivers behind OSS. They should find ways on how to ensure that the MFI/FI remains sustainable while ensuring that it does not experience any mission drift. Will the ratio improve with larger loan sizes, high yields, low financial expenses or efficient operations? OSS is a simple and important measurement for MFI/FI managers, particularly for young MFI/FIs that want to monitor their path to sustainability.

**Revised Islamic microfinance indicator**

$$\text{Operating self-sufficiency} = \text{operating income during the period} / (\text{Financial expenses} + \text{provision expenses} + \text{operating expenses during the period})$$

The calculation is the same. Income generated from financing portfolio includes all profits and fees charged by the MFI/FI that are Sharia-compliant. Provisional expenses may be higher for MFI/FIs that engage in

venture capital investments. Such investments may take some time to generate income in the initial term and should be monitored closely.

**Table 16 - Summary of Financial Performance Indicators**

Conventional Financial Performance Ratio	Islamic Financial Performance Ratio
<b>Category 1 - Portfolio Quality</b>	
1. PAR30 = Outstanding balance of loans that is due more than 30 days/outstanding balance of all loans	<ul style="list-style-type: none"> <li>▶ For Debt instruments- PAR30 = Outstanding balance of financing that is due more than 30 days / Outstanding balance of all financing</li> <li>▶ Unrealized Portfolio Revenue (UPR)= (Expected ROI of investment- Actual ROI of investment)</li> </ul>
2. Restructured Portfolio= Outstanding Restructured Portfolio / Outstanding balance of all loans	▶ Restructured Portfolio= Outstanding Restructured Portfolio in that was in arrears / Outstanding balance of all financing
3. Write off Ratio = Loans written off during the period / Average Outstanding balance of all loans	▶ Write off Ratio = Financing written off during the period / Average Outstanding balance of all financing
<b>Category 2 - Efficiency and Productivity</b>	
4. Operating Expense Ratio = Operating Expenses During the Period / Gross Loan Portfolio	▶ Operating Expense Ratio = Operating Expenses During the Period / Gross financing Portfolio
5. Cost per borrower = Operating Expenses During the Period / Average Number of Active Borrowers	▶ Cost per financing client = operating expenses during the period/average number of active financing client
6. Loan officer Productivity = Number of Active borrowers / Number of Loan Officers	▶ Financing officer Productivity = Number of Active financing clients / Number of Financing Officers
7. Staff Productivity = Number of Active borrowers / Number of Staff	▶ Staff productivity = number of active financing clients/number of staff
<b>Category 3 - Financial Management</b>	
8. Debt /Equity Ratio = Total Liabilities / Total Equity	▶ Wadia account/total equity (Wadia equity ratio) + financing from other party/total equity (external financing ratio)+ Mudaraba fund/total equity (Mudaraba financing equity ratio)
9. Cost of Funds Ratio = Expenses on funding liabilities (interest and fees) during the period/ Average funding liabilities	▶ Cost of Funds Ratio = Expenses on funding liabilities during the period/ (Average Wadia Account + Average Financing From Other Party + Average Mudaraba Fund)

Conventional Financial Performance Ratio	Islamic Financial Performance Ratio
10. Financial Expenses Ratio = Expenses on funding liabilities (interest and fees) during the period/ Average Gross Loan Portfolio	▶ Financial Expense Ratio = Expenses on funding liabilities during the period/average gross financing portfolio
11. Liquidity Ratio = Cash and bank deposits + Short term financial investments (<3 months)/ Total Current Liabilities	▶ Liquidity Ratio = Cash and bank deposits + Short term financial investments (<3 months)/ Wadia Account + Shot-term Financing from Other Party + Mudaraba Fund (short-term)
12. a) Portfolio Yield = Income from loan portfolio (interest and fees) during the period/ Average Gross Loan portfolio b) Portfolio Yield = Operating Expense ratio + Financial Expense ratio + provision expense ratio + Net profit margin	▶ 12a) Portfolio Yield = Income from financing portfolio (profits and fees) during the period/ Average Gross Financing portfolio 12b) Portfolio Yield = Operating Expense ratio + Financial Expense ratio + provision expense ratio + Net profit margin
<b>Category 4 - Profitability and Sustainability</b>	
13. Return on Equity = Net Income before grants received and after taxes / Average Total Equity	▶ Return on Equity = Net Income before grants received and after taxes/ Average Total Equity
14. Return on Assets = Net Income before grants received and after taxes / Average Total Assets	▶ Return on Assets = Net Income before grants received and after taxes / Average Total Assets
15. Operating Self-sufficiency = Operating income during the period/ (Financial expenses + provision expenses + operating expenses during the period)	▶ Operating Self-sufficiency = Operating income during the period/ (Financial expenses + provision expenses + operating expenses during the period)



# Rating of Economic Empowerment Institution

## 1. PURPOSE OF RATING AN MFI/FI

MFIs/FIs conduct a rating exercise for various reasons. Typical reasons for such an exercise include communicating -

- a) What the mission and values of the MFI/FI are
- b) The performance of the MFI/FI in conducting its activities in a professional manner
- c) The benefits and results generated by the MFI/FI for its stakeholders, especially clients, investors and regulators

A rating exercise is an exercise of transparency, whereby the MFI/FI not only communicates the strengths of its operations, but also the weaknesses. Many MFIs/FIs use the rating exercise as an exercise of self-evaluation on what it can do better. Donors, investors and, increasingly so, regulators put much importance on the rating of MFIs/FIs, given their interaction with the poor and vulnerable populations. An MFI/FI, especially one that collects savings, could be a catalyst for financial inclusion and poverty alleviation, or it could also be a catalyst for over-indebtedness and a cause for the poor to never come out of poverty. By benchmarking the MFI/FI's policies with best practices, rating activities help inform stakeholders on whether the MFI/FI's activities are beneficial to society.

Investors also use independent ratings as part of good governance practice, as they provide transparent and objective information on the performance and risk profile of their potential and current investees. Risks that investors would need to mitigate include not only financial risks but also reputational risks, especially as many of such investors have social missions they must fulfil in addition to the expected financial returns.

## Marketing the institution as a socially responsible investment opportunity

Regulators often require, and use, rating exercises to understand whether the MFI/FI is a boon or bane to society, especially to the poor and vulnerable populations it typically serves. The focus is often two-dimensional- financial and social. Regulators want to ensure that the MFIs/FIs will continue to be going concerns so that the trust gained from society in the form of savings collected and their dependence on the services would remain in the long run. They want to know that the microfinance sector is healthy and will not cause any harm. Investors' expectations are much higher than regulators. Investors want to ensure that the funds are utilized in an efficient manner that would derive sufficient profits to meet their expected rate of return. In addition, investors often want to ensure that their funding has contributed to the local development agenda. They want to be assured that the funds have helped reduce poverty, improved the environment and contributed to the social cause that is in line with their investment mandate.

## 2. DIFFERENCE BETWEEN SELF-EVALUATION AND EXTERNAL RATING

MFIs/FIs should conduct self-evaluation exercises by using checklists, questionnaires and surveys of management, staff and clients in order to better understand how they are perceived and the value they are providing to their stakeholders. These findings can be used to benchmark against their competitors and industry averages to give them a clear understanding of their value proposition. Such self-evaluation exercises could also be used as part of their preparations before conducting an independent external evaluation.

An external rating exercise involves an independent evaluator who conducts a comprehensive validation on whether the self-evaluation conducted by the MFI/FI is indeed a true and fair reflection of practicing the

policies it set for itself throughout the organisation. The evaluators review every performance dimension of an MFI/FI and determine their effectiveness in a transparent manner. All findings by the evaluator are published and made available to the public or targeted stakeholders. While the evaluator remains independent in his evaluation, clarification may be made with the MFI/FI so that the findings are fairly reflected and evidence-based.

### 3. RATING DIMENSIONS OF AN ECONOMIC EMPOWERMENT INSTITUTION

MFI/FIs need to demonstrate their ability to not only benefit their clients, but to do so in a sustainable manner. Hence, rating often encompasses these two themes- (a) social performance; and (b) financial performance.

**Social Performance** - Chapter 4 of this toolkit details the social indicators MFI/FIs are expected to measure and how they are applied in Islamic finance. Social performance, as defined by the Social Performance Task Force, is “the effective translation of an institution’s mission into practice in line with accepted social values.” An MFI/FI’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 includes client protection but is also explicitly concerned with how to generate benefits for poor clients. Client protection is the responsibility of all providers and is, hence, essential for all double bottom-line institutions. Chapter 4 provides guidance on how MFI/FIs can apply the six Universal Standards for Social Performance Management and seven Client Protection Principles.

**Financial Performance** - Chapter 5 of this toolkit details the financial indicators MFI/FIs are expected to measure and how they are applied in Islamic finance. Financial performance is a snapshot of the current situation of the MFI/FI. It should be read in its entirety to provide a good understanding on how it is

performing from various perspectives. A 3-5 year trend analysis would also help determine the changes in focus and the direction in which the MFI/FI is heading. It would also help to have a benchmark or market analysis conducted in order to make comparisons with other microfinance peers in the sector. In addition, financial performance ratios should be read together with the social performance indicators in order to have a clearer understanding of the on-the-ground reality and context of why the numbers are as they are reported. These financial indicators are derived from the MFI/FI’s financial statements such as the income statements, balance sheets, cashflow statements and portfolio reports. The financial indicators, which have been standardized by the SEEP network, are categorised in terms of (a) portfolio quality; (b) efficiency and productivity; (c) financial management; and (d) profitability and sustainability.

Additionally, applying those social and financial performance standards that were developed by the conventional microfinance sector and are in line with the principles of Islamic microfinance, IsDB also developed the Economic Empowerment Impact performance standards, which are unique to the Islamic microfinance sector.

### 4. ECONOMIC EMPOWERMENT IMPACT AS THE ADDITIONAL PERFORMANCE DIMENSION

The weakness of the conventional microfinance sector lies in its inability to measure its own impact without undertaking costly and challenging impact assessment surveys such as the randomized control trials. The arm’s length nature of interest-based loans means that it would be impossible to measure the benefits derived from the transaction as they happen, and the only way benefits can be measured are after-the-fact. Islamic microfinance differs from this approach, as it engages directly in the value chain. If an MFI/FI buys its client’s product (e.g. tomatoes, carrots, etc.), it would be able to measure the cost of production with the revenue their clients earn by selling to them in order to measure the benefit. It would also know its own profits by selling these products to supermarket outlets and retail stores and how much the retail stores earn by selling their products to the end consumer. When an entity



engages in the value chain, it will not be long before it understands its sphere of influence in the value chain and whether it is able to generate value by developing win-win transactions with its clients.

### **Economic Empowerment Impact Performance**

- Chapter 3 of this toolkit details the Economic Empowerment Impact indicators that allow MFI/FIs to demonstrate their value add to their clients. A conventional MFI/FI interested in practicing Economic Empowerment should first take steps to be Sharia-compliant. But it should not stop there, further steps should be undertaken to make it an MFI/FI. Economic Empowerment Impact indicators can be categorized into qualitative and quantitative indicators. The qualitative indicators measure how the MFI/FI is involved and helps support its client's business. Since it is well recognized that access to finance is only one aspect of the client's success (other success factors include access to markets, access to technology, access to information, etc.), qualitative indicators measure the non-financial services provided by the MFI/FI. To complement qualitative indicators, the quantitative indicators measure the impact of the services (including non-financial) provided by the MFI/FI. The quantitative indicators described under Chapter 3 of this toolkit measure the impact of the microfinance intervention by determining the benefit gained by the client and directly attributable to the microfinance intervention.

## **5. TOOLS FOR COLLECTING RATING INFORMATION**

Various means are used to collect the information needed to conduct a thorough rating exercise. These methods include surveys, interviews and financial statements, as well as other quantitative value chain data. The MIS is an essential platform to collect and record such data and allow management to understand their performance in an objective manner. A discipline on how to collect data, who to collect data and when to collect data should be incorporated as part of the institution's Standard Operating Procedures to ensure consistency and reliability of the data collected. While data collecting is essential, it should not be done in a manner that would be inconvenient to clients or create a heavy burden for the institution that would be passed on to clients.

## **6. RATING CLASSIFICATIONS UNDER THE THREE RATING DIMENSIONS**

Instead of developing a single rating system similar to the Microfinance institutional rating and another on the Social Rating system, the three dimensions are kept separate in order to provide a comprehensive understanding of the performance of the MFI/FI. Each of the three dimensions can be categorized into five rating classifications as shown below -

**Table 17 - Summary of Rating Classification**

Rating Dimension	Financial parameters	Social parameters	Economic Empowerment Impact parameters
<b>Classification</b>			
<b>A (Excellent)</b>	▶ Capacity to manage financial Risks	▶ Social performance management	▶ Involvement in the value chain
<b>B (Good)</b>	▶ Financial fundamentals	▶ Management of Client Protection Systems	▶ Non-financial support to clients
<b>C (Satisfactory)</b>	▶ Management of credit risk	▶ Management of Mission drift risk	▶ Benefit/Impact generated to clients
<b>D (Weak)</b>	▶ Operational productivity and efficiency		
<b>E (Poor)</b>			

Therefore, an MFI/FI may have a number of combinations that reflect the financial, social and Economic Empowerment Impact performance (e.g.

AAA, AAB, AAC, BAA, BBA, etc). An MFI/FI that received a rating of ABC would mean that it is rated as -

**Table 18 - Rating Classification of a MFI/FI rated ABC**

Rating Dimension	Financial parameters	Social parameters	Economic Empowerment Impact parameters
A	<ul style="list-style-type: none"> <li>▶ Excellent capacity to manage financial Risks</li> <li>▶ Excellent Financial fundamentals</li> <li>▶ Excellent Management of credit risk</li> <li>▶ Excellent Operational productivity and efficiency</li> </ul>		
B		<ul style="list-style-type: none"> <li>▶ Good Social performance management</li> <li>▶ Good Management of Client Protection Systems</li> <li>▶ Good Management of Mission drift risk</li> </ul>	
C			<ul style="list-style-type: none"> <li>▶ Satisfactory Involvement in the value chain</li> <li>▶ Satisfactory Non-financial support to clients</li> <li>▶ Satisfactory Benefit/Impact generated to clients</li> </ul>

## 7. RATINGS - A STANDARD FOR PROFESSIONAL MANAGEMENT OF THE ECONOMIC EMPOWERMENT SECTOR

Ratings are only a means of communicating the standards expected from MFI/FIs. These standards help MFI/FIs measure their performance over time, as well as against their competition. This will help the Economic Empowerment Sector improve further through professional management, ensure transparency and allow donors, investors and regulators to fully understand the sector and how to support it. Ratings also allow policymakers to understand the systemic risks and challenges faced by MFI/FIs and help them address these issues. MFI/FIs can also attract funding from commercial and/or social sources by projecting a professional and transparent image.

Lastly, ratings offer a platform for MFI/FIs that is not available for interest-based conventional MFIs/FIs. MFI/FIs can clearly communicate the value they provide by measuring the benefits to their mostly poor clients. Donors and investors will also better understand the benefits and risks involved in providing funding to a particular MFI/FI. It is with such evidence-based measurements that MFI/FIs can directly address the challenge that the microfinance sector was set out for, namely alleviating poverty.



# Implementing a Monitoring and Evaluation System

## 1. BASIC DEFINITIONS OF MONITORING AND EVALUATION

Monitoring and evaluation are tools that managers, governments and donors can use to measure and evaluate progress and outcomes then feed this information back into the processes of decision-making, management and governance. The primary objective of donor/funder microfinance projects is to provide financial services to underserved markets (especially women and youth) at an affordable cost. The target clients are generally poor communities (income generating activities for the ultra-poor and micro and very small enterprises for the economically active poor).

To find out whether the project attained its goal and achieved the required outcomes, it is very important for the monitoring unit to track the indicators on the results framework that is adopted by international financial and non-financial institutions. M&E provide a flow of information for internal uses by managers, and for external use by stakeholders who expect to see results, want to see demonstrable impacts and require accountability and trustworthiness on the part of the public sector. Member countries and institutions are accountable to stakeholders and this requires them to both achieve expected outcomes and be able to provide evidence that demonstrates this success. Monitoring and evaluation of projects are highly needed to measure project performance, track progress towards achieving desired goals and learn and apply lessons.

The OECD provides the following definitions of M&E -

**Monitoring** is the continuous collection of data on specified indicators to assess for a development intervention (project, programme or policy), its implementation in relation to activity schedules and expenditure of allocated funds and its progress and achievements in relation to its objectives.

**Evaluation** is the periodic assessment of the design, implementation, outcomes and impact of a development intervention. It should assess the relevance and achievement of objectives, implementation performance in terms of effectiveness and efficiency and the nature, distribution and sustainability of impacts.

At the IsDB and sector level, M&E can -

- ▶ Improve project and programme design through the feedback provided from mid-term, end of project and post evaluations
- ▶ Inform and influence the sector assistance strategy through analysis of the outcomes and impact of interventions and the strengths and weaknesses of their implementation, enabling the compilation of lessons learnt and best practices

At the MFI/FI and project level, M&E can -

- ▶ Provide regular feedback on project performance and signal necessity for corrections
- ▶ Identify problems early on and propose solutions
- ▶ Monitor field implementation of the project and outreach
- ▶ Evaluate the achievement of project objectives

## 2. USE OF THE LOGICAL AND RESULTS FRAMEWORK IN M&E

The results framework is based on the concept of project logic and logical framework analysis. Good project design is based on a clear and logical project strategy. A logical framework analysis should be conducted to analyse the causal relations (or "hierarchy") between inputs, activities, outputs, and outcomes leading to the project's developmental objective(s).

### Definitions of project hierarchy levels

**Higher level development objectives** - the longer-term widespread improvement in society to which

achievement of the project development objective(s) is intended to contribute.

**Project development objective** - the combination of one or more project component outcomes that make up the physical, financial, institutional, social, environmental or other development changes which the project is designed and expected to achieve.

**Project component outcomes/results** - the effects of project components bringing intermediate effects for beneficiaries in terms of observable change in performance, behaviour or status of resources.

**Outputs** - the products, capital goods and services resulting from a development intervention and which are necessary for the achievement of project component outcomes.

**Activities** - the actions taken by project implementers that deliver the outputs by using the inputs provided.

**Inputs** - the human and material resources financed by the project.

The following diagram illustrates how the logical framework analyses of different project components can be linked together.

**Table 19 - Theory of Change of the Logical Framework**

Means-ends Chain	equals	Logical project design	subject to	Required conditions being in place
End		Higher level development objectives		
▲		▲		necessary conditions
end (menas)		Project level development objective(s)		
▲		▲		necessary conditions
end (menas)		Project component outcomes/results		
▲		▲		necessary conditions
end (menas)		Outputs		
▲		▲		necessary conditions
end (menas)		Activities		
▲		▲		necessary conditions
Means		Inputs		

Thus -

- ▶ **IF** inputs are provided, **THEN** activities can take place;
- ▶ **IF** activities are successfully completed, **THEN** planned output should result;
- ▶ **IF** outputs are used as intended, **THEN** the project component outcomes/results should be realised;
- ▶ **IF** the outcomes are achieved, **THEN** the project development objective(s) (PDO) should be achieved; and
- ▶ **IF** the PDO is achieved then the expected contribution should be made to higher level developmental objectives

The Logical and Results Framework is the key element that links the project components together and shows the linkages and interactions leading to the project developmental objective(s). Using a logical and results framework, there are generally two levels of monitoring - implementation monitoring and results monitoring.

**Implementation Monitoring** is when the operation and performance of the project are assessed in terms of the effectiveness and efficiency of the processes through which inputs are utilised to produce the planned outputs.

**Results Monitoring** is monitoring at the level of the outcomes (short-term and long-term), that is the

achievement of project outcomes is measured in terms of results, which are the extent to which the observable outcomes are as per the initial plan.

Implementation and results monitoring are usually done through an MIS, tracking the day-to-day implementation of the project. The MIS will include the procurement system, financial flows etc., as well as records of physical activities and processes and the key indicators used for implementation and results monitoring.

The links between the different levels are depicted in the following diagram -

**Table 20 - Focus of M&E in a Logical Framework**

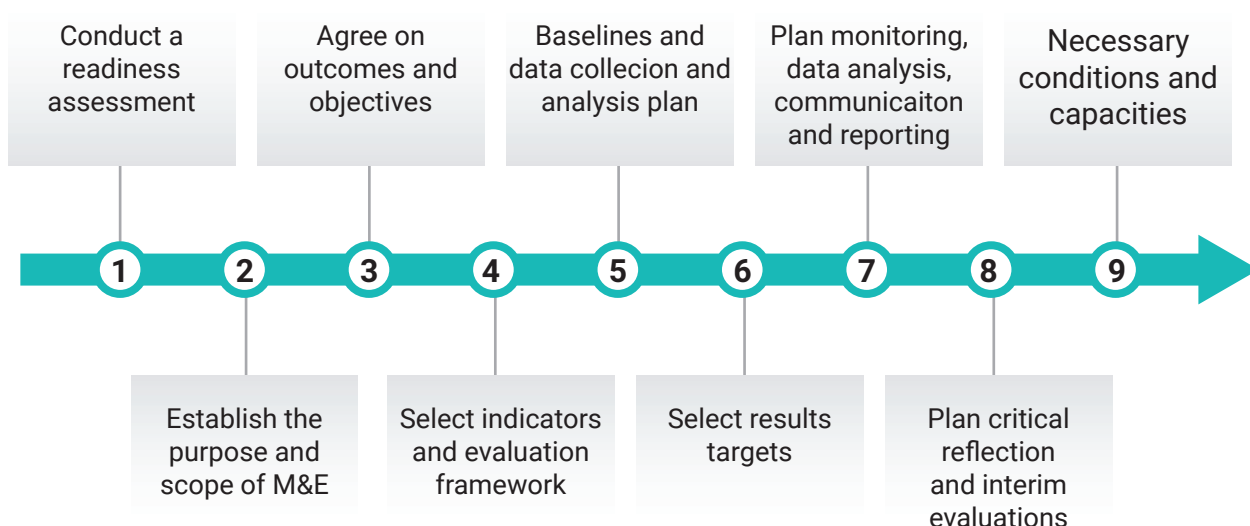
Project Logic	Type of Indicator	Focus of M&E
Objectives	Impact	Results Monitoring
PDO and Outcomes	Outcome	
Outputs	Outputs	Implementation Monitoring
Activities	Process	
Inputs	Inputs	

### 3. PLANNING AND IMPLEMENTING A PROJECT M&E SYSTEM

to achieve the purposes within the project cycle. The steps in planning and implementing a project M&E system are as follows -

A project M&E system is the set of planning, information gathering, analysis and reporting processes necessary

**Figure 5 - Process of Planning and Implementing a M&E System**



1. Assess the existing readiness and capacity for M&E
  - ▶ A review of current capacity within the MFI/ FI and its partners who will be responsible for project implementation covering technical skills, managerial skills, existence and quality of data systems, available technology and existing budgetary provision
  - ▶ Are there other institutions, such as universities, private consultants or government agencies, which have the capacity to provide technical assistance and/or training?
2. Establish the purpose and scope
  - ▶ Why is M&E needed and how comprehensive should the system be?
  - ▶ What are the IsDB and government requirements with regards to M&E?
  - ▶ What should the scope and degree of rigour of the evaluation of final project impact be?
  - ▶ Should the M&E process be participatory?
3. Identify and agree with the main stakeholders regarding the project's outcomes and developmental objective(s)
  - ▶ Setting outcomes is essential in building an M&E system
  - ▶ Indicators, baselines and targets are similarly derived from the setting of outcomes
4. Select key performance indicators and evaluation framework.
  - ▶ Indicators are the qualitative or quantitative variables that measure project performance and achievements
  - ▶ Indicators should be developed for all levels of the project logic
  - ▶ The evaluation framework sets out the methods to be used to address the question of whether change observed through monitoring indicators can be attributed to the project interventions
5. Set baselines and plan data collection and analysis
  - ▶ The baseline is the first measurement of an indicator, which sets the pre-project condition against which change can be tracked and evaluated
- ▶ A single point in time or current value may not be representative and it may be better to use an average, for example, for the three previous years if such data is available
- ▶ Baseline data must be gathered for the key performance indicators and this may require implementation of a baseline survey, unless existing data sources are adequate
- ▶ Subsequent data gathering and repeat surveys for the implementation period of the project and beyond should then be planned. Data collection may be continuous or periodic depending on the nature and purpose of an indicator
6. Select results targets
  - ▶ Target setting is the final step in building a results-based approach, following logically from defining outcomes, indicators and baselines.
  - ▶ A target is a specification of the quantity, quality, timing and location to be realised for a key indicator by a given date.
  - ▶ Starting from the baseline level for an indicator, the desired improvement is defined by taking account of planned resource provision and activities to arrive at a performance target for that indicator.
  - ▶ Most targets are set annually, but some could be set quarterly or for longer periods. Targets do not have to be single numerical values and sometimes a range of achievement may be more appropriate. Targets should also be kept under review and revised flexibly as necessary to take account of changing resource availability or other factors beyond the control of project management, but not to disguise poor project performance.
  - ▶ It is important to be realistic, taking account of what is feasible and being sensitive to the political issues associated with targets that are publicly announced. As outcomes are typically longer term, it is usually necessary to establish targets as short-term outputs on the path to achievement of an outcome.
7. Plan monitoring, data analysis, communication and reporting
  - ▶ Implementation monitoring tracking the inputs, activities and outputs in annual or multiyear work plans, and 'results monitoring' tracking

achievement of outcomes and goals, are both needed.

- ▶ The demands for information at each level of management need to be established, responsibilities allocated and plans made for -
    - What data to be collected and when
    - How data are collected and analysed
    - Who collects and analyses data
    - Who reports information, and in what form, to whom and when?
    - An assessment of the flow of information and degree of detail needed by each level of management will help clarify the indicators to be measured. The agency managing the project will require different types of information for its own internal management, compared to the reporting requirements of higher levels of government and IsDB.
8. Plan the form and timing of critical reflection and interim evaluations
- ▶ Supervision requirements of IsDB and government may require periodic and formalised evaluations to take place.
  - ▶ The data needs and analysis requirements for mid-term, end of project and ex-post evaluations should be considered and planning for these linked to the planning of monitoring and choice of evaluation framework.
  - ▶ A timetable of formal evaluation reports should be set out
  - ▶ An indication also needs to be given at the design stage about feedback mechanisms for evaluation results beyond donor formalities such as mid-term and completion reviews. This is linked both to the development of accountability within the project, sector and higher levels of government, and the need to provide information to support decision-making.
9. Plan for the necessary conditions and capacities
- ▶ It is necessary to plan the organisational structure for M&E, including whether an M&E unit specific to the project is needed.
  - ▶ Appropriate organisational structures for M&E should be discussed with partners and other stakeholders.
- ▶ Planning should cover staffing levels and types, responsibilities and internal linkages, incentives and training needs, relationships with partners and stakeholders, horizontal and vertical lines of communication and authority, physical resource needs and budget.
  - ▶ Monitoring and ongoing evaluation should normally be the responsibility of the project coordinator, assisted by an M&E Specialist.
10. Monitoring business partners and clients
- ▶ It is important that the MFI/FI monitors the performance of its business partners and clients to ensure that they fulfil their roles appropriately.
  - ▶ Strong monitoring of the business issues faced by clients will allow the MFI/FI to better understand the risks involved and provide them with a clear understanding on how to help their clients mitigate such risks.
  - ▶ Detailed checklist of the areas to monitor are found in **Annex-2**.

#### 4. THE COMPONENTS OF A PROJECT M&E SYSTEM

A good M&E system has six main components that help ensure that M&E is relevant to the project, within the capacity of the borrower's organisations and is used to good effect.

1. Clear statements of measurable objectives for the project and its components.

The Project Development Objective (PDO) statement clearly identifies who the primary target group is, the specific and measurable benefits that the target group will receive from this project, and the expected change in behaviour, situation, or performance of the primary beneficiaries (what will the target group be doing better or differently as a consequence of the project?).

2. A structured set of indicators covering - process, outputs, outcomes, impact

Indicators provide the qualitative and quantitative detail necessary to monitor and evaluate the objectives at all levels of the project hierarchy.



**Process indicators** monitor the activities completed during implementation and are often specified as milestones or completion of sub-contracted tasks, as set out in time-scaled work schedules.

**Output indicators** monitor the production of goods and services by the project.

**Outcome indicators** are specific to a project and are the end of the logical chain of cause and effect that underlies its design. Often achievement of outcomes will depend at least in part on the actions of beneficiaries in responding to project outputs, and indicators will depend on data collected from beneficiaries.

**Impact indicators** usually refer to medium or long term developmental change to which the project is expected to contribute.

It is important that indicators used with the results framework are SMART (Specific, Measurable, Attributable, Realistic, and Timebound) if they are to accurately measure results achieved through the project -

**Specific** means that the indicator measures only the design element (output or outcome), which is intended for measurement, and not any other elements in the project.

**Measurable** means that there are practical ways of measuring the indicator, being clear and unambiguous in terms of what is being measured.

**Attributable** means that the indicator is a valid measure of the targeted developmental issue and the project can be credited for the changes in that developmental issue.

**Realistic** means that indicators selected must be realistic in terms of their ability to collect the data with the available resources.

**Timebound** has several connotations. First, indicators must be timebound in terms of the time spent in data collection. Second, indicators must reflect the timing of collection, being cognizant of seasonal differences. Third, the time-lag between activities and output and outcomes must also be reflected in the indicators that are chosen.

3. Data collection mechanisms capable of recording progress over time, including baselines and a means to compare progress and achievements against targets.

For project M&E, data will be needed both for the baseline situation and for measurement of change over time in the range of indicators selected. It is important to collect only the data that will be used effectively to improve management and decision-making. The plan for a project M&E system should be based on a clear and detailed assessment of the following -

- ▶ What – the data to be collected, in what form, with what degree of aggregation or consolidation and for what purpose
- ▶ When – the frequency of data collection and reporting
- ▶ Who – the responsible persons, their responsibilities and capacities
- ▶ How - methods and procedures for data collection, checking, validation and storage and for analysis and reporting
- ▶ Where – locations for data collection and processing, and the destinations for reported information

4. Where applicable, building on data collection with an evaluation framework and methodology capable of establishing causation (attribution).

The evaluation framework lays out the analytical tools that will be used to address this problem, usually by testing observed change against a counterfactual (i.e. the situation that would have happened had the project not taken place).

Identifying the counterfactual is difficult but there are strategies for doing so, using both experimental and quasi-experimental designs. Use of random assignment and control or comparison groups are the basic strategies that can be adopted.

5. Clear mechanisms for reporting and use of M&E results in decision-making.

The uses of the information and the feedback mechanisms need to be structured and scheduled according to the needs of IsDB and other partners and stakeholders.

For example -

- ▶ Project management will need to monitor expenditure and progress against schedules, weekly and at least monthly.
- ▶ Outputs are unlikely to be measurable at less than three-monthly intervals, and some may need much longer.
- ▶ Consultations with beneficiaries, or surveys of their satisfaction with project services, should be timed to supply information to use in planning project activities.

From the start of the project a communication strategy needs to be developed that would address the following questions -

- ▶ Who will receive what information?
- ▶ In what format?

- ▶ When?
  - ▶ Who will prepare the information?
  - ▶ Who will deliver the information?
6. Sustainable organizational arrangements for data collection, management, analysis and reporting. Monitoring is a tool of good management and the responsible unit should ideally be located within, or close to, project management. Thus, the resources, training and technical assistance for the unit should be specified in the project implementation plan. Where independent external expertise is needed, it should be procured through partnership in the case of national or sectoral agencies or contracted on a consultancy basis supervised by project management in the case of other agencies.

## 5. A SAMPLE RESULTS FRAMEWORK FOR MICROFINANCE -

**Table 21 - Project Results Logical Framework Template**

Narrative Summary	Performance Indicators	Means of Verification	Risks and Assumptions
<b>Impact</b>			
<b>Contribute to poverty reduction</b>	1. Incidence of Poverty - % of Clients that come out of poverty 2. Benefit gained by clients - \$ attributed to Economic Empowerment interventions	Core Banking Solution	-
<b>Outcomes</b>			
<b>Outcome - Mainstreaming Economic Empowerment</b>	1. Number of clients served 2. Number of clients provided capacity building 3. Number of partner institutions trained in Economic Empowerment Methodology 4. Number of direct and indirect jobs maintained or created for the targeted poor clients 5. Number of Value Chain projects attributed to Economic Empowerment interventions	PMU Reports/ Core Banking Solution	Climate change effects on agriculture and livelihoods of people  <b>Mitigation -</b> Contribution to index-based insurance thinking group

Narrative Summary	Performance Indicators	Means of Verification	Risks and Assumptions
<b>Outputs</b>			
<b>Output 1 - Capacity Building of partners, sector institutions and beneficiaries is completed</b>	<ol style="list-style-type: none"> <li>Number of Training Sessions Conducted to clients</li> <li>Number of Training Sessions Conducted to Partner Institutions</li> </ol>	PMU Reports	Complexity of new financial products
<b>Output 2 - Economic Empowerment products are offered in the country</b>	<ol style="list-style-type: none"> <li>Number of Economic Empowerment financial Products developed</li> <li>Number of non-financial services provided</li> <li>Amount Disbursed to end beneficiaries</li> </ol>	NGO and PMU Reports	<p><b>Mitigation</b> - Training of MFI/FIs, partners and beneficiaries</p> <p>Weak capacity of executing agency</p>
<b>Output 3 - Project Management and M&amp;E system is in place</b>	<ol style="list-style-type: none"> <li>PMU is operational</li> <li>Baseline survey conducted</li> <li>M&amp;E system is operational</li> <li>Appropriate Economic Empowerment MIS system is operational</li> <li>Number of timely reports from PMU (monthly)</li> </ol>	PMU Reports	<b>Mitigation</b> - Capacity building
<b>Activities</b>			
<p><b>Capacity Building for Implementing entity, sector institutions, project partners and beneficiaries.</b></p> <p><b>Line of Financing for solidarity groups and micro entrepreneurs</b></p> <p><b>Project Implementation Support and Audit</b></p>	<p>Financial inputs (USD) -</p> <p>Total financial outlay - US\$xxx million</p> <p>Financing Plan Breakdown</p> <p>Line of financing - US\$ xxx</p> <p>Capacity Building - US\$ xxx</p> <p>Project Implementation Support and Audit - US\$ xxx</p>	<p>▶ Financial agreements</p>	<p>▶ No delay in signature and effectiveness of financial agreements</p> <p>▶ Availability of counterpart funding</p> <p>▶ No delays in procurement process</p>



## Performance Monitoring of Business Partners and Clients

In Economic Empowerment, the MFI/FI is a business partner and gets to wear different hats - that of a trader, partner, investor, lessor and lender, depending on the agreement signed between the MFI/FI and the client. One of the responsibilities of the MFI/FI is to supervise and assist the partner or client in its business and ensure that the planned targets and activities that were set in the business plan of the partner or client are proceeding according to plan. Monitoring the business performance of partners and clients ensures a win-win situation for the MFI/FI and the client, as it encourages transparency, informs the MFI/FI of the needs of the client, allows corrective actions for the client, helps in the repayment and leads to a longer lasting business relationship between the MFI/FI and the client.

### Checklist on performance monitoring of business partners and clients

- ▶ Is the business producing at the level foreseen in the business plan or the financing analysis?
- ▶ Is there additional capital invested in this period by the entrepreneur?
- ▶ Does the business have sufficient liquidity and cash?
- ▶ Is the business operating at full capacity?
- ▶ Are deliveries being met on time? Has the client rejected orders because of capacity or lack of raw materials? Are stocks well-protected by physical supervision, and does the client maintain updated stock records? Has the client insured equipment and stocks against theft, fire and disaster?
- ▶ Where does the client source its raw materials?
- ▶ Does the client receive credit terms from suppliers?
- ▶ Can the MFI/FI receive better credit terms and lower wholesale price? Is there opportunity for Murabaha transactions?
- ▶ Amount of fixed assets, working capital and inventory?
- ▶ Who are the clients of the business? Has the number of customers increased/decreased during the past period?
- ▶ What are the actual and expected orders and sales and are they at the level that was projected?
- ▶ What are the terms of sales? Does the client extend credit to the customers? Is it easy to ascertain outstanding debts for each customer? Are average days of credit extended known to the client?
- ▶ Can the client list all business costs and expenses? Indicate what costs are variable and which are fixed - differentiate for costs of inputs, production, energy, labour, maintenance, transport and costs of capital.
- ▶ How do the costs compare with the client's selling prices? Profitable?
- ▶ Where are the sites where the goods are sold - from the home, in local shops, in the marketplace, on the street?
- ▶ Indicate the type of promotional activities done (sign, word of mouth, advertising, flyers, public notes, newspapers or radio)?
- ▶ Is the market for the client's products relatively stable, or highly seasonal and volatile?
- ▶ Describe competition - are there many businesses competing in the community or in neighbouring communities with the same type of activities as the client's business?
- ▶ What is better/different about the goods produced compared to what is available from others?
- ▶ If someone started the same business in the client's community, would the client's sales decrease? Would that person be able to make a living as well?
- ▶ Has the number of businesses doing the same activity in the region changed since the client received a financing? If so, how and why?
- ▶ Has there been a change in the location of the business? If, yes, what were the reasons?

- ▶ Can the entrepreneur spare enough time to participate fully in the activities and/or run the business?
- ▶ Is the client maintaining adequate financial controls and records, such as a cash book, sales book, purchase book, stock book and expense account/ledger?
- ▶ Does the client reconcile his cash book with bank statements on a monthly basis?
- ▶ Is the client drawing too much money for private use from the business? Is the client paying personal expenses through the business account?
- ▶ Does the entrepreneur know about upcoming payments due and other financing conditions?
- ▶ Does the client prepare - a profit and loss statement, cash budget, balance sheet, costing of his products, costing per order?
- ▶ Does the client require training in running the business?
- ▶ Does the client have control over her own financial resources?

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#### Contact Information

Office: Economic Empowerment Department  
Islamic Development Bank  
8111 King Khalid St., Al Nuzlah Al Yamania Dist. Unit No. 1  
Jeddah 22332-2444, Kingdom of Saudi Arabia

Phone: +966 12 6361400  
E-mail: [infoeed@isdb.org](mailto:infoeed@isdb.org)  
Website: [www.isdb.org](http://www.isdb.org)