Middle-East Journal of Scientific Research 17 (3): 359-366, 2013
ISSN 1990-9233

DOI: 10.5829/idosi.mejsr.2013.17.03.12160

Designing Islamic Microfinance Products for Islamic Banks in Malaysia

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Abstract: Microfinance is recognized as a developmental tool to fight poverty. Recent studies have shown positive impacts of the microfinance on the income and health of the clients. It has started in Bangladesh and spread to other continents of the world. However, there is agitation that microfinance has not been able to achieve its objective of fighting poverty. This is due to the shift that has taken place in the industry from poverty focused to profit oriented business. Above all, microfinance faces other challenges on its way to succeed. One of the major challenges is that the product is not universally applicable or it does not tailor with the belief system of the Muslims. Since interest (riba) is prohibited in Islam, many Muslims denounce conventional microfinance for fear of violating their religious injunctions even though many others have accepted it out of necessity. The objective of this paper is to propose a shariah compliant microfinance product in Islamic banking operations particularly in Malaysia.

Key words: Microfinance · Islamic microfinance · Poverty · Malaysia

INTRODUCTION

In the last 3 decades microfinance has been recognized as an effective in poverty reduction, income enhancement and health and education improvements [1]. The impact of microfinance is more visible in countries where poverty is high mainly developing countries such as Asia, Latin America and African continent. In fact, the founder of contemporary microfinance Muhammad Yunus started the initiative in a village in Bangladesh in late 1970s and subsequently spread not only to other parts of the country but also some developed and developing countries. Although the number of people living on less than 1.25 USD per day have declined from 1.8 billion to 1.4 billion between 1990 to 2005 [2], yet reducing this to below 1 billion by 2015 requires concerted effort from various stakeholders at national and international environment.

However, conventional microfinance does not tailor with the culture and belief system of Muslims where they exist [3, 4]. And even if the finance is made available, some poor folks are voluntarily excluded because of the nature of the product [5, 6]. This poses challenges to the targeted number of poor to be reached by the microfinance industry by 2015 and this has an implication on the millennium development goals of fighting poverty. Microfinance itself is not a magic or panacea to poverty but rather it facilitates its reduction significantly. This is more effective when the services are widely defined to include not only credit but also insurance, remittance, savings and deposits.

In Malaysia, microfinance faces several challenges. First, there is resistance of the conventional microfinance among some Muslims in the country due to its dealing with interest that is prohibited in Islam. Conventional microfinance offers simple interest based deposits and

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loans, the Islamic system provides an array of instruments for mobilisation of funds, financing and for risk management [7].

However, some clients either are unaware or they are facing no option but to take the loan with interest. The agitation becomes more pronounced when the Islamic banking becomes applicable in the country Hassan, Abdul Rahman, Abu Bakar and Lahsasna, [8]. The adverse effect of interest rate also is aggravated when the market fluctuates down ward and business profits become low. Experts and opinion leaders propose alternative cause of action but not much has been done to develop the products applicable by Islamic microfinance institutions. The objective of this paper is to propose a shariah compliant microfinance product in Islamic banking operations particularly in Malaysia. The paper is divided into 4 major sections. Section 2 focuses on the related literature on microfinance in general and in Malaysia. Section 3 presents Islamic microfinance and the proposed model. Finally, section 4 concludes the paper.

Related Literature Review: Microfinance has been growing rapidly in the past three decades to serve the 'non-bankable' segment of the society and being used as an effective tool to fight poverty. Islamic finance is another fast growing industry both in Muslim majority countries or not. Both have common features that are caring for the society, advocate entrepreneurship and risk sharing, focus on developmental and social goals, promote social justice and financial inclusiveness [9, 10]. However, the growth of Islamic microfinance is still way lagging behind its conventional counterpart both in market penetration and performance. There is an unmet demand for Islamic microfinance product in the market [9, 11]. Nonetheless, microfinance is considered as a risky and costly business for banks due to information asymmetry, adverse selection and moral hazard [12] hence is justified as not economically viable, thus commercial banks do not pay much attention to it. As a result Brugnoni [9] stated that most microfinance providers are dominated by NGOs.

Microfinance is one of the tools which can either be a deposit, a disbursement of small size loan in generating project or business expansion, payment services, money transfers or micro insurance to poor low income household and their micro enterprises [1]. The poor are presumably being considered as 'non-bankable' and not credit worthy due to their lack of physical assets; hence granting credit to them is 'very risky'. Nevertheless, the Grameen bank model that was introduced by Yunus [13] overcomes this predicament and the poor are given the chance to provide 'social collateral' instead. This is done through group lending, peer monitoring, joint liability and eventually has effectively increase repayment rate, decrease adverse selection and significantly reducing cost especially loan loss [14].

Hence, the key benefits of microfinance are provision of capital to the micro entrepreneurs; easy fast and convenient delivery of the services to the clients [15]. However, it has other challenges such as high cost of capital, exploitations of the poor, lack or entrepreneurial development scheme, mismatch between demand and supply and lack of shariah compliant among others [4, 7]. Some of the challenges are argued to be obstacles to poverty reductions.

Financial Sustainability Versus Poverty Reduction: There has been a debate on one of the major issues in microfinance that is sustainability. Some scholars opined that microfinance can be commercially and financially sustainable while others argue that the objective of microfinance is not profit oriented but rather poverty reduction, so any microfinance that wants to provide services should be not-for-profit. Mohammed and Hasan [3] stated that a microfinance institution (MFI) is either a government agency, NGO supported or a mix of these. The authors also commented that many MFIs had problems of funds sustainability due to overdependence on government funding and donations. MFI are therefore argued to be commercialized in order to be self-reliant [16].

Churchill [17] and Norell [18] attempts to incorporate banking practices into MFI and found that the impact of customer loyalty, credit scoring, follow up on loan arrears, updating and enforcing credit policies add value to MFI and crucial factors to their successes. MFIs can even turn into profitable entities as mentioned by Brau and Woller [14] that they (MFIs) can work towards double bottom line, both financial and social. BancoSol is an example of MFI turned into commercial banks. Started in Bolivia as a non-profit micro lending entity called PRODEM it then grew into a bank called BancoSol after outstripping the capacity of the local banking system in supplying its lending capital. Among the shareholders of BancoSol are ACCION International, Bolivian business leaders, Calmeado Foundations, Bolivian banks and other investors. Within 5 years, BancoSol declared its first dividend. The program keeps on growing until today. On the other hand Woller [19] found that MFI commercialization will cause mission drift but believed that the good impact of it is much more than the downside. Applying microfinance in formal banking will promote good and inclusive financial governance which make it more efficient. Woller also stressed that MFI however must stay focus on poverty alleviation rather than making profit.

Conventionally, microfinance as a financial services need by the low income earners will be supplied by the financial markets. However, the major stumbling block is the credit rationing by the banks and financial institutions. Since poor has neither collateral nor credit record the credit supply theory suggest that he would pay an amount of interest above the market rate or the credit is rationed according to the perceived risk. Apparently commercial banks either overestimate the risks or underestimate the gains from lending the poor micro-entrepreneurs [20]. Other reasons could be that they are unaware about the technology to reach the poor and the policy regulation could impose certain requirements that stand as barriers to access loans by those groups of people [21].

Microfinance in Malaysia: In its effort to ensure sustainable microfinance in the country, the Bank Negara Malaysia has set up various strategies and policies to support the sector. Some of these strategies are to ensure financial inclusiveness whereby the financial sector meets the needs across all segments of society, fair and equitable practice with empowered and educated consumers.

Of the total establishments in Malaysia, 80 percent is microenterprises whose financing attracts less attention to the financial institutions particularly commercial banks. In a study conducted by Bank Negara Malaysia only 13 percent of microenterprises indicated that financial institutions were their main source of financing. Majority sourced funds from own money (34 percent) followed by friends and family (24 percent). The contribution of SMEs to the economy is 32 percent in 2010 and is expected to reach 41 percent in the year 2020. In terms of employment, SMEs employs 59 percent of total labour force in the country in 2010.

Malaysia establishes several government agencies to finance micro, small and medium enterprises. Microfinance providers in Malaysia are dominated by government agencies and NGOs which is also typical in other places in the world as stated by Brugnoni [9]. Their main activities are all directed to reduce the number of household poverty that is “to disburse small loans on reasonable terms exclusively to the very poor households to finance additional income generating activities” [22]. The target is the poor and the bottom of the pyramid group. For the purpose of pilot study Gibbons and Kasim [22] developed the mean test to identify the right target group and reach them out. The identified target group were offered loan with no collateral. The impact studies conducted on Amanah Ikhtiar Malaysia shows good results it has brought to the community [23].

With a population of more than 28million of which 60 percent is Muslims, Malaysia stands as a large consumer market for micro-entrepreneurial development. Giving its strong infrastructural environment the entrepreneurs are more likely to thrive compared to when the infrastructure is weak. In Malaysia, there exist a huge number of financial service providers, some in form of formal bank others NGOs or government based agencies that specialise in supplying finance to individuals and businesses. One of the major suppliers of financial services to the poor is Amanah Ikhtiar Malaysia (AIM) that has started in 1987. The objective of AIM is to reduce poverty through income generating activities undertaken by the clients. However, AIM follows Grameen Bank model of loan disbursement although it charges only 10% on loans above MYR 3000. The model also has weekly meeting by the clients or sahabat. The repayment rate is more than 95 percent [8, 23].

Despite its achievement in having nationwide coverage with the clients of over 300,000 sahabat, there are obstacles and challenges that need to be overcome. One of these challenges is the modus operandi of giving loan on interest. Islam prohibits taking and giving loans by Muslims. Critiques argue that certain agencies extend financial transaction on interest to the rural poor whose hitherto were not indulging in such practices. Similarly, the lender borrower relationship that allows risk on the clients only is another issue of paramount importance. Islamic mode of finance has encouraged risk sharing as well as profit sharing. There is no return without risk. Hence, partnership modes of financing are best suited for Muslim communities and it enhances productivity and wealth sharing in the society. It links the capital owner with the user in a cooperative way and developmental manner. Islamic microfinance could work with other networks such as retailers and wholesalers in a cooperative manner to achieve business success of micro-entrepreneurs. [24] argues that mainstream banking system based on financial collateral and interest loaded loans cannot be friendly to the needs of grassroots development. In contrary, Choudhury [24] argues that Islamic banking by their interest free instrument and friendly operation are able to mobilise savings and generate a cordial relationships between the staff and the micro-entrepreneurs at grassroots as the case in Bangladesh.

Islamic Microfinance and the Proposed Model: According to Chapra [25] lack of access to finance by the poor entrepreneurs brings about lack of broad-based ownership of businesses and industries which in turns, hinders realisation of egalitarian society. This phenomenon is rampant is Muslims majority countries, thus requires attention from Islamic financial institution.

Islamic microfinance represents the combination of two rapidly growing industries: microfinance and Islamic finance. However it is such a risky and costly business that many Islamic banks shy away from providing the product. Microfinance institutions (MFIs) are dominated by non-government organizations (NGOs).

Islamic finance products including Islamic microfinance should be according to shariah that is free from riba, gambling, ambiguity or uncertainty (*gharar)* and *haram* activities [26]. As interest is prohibited in Islam, financing contracts are conducted differently than the conventional way. They are done according to sales or lease contracts. The most widely available types are *Murabahah* sale (cost plus mark-up), *Ijarah* (leasing), *Mudharabah* (profit sharing), *Musharakah* (profit and loss sharing) and *Qardh* (loan).

Hassan and Mahknecht [7] find that Islamic microfinance in Indonesia has lagged far behind their conventional counterpart in raising funds through deposits. In the case of Malaysia, the Islamic microfinance institutions need to redesign many of deposit products by considering the needs and preferences of the clients. Islamic microfinance can mobilise funds through partnership modes of financing or modern equity [7].

The financing instruments are (1) profit-lost-sharing such as mudarabah and musharaka (2) sale-based modes such as murabaha (3) Lease based mode such as ijara and (4) Qard-Hasan. It should be noted that many Islamic financial Institutions prefer murabaha because it requires no credit record of the client, there is existence of well-defined contracts and lower administrative cost. However, profit loss sharing generates high return for the institution.

In addition Qard Hasan has been found as an effective mechanism of financing poor. Given its strong religious connotations, Qard Hasan is used by many Islamic microfinance Institutions such as *Baitul mal wal tamwil*, Indonesia to mobilise funds and finance micro entrepreneurs. It has also been practiced in Egypt to relieve poor from conventional microfinance debt [27]. The cordial relationship and strong bond between the institution and the client reduces default and delinquencies to the minimum [7].

Islamic microfinance institutions use Islamic insurance mechanism to mitigate risk. This could be through the popular technique called kafala or guarantee in the case of individual client or social collateral in the case of group lending/project. This however, may be inefficient, causing the need for additional actions such as compulsory savings or micro-takaful.

It should be noted that Islamic microfinance is far better than its conventional counterpart in terms of richness and varieties i.e. the scope and various products applicable to different group of people. These include sale based contracts, partnership contracts and leasing type contracts. However, practically, Islamic microfinance is lagging behind in terms of penetration and coverage [7].

Product Development in Islamic Microfinance Sector: One of the challenges of Islamic microfinance is the murabaha centric despite the various products of Islamic microfinance as describe in this paper. This leaves the application of partnership based contracts unrealised fully in spite of the numerous advantages of profit and loss sharing. This could also be attributed to the perceived risk involve in practicing the product.

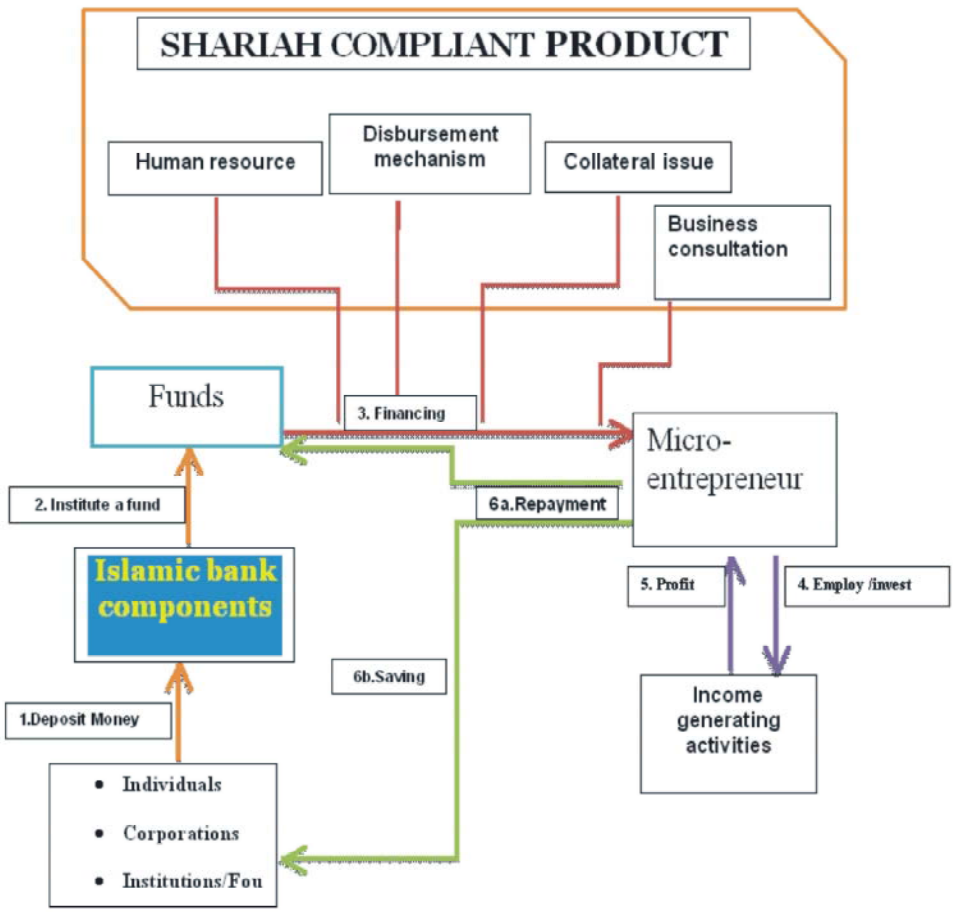
In addition, Shariah compliant is one of the major distinguishing features of Islamic microfinance. However, currently, Islamic microfinance does not have such board to ensure sharia compliance by the institution. Hassan and Mahknecht [7] suggest that the institutions could pool resources together to form shariah board.

Hassan and Mahknecht [7], highlight cases whereby the interest based loans would like to highlight their closeness to the spirit of shariah due to their benevolent nature. For instance, in the case of India, successive government have been providing loans through microfinance institutions at much lower interest rate and during hardship or bad season or business failure the loan is either waived, or extended for future payment. As a result, the practice was claimed to be more equitable than profit and loss sharing. Islamic microfinance treats delinquency and waving on case by case.

On the deposit side, micro-saving of the investors and pooled and invested in form of mudaraba that give return the savers. Islamic microfinance could scale up the growth of ISMFIs and overcome the capital needs. In conventional microfinance there is increasing investment in Microfinance Investment Fund through bond and equities. Recently, Islamic Development Bank initiated Islamic Microfinance Investment Fund.

The need for developing Islamic microfinance products is stressed by Hassan and Mahknecht [7] According to them "There is indeed the need and considerable scope for Islamic microfinance providers to develop new products as a solution to a variety of financial problems. However, the right approach to product development is a strategic one that takes a holistic view of microfinance as a composite product meeting the needs for financing, saving and investment, insurance, remittance and other services". This paper proposes a shariah compliant microfinance product in Islamic banking operations particularly in Malaysia.

The Framework of Integrating Microfinance in Islamic Banking Operations



THE PROPOSED MODEL

In the above model or structure we can observe the following:

- Individual, institution and Corporations deposits their money into the bank under shariah compliant agreements.
- An Islamic bank institute a pooled fund composed of different deposits.
- After instituting the fund, the bank prepares a product (contract agreement) that can be used when lending the money to the microbusiness people
- Microbusiness people employ or invest the funds they obtain from an Islamic bank into income generating activities.
- The profit that the microbusiness people generate is shared into two parts:

6a. as the repayment it can be in form of rentals if it is ijarah or the share of profit if it a partnership

6b. as savings that go into the individuals, corporations and other institution like unit trusts. Then the cycle continues

Ijarah financing can be the viable mode for the above model. Al-ijarah is a contract whereby the lessor (Islamic Bank) will rent the asset(s) to the lessee (customer) over a certain period and at a monthly rental amount as agreed by both parties. An example can be a person who wants to produce juices and sells to students but needs a small machine to start his business. In this case, the bank will buy the needed machine say at RM1000 and rent it to the customer. The customer in turn will be paying rentals for its use. The remaining of the money after all expenses are deducted will be either saved or used in expanding the business thus re-invest in the same business.

Another viable mode can be Musharaka mutanaqisa (diminishing partnership). Musharaka mutanaqisa is a form of musharakah (partnership) which lead to the ownership of the asset or the project by the client. In this mode the bank participate as a financial partner, in full or in part for a project or business venture. The agreement clearly states profit-sharing ratio amongst the partners. For example let us say 90% of the cost of the machine as in the above case of a juicer producer is paid by the bank and the remaining 10% will be provided by the customer. The profit from the use of the machine will be shared based on the agreed ratio say 30:70. Thus the bank will have 30% of the profit and the client 70%. The customer will have to relinquish his part of share for the bank in order to have great share and slowly pushing the bank out of the partnership until the customer owns the machine fully. What it means here is the client will be getting less profit as agreed in the contract agreement.

In *murabah* financing, the bank will buy the machine and sale it to the customer at cost-plus on deferred payments. In this mode, the customer fully owns the machine but have the liability of paying the purchasing price to the bank either at lump-sum in future or instalment. In the preceding case, the bank will buy the machine at RM1000 and sells to the client at RM100 plus profit margin or mark-up say of 10%.

Mudharabah contract, whereby one party acts as capital provider and the other acts as the service provider can be also the viable mode. The bank will be the capital provider and the client will come in the partnership with his skills by providing necessary services. As the in our case, the bank will provide the cost of the machines and the client will be the operator and seller of the juices. The profit will be shared amongst them based on pre-agreed ratio. Of course if the loss incurred the bank will lose his capital and the client will lose his time and effort, thus he loose the opportunity cost.

Justification for the Proposed Model: Given the rapid growth and development of Islamic finance in Malaysia, Islamic banks can reach to the lower bottom clients than any other alternative. For instance the growth of Islamic bank branches in Malaysia increased from 126 in 2004 to 766 in 2005 [28]. In fact, recent data shows double digit growth not only for the industry but also for individual banks.

On different note, Islamic banks are expected to provide corporate social responsibility to promote peace and stability among members of the society. According Prime minister of Malaysia Datuk Seri Najib Islamic microfinance represents an opportunity for Islamic finance to develop ethical yet profitable products [29]. In line with this, certain funds could be created to donate for instance, 1 percent of gross profit to foster entrepreneurial development in the society. This fund could be channelled to micro entrepreneurs through the proposed structure of the model. The return and the capital could be used for revolving funds and at the same time banks` annual contribution continues. It has been established also that access to capital at subsidized rate improves the performance and goal attainments of microfinance Ly and Mason [30].

The existing structure of the banks could be utilised to reduce significantly the cost of delivering finance to the poor. Islamic banks could utilise their current staff and structures as well as facilities to reach the largest number of potential poor entrepreneurs. Products such as mobile banking can assist in targeting rural poor and that would eliminate or reduce significantly transaction costs.

The potential demand for tailored microfinance services according to Segrado [31] is still largely unmet especially where Muslims are in majority such as Malaysia. Similarly the high demand for Islamic banking in low and middle income classes would require merging Islamic banks and microfinance supply. Some researchers suggest that the underlying causes for of the genesis of modern Islamic economics was motivated by the desire to reflect beliefs about Islamic identity than to establish a more ethical or religiously sound banking system [31]. However, this seems to be disputed by the recent financial crisis that has proven not only the viability of Islamic banking and finance but its resilience to crisis when it occurs.

Challenges of the Proposed Model and Solutions: One of the challenges of Islamic banks providing microfinance is achieving suitable support from the government and regulators in the market [29]. This can be relatively easier to overcome in case of Malaysia since the government especially the Central Bank of Malaysia is proactive in favourably regulating the Islamic finance industry.

Human capital requirement is another potential challenge that could face the Islamic banks in the supply of Islamic microfinance. This is not only for the clients but also the institutional staff. Traditional microfinance services are delivered to the clients directly by the institution. The ratio of staff to client must be reasonable and kept at minimum. However, this could raise the administrative cost high. Islamic banks could be utilising various means such as mobile banking, agents and petrol stations.

In addition, sharia expert that would be needed to facilitate product development is another issue at stake. Even the existing practice requires more sharia advisors as their number is still small. When the activities are widen, there would be much higher need of the sharia advisors and that would add to the cost of the banks and subsequently the product prices.

Moreover, the proposed model is likely to face some elements of resistance from some quarters since the mind-set of the practitioners is toward financing big and more profitable business. This may not be the case in microfinance. However, it should be noted that, Islamic banks could create a separate departments to deal with micro-entrepreneurs whose may have different evaluation criteria for loan/contract approvals. It is worth mentioning also that project viability is an important factor for approvals by the banks. Islamic finance has the dual objectives of maximising profits as well as welfare of the society through creation of financial institutions that can offer effective financial services at the grass root levels [32].

CONCLUSION

The three decades of microfinance has generated various responses in the academia, industry and policy makers. Generally, microfinance is celebrated as an effective tool of fighting poverty. However, the conventional microfinance faces some obstacles that retard its full utilisation as poverty reduction mechanism. Some of these obstacles are charging high and fixed interest on loans which is prohibited in Islam, low outreach of microfinance. This led to the emergence of Islamic microfinance in some Muslims countries and communities. Despite this development, Islamic microfinance institutions could not reach larger number of the poor. In view of this, the research felt the need to design and develop Islamic microfinance products for Islamic banks. Given their customer base and widespread branches and technologies, Islamic banks, are likely to make a significant dent on poverty reduction in Malaysia. On top of that, Islamic microfinance and Islamic banking shared fundamental principles of ensuring wealth circulation in the society and betterment of the poor individuals. The research present the proposed model that would be used to incorporate Islamic microfinance services by Islamic banks in Malaysia. Further research would be carried out among the staff of Islamic banks to investigate suitability and application of the model as describe in the previous section.

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