

The Efficiency of Microfinance Institutions Applying Principles of Islamic Banking

Bachelor Thesis

in

Microfinance

at

**The Swiss Banking Institution of
the University of Zürich**

with

PROF. DR. URS BIRCHLER

Author: BENJAMIN FLORIAN ISLER

Date of submission: 07.10.2010

Executive Summary

Problem

The Islamic religion brings some new issues into the banking sectors, which affect their common service delivery. The main issue is the prohibition of interest, the so called *Riba*. The common services like savings and loans are affected by that. Since loans as well as savings request interests in return for the delivery. Like mention this is forbidden in the Islam and subsequent are the Islamic banking institutions facing a major challenge, which is how else to deliver these services.

Regarding this issue in the context of microfinance has even a greater impact. Because microfinance institutions do not request any collateral to secure their loans, thus they have to charge higher interest rates to compensate the additional risk. This method is impossible in Islamic banking. Therefore the Islamic microfinance institutions have to develop different lending methodologies. This affects the *efficiency* of the Islamic microfinance institution, because the new lending methodologies are more costly and therefore less efficient. Therefore it is assumed that there is a gap of *efficiency* between conventional and Islamic financial institutions.

The aim of this thesis is to measure if there is an actual gap in *efficiency* between conventional and Islamic microfinance institutions and if yes, give possible improvements.

Approach

The thesis uses a theoretical analysis of the cost structure of the products offered by conventional and Islamic microfinance institutions. After this the products potential cost *efficiency* is compared, in order to make a hypothesis, which institution should be more efficient. Then the thesis analyses two institutions, a conventional and an Islamic microfinance institution. The institutions are analysed, using traditional performance indicators and ratios. After analysing their overall performance the institutions are compared, to reveal which is more efficient. In order to make the comparison easier the institutions are located in the same country.

Findings

The thesis reveals that there is an actual gap in *efficiency* between conventional and Islamic microfinance institutions. It shows that this is mainly due to the different products offered. Since they are less cost efficient and therefore generate less income. Thus the *efficiency* of the Islamic microfinance institution is affected and this is revealed by this analysis.

The thesis suggests that Islamic microfinance institutions can improve their *efficiency*, by offering a bigger range of products. Also in the particular case of this thesis, the institution analysed is not for profit. Thus it just offers products not generating profit. Therefore this particular institution can improve its *efficiency* easy by offering any sort of for profit products. The thesis makes other suggestions to improve the *efficiency* of an Islamic microfinance institution, but these are not as contributing as the products.

General Assessment

It is expected that Islamic microfinance institutions are less efficient than conventional microfinance institutions. This is due to the prohibition of interests and the therefore different lending methodologies. These are more costly, because the lenders have to be screened and monitored better and over a longer time. Thus it is suggested that the financial services offered by Islamic microfinance institutions generate lower income than those of conventional microfinance institutions. Subsequent is the Islamic institution itself less efficient. But since the market of Islamic microfinance is young and still emerging, there is no empirical evidence for this hypothesis, now.