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Original Research Article

Initiation of Sustainable Islamic Microfinance Institutions in Pastoralist Area

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Abstract

Microfinance Institutions (MFI) are expanding their reach in Ethiopia at an accelerating trend. The study has attempted to look at the initiation of sustainable Islamic MFI in Afar region. Concurrent triangulation strategy was adopted to address the research objectives. In order to get relevant data, descriptive research design and quota sampling methods were used. And survey have been taken through questionnaire from three Zones of Afar region namely Zone 1 (Awsi Resu Zone), Zone 2 (Kilbeti Resu Zone), and Zone 3 (Gebi Resu Zone), with a total sample size of 227 pastoralists, document review and face to face interviews conducted with the officials responsible for initiation of MFI in Afar region. The results showed that the nonexistence of statutory provisions regarding to the operations of Islamic microfinance institution resulted to delay its introduction in Afar region. In addition, the assumed high transaction costs that will be incurred in providing financial services to pastoralists pointed as challenging factors. To overcome these, laws and regulations should be designed to foster the establishment of Islamic MFI and also use Islamic microfinance models such as mudharaba, musharaka, murabahah, ijarah, qard al-hasan and others models that comply with Shariah principles.

Keywords: Islamic Micro Finance Institutions, Financial services, Concurrent triangulation Strategy, Pastoralist.

1. INTRODUCTION

Financial institutions facilitate the flow of funds between savers (suppliers) and to those who demand funds. Hence, there are various types of financial institutions. These include banks, insurances, stock markets, microfinance institutions (MFI), saving and credit associations and so on. Their business operations also varied among the types of financial institution. However, as Greenbaum and Thakor (2007) noted, all financial institutions have common characteristics in processing risk and information that could arise during the matching of supply and demand of funds.

In addition to the above general function of financial institutions, microfinance institutions play major role to alleviate the poverties of poor citizens. As Srnec and Havrland (2006) defined microfinance, it is the supply of loans, savings, and other basic financial services to the poor. In a broadest term, microfinance is the provision of various types of micro-financial services to the poor and low income households that cannot get the usual services of commercial banks due to various challenging factors, such as lack of collateral to borrow from them, inaccessibility and so on.

Recognizing the benefits of MFI, in Ethiopia, now a day numerous microfinance institutions established. As National Bank of Ethiopia (2014/15) reported, by the end of 2014/15 there are about 35 microfinance institutions in Ethiopia. However, their spread throughout the country is not satisfactory. In this regard, Wolday and Anteneh (2011) pointed out that MFI in Ethiopia have shown remarkable progress, but the thirty MFI as of 2009 meet only less than 20 percent of the demand for financial service of the financing exclude population. This indicates that most of poor and low-income households could not get financial services easily.

Among the pastoralist areas of Ethiopia, Afar regional state is the one which is located in the north east part of Ethiopia. According to Central Statistics Agency of Ethiopia population census report of 2007, 95.3 percent of the people are Muslims. The report also indicated that more than ninety percent of the people are pastoralists while the remaining are agro-pastoralists. Besides, based on the agency, the regional state comprises twenty-six percent of Ethiopian pastoralists.

According to Microfinance Gateway (2015), pastoralists in Ethiopia are among the most vulnerable populations to shocks and stresses in the world. In which, the pastoralists need some sort of development actions to be maintained to enhance their livelihood and engagement with the other parts of the country.

Like the other pastoralist areas of Ethiopia, in Afar pastoralist region, there is no Islamic MFI which is licensed and regulated by the National Bank of Ethiopia (NBE) to provide Islamic financial services in the region. Concerning this, some researchers (Abdi, 2004; Nur, 2006; Kejela *et al.*, 2008; Mesaud, 2011) had undertaken research on MFI in pastoralist communities of Ethiopia.

Particularly, Kejela et al. (2008) had undertaken a research on microfinance services in Afar and Somalia pastoral communities. Their study investigated the nature, magnitude and demand for MFI in Afar and Somali regions and recommended the appropriate financial services compatible to the pastoral communities. Mesaud (2011) also studied the nonexistence of MFI in Afar pastoralist people, and based on the demand side, the researcher recommended the introduction of MFI in Afar region as a key to alleviate the problems faced by pastoralists.

Even though various researchers conducted studies on MFI in pastoralist communities, most of them concerned with the economic value of introducing MFI, i.e., alleviating poverty. However, prior studies have not studied the factors that could impede the introduction of sustainable Islamic MFI in Afar pastoralist communities and their counterparts that can help to enable the introduction of sustainable Islamic MFI in the region. Thus, this research has tried to study the Initiation of sustainable Islamic MFI in Afar region. As a result, the study could have implications to take corrective actions to establish Islamic MFI that can benefit the pastoralist people of Afar region. As well as, the study attempted to contribute to the literature body by studying the issues involved on Islamic MFI.

2. LITERATURE REVIEW

Microfinance has been defined by different authors, but the central theme of its definition concentrated around the provision of micro-financial services for the poor. Hereunder, two definitions of microfinance presented. Srnec and Havrland (2006) defined microfinance as:

"…*the supply of loans, savings, and other basic financial services to the poor. Hence, people living in poverty, like everyone else, need a diverse range of financial instruments to run their businesses, build assets, stabilize consumption, and shield themselves against risks*."

From the above definitions, one can understand that microfinance is the provision of micro (small) financial services such as saving and credits to low-income and poor households in order to tap the problems arising from poverty in which the loan amount gained from MFI invested in micro-enterprises and some number of incomes from the micro-enterprises saved in MFI.

MFI use various types of financing models to provide the appropriate financial service for the poor and low-income households. Hence, the existence of various conditions leads to use specific type of microfinance model which is twofold, i.e., tackling problems and utilizing benefits originated from the conditions.

According to Obaidullah and Khan (2008), good microfinance programs are characterized by small, usually short-term loans; streamlined, simplified borrower and investment appraisal; quick disbursement of repeat loans after timely repayment; and convenient location and timing of services. Thus, providing micro-financial services shall be tailored to the needs of the clients and conditions involved in providing services.

Rasmussen (2007) indicated that commercial MFI consist of two types that are ordinary banks, which have decided to commit some of their organization and capital to microfinance activities targeting poorer groups, and non-profit MFI who have transformed themselves into commercial institutions. As author classified, the second type of model is non-profit MFI that are both NGOs and the so-called non-bank financial institutions. A typical characteristic of this model is that all of the income from the activities in the organization will be invested in the development of the organization.

As Obaidullah and Khan (2008) indicated, the popularized model that has been replicated in many countries in a wide variety of settings is the Grameen Bank model. In this model, potential clients are required to organize a peer group that will commit to a mutual loan repayment guarantee. Loan is then delivered through small affinity-based groups, usually five to seven members in each group (Getaneh, 2010).

Zahid Mahmood (2017) gauge the impact of Islamic microfinance on the household welfare of the target clients by observing its impact on health, education, income, expenditures and assets of the poor who took loan from Islamic Microfinance institutions (IMFIs). Results delineate statistically significant differences in Pre and Post borrowing scenarios in the welfare indicators of the target households. It has been observed that borrowing from Islamic Microfinance institutions has not only significantly raised monthly income; expenditures on food, education and health; and incremented households' assets but also surprisingly raised borrowed amount of loan which negatively affected income.

Zahoor Khan *et al.* (2018), case describes how Akhuwat - an Islamic microfinance NGO, working in various parts of Pakistan on qard. al-h. asan basis, significantly reduced high operating cost through its innovative and Islamically charished process of benovelence and cooperation. In conventional microfinance models, high operating cost is usually considered as unavoidable cost and is ultimately transferred to the poor clients as direct credit supply cost. Akhuwat first channelized qard. al-h. asan to the poor and financially marginalized communities in Lahore region through technically viable, cost efficient, socially responsible and religiously compatible processes which distinguished Akhuwat model of Islamic microfinance.

Bayu ArieFianto *et al*. (2019) investigates the determining factors of non-performing financing in Islamic microfinance institutions (MFIs) in Indonesia. Using logistic regression, the study sample comprises data from 140 clients; 90 with a good financing status and 50 with a poor financing status. The results show that age, gender, occupation, and type of contract influence the non-performance of clients of Islamic MFIs in Indonesia based Probit regression confirmed the results.

Md. Nur Nobi *et al*. (2021) investigate the effect of the Islamic Micro Finance on the resources of individuals borrowing from an Islamic microfinance institution and their poverty status. The analysis shows that the Islamic micro finance is an instrument that can help to accumulate savings and income and finally assist to alleviate their poverty and at the same time it is not only the instrument that can alleviate poverty but it is the vital component that can help to the poor people for standard living levels.

In Ethiopia, most of MFI use the Grameen Bank model (Getaneh, 2010), that is group guarantee lending model. According to the author, the group guarantee lending model well-matched with the social structures in rural Ethiopia, it also removes the problem of collateral requirements when the needy poor seek loan from MFI. However, there is no formal MFI that use any of the above-mentioned models in pastoralist areas.

As per Obaidullah (2008), interest rate - high or low, is rejected by Muslims as tantamount to *riba* (interest) - something that is prohibited in no uncertain terms by the Islamic *Shariah*[1]. Besides, Smolo and Ismail (2011) also claimed the prohibition of interest payment and receipt by *Shariah*. Consequently, financial exclusion worsened in Muslim societies by their aversion to microfinance that is based on interest or *riba* (Obaidullah, 2008). Despite this fact, there are other types of models that consider the issues involved in providing financial services for Muslim communities.

Various studies claimed that Islamic MFI introduced recently in order to overcome interest-based loans of MFI (Smolo and Ismail, 2011; Parveen, 2009). As Smolo and Ismail (2011) highlighted, Islamic MFI is one of the components in the Islamic financial system that offers a wide range of financial services to those people who are excluded from the formal Islamic financial system, mainly because they lack the guarantees required by an Islamic financial institution.

Providing microfinance services that preserved *Shariah*[1] principles for the needy poor of Muslim people is appropriate. The article of Smolo and Ismail (2011), using contractual framework, abled to explore Islamic MFI models. As per the authors, *Shariah* compliant contracts that can be easily used by Islamic MFI, among others, are as follows: (i) *Mudharaba* (profit and loss sharing); (ii) *Musharaka* (partnership); (iii) *Ijarah* (leasing); (iv) *Ijarah wa iqtina* (lease to purchase); (v) *Qard al-hasan* (benevolent loan); (vi) *Murabahah* (cost-plus financing); (vii) *Bay al-salam* (pre-paid purchase); (viii) *Bay al-istisna* (progressive financing); and (ix) *Musharaka mutanaqisah* (diminishing partnership). Although Smolo and Ismail (2011) do not prioritized these nine models, the authors had cited from other studies that the *murabahah* (cost-plus financing) as the most preferable by Islamic MFI because a very small number of clients keep books.

According to Frasca (2008), the three models which are most relevant to microfinance are: *mudharaba* and *musharaka, murabahah*, and *ijarah*. Hence, the author claimed that *musharaka* and *mudharaba* are profit-loss sharing schemes which are most often encouraged by *Shariah* scholars. However, there are differences between *musharaka* and *mudharaba*. Concerning this, Obaidullah (2008) noted that in *mudharaba* model the MFI provides funds to finance specific venture indicated by the micro-entrepreneur and the institution become the owner of the capital and the micro-entrepreneur is responsible for the management of the business and provides professional, managerial and technical expertise for initiating and operating the business enterprise or project. In this model, profit is shared according to a pre-agreed ratio, whereas losses are entirely absorbed by the capital provider, i.e., MFI.

In *musharaka* model, micro-entrepreneur and the Islamic MFI agree to combine financial resources to undertake any type of business venture, and agree to

[1] *Shariah* is Islamic law and its primary sources are the *Holy Qur'an* and the *Sunnah*. *Sunnah* refers to whatever was reported that the Prophet Muhammad (peace and blessings be upon him) said, did, or gave his tacit approval, which are followed by the consensus of the jurists (*ijma*') and analogy (*qiyas*) (Smolo and Ismail, 2011).

manage the same according to the terms of the agreement. Profits and losses are shared between the MFI and the micro-entrepreneur in the pre-agreed ratio and in proportion of their capital contributions, respectively (Obaidullah, 2008). On the other hand, as the author indicated, with *musharaka mutanaqisah* (diminishing partnership) the Islamic MFI share in the equity is diminished each year through partial return of capital, whereas the micro-entrepreneur's capital steadily increases over time, ultimately resulting in complete ownership of the venture.

Murabahah, as Smolo and Ismail (2011) indicated, is cost-plus financing model used by Islamic MFI. In other words, it is an asset-backed sales contract used to finance the purchase of goods needed by the client as working capital (Frasca, 2008). To carry out this model, the client applies a request to specific asset from the MFI, then the institution will acquire the requested asset from the market and sales backed to the client at cost plus markup price on account. Hence, the ownership to the asset remained to the MFI until the client entirely repays the institution using installment or lump sum payment methods. As Frasca (2008) argued, the markup or profit margin in *murabahah* model is distinct from interest as it remains fixed at the contract's inception and even in the case of past due date.

Based on the definition of Obaidullah (2008), *ijarah* implies leasing or hiring of a physical asset, i.e., it is a popular debt-based product in which the MFI assumes the role of a lessor and allows its client to use a particular asset that it owns by receiving predetermined rentals payment for a specific time period. As the author stressed, in a conventional financial lease, the lessor transfers substantially the risks to the lessee, whereas an important *Shariah* rule governing *ijarah* as a tool of microfinance is that the risk and liabilities emerging from the ownership of the asset substantially remain with the lessor - in order that its profits are deemed legitimate in the eyes of *Shariah*. As Smolo and Ismail (2011) indicated, *ijarah wa iqtina* (lease to purchase) model is similar to *ijarah*, however, the only difference between the two models is the client of MFI in *ijarah wa iqtina* model is required to purchase the leased asset at the end of the contract and rental fees paid by the client included as the price of the asset during the asset's ownership transferred.

The other type of Islamic MFI model is *qard al-hasan*, Smolo and Ismail (2011) called this model as benevolent loan. As the authors described, it is an interest-free loan given for either welfare purposes or for fulfilling short-term funding requirements, in which the borrower is only obligated to repay the principal amount of the loan without any increase. Besides, *qard al-hasan* has corresponding in the nature of non-interest bearing deposits by clients, which are regular source of funds for the Islamic MFI.

Bay al-salam (pre-paid purchase) and *bay al-istisna* (progressive financing) models in Islamic MFI are based on advance payments by buyer for a given good. In *bay' al-istisna* model, goods are manufactured and delivered based on the buyer specifications, whereas in *bay' al-salam* model goods are already manufactured prior to the buyer entered in to the contract of agreement (Smolo and Ismail, 2011).

As Smolo and Ismail (2011) recommended, *zakah* [2], *sadaqah* [3] and *waqf* [4] can be successfully integrated into the microfinance programs for the sake of poverty alleviation. Supporting this, Obaidullah and Khan (2008) also noted *zakah* and *sadaqah* as instruments of charity occupy a central position in the Islamic scheme of poverty alleviation. As Smolo and Ismail (2011) believed, Islamic MFI could act as agents or intermediaries of these three financing modes to the poor. However, the organizations that participate in *zakah*, *sadaqah* and *waqf* could be only NGOs that provide microfinance services, because the conventional MFI often governed and regulated by the financial industry overlooking body. This implies that *zakah*, *sadaqah* and *waqf* usually neglected by the conventional MFI (Smolo and Ismail, 2011), as a result their benefits to the poor people have not been utilized.

According to Obaidullah and Khan (2008), instruments of financing used by Islamic MFI may be broadly divided into (1) participatory profit loss-sharing modes, such as, *mudharabah* and *musharakah*; (2) sale-based modes, such as, *murabahah*; (3) lease-based modes or *ijarah* and (4) benevolent loans or *qard* with service charge. However, this broad classification should include the recommendation of Smolo and Ismail (2011) - charity, i.e., *zakah*, *sadaqah* and *waqf*.

In general, Islamic MFI could be established based on two approaches: not-for-profit or charity-based and for-profit approach (Smolo and Ismail, 2011). Besides, Obaidullah and Khan (2008) highlighted that in the Islamic countries, current and potential providers of Islamic microfinance services are likely to be either the conventional MFI expanding the scope of their services to include Islamic microfinance or the Islamic financial institutions expanding the scope of their services to include microfinance services. Moreover, the authors indicated that the instruments for

[2] Zakah refers to the amount payable by a Muslim on his net worth as a part of his religious obligations, mainly for the benefit of the poor and the needy. It is an obligatory duty on every adult Muslim who owns more than a threshold wealth (Obaidullah and Khan, 2008).

[3] Sadaqah refers to voluntary contributions for charity (Obaidullah and Khan, 2008).

[4] Waqf is an endowment or a charitable trust set up for Islamic purposes, usually for education, mosques or for the poor (Smolo and Ismail, 2011).

mobilization of funds to the institutions may be broadly divided into (1) charity that includes *zakah*, *sadaqah*, *waaf*; gifts; (2) deposits that may take the form of *qard al-hasan* and *mudharabah* and (3) equity that may take the form of classical *musharakah* or the modern stocks.

On the other hand, high transaction costs imped the introduction of MFI. Transaction costs refer to either money paid out or opportunity costs to access the loan. As Dehem and Hudon (2010) mentioned, different individual or group lending arrangements of MFI impose different levels of transaction costs on borrowers and lending agencies. The authors (cited in Cheung, 1969) also noted that transaction costs are any costs that arise due to the existence of institutions and the appearance of an economic exchange. Particularly, as reported in Info Resources (2008) article, provision of financial services in rural areas is associated with high unit costs both for institutions and for their clients. This is due to the fact that infrastructure for transport, communication and information technology is less developed in rural areas, as well as to the remoteness of these areas. In addition, Sileshi (2015) study found that MFI in Ethiopia are operationally self-sufficient while they are not financially self-sufficient.

Mesaud (2011) also studied to explore the challenges and prospects of introducing sustainable microfinance services for Afar pastoral population. As the researcher concluded, there were specific constraints which could increase cost of providing services to the pastoralists; however, the existence of compromising factors like good demand and culture of repayment enforcement by the cultural court could help sustainable microfinance service introduction in Afar region. Despite the researcher's attempt, it is hard to conclude about the demand and sustainability issues of MFI in Afar region using the responses of 60 respondents. Thus, this type of problem could lead to further studies in the area.

Abdu seid Ali (2020) examines the performances Islamic micro finance institutions and their implication for financial inclusion and poverty alleviation in Ethiopia. A survey was conducted on interest free micro finance windows in the existing conventional micro finance institutions in different parts of the country. The results revealed that most of the institutions provide murabaha which is a popular form of financing small entrepreneurs and businesspersons. However, the main challenges of interest free micro finance system are unavailability of clear and detailed legislation from the regulator National Bank of Ethiopia (NBE), shortage of trained and knowledgeable workforce related to interest free micro finance services, immense and arduous administrative cost of the system and clients' nonconformity with some Sharia principles like failure to deliver the item to the institution after they acquired it from the market on behalf the micro finance institutions.

3. MATERIALS AND METHODS

To get a brief understanding of the research problem and to benefit from the method adopted, mixed method design was used. Besides, concurrent triangulation strategy of mixed method has been used. This strategy characterized by the collection of both quantitative and qualitative data concurrently (Creswell 2009). As the author noted, the mixing of this approach, usually found in an interpretation or discussion section, is to actually merge the data (i.e., transform one type of data to the other type of data so that they can be easily be compared) or integrated or compare the results of two databases side by side in a discussion.

Therefore, to get relevant data concerning the issues, survey, documents review and interviews strategy of inquiry has been employed. The study's population units comprise pastoralists, in which they are expected to be the users of microfinance services of MFI. Therefore, the respondents of the survey have been pastoralist people. The report of Central Statistics Agency of Ethiopia (2007) indicated the total population size of pastoralists in Afar region as 409,123. Of this total target population, above age 19 years old are 220,500. A total sample size of 227 pastoralists with 17 non response rate taken as respondents to the survey instrument[5]. Besides, the respondents have been taken from three Zones, namely Zone 1 (*Awsi Resu Zone*), Zone 2 (*Kilbeti Resu Zone*), and Zone 3 (*Gebi Resu Zone*). Accordingly, from each Zone, 70 respondents (35 females and 35 males) who are participating in the local market place of *Aysa'ita* town (Zone 1), *Ab'ala* town (Zone 2), and *Melka-Werer* town (Zone 3) have been selected. In addition, to generate the sampling frame, lists of respondents generated using nonprobability selection from the market place till the respected Zones' sample size quota satisfied. As, Swanson and Holton (2005) suggested, nonprobability samples are often used for surveys of hard-to-identify populations and the rationale to use it is the advantage of being relatively convenient and economical.

The survey instrument has been developed based on the extensive literature review. Items in the instrument included both open ended and close ended questions. Thus, the survey instrument concurrently gathered both qualitative and quantitative data from the

[5] $ss = \frac{Z^2 * (p) * (1-p)}{c^2}$

Where:
Z = Z value 95% confidence level
p = percentage picking a choice
c = confidence interval 6.5
ss=Sample size

respondents' based on one point in time data collection procedure, i.e., cross sectional. On the other hand, face-to-face interview has been held with official who concerned with the introduction of MFI in Afar region. In respect of interviewee's character, interview questions have been prepared prior to conducting the interviews, while emerging questions also forwarded during the interview. In addition, before conducting the interview, respondent's willingness has been asked first. After getting the willingness and schedules, the researchers have conducted the interview using interview protocols. Document reviews also has been used to better understand the issues involved in the study. Relevant documents that deal about MFI in Afar region and Ethiopian case in general, has been identified and used.

Data obtained from the above mentioned three strategies of inquiry has been analyzed using quantitative and qualitative data analysis techniques. To analyze quantitative data obtained from the survey instrument, descriptive statistics were used, such as frequency, cross tab among tables, and percentage. In order to give a clear view of the finding for the quantitative data, tables have been entirely used. On the other hand, qualitative data obtained from the interview and document reviews have been noticed in to appropriate contexts and analyzed thematically. Since this study adopted the concurrent triangulation strategy of mixed methods, the analysis of both quantitative and qualitative data concurrently integrated in the analysis part.

4. RESULTS AND DISCUSSION

Microfinance is about the provision of small financial services for those individuals which are actually neglected by the conventional commercial banks. The main aim of microfinance is to alleviate the poverty of low-income households and needy poor. However, whether microfinance institutions or other types of financial institutions exist or not exist to serve the communities, individuals most often engaged with the informal methods of financial services activities. According to Mario and Gianfranco (2006), informal institutions (self-help groups, credit associations, families, individual money lenders) do not have the status of an institution and they provide services on a voluntary basis and are not subject to any kind of control or regulation. These practices also exist in Afar regional state. On the other hand, the formal financial services provided by institutions that are regulated and registered by the regulating body of the country. As Mario and Gianfranco (2006) indicated, the formal institutions offer credit and they are deposit-taking institutions: for these reasons, they are all under banking regulation of the country.

4.1 Banking services

The most common formal financial services used by individuals throughout the world are the services provided by banking institutions. As Table 4.1 shows, of the total respondents, 79 percent of them have never used the services of banking institutions, whereas 21 percent of respondents have the practices of using banking services. In this case, it can be said that the provision of banking services to the pastoralists is not in momentum leap. About 79 percent of respondents, who have not practiced of using banking services, have the intent of getting banking services, but the remaining did not intend to use the services.

Table-1: Practice of Banking services

Practice of banking services	Frequency	Percent
Yes	44	21.0
No	166	79.0
Total	210	100.0

Various types of financial services provided by banks, such as local and international money transfers, saving accounts, lending, checking accounts, foreign exchanges, changing currencies denominators, and so on. In this regard, respondents (21 percent) have been asked what type of services they used. Of the 44 respondents who have the practices of using banking services, about 48 and 39 percent (see Table 2) of them used the services to withdraw transferred moneys and to send moneys for others, respectively. Hence, small number of respondents used the services of saving and currency denominator changing.

Table-2: Types of services

Types of services	Frequency	Percent
Transferring	17	38.6
Saving	5	11.4
Changing currency denominator	1	2.3
Withdrawing transferred money	21	47.7
Total	44	100.0

Notably, the dominant type of service used by pastoralist is money transfer. However, no respondent has used the service of borrowing from banks. This implies the fact that banking services mostly provided at the urban areas and they do not provide small credits (microcredit) for households.

4.2 Microfinance institutions

Even though using banking services indicated as the most common type of financial services, the outreaching of banking sector is insignificant due to the disparity of serving low-income households and needy poor. To apprehend such problems microfinance institutions have been introduced in many countries, including in Ethiopia. However, as indicated previously, there is no MFI in Afar region to serve pastoralists. Thus, to assess the pastoralists' need of MFI introduction in Afar region, data have been gathered concerning to MFI.

Respondents have been asked whether they were familiar with micro saving and credit services of financial institutions. Hence, individuals' familiarities with the terms of micro saving and credit of financial services have the effect in using MFIs' services, because MFI provide small amount of loans for their customers and they also receive deposits from customers. Concerning this, Table 4.3 summarizes the familiarities of respondents with the terms of micro savings and credits of financial services.

Table-3: Micro saving and credit services

Familiarity with saving and credit of financial services (n=210)	Needing micro saving and credit services provider institutions			
	Yes		No	
	Count	Table n %	Count	Table n %
Yes	64	30.5	1	.5
No	140	66.7	5	2.4

As the above table presented, of the total respondents, 69 percent of them were not familiar with the terms of micro saving and credit financial services, but the remaining percent of respondents were familiar with the issues. About 97 percent of respondents have the intent of using micro saving and credit of financial services if institutions introduced in Afar region to provide these services.

Those respondents who want the introduction of MFI in Afar region have been asked, if the institutions introduced in Afar and provide credit services for them, for what purposes they will use the loan proceeds. As the table below shows, respondents will use the proceeds for two purposes, i.e., for household expenditures and business operations purposes.

Table-4: Purposes of using borrowing from MFI

Purposes of using loan proceeds	Frequency	Percent
For household expenditures	4	2.0
For business operations	200	98.0
Total	204	100.0

Using the loan proceeds for the purpose of business operations have been intended by 98 percent of respondents, of the 204 respondents, whereas 2 percent of respondents will use the proceeds for their household expenditures. Generally, MFI provide credits in order to alleviate the poverty of low-income households and needy poor. This also accomplished by individuals by engaging in profit generating business operations. Hence, the return or profits of the business operations should exceed the cost of borrowing incurred by the individuals when they take credits from MFI. This implies that MFI usually do not provide credits to use the proceeds for household expenditures. Notably, small number of respondents (2 percent) has the intent of using the proceeds for their household expenditures. Thus, Afar region pastoralists' intent is in line with MFI principles of providing credit services. The other issues involved in providing credits by MFI is the credit systems given to individuals. Item in survey instrument has asked respondents to choose among the four choices of credit systems to be implemented if MFI introduced in Afar region. As the table below shows, respondents have chosen the given credit systems – in cash, livestock, cereal, and goods. About 94 percent of respondents have chosen in cash credit system if MFI introduced in Afar region, while about 6 percent of them have chosen in kind credit system.

Table-5: Credit systems required from MFI

Credit systems	Frequency	Percent
Cash	192	94.1
Livestock	7	3.4
Cereal	1	.5
Goods	4	2.0
Total	204	100.0

When the credit system of MFI called as in kind, the institution based on the agreement of the borrowers first acquire the tangible asset from the market, then the institution deliver the tangible asset to the borrower. The borrower will assume liability for the amount spent in acquiring the tangible asset and at the maturity date he/she will pay the proceeds. However, this type of credit system indicated as loophole prone for various types of problems compared to in cash credit system, such as difficulty in managing and acquiring the assets by the MFI. Taking these issues, pastoralists have the intent of taking credits in cash, which is the preferable system of credit services by MFI.

The conventional MFIs' sources of income generated from interest rates applied on loans. However, interest payment on loans is the major issue involved in the introduction MFI in Afar region. This resulted from the fact that almost all of pastoralists are the follower of Islam religion, and this religion prohibits the payment and acceptance of interests on financial services[6]. In order to comply with the Islamic religious principles, Islamic Microfinance Institutions (IMFI) with various types of models has been developed to provide financial services for Muslim communities.

In line with the above discussion, data have been gathered from respondents, who want the introduction of MFI in Afar region, about interest payments. All respondents have replied that they will not accept loans if the MFI requires interest payments on loans. Their reason to abandon such practices was the prohibition of paying and accepting of interests on loans by the religion of Islam.

The payment methods that respondents preferred is presented on Table 6. About 95 percent of respondents have the intent of only repaying the loan principal/face value [7] to the institution and about 5 percent of respondents will pay service charges to the service rendered by the institution. Only one respondent intended to share profits when his/her business generates profits to the institution. In general, most of respondents preferred only repaying the loan proceeds and they will neither share profits nor pay service charges. This implies that, pastoralists in Afar region prefer *qard al-hasan* (benevolent loan) model of IMFI. This model is an interest-free loan given for either welfare purposes or for fulfilling short-term funding requirements, in which the borrower is only obligated to repay the principal amount of the loan without any increase (Smolo and Ismail, 2011).

[6] Interest (riba) is prohibited in no uncertain terms by the Islamic *Shariah* (Obaidullah, 2008).

[7] Loan principal or face value represents the amount of the original loan that is to be repaid on the loan maturity date.

Table-6: Method of Payment for Services

Types of payment for the services used	Frequency	Percent
Profit sharing	1	.5
Paying service charges	10	4.9
Only repaying the original loan proceeds	193	94.6
Total	204	100.0

However, if the MFI in Afar region introduced, the institution must have to get substantial amount of funds from donors. If it is true, the institution can satisfy the principles of going concern [8], otherwise the sustainability could be under question. This also could not indicate that the institution will provide formal financial service; rather it is like in providing semiformal financial services. According to Mario and Gianfranco (2006), semiformal institutions are registered entities like financial NGOs, which are subject to all relevant general laws but they are not under banking regulations; because they provide various financial services, but they are not deposit-taking institutions or, if they are, they cannot grant credit. However, using other models of IMFI, it is possible to introduce MFI in Afar region.

Moreover, group guarantee is also the issue in introducing and operating of MFI. The prominent future of MFI that differentiate it from the conventional commercial bank is that the eradication of collateral requirements to borrow moneys from the institution. Accordingly, MFI use group-based lending method as a substitution of collateral requirements, because low-income households and needy poor could not get assets that can reserve as collateral. In this case, respondents have been asked whether they can form group to borrow from the institution or not and being a guarantor for the group members or not, if MFI introduced in Afar region.

As the table below shows, of the 204 respondents who want the introduction of MFI in Afar region, about 62 percent of them could form group to borrow moneys from the institution, as well as they could be guarantor for the moneys borrowed by the group members. Whereas, about 14 percent of respondents could not form group to borrow from the institution and they could not also be a guarantor for the group members' loans. Besides to these two strands, about 22 percent of respondents could form groups to borrow moneys, but they could not be a guarantor; and 2 percent of respondents could not form group to borrow, but they could be a guarantor.

[8] The business continues in operation for the foreseeable future.

Table-7: Group borrowing and guarantee

Forming group to borrow moneys from MFI (n=204)	Being a guarantor for the group members borrowed moneys			
	Yes		No	
	Count	Table n %	Count	Table n %
Yes	126	61.8	45	22.1
No	4	2.0	29	14.2

From the above discussion, it can be inferred that, if MFI in Afar region introduced, pastoralists could form groups in order to get loans from the institution. Hence they can also be guarantors for the other members in the groups they belong.

In general, based on the assessments made with respondents so far, including the informal financial service practices, pastoralists in Afar region have the intention of using MFI services if the institution introduced. Hence, loans received from the institution most likely will be used by the pastoralists to commence or progress business operations. This intention is also in line with the objectives of MFI existence.

4.3 Compatible models of MFI to Afar region

To introduce sustainable MFI in Afar region, various factors can affect it. The factors either treat the institution positively or negatively. According to the interview results, the most predominantly indicated challenging factor to introduce MFI in the region is the issue of interest payments on loans. However, there are various types of Islamic microfinance models that tap with interest payments on loans. In addition to interest payments, other factors like high transaction costs could also affect the introduction of sustainable MFI in Afar region.

Good microfinance programs are characterized by small, usually short-term loans; streamlined, simplified borrower and investment appraisal; quick disbursement of repeat loans after timely repayment; and convenient location and timing of services (Obaidullah and Khan, 2008). This implies that in order to achieve the objectives of MFI, the institutions must have to adopt a suitable way of doing businesses. In general, before and after starting operations, MFI should recognize and handle various types of factors that affect its sustainability.

In order to introduce a formal MFI in Afar region, the concerned bodies must have to comply with the Ethiopian Micro-Financing Business Proclamation No. 626/2009 and directives issued by National Bank of Ethiopia (NBE). Accordingly, operating MFI in Ethiopia is under the supervisions and regulations of NBE, which is stated under the proclamation. Proclamation No 626/2009 of article 3 stated that:

…the main purpose of a micro-financing institution shall be to collect deposits and extend credit to rural and urban farmers and people engaged in other similar activities as well as micro and small scale rural and urban entrepreneurs, the maximum amount of which may be determined by the NBE.

Obviously, the main aim of MFI is to alleviate the poverty of low-income households and needy poor by providing micro financing services to them. Thus, the institution to be established in Afar region also must have the purposes indicated by the proclamation.

To establish financial institutions, including MFI, in Ethiopia, the directives of NBE requires the companies to issue shares (common stock and/or preferred stock); otherwise NBE will not give license of operation. Thereby, to establish formal MFI in Afar region, the institution must have to be a share company by issuing common stock and/or preferred stock. As such, directive number MFI/1/1996 of minimum paid up capital and information required from applicants stated that:

…those applicants who want license of establishing MFI shall have the minimum paid-up capital of Birr 200,000. Hence, evidence for paid up capital which includes certificate of deposit in a blocked subscription account and evidence for valuation of contributions in kind is required whether the applicants meet the minimum paid-up capital.

In addition to the above requirements, to establish MFI in Ethiopia, there are numerous requirements laid down on various directives of NBE. However, there is no any kind of directives that outlines the issues of providing Islamic microfinance services to Muslim communities in Ethiopia. As it was indicated in introduction part, pastoralists of Afar region do not pay and receive interests on loans due to the prohibition of such practices by the Islamic *Shariah*. Thus, the non-availability of providing Islamic microfinance services in NBE's directives has resulted to delay the establishments of MFI in Afar region.

However, using various types of models available in IMFI, NBE can vest the operation of Islamic micro financial services in its directives. As it stands, one of the objectives of this study is to identify the compatible models of MFI for the pastoralist people of Afar. Thus, based on the results obtained from the survey, hereunder attempts have been made to identify the compatible models.

Introducing sustainable MFI in Afar region needs to take in to consideration the factors involve in operating the institution. By considering the requirements of the proclamation and directives mentioned above, appropriate models can be identified. As reviewed in chapter two, MFI can be classified based on the lending models used by the institution, such as Grameen Bank, Village Bank, Credit Union, Self-Help Groups, Rotating Savings and Credit Associations models and so on. Of these mentioned models, the Grameen Bank model and the Village Bank model are the more structured that have been able to enhance their outreach (Obaidullah and Khan, 2008). In particular, the Grameen Bank model is the most popular model throughout the world. Getaneh (2010) also claimed that most of Ethiopian MFIs use this model.

The reason behind Grameen Bank model popularity is that it avoids collateral requirements to borrow from the institution, instead it uses group guarantee lending methods. In this manner, potential customers make a group that will commit to a mutual loan repayment guarantee. Loan is then delivered through small affinity-based groups, usually five to seven members in each group (Getaneh, 2010). Proclamation number 626/2009 of article 16 also allowed MFI to extend loans to groups and to individuals; and loans may be made without collateral, secured by collateral or secured by group or individual guarantees as appropriate and at the discretion of the institution.

In line with Grameen Bank model, of 210 survey respondents, 61.8 percent of them have the intent of forming groups to borrow and being guarantor for the other members' loans in the groups and 24.1 percent of respondents have the intent of either forming groups or being a guarantor (see Table 4.7). Besides, 74.3 percent of respondents also have the intent of forming partnership businesses that is part of forming groups. Thus, using the Grameen Bank model, if MFI established in Afar region, the institution can provide loans for pastoralists and it can avoid the collateral requirements that is required by the conventional commercial banks.

The provision of micro financial services that preserve *Shariah* principles for Muslim individuals is unquestionable. However, making recommendations like Kejela et al (2008) made, i.e., using the word 'service charge' instead of 'interest' on loans, is not appropriate, because there are various types of models that preserve the *Shariah* principles. As reviewed in chapter two, Smolo and Ismail (2011) have explored nine types of models that can be used by IMFI, they are: (i) *Mudharaba* (profit and loss sharing); (ii) *Musharaka* (partnership); (iii) *Ijarah* (leasing); (iv) *Ijarah wa iqtina* (lease to purchase); (v) *Qard al-hasan* (benevolent loan); (vi) *Murabahah* (cost-plus financing); (vii) *Bay al-salam* (pre-paid purchase); (viii) *Bay al-istisna* (progressive financing); and (ix) *Musharaka mutanaqisah* (diminishing partnership).

Among the above mentioned nine models, Smolo and Ismail (2011) have indicated *murabahah* (cost-plus financing) as the most preferable by Islamic MFI because a very small number of clients keep books. On the other hand, Frasca (2008) has prioritized *mudharaba* and *musharaka* (both are similar in terms of sharing profits and losses), *murabahah,* and *ijarah* as the most relevant models to IMFI. Among these the author also claimed *mudharaba* and *musharaka* as encouraged by *Shariah* scholars.

In *mudharaba* model, the institution finance specific type of business which is indicated by the customer and it becomes the capital owner of the business, while the customer is responsible for the appropriate operation of the business. Then profits generate by the business shared based on predetermined ratio between the institution and the customer; whereas if the business incur loss the institution entirely assumes it (Smolo and Ismail, 2011). In *mudharaba* model also, customer can make deposits in the institution, and based on the profit-loss sharing method, the depositor is entitled to share. Whereas, in *musharaka* model, both the institution and the customer contribute finances to run business based on their terms of agreement. Then business's profits-losses shared based on predetermined ratio and in proportion to the capital contribution among them, respectively.

According to Smolo and Ismail (2011), *murabahah* is cost-plus financing model used by IMFI. In this model, the customer applies at the institution to purchase certain types of assets, after the approval the institution acquire the assets from the market and sales backed to the customer on account (credit) at cost plus markup prices. Until the customer finished payments of the loan, the title to the assets remained to the institution. Hence, Frasca (2008) claimed that the markup price is completely different from interests on loans, because it remains fixed at the contract inception.

The *ijarah* model is leasing of physical asset, in which the institution assumed as lessor and the customer under the provisions of the institution uses the asset by making predetermined rental payments for specific period (Obaidullah and Khan, 2008). As such, the risks and liabilities emerging from the ownerships of the assets remain to the lessor.

In addition to the above models, *qard al-hasan* model also can be used by IMFI. This model called as benevolent loan (Smolo and Ismail, 2011), in which it is interest free loan given to borrower and he/she only repays the original loan proceeds. On the other hand, in this model, customers can make deposits at the institutions without interests. Thus, funds acquired as deposits can be provided as loans to others with similar maturity periods.

From the above discussions of IMFI models, it can be said that introducing MFI in Afar region can be possible using *mudharaba, musharaka, murabahah, ijarah, qard al-hasan and* other models not mentioned here. Returning back to the survey respondents' requirements, of the 204 respondents who have the intent of using micro financial services, 94.6 percent of them have the intent of repaying only the original loan proceeds. This requirement is in line with *qard al-hasan* (interest free loan) model. However, providing only such types of loan make the institution as non-for-profit organization and it must have to raise funds from donors and potential depositors. Although proclamation number 626/2009 of article 22 allowed MFI to obtain grant from local or foreign sources for the purpose of lending or capitalization, the institution treated as semiformal financial institution and it could endanger the sustainability issues when the institution only looking the hands of donors.

Thus, using *mudharaba, musharaka, murabahah*, and *ijarah* models, sustainable MFI can be introduced, because it can generate incomes by sharing profits from customers' businesses and the mark-up prices applied on *ijarah* services. *Qard al-hasan* model of deposit taking financial service, however, can be used at the institution since the customers do not requires interests on deposits. Beyond using these models, the concerned bodies also must have to get the considerations of NBE in using these models, because NBE has outlined the financial activities that shall be carried out by the MFI. To encompass IMFI operation in Ethiopia, it needs amendments to the directives of micro financing institution of NBE. As a result, the path to introduce MFI in Afar region will be furnished.

4.4 Transaction costs involved in providing financial services

If MFI introduced in Afar region using various types of models that comply with Islamic *Shariah*, transaction costs also incurred like the conventional MFI. Thereby, the other objective of this study is examining transaction costs involved in providing financial services for pastoralists.

Transaction costs are either the real costs paid out in terms of moneys/resources and/or opportunity costs that are forgone benefits in pursuits of undertaking other actions. As it was reviewed in chapter two, real costs can be as transportation and stationary cost, cost of maintaining bank account (if a MFI's customers required to open a bank account to receive a loan), and so on. Heney (2006) mentioned that customers' attendance in meetings held by MFI and the corresponding absence from their business operations, missing investment opportunities due to delayed loan disbursements by MFI, elongated loan approval systems, compulsory deposit requirements as some of opportunity costs involved in providing financial services. These types of transaction costs can also be incurred if MFI introduced in Afar region. However, specific to Afar region's socio, economic, environmental, and political factors, other types of costs could also arise.

The main sources of income for pastoralists generated from rearing livestock, such as goat, sheep, cattle and camels. In doing so, most of them use mobile settlement style to get grazing and water sources for their livestock. Thus, this type of settlement style could raise other types of transaction costs in providing financial services for them. The first thing is problems in forming groups to borrow from the institution. This also raises problems in supervising and managing the groups' members by the institution since it uses Grameen Bank model to avoid collateral requirements. As a result, transaction costs could be higher compare to other MFI located in other countries. If the institution found this as problematic, it will focus to pastoralists who are dwelling in urban areas and near to the institution and its branches. Accordingly, the institution will lose its mission to provide financial services for those who are neglected by the conventional commercial banks.

As most authors argued, transaction costs increased when MFI provides financial services in rural areas compared to urban ones due to lack of infrastructures suitable to the institution and to the customers in operating their businesses. In addition to this fact, transaction costs also increase when numbers of customers available to borrow are low, difficult environment conditions, lack of entrepreneur skills by customers, and so on. As such, both the institutions and customers' transaction cost increases, because more dominantly pastoralists reside in rural areas that lack suitable infrastructures adding to the hotness climate conditions.

Other types of transaction costs could also arise in providing Islamic financial services. Because in the earlier discussed models of IMFI, most of the time the loan given to the customer by acquiring assets and the profits-loss shared by the institution and customer. Providing such types of loan is not direct endeavor; rather it involves various activities such as appraising the market value of the assets, assessing the performances of borrowers, actively supervising customer's business operations to avoid deceptions in disclosing profits-losses and so on. As a result, the institution and the customer will incur additional transaction costs.

5. CONCLUSION

Financial institution's main purpose is facilitating the flow of funds between savers (suppliers) and those who demanding funds. As such, MFI also has the purpose of facilitating fund flows, but their main aim is to alleviate poverties of the individuals, at large the country. This also differentiates MFI from the conventional commercial banks, because commercial banks provide financial services for average-income households and large organizations. On the other hand, MFI provide finances for low-income households and needy poor in terms of micro (small) loans that could be used to operate income generating businesses. They also provide other types of micro financial services such as saving (deposit) and insurance for their customers.

Even though the numbers of MFI in Ethiopia increase now a day, there is no any formal MFI in Afar region that provides micro financial services to pastoralists. The non-existence of the formal MFI also indicated by other researchers in other pastoralists areas of Ethiopia. As a result, pastoralists of Ethiopia, specifically Afar region, did not utilize the benefits of MFIs' financial services.

As it stands, pastoralists have the intent of using financial services if MFI introduced in Afar region. MFI provides loans for their customers that should be used to operate income generation businesses. In line with this, pastoralists' intent of taking loans from the institution is also to start up or advance business operations which are in line with the principles of lending by MFI. However, pastoralists will not pay interests on the loans which are taken from the institution. This resulted from the prohibition of paying and receiving interests on financial transactions by the Islamic *Shariah* because they are the follower of Islamic religion.

The non-availability of statutory provisions regarding to the operations of Islamic microfinance in NBE directives has resulted to delay MFI introduction in Afar region. However, there are various types of models used by IMFI that comply with *Shariah* principles, such as *mudharaba*, *musharaka*, *murabahah*, *ijarah* and *qard al-hasan* models. These models avoid the traditional interest payments requirements of MFI, instead they use sharing of profits and losses from the customers' businesses, markup prices, and benevolent loan (only repaying loan proceeds).

High transaction costs that will be incurred also hinder the introduction of sustainable MFI in Afar region. The transaction costs could be either real costs or opportunity costs. Real costs include: transportations costs incurred when the borrowers attend the meetings of the institution and when the institution's staff visit and supervise customers' business operations, obtaining bank account due to compulsory requirements by the institution, and so on. Opportunity costs include: missing businesses operation when customers attend meetings, compulsory saving requirements which could be used in other business operations, and so on.

Moreover, forming groups by pastoralists could be difficult due to their settlement style, in which most of them have a mobile settlement style in order to secure grazing land and water for their livestock. Thus, using Grameen Bank model to avoid collateral requirements also arise transaction costs in managing and supervising groups members.

In general, although some challenging factors exist to establish MFI in Afar region, some of them can lead to speeds up its introductions. Among them, the availability of various IMFI models could ease the challenges to extent. Particularly, the aims of MFI could be speed up its introduction in Afar region. Thus, the following section provides the study's implications to introduce sustainable MFI in Afar region.

Given the challenging factors of MFI operating in Afar region, laws and regulations should be designed to foster the establishment of IMFI in the region. Thereby, the concerned bodies for the establishment of MFI in Afar region shall confer with NBE to vest its authoritative provisions of operating Islamic microfinance in pastoralists' areas of Ethiopia, particularly Afar region. Hereunder some points forwarded. Thus, if the concerned bodies deserve statutory provision of operating IMFI, the institution shall adhere with the customs and traditions of pastoralists. In this case, the term service charge should not be used to conceal interest payments; rather the institution should adopt and use Islamic microfinance models such as *mudharaba*, *musharaka*, *murabahah*, *ijarah*, *qard al-hasan* and others models that comply with *Shariah* principles. In additions, transaction costs could be high in providing micro financial services to pastoralists. In this case, the institution shall not dump the entire costs on the customers, rather it shall have other types of income generating activities, such as raising funds from donors (to some extent).

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