SMALL, MEDIUM AND MICRO ENTERPRISE POLICY DEVELOPMENT PROJECT (SMEPoL)

EGYPTIAN MINISTRY OF ECONOMY AND FOREIGN TRADE, AND THE CANADIAN INTERNATIONAL DEVELOPMENT RESEARCH CENTRE

A BACKGROUND PAPER
RELATIVE TO INCREASED ACCESSIBILITY OF FINANCE FOR M/SME’s:
CREDIT SCORING AND CREDIT BUREAUS

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RELATIVE TO INCREASED ACCESSIBILITY OF FINANCE FOR M/SME’s:
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1. INTRODUCTION
Building a strong free-market economy is a complex and slow process. Developed economies have taken decades to build and refine institutions, infrastructure, policies, programs and regulations, education and training, and many other structural components within economic, political and social systems. Even with this complex system, economies falter and have to recreate new approaches in order to advance.

In developing economies, this process is made more complex by the internal and external pressures to “catch up” with other more developed economies. These countries and economies have to learn quickly and adapt lessons from other systems to fit their own specific cultural, social, economic and political values, constraints and opportunities. Such is the case with the development of micro, small and medium businesses in Egypt. With almost 70 million people, an average annual income of less that $1,000, and a literacy rate of approximately 50%, the challenges are immense.

That said, there have been many assistance programs and projects sponsored by agencies such as CIDA and USAID, and initiatives by educational and not for profit organizations as well and private sector. The ongoing challenge is to continue to build the support necessary for economic development and advance the social, economic and environmental well being of the Egyptian people.

2. THE ISSUES
The historical development and the internal and external support for small business development and the entrepreneurship of Egyptian small business has resulted in a situation where approximately 75% of private sector employment is in small businesses. If employment and the economy of Egypt are to continue to grow, creating an environment that will allow these businesses to flourish is critical. However, many potential obstacles stand in the way of continued growth and evolution of the small business sector. Some of these include:

- Limited access to capital
- Complex legal and institutional systems for commercial lending
- Inadequate supplies of skilled labour
- Limited access to information, high input costs
- Lack of adequate physical facilities and infrastructure
- Inadequate marketing
- Poor networking
- Regulations

Addressing all of these issues is a long and complex process. This project is intended to assist in this process by considering the role that a credit bureau system and/or credit scoring could play in further development of the small business sector.
Credit bureaus such as Equifax, Experian and TransUnion (in Canada and the US) assist lenders by providing a systematic approach to credit history, assessment of risk, and access by lenders to this information. These companies are expanding into international markets, but thus far have limited their areas of operation to relatively strong economies, and countries that have a record of political stability. They do not currently operate in Egypt.

However, implementing a form of credit rating and/or credit bureau services in Egypt may assist Micro, Small and Medium businesses by facilitating access to capital from lending institutions who need reliable information on potential loan clients and a consistent approach to risk assessment.

3. PROJECT GOALS and OBJECTIVES
This goal of this project is to prepare a paper on the opportunities, constraints and possible solutions to implementing a (system of) credit bureau and/or credit scoring that will result in increased financing for Micro, Small and Medium business enterprises.

The objectives are to:

- Prepare a brief inventory and description of the organizations in Egypt that support M/SME, including their mandates, and available resources.
- Briefly review and describe the problems encountered by Micro, Small and Medium enterprises (M/SME) in accessing financing in Egypt.
- Prepare a detailed description and analysis of the costs, benefits and implications of implementing a system of credit bureaus and/or credit scoring by:
  - Reviewing the North American Equifax, Experion and TransUnion systems
  - Describing best practices in other countries that have implemented credit bureau and/or credit scoring systems
  - Describing how such a system would benefit M/MSE’s in Egypt, and
  - Providing an analysis of possible application in Egypt including advantages, disadvantages, costs, and key factors for implementation.
4. INVENTORY OF ORGANIZATIONS AND INSTITUTIONS THAT PROVIDE CREDIT TO M/SME’S

There is a wide range of formal credit sources for M/SME’s. These are in addition to a range of traditional or informal sources. The formal sources of credit are dynamic and vary with national and NGO program changes.

The key sources of financing for M/SME’s are National Programs, Formal Lending Institutions and Banks, and NGO programs. Tables 1 to 3 present a summary of key sources, including their mandate, scope, lending methods, and resources. Friedrich-Ebert-Stiftung Egypt Office maintains a more complete directory of current M/SME programs and organisations.

This overview is intended to demonstrate the range of current options and their relative scale of contribution to M/SME development. Summary observations are:

- In relative terms, the Social Fund for Development program as currently implemented through banks has a high default rate. However, the national program is also the largest single loan support for M/SME’s and, as implemented through the banking system, is relatively accessible in geographic terms.
- NGO’s play a significant indirect role in national programs and formal banking options, as well as through direct financial programs.
- There is a wide range of options available. However, the accessibility of these options (location, business focus, requirements, etc.) is less clear.

Section 5 reviews some of the current issues confronting M/SME’s when accessing formal financing options.

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1 A more comprehensive directory of M/SME programs and organisations can be found at http://www.fesegypt.org/dirsearch1.asp Site maintained by Friedrich-Ebert-Stiftung Egypt Office
<table>
<thead>
<tr>
<th>Name</th>
<th>Social Fund for Development</th>
<th>Credit Guarantee Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>M/SME Mandate</td>
<td>• Enterprise Development Program: Supporting new and existing small enterprises using an integrated package of credit and business support services</td>
<td>• Small Scale Enterprise Program • Health Care Cost Recovery Project</td>
</tr>
<tr>
<td>Program Scope</td>
<td>• Provides subsidized credit assistance through financial intermediaries (mainly banks) • Provides business support services directly through SFD staff and indirectly through NGOs</td>
<td>• Loan guarantees to banks of up to 50% on loans to M/SME’s in return for a fee of 1% per annum on the outstanding balance of the guarantee • Grants loans from the Social Fund for Development • Wholesaler of M/SME loan funds to existing and new organizations</td>
</tr>
<tr>
<td>Resources</td>
<td>• $411 million (1997) for working and investment capital</td>
<td>• Private sector joint stock company by 9 Egyptian commercial banks and one insurance company with support from the private sector • 1997 project agreement with USAID and the Egyptian Government ($85 million)</td>
</tr>
<tr>
<td>Lending Methods</td>
<td>• Provides credit through public sector banks that borrow from SFD for on-lending purposes. • Offers banks training packages and procedures for small business lending • Sets the interest rate structure (7%-13%) for banks to use with SFD loans</td>
<td>• Loan guarantees to banks • 60 new M/SME lending units throughout Egypt (replaced USAID in supervising these activities)</td>
</tr>
<tr>
<td>Other Details</td>
<td>• History of high loan default rate • Loan Conditions include: • applicant age between 21-55 yrs. old; permanent residence in the governorate where the project will be implemented; completion of military service or at least 5 years exemption; literacy certificate for those who are not educated; • not a student or employee in the government, the public or the private sector (otherwise pledge to resign if gets the loan); • adequate experience in the field of the enterprise, or qualifications compatible with the nature of the enterprise (requiring an experience certificate issued by the Directorate of Labour Force and Training, or equivalent proof of training). • Priority is given to projects that: offer the largest number of job opportunities, conform to the project types approved by PWP, use labour-based methods for at least 25% of the total project cost, serve a maximum number of beneficiaries, have a positive social and environmental impact on the community, and that attain at least a 12% economic rate of return for each project component, have adequate Sponsoring Agency (SA) management capacity, and have proponent cost sharing investment of at least 10% in project capital, operation and maintenance costs.</td>
<td>•</td>
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</tbody>
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|------|--------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| M/SME Mandate | • Small Enterprise Credit Program  
• Cairo focus | • Limited – mainly through the Social Fund for Development (SFD – see above) |
| Program Scope | • Offered through 33 of 66 branches (1998) with plans for nationwide expansion  
• Managed separately from traditional operations | • Delivery Agents that grant loans from the SFD (see above) |
| Resources | • Financed mainly by USAID, plus by CIDA, & the Ford Foundation  
• 160 loan officers (1998) | • SFD  
• Note: don’t use very large resource of deposits (1995/95 national total of $15 million) |
| Lending Methods | • Individual successive loans from $100-3000  
• Disbursement and repayment through weekly visits by loan officers at borrower’s site  
• Compulsory savings of 10% of loan | • As per SFD loan terms and methods |
| Other Details | • In 1997, had a repayment rate of 94.4% on M/SME lending  
• Planning to expand to cover all 66 branches  
• Planning to build a training centre for M/SME lending  
• Limited managerial commitment  
• High overhead costs | • |

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<table>
<thead>
<tr>
<th><strong>Table 3: NGO &amp; Donor Organizations</strong></th>
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<tr>
<td><strong>Name</strong></td>
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<td><strong>M/SME Mandate</strong></td>
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<td><strong>Resources</strong></td>
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<td><strong>Lending Methods</strong></td>
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<td><strong>Other Details</strong></td>
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6 [http://www.unesco.org/most/mideast1.htm](http://www.unesco.org/most/mideast1.htm)  
5. **ISSUES AND CONSTRAINTS FACED BY M/SME’S IN OBTAINING FINANCING**

5.1 **Overview**

This Section of the Report provides an overview of issues and constraints faced by M/SME’s in Egypt in obtaining financing through formal lending institutions and organizations. Currently, the majority of M/SME’s rely on informal financing mechanisms to support independent entrepreneurship. Despite this, the M/SME sector employs more than two thirds of Egypt’s entire labour force,\(^9\) which is also three quarters of the country’s private nonagricultural labour force.\(^4\)

The need to develop and expand formal financing options for these entrepreneurs is critical to the ongoing growth of the M/SME sector. Some responses to this need are already in place. For example, in a recent paper by the World Bank, two of the top three examples of “best practice micro finance in the Middle East and North Africa” are from Egypt – the Alexandria Business Association (ABA) and the National Bank for Development (NBD). The ABA is an NGO, the NBD is a registered bank. Both cater almost exclusively to urban borrowers.\(^11\)

To date, the vast majority of M/SME’s have had to rely on informal financing options because of issues and constraints in the formal lending sector. The following point form summary highlights some of the key issues already identified as part of national and NGO research and experience.

a) **Limitations in available financing**

- In 1997, about $560 million (0.76% of Egypt’s GDP) was provided to M/SME’s through over forty programs (sponsored by donor institutions, NGOs, and the Social Fund for Development) – this reached only 5-6% of potential clients (total number of M/SME’s)\(^12\) and consequently supports few start-ups and little expansion.
- There is an estimated M/SME credit gap of 1,475,000 M/SME borrowers requiring US$371 million in micro financing.\(^13\)

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Current informal lending is sensitive to and dependent on local-level microeconomic controls (licensing, tax administration, physical space, etc.) and informal credit markets (8).

Weak institutional infrastructure providing services (8).

Bank branch numbers are apparently consolidating (14) – currently approximately 2,200 branch offices.\(^{14}\) This may reduce accessibility in more remote/rural areas.

Reliance/dependency on donor and external support and funding (8, 10).

History of banks ignoring or not responding to M/SME sector needs (9) coupled with an historic cultural distrust of banks and financial institutions.

Low awareness among M/SME’s about what is available, especially outside of urban centres.

Few, if any, linkages with large and foreign enterprises, networks, and support (9).

95% of Egypt’s M/SME’s do not maintain bank accounts, therefore informal saving mechanisms are the main funding source for start-up and capital (18), and those savings are not part of the deposit pool that banks and lending institutions have available for otherwise supporting M/SME loans.

Subsidized M/SME funding programs with interest rates below market levels creates unrealistic and unsustainable dependencies whereby funds quickly deplete and M/SME’s are sheltered from realistic market forces.

Some M/SME tax holidays have been available through specific credit projects, but not universally applied therefore creating an uneven playing field (18).

The most popular informal saving mechanisms used by M/SME’s are Rotating Savings and Credit Associations (RoSCAs) – *gamae’yat* in Egypt—a group of individuals who come together and make regular cyclical contributions to a common fund, which is then given as a lump sum to one member in each cycle.\(^{15}\) RoSCAs offer quick fund access, close access, low transaction costs, an informal commitment to save, a friendly atmosphere, informal and flexible terms, and low savings thresholds (18).

Costly and slow for NGO’s or micro finance institutions (with legal status) to establish or expand substantial resources, programs, and outreach.\(^{16}\)

\(^{b)}\) Constraints imposed by the mandates of lenders

Small and Micro business loans are not yet a key bank function, therefore not promoted because current operational and administrative costs for case-by-case M/SME loans exceed any profit potential – no systems or models have yet been pursued whereby M/SME lending can be profitable.

Current lending terms and conditions require small businesses to borrow relatively large loans (13).


\(^{15}\) Grameen Communications. 2001. “Microfinance-Credit Lending Models”.

[http://www.grameen-info.org/mcredit/cmodel.html](http://www.grameen-info.org/mcredit/cmodel.html): For example: a group of 12 persons may contribute US$33 per month for 12 months. The US$396 collected each month is given to one member. Thus, a member will 'lend' money to other members through her/his regular monthly contributions. After having received the lump sum amount when it is his turn (i.e. 'borrow' from the group), s/he then pays back the amount in regular/further monthly contributions. Deciding who receives the lump sum is done by consensus, by lottery, by bidding or other agreed methods.

\(^{16}\) Brandsma and Chaouali. 1998. p.4.
M/SME’s would have relatively small and numerous accounts that would possibly overburden banks’ capacities (18).

The time required for loan application is extensive and is viewed by M/SME’s as “time away from work” – it impedes necessary short-term earning potential of applicants.

Banks unable to leverage NGO credit resources for M/SME’s because NGO legal status makes it difficult to engage in legal proceedings against them (12).

Very limited domestic supervision expertise for micro-finance deposit, savings, and loan services.

Social Fund for Development (SFD) requires applicants to: have completed military service (or at least 5 years exemption); have a literacy certificate or equivalent proof of education; have an experience certificate (or equivalent) issued by the Directorate of Labour Force and Training; and not be a student or otherwise employed in the public or private sectors (or willing to resign if granted a loan).17

c) **Problems associated with assessment of risk**

- History of high loan default rate in the Egyptian private sector (13).
- Youth/young and start-up entrepreneurs (those who typically need the most Government and financial support) have little financial history on which to assess credit worthiness. These entrepreneurs are especially important to assess for long-term support/sustainability due to the high failure rate during the first four years of a new enterprise or entrepreneur (6).
- M/SME’s have difficulty attracting/acquiring the necessary skilled labour, technologies, product and market information, production inputs, and physical space (9).
- Little capacity to provide feasibility studies and business plans to a level that lending institutions require (13).
- Limited M/SME access to public contracts and larger contracts that offer longer-term forecasting and stability.
- Banks use similar securitization standards to what they apply to larger clients.
- Lack of local financial institutions with direct knowledge of the borrowing agent.18
- Muslim religious beliefs with respect to money management, profit, debt, and interest (see Attachment A) have historically discouraged borrowing and lending practices that would otherwise build a high credit rating/score in an open market context – what has been culturally/religiously valued as responsible money management or “good practice” is not necessarily valued or measured in dominant credit bureau scoring models.

d) **Lack of M/SME related expertise by lenders**

- Bank overhead costs (appraisal and supervision of M/SME loans) are high relative to typical loan amounts (12), therefore little or no profit incentive under the current structure/system.
- New and little marketing, appraisal, and supervision experience with M/SME’s (14).
- Few, if any, performance incentives for loan officers in traditional banks to work with M/SME’s.

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• Loan officers have no experience or reference point for evaluating applications from ‘market-niche’ or ‘avant-garde’ M/SME Entrepreneurs who pursue unexploited market-niches (domestic or global) and enterprises at a dynamic and rapid pace.\(^{19}\)

• Internal assessment of current micro finance institutional training needs emphasizes needs in: loan portfolio management, management information systems, delinquency management, product development, loan officer incentive systems, program evaluation, and accounting, budgeting and control.\(^{20}\)

e) **Interest rate and repayment policies**

• Typically high to cover overhead for loan appraisal and supervision, especially for micro-enterprise applicants.

• Though accessible, flexible, and quick, the informal credit market (which nearly monopolizes M/SME lending) is very expensive (with interest rates sometimes nearing 100%) and has limited resources (15).

• Several M/SME lending programs sponsored by national and international entities offer loans below market interest rates – though initially attractive to M/SME’s, this is unsustainable and rapidly depletes the available subsidized funding (17).

• SFD considering loan packages with both a non-refundable grant coupled with a repayable portion at sustainable interest rates (17).

f) **Collateral and/or equity constraints**

• Informal urban real estate holdings (i.e., unregistered – mainly because of complexity and high cost) account for about 94% of all urban real estate and unregistered agricultural land holdings are the majority of total agricultural land in Egypt: M/SME’s therefore have little “official” collateral (14) or legal proof of facilities.

• M/SME’s do not invest in building or land (84% operate from rented shops), so have very little fixed capital and keep minimum inventory levels (8).

• Formal lending institutions face high overhead costs for legal process of recovering relatively small collateral – perceived/real high risk and high cost (13).

g) **Other issues relevant to a credit bureau and/or credit scoring system “solution”**

• M/SME’s are institutionally under-represented and lack access to decision-makers (8), therefore have little cohesive lobbying ability, profile, or support network to resolve/address common issues regarding access to financing.

• International/western scoring systems have been designed in a different cultural, religious, financial, and operational (technology, infrastructure) context with respect to borrowing and lending practices (see Attachment A)\(^{21}\).

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Establishing a nation-wide credit scoring service and credit bureau system also requires design and delivery attention to principles of Islamic Banking (see Attachment A). These principles partially define the informal and formal operating context of potential M/SME clients and supporters. Islamic scholars, together with senior financial managers/experts, may need to similarly define “Islamic Principles for Credit Scoring”. This would be important to fully reflect and respect the context of the financial history of potential M/SME clients in the loan application and risk assessment process. Similarly, a credit scoring system would need to somehow recognize and value potential clients’ loan repayment compliance and financial history in the dominant informal lending sector.

5.2 Proposed Responses to Issues

Though Egypt has these innovative and successful M/SME formal financing services, current services only begin to address the level of lending support that the sector could use. The Government of Egypt has identified several supporting institutions and systems that seem necessary to expand financial services for M/SME’s:

- Credit Bureaus to avoid cross-financing and perpetual client indebtedness, and to maintain the financial viability of the service providers;
- Rating Agencies to assess the credit viability of loan applicants and to support lending institution operations;
- Credit Guarantee Schemes that don’t deter rigorous loan recovery efforts; and
- Credit Scoring to minimize the risks of lending without adequate collateral, to reduce client screening and appraisal costs, to speed up loan processing, and to determine loan pricing relative to risk levels.

These proposed supporting institutions could help to address some of the main impediments to M/SME financing, which currently include:

- high risk assessment and operational costs require high interest rates for borrowers and result in low revenues and profit incentives for lending institutions;
- low M/SME participation rates, collateral, and credit history; and
- urban-centred institutional focus with limited rural extension services.

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6. CREDIT SCORING AND CREDIT BUREAUS

Central to the proposed changes in the system of credit access for M/SME’s is the concept of a credit rating system, possibly implemented through a Credit Bureau. The following sections present a brief description of these two concepts.

6.1 Credit Scoring

Credit scoring systems are used as an objective method to estimate credit risk. In simple terms, a credit scoring system uses a mathematical formula to determine a borrower’s likelihood to pay back credit. Formulae models are built by using a random sampling of customers, or if a large enough sample cannot be met, information from similar customer data is used. The samples are broken down into factors that determine creditworthiness. Each factor is weighted on its ability to predict whether the borrower can pay back credit received. The models only work well if a large enough sample is taken.

Based on available information on credit history, a credit report lists the state of a borrower’s credit by account type. The credit bureau Equifax uses a rating system of R1 to R9; R1 being the best rating. For example, a borrower may have a credit card that is paid on time, all the time, with very little balance being carried over from month to month. This would be considered a good account, or R1. However, the borrower may also have an R9 business loan that was never paid and written off by the lending institution, which of course, reflects badly on the borrower. In the North American context, this information is often mitigated by time – usually 7 years.

Some Credit Bureaus go even further. They mathematically analyze the data on a borrower’s credit report and the result is a single number that can be compared to thousands of other credit reports. Fair, Isaac and Company, who has been leaders in credit scoring models since the 1950s, developed this method of calculation – FICO Scoring. In their system, the higher the score, the lower the risk for the lender. Credit scores range between 900 and 300. A borrower with a score 620 or lower is a poor credit risk while a score of 660 or greater is considered to be of less risk for the lender.

There are many different formulae being used, but the basic information that most rely on, and the general proportion or percentage that each factor constitutes in the overall score (the percentages at the end of each point relate to the estimated weight of each item\(^23\)) is:

- Bill payment history (more recent transactions are weighted more heavily) - 35%;
- Outstanding debt (how much of available credit is used by the borrower) - 30%;
- History of credit use (how long the borrower has been using credit responsibly) - 15%;
- Very recent credit activity (has the borrower been seeking credit?) - 10%;
- Type of credit vehicles held by borrower (car loans, credit cards, mortgages, etc.) - 10%.

\(^{23}\)http://www.hsh.com/pamphlets/aboutfico.html
It is important to note that the proportions are only estimates. The actual formulas are considered “proprietary” and are not divulged by the credit bureaus. The formulas are also manipulated depending on the type of credit applied for.

Reasons for low scores are generally:
- Serious delinquency;
- Serious delinquency, and public record or collection filed;
- Derogatory public record or collection filed;
- Time since delinquency is too recent or unknown;
- Level of delinquency on accounts;
- Number of accounts with delinquency;
- Amount owed on accounts;
- Proportion of balances to credit limits on revolving accounts is too high;
- Length of time accounts have been established; and
- Too many accounts with balances.24

There are two major problems with credit rating systems. One is that errors that can be found on any given credit report; these range from actual credit data errors to having another person’s information erroneously entered on to the borrower’s credit report.25 The second problem is that many people don’t know their credit score, or if they do, they don’t know how to improve it. The FICO® scoring model provides the applicant with up to four reasons why they didn’t receive a higher credit score. These reasons range from “payment delinquency” to “too few rotating credit accounts”.26

Even with these limitations, credit rating reports generally cut down lending costs and provide a basis for equitable treatment when it comes to lending to minorities and others traditionally denied credit.

6.2 Credit Bureau

As credit became more popular with the general public and lending became riskier, small credit lenders needed a reliable source for determining the credit worthiness of their customers. Because they were unable to supply a large enough modeling sample from their own clientele, small credit lenders looked for the information elsewhere. Credit bureaus were developed to meet the needs of small credit lenders.

Companies who provide credit regularly send credit information and updates about their clients to credit bureaus, which in turn update and merge the information into credit reports. Credit Bureaus act as a “library” of credit information and as a supplier of credit worthiness assessment through credit rating analysis. Although differences in style, format and coding may occur

24 http://www.myfico.com/
25 http://www.consumerfirstmortgage.com/fico_scores.htm
26 http://www.fico-credit-scores-and-beacon-credit-scores.com/interpreting.html#2
between the various credit reporting bureaus, the typical credit report includes four of the following types of information 27:

**Identity information**: name, nicknames, current and previous addresses, Social Security number, date of birth, and current and previous employers. This information comes from any credit applications and its accuracy depends on the applicant filling out forms clearly, completely and consistently.

**Credit information**: specific information about each credit and bank account including the date opened, credit limit or loan amount, balance, monthly payment and payment pattern during the past several years. The report also states whether anyone else besides the individual (i.e., a spouse or co-signer) is responsible for paying the account. This information comes from credit companies.

**Public record information**: information on bankruptcy, court records, tax liens and monetary judgments, and in some cases, overdue child support payments.

**Inquiries**: includes the names of those who have obtained a copy of your credit report for any reason. This information comes from the credit-reporting agency, and it remains available for as long as two years in the United States.

Once the data is complied, it can be analysed using a credit rating formula as described above to generate a credit assessment report and “score.” Credit lenders can purchase these reports and use them to determine creditworthiness of applicants.

Credit Bureaus have made lending more efficient and cost effective for the credit givers, to the point that even large lenders use their services. Credit Bureaus have recently allowed borrowers access to their own reports to help the borrowers understand why credit has or hasn’t been granted.

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27 http://www.bankrate.com/brm/green/cc/crdt2g.asp
7.0 NORTH AMERICAN CREDIT BUREAUS

The credit reporting industry has long played an essential role in the American economy, and more recently in European and Asian economies. Economic growth is facilitated by credit reporting agencies providing updated consumer information to help lending agencies make fast and accurate decisions for consumer credit transactions. This, in theory, benefits the applicant and the lending agency that are both “clients” of the bureau.

In North America there are three major credit bureaus, and many minor ones. Each has its own credit rating system, including a credit scoring system based on the Fair, Isaac and Company model, known as FICO®. The “Big Three” bureaus are Equifax (est. 1899), Experian (est. 1932), and TransUnion (est. 1960). The main focus of these bureaus is on individual consumers. Other firms such as Dunn and Bradstreet focus specifically on businesses. For micro and small businesses, the “consumer” or individual is also the “business.” So these major credit bureaus are the most appropriate model to consider. They are all expanding into international markets. As presented below, each company provides broadly integrated business and personal financial services, not just credit scoring.

7.1 Common Objectives and Benefits

Credit reporting strives to provide the following benefits to the financial system and the economy:

- Allowing consumers with good credit to open and expand credit lines;
- Providing businesses with reliable data to make sound judgements about credit;
- Decreasing loan losses and personal bankruptcies by providing crucial information needed for credit grantors to more accurately assess the profile of an individual borrower;
- Reducing risk-assessment costs by accessing the comprehensive information gathered by the credit bureau more quickly and accurately;
- Increasing borrower privacy protection by providing a systematic basis for lending without the hassle of lengthy support documentation;
- Reducing fraud by providing additional information such as invalid addresses and Social Security numbers that allow credit grantors to identify and avoid potentially fraudulent credit applications;
- Speeding access to data by allowing consumers to make immediate large-scale purchases such as a car.

These objectives are implemented by providing credit reports to lenders, primarily banks, credit unions and other large companies that offer credit to their customers. Following is a brief description of each of the three major credit Bureaus.

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7.1 Experian

Based on their promotional material, Experian describes its business as follows:

“Experian enables organizations to find the best prospects and make fast, informed decisions to improve and personalize relationships with their customers. We do this by combining sophisticated and intelligent decision-making software and systems with some of the world’s most comprehensive databases of information on consumers, businesses, motor vehicles and property. Through multi-channel delivery of our Web-based products and services, Experian enables its clients to conduct secure and profitable e-business and develop state-of-the-art Customer Relationship Management (CRM) systems for communicating and building relationships with customers. Experian is a subsidiary of GUS plc and has headquarters in Nottingham, UK, and Orange, California. Our 12,000 people support clients in more than 50 countries. Annual sales are approximately $1.5 billion.”

Experian has offices in Argentina, Asia Pacific, Austria, Brazil, Canada, France, Germany, Ireland, Italy, Monaco, Netherlands, Portugal, South Africa, Spain, Turkey, United Kingdom and United States. The products offered are based on credit information and assessment and related services. Using their database they offer:

- **Customer identification services:** They can assess important potential customer data across the entire enterprise, enabling companies to target customers and manage those customers for long-term business growth and profitability.
- **E-commerce access and services:** Web based information services allow companies to reach prospects and customers, and build lasting customer relationships.
- **Client Management Services:** They offer assistance to clients for managing day-to-day processes better and improving risk exposure, reduce decision-making times, and obtaining the highest return from customer and account management strategies.
- **Market Research:** Ability to manage and evaluate large databases allows them to support businesses that utilize demographic, geographic and lifestyle data to drive their marketing campaigns. They have software and professional support ranging from identifying and targeting new customers to creating effective customer management strategies and processes.

7.2 Equifax

Again, from their own promotional material:

“Equifax enables and secures global commerce through its information management, consumer credit, marketing services, business information, authentication, and e-commerce businesses. As the leader in information management,

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29 [http://www.experian.com/about.html](http://www.experian.com/about.html)
services, Equifax adds value wherever customers do business, including the financial services, retail, healthcare, telecommunications/utilities, information technology, brokerage, insurance and business lending industries and government. Equifax also enlightens, enables and empowers consumers to manage and protect their financial health with services offered at www.equifax.com. The company ranked in the top five in return on equity among Business Week's Best Performers for 2001. Equifax employs 5,800 in 13 countries and has $1.1 billion in revenue.

Equifax provides an innovative and comprehensive portfolio of knowledge-based solutions for businesses worldwide. Enabling and securing global commerce, Equifax brings buyers and sellers together through information management, transaction processing, direct marketing, customer relationship management and e-commerce security solutions. The company provides an array of industry specific solutions for our customers wherever they do business, including the Internet and other networks.”

Equifax has offices in Argentina, Brazil - SCI/Equifax, Canada, Chile, El Salvador, Italy, Peru, Spain, UK and Uruguay.

Equifax provides a portfolio of knowledge-based solutions for businesses including:

**Information Services:** Equifax provides information solutions and services to customers within specific industry segments, to precisely focus on industry needs and to provide product expertise to each industry segment.

**Equifax Secure:** Equifax Secure offers an array of e-commerce solutions that enable customers to conduct their business safely, securely and efficiently over the Internet.

**ePORT - Web Access:** Equifax’s Business-to-Business Internet delivery channel for consumer credit information.

**EFX Link Partners:** The Equifax Link Partner Program allows customers to place links on a customer’s web site that takes users to the Equifax Consumer Site.

**Equifax Global Online:** Equifax's Global Online allows users to order both online and investigative reports on businesses in over 200 countries.

**Global EFX Links:** Equifax brings buyers and sellers together around the world, enabling and securing millions of transactions in marketplaces that span the globe. Equifax operates in 17 countries with sales in nearly 50 countries.
7.3 TransUnion

Again, from their own promotional material:

“For more than 30 years, TransUnion LLC has been a global provider of information and decision-processing services, maintaining one of the largest databases of consumer credit information in the world. Fortified with expanded capabilities, a commitment to new product development, and investment in technology, TransUnion's professionals partner with customers to create and apply business intelligence to effectively manage risk and capitalize on opportunities.”

…”with 4000 employees worldwide, TransUnion LLC enables businesses to effectively manage their financial risks and capitalize on market opportunities with innovative credit decision tools and information. The company's products and services are shaped by customer needs and reflect the most advanced, tailored solutions for diverse industry sectors.

TransUnion serves a broad range of industries including financial and banking services, insurance providers, mortgage and real estate services, direct marketers and retailers, collection agencies, communication and energy companies and healthcare facilities. TransUnion's extensive product offerings meet the changing credit requirements of customers not only by providing basic credit reports but also by developing and marketing a broad range of information products and services such as risk and profitability models, credit approval assessment, fraud prevention, portfolio management and target marketing tools.

Today, TransUnion LLC has more than 250 owned and affiliated credit bureaus nationwide and international operations in 24 countries on five continents. Introduced in 1972, the TransUnion Credit Reporting Online Network Utility System (CRONUS) was the first digital information storage and retrieval data processing solution. CRONUS unified the data, providing credit grantors across the country with a single, fast and accurate source of consumer credit information. Credit grantors were able to receive and update information directly on their personal computers or workstations as a result of CRONUS.”

International offices, either TransUnion-owned or through alliances and partnerships, are located in Botswana, Canada, Colombia, Costa Rica, Czech Republic, Hong Kong, Kenya, Mexico, Namibia, Peru, Puerto Rico, South Africa, Spain, Swaziland, Thailand, and Zimbabwe.

In addition to credit rating services, TransUnion also provides services to resolve or prevent problems with credit fraud. Professional staff is trained in the techniques of detection, prevention, and resolution of all credit fraud related situations, while understanding the many applicable laws, regulations, and consumer relations policies.

http://www.tuc.com/AboutTU/AboutTransUnion.asp
8.0 Other International Credit Bureau/Lending Examples

This section profiles three examples of credit and financing systems in contexts with some relevance to Egypt.

The first, the Turkish Credit Bureau, has been operating for six years in an Islamic nation with a similar population size to Egypt. Turkey, however, has a much higher literacy rate (82.3% compared to 51.4% in Egypt), life expectancy (70.97 years compared to 63.33 years in Egypt), and GDP purchasing power parity ($409.4B compared to $200B in Egypt). This example, however, profiles the basics of a national credit bureau established and supported by a major international credit bureau, Experian.

The second, the American Finance House Lariba, has been operating in the United States since 1987, and abides by Islamic financing practices when extending “credit” to a client base of Arab-Americans and Muslims of Southeast Asian roots. Besides assessing credit-worthiness of an applicant, the company screens potential clients for religious outlooks and business practices that match their own principles. This example profiles one approach to financing personal loans and small enterprise development within Islamic principles.

The third, the oft-acclaimed Grameen Bank, is specific to micro-enterprise credit. Initiated in the Islamic and impoverished context of Bangladesh, Grameen-style micro-credit programs have since spread around the world. The Grameen Bank Replication Program (through the Grameen Foundation, USA) provides training and advisory assistance for advancing microfinance institutions that target the poor. This example profiles credit principles particularly relevant in a setting with little established prospective client credit history or financial collateral.

8.1 Kredi Kayıt Burosu A.S. (KKB) – Turkish Credit Bureau

The Kredi Kayıt Burosu A.S. (KKB – Turkish Credit Bureau) was founded in 1995 by 11 major Turkish banks. This private company operates independent from the member institutions (now totaling 30) to manage Turkey’s largest database of personal credit information. The KKB manages the exchange of information (Credit Reference System – CRS) between financial institutions for the purpose of monitoring and controlling consumer credit information, including credit cards.

Experian built, supplied, and continues to support the database and information sharing software used by the KKB. Experian offers an extensive range of decision support services in Turkey including application processing, credit scoring, customer management solutions and strategic consultancy. Experian supports the KKB from its corporate headquarters in Nottingham, UK.

Establishing the KKB required an amendment to the Banking Law of Turkey (in 1993) to make data sharing possible between two financial institutions or through a company owned by at least ten financial institutions. A subsequent amendment in 1999 allows for a larger KKB member portfolio that includes:

Banks
Consumer Credit Companies
Finance Houses
Insurance Companies
Stock Exchange Companies
Leasing, Factoring, Forfeiting Companies, and
Organizations approved by the Banking Regulation and Supervision Board.

The publicized “benefits of services rendered by KKB to its members” includes:

- Minimizing the risk in consumer credit portfolios,
- Ensuring fast and efficient credit decisions,
- Measuring credit risk efficiently to increase the volume of extended credits,
- Promoting wider use of personal credits,
- Assisting with rational decisions when setting new credit limits for existing customers,
- Encouraging personal credit customers to make payments regularly, and
- Discouraging problematic customers from working with KKB member institutions.

KKB’s CRS Database provides both positive and negative credit data, with the aim of providing a comprehensive picture of the customer’s credit portfolio. Members can access information about the frequency of individuals' credit record inquiries and payment history (including erratic payments, arrears, and non-payment) to distinguish between low/no-risk forgetful payers and high-risk payment defaulters. The predictive relevance of the CRS Database increases through time as members contribute more data – there are now over 25 million account records. The KKB manages, but does not alter any of the data, not even the data field format provided by the contributing member. Conversely, members are expected to provide all available data for other members to access in the CRS Database.

The KKB offers its members the technical support and training necessary for all elements of using and contributing to the CRS Database, including data quality monitoring, and how to capture, verify, and analyze available credit information.

8.2 American Finance House Lariba

This Pasadena-based (California, USA) lending firm, American Finance House Lariba, subscribes to Islamic financing practices. Though a relatively small firm that focuses on home, auto, and business equipment financing, American Finance House Lariba abides by the following “Lariba Concept” principles:

1. Money is not a commodity. It is a measuring scale. It also does not reproduce. It only grows when used in an economic activity. Money is man-made.

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35 source: http://www.lariba.com/concepts.shtm
2. Wealth should be circulated within the community by investing it to help develop the community in order to create jobs, economic growth and prosperity.

3. LARIBA is usually confused with "Interest Free". We believe that this is a narrow and inaccurate definition. The LARIBA system of economics, finance and monetary theory is based on three important pillars:
   a) Wealth and property (Assets) are God's properties. Man (male/female) is appointed as its trustees and custodians.
   b) The system of "Zakkah" or "alms" giving.
   c) The system of "Miraath" or inheritance.

   We do not do the halal - "LARIBA" - financing justice by simply calling it interest free, because at the end of the day profits are to be made and rates are calculated and many may say so, "What is the difference?"

   A LARIBA financial institution is that which operates without "Riba".

4. LARIBA financing is socially responsible. It requires that the LARIBA banker/financier know how the applicant will use the money and that the exchange of assets/properties or the leasing of such is made.

   This way money can be used to generate economic activities in the community.

   LARIBA is not money lending, it is actual financing of a tangible asset.

American Finance House Lariba approaches lending either as a Joint Venture, or as a Joint Venture Lease-To-Purchase.\textsuperscript{36} In the Joint Venture (\textit{musharaka}) model, the business owner enters into an agreement with the Islamic Financial Company to buy the business according to a certain ownership distribution. The operator agrees to operate the business for a fee. The profit is distributed between the two entities according to an agreed upon formula. The operator may include in the agreement his/her right to purchase the business after a certain period and according to a specific formula.

The Joint Venture Lease-To-Purchase model is the same as above, but the operator opts to buy back the shares of the company at cost over a period. Both parties professionally evaluate the lease rate, and on that basis, the customer and bank agree to the monthly lease rate.

8.3 \textbf{Grameen Bank}

Professor Muhammad Yunus initiated the Grameen Bank (GB) in the early 80’s as an experimental project for enabling the rural poor in Bangladesh to break out of a vicious cycle with moneylenders. The Grameen Bank’s success lay in knowing its cultural landscape, and in taking its task seriously: staff were hired and trained, systems were established, and all loans were expected to be repaid. The lending model evolved to favour credit circles: Typically, a

\textsuperscript{36} Source: American Finance House. \url{http://americanfinance.com/financing/business.shtm}
group of five women, each with their own micro-enterprise, depended on one another’s loan repayment before they could access their own loans.

As such, the GB micro-credit model provides small loans to the poor through peer lending and using social collateral, rather than the typical financial collateral required by lending institutions. Yunus observed that commercial banks would not extend institutional credit to poor women because:

- The poor could not provide collateral,
- They were illiterate so could not process relevant papers and record-keeping, and
- Banks did not like to do business with so many small clients, but preferred larger loans with a few big clients.

Eventually, through accumulated savings, the borrowers bought control of the bank and form the majority of the Board of Directors. By the mid 90’s, more than three-quarters of GB shares were owned by the land less members. The GB model demonstrates that, micro-credit can enable the poor to shift from mere survival towards increased levels of security then self-respect.

The bank workers undergo intensive training for closely administering and supervising all loans – this ensures consistent loan policies and high compliance rates. Grameen Bank staff training is intensive and specifically emphasizes:

1. an understanding of the social and economic milieu and the operating constraints for the Bank;
2. the capacity to identify the target clientele group, organize and motivate them and prepare them to receive the Bank's services;
3. an understanding of how to process loan applications and assist centre chiefs in conducting meetings, collecting various dues, and preparing source vouchers for bank accounts; and
4. the ability to manage branch administration and accounts and to supervise loan recovery.

As such, the GB employees work very closely with the clients and “go to the borrowers” rather than the poor having to go to the bank. Over 90% of borrowers are women. And the GB encourages that borrowers diversify their micro-enterprise so not to risk all their eggs in one basket, and to help ensure a more steady cash flow and savings potential.

Rahman, and others, provide detailed guidance for replicating the GB model in a different cultural and economic setting. Some specific challenges when replicating the GB include:

- Ensuring non-interventionist support, not obstruction from government bureaucracy;

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• Early on, progressing away from donor agency dependency and toward self-reliance;
• Providing adequate loan scope or credible backing for increasing or “graduating” borrowers who successfully break out of poverty cycles;
• Maintaining highly motivated and well-trained staff, possibly through early incentive structures;
• Avoiding too rapid an expansion that leaves some projects ill-managed; and
• Maintaining a social development niche.⁴⁰

In addition, there’s been some incidence of Muslim fundamentalist resistance and backlash to the GB micro-credit focus on empowering women.

⁴⁰Rahman, Atiur. 1996.
9.0  ISSUES IN ESTABLISHING AN M/SME CREDIT SYSTEM IN EGYPT

This section summarizes many of the issues in applying a credit bureau and scoring system for M/SME development in Egypt. First, some current systemic considerations are presented before offering reflections and recommendations about possible approaches.

9.1  Systemic issues

Micro, small, and medium enterprise development in Egypt share many common obstacles, objectives, and needs. Credit bureaus, scoring, and programs must clearly define their objectives, target audience(s), intended benefits, available resources, delivery mechanisms, institutional sustainability, and role in business and economic development.

Egypt’s five most significant issues for introducing credit scoring for M/SME’s are likely to be:

1. Familiarity, availability, and perceived adequacy of current informal credit options will continue to restrain use of formal credit systems;
2. The lack of formal credit history and consistent records will make development of a reliable credit data base difficult;
3. The lack of legally registered or recognised collateral e.g., property and buildings is an obstacle to a good credit rating in both urban and rural contexts;
4. A successful system will have to reach out beyond urban centres to the urban fringe and rural areas; and
5. Geographic reality is that there is a wide dispersion of banks and people.

From reviewing literature, case studies, programs, and practical examples from elsewhere there seems to be a consistent distinction between the differing credit needs of micro businesses and small/medium enterprises. With micro credit, it will be important to separate the motives of “social capital investment” from “entering the global market economy”. This will help to define appropriate organizational strategies for building enterprise capacity and responsive credit mechanisms. Investing in “social capital” through increased access to micro enterprise credit seems a sensible first step from which some businesses may graduate toward small and medium enterprise.

For small and medium enterprise credit, risk assessment will need to focus less on social collateral, and more on enterprise feasibility in both domestic and global markets. This will require loan officer expertise and an approach to credit scoring that differs from that used for micro credit.
9.2 M/SME’s

Current financing

- In the villages, many people concurrently use formal and informal loans from a variety of sources, including the popular gama’eyat (Rotating Savings and Credit Associations). “Many households participate in both sectors, since the two sectors serve differing credit demands. The formal sector services loans for investment purposes, while the informal sector provides smaller loans for bridging or consumption smoothing purposes.” Because of this “mix”, and the difficulty in documenting the informal debt load, it will be challenging to build a comprehensive credit history that safeguards against loan applicants over-extending themselves.

- Formal and informal financing are currently interwoven: e.g., those who provide informal credit may be doing so with a formal bank loan; and an informal lending circle may be organized by a wife to pay off her husband’s formal loan.

- Five categories of informal finance include: occasional lending, regular lending, interlinked credit, finance through collective agreements, and informal finance at the corporate level. The promotion and assessment of formal credit will need to account for and find ways to value/score/assess each of these informal lending categories.

- “It is remarkable to notice that many of the informal loans [90.6% in one specific study] were implicitly and explicitly interest free. This is attributed mainly to the strong cultural and religious traditions against usury in Egypt. It is also interesting to note that 92.6% of informal transactions were undertaken without marketable tangible collateral. The rare use of collateral can be explained by the free flow of information between lenders and borrowers and the fact that the informal financial market is governed by a complex nexus of personal relations that establish an effective enforcement mechanism in the case of default.”

- Though few villages have commercial bank branches, villagers can access banking facilities in adjacent towns. Meanwhile, money keepers and merchants who sell goods or services on credit provide village-based financial services. A more formalised credit system will need to ensure easily accessible outreach to villages, and will need to show convincing reasons for prospective clients to change from trusted and functional informal and multi-level credit services.

Financing Concerns

- Some are concerned that, “introducing micro-loans for small-scale enterprise may actually contribute to the destruction of local non-monetarized economies and create dependence on a


highly volatile and inequitable global economy where factors such as currency devaluation can prove disastrous.”

- Most rural and urban poor (who are most likely to be micro credit clients) have no formal rights to their property – the builders did not seek official permission because of time, cost, and approval concerns. Without legal rights, property cannot be used to secure a loan. This can be considered “dead capital”, and accounts for 90% of Egypt’s urban dwellings and over 80% of rural dwellings. Valued at roughly $240 billion, this is equivalent to three times the GDP and should, at least partially, be mobilized into “living capital” to jumpstart M/SME financing. This may, however, present new and possibly undesired risk for those who need the security of their basic shelter/dwelling.

- Village bank micro credit models (such as the Grameen Bank) typically have a strong social impact on women by enabling economic activity outside their homes, developing market negotiation skills, altering local power relationships, and building new support networks. The “empowerment of women” has raised some concern and backlash from some Islamic fundamentalists. Credit system design should proactively “empower” while also safeguarding client and institutional security and safety.

- There is concern that credit circles through village banking (the most common micro-credit model) may negatively influence an individuals personal credit records if someone betrays the group, commits fraud, or if there is general group dysfunction and failure. Group credit and individual credit should be able to co-develop and co-exist in micro credit.

- NGO’s have been instrumental in pioneering and delivering micro credit programs, but have shown some limitations in growing with their clients or allowing their clients to grow. It will be important to closely assess the institutional stability and organizational preparedness of NGO’s to offer and operate sustainable micro finance programs if linked to a national credit bureau and a national credit initiative.

## 9.3 Banking/Financing System

### Dispersion

- Egypt has over 80 banks, dominated by four large, state-owned commercial banks that account for nearly 70% of total assets held by commercial banks, and 68% of loans. As happened in Turkey, a clear consortium of lending institutions would be useful for establishing a nation-wide credit bureau with shared benefits throughout the country and

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across a spectrum of lending institutions and enterprise needs. The state-owned commercial banks could do their own joint credit initiative, but this does little to de-centralize for entry into the global market. With so many banks, and an even more prolific informal lending sector, a national credit bureau initiative requires broad acceptance. Without relatively comprehensive participation by the banks, the database will be very limited with high risk of borrower over-extension and default.

- Efficient M/SME credit scoring requires all institutional branches to have the same lending technology (computer resources, databases, interpretation, etc.) and to be electronically linked to a common credit bureau or data bank. There may be high start-up and implementation costs including hardware, software and training.

Bank Systems

- Several challenges to increased M/SME financing through the banking system include:55
  i. creating unique ID numbers for each applicant (personal and/or enterprise) to be used throughout the credit system;
  ii. the potentially high cumulative cost of accessing credit reports for large numbers of small loans;
  iii. a fear that sharing client credit history increases competition for the most credit-worthy clients;
  iv. frequent downloading of financial data to keep up with short-term loan cycles (and possible defaults); and
  v. setting minimum loan amounts for inclusion in the credit bureau data. Many systems, even in developing economies, set minimum loan amounts. Limits are likely to exclude all micro and many small businesses from the database and rating system.56

Experience/Expertise

- In the early stages of building a comprehensive database for credit scoring, the judgement of loan officers will be the biggest liability or asset. Development of a reliable database will be dependent on their skill and care in starting the formal credit history for clients.

- Even with a credit bureau, loan officers will need to look for “hints of risk” and then “convert their subjective judgements into quantitative forms” for scoring based on perceived “reputation [of the applicant] in the community, entrepreneurship, experience with debt [formal and informal], and informal support networks.”57

- “Loan officers and credit managers in the branches may feel threatened by scoring [because] they spend a lot of time and effort to learn to judge risk, and [may be] suspicious of a computer program – written by someone who has never met one of their clients – that claims to improve on their judgements.”58

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56 Miller, Margaret. 2000. pp. 12


Based on the information about the current system in Egypt, the Alexandria Business Association (ABA) seems to offer an example of both a sustainable track record and the institutional stability necessary to be a leader in developing a credit rating database and approach for expanding micro credit while bridging credit-scoring gaps between micro and small enterprise.

**Succession and Sustainability**

- “A crucial measure of the success of micro enterprise programs is the extent to which they integrate the poor into the formal economy. This strategy has quite radical implications for financial sustainability issues, since it entails adopting an on-going strategy of taking in new (less profitable) members and graduating those who are most successful (profitable).”  
  
  M/SME growth (client progression) from initial group credit to personal credit can be challenging for micro credit institutions that want to keep their best clients, but may not have the infrastructure or resources to offer larger loans.  

**9.4 Credit Rating Systems**

**Suitability and Sustainability**

- “Because credit bureaus have fixed costs and are characterized by economies of scale, private entities usually enter the market only after a public credit register has been functioning for some time. Privately managed bureaus then complement the records contained in the public credit registers – and, by expanding the breadth, quality, and accessibility of information, improve and re-package an already valuable product.”  

  Egypt needs to assess the suitability of current credit databases and models used by the four major state-owned banks. From our review, it is not clear if these can be adapted or applied to an expanded M/SME context. Is there common ground in the current credit review systems used by ABA or National Bank for example?

- “Although scoring is less powerful in poor countries than in rich countries, and for large rather than micro or small clients, and although scoring will not replace the personal knowledge of character of loan officers or of loan groups, scoring can improve estimates of risk. Thus, scoring complements – but does not replace – current micro finance technologies.”  

  While a credit bureau can provide another tool for speeding up loan decisions while reducing risk, knowledgeable loan officers working close to the clients are still key for success and require focused investment and incentive.

- Credit-scoring formulae must include weights for different characteristics of not only borrowers, but also of lenders and loans. The loan officer’s personal knowledge, judgement, and track record also influence the risk calculations.

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60 Goldmark, Lara. 2001


62 Schreiner, Mark. 2001.

63 Schreiner, Mark. 2001.
It will be important to examine if and how the KKB in Turkey, the American Finance House Lariba, and the Alexandria Business Associations integrate Islamic Banking values and principles in their respective credit scoring models and decisions.

10. APPROACHES TO ESTABLISHING AN M/SME CREDIT SYSTEM IN EGYPT

10.1 General Principles
Micro-enterprise credit is typically considered separate from small and medium enterprise financing – the clients are usually of lower income, the loan amounts less, the terms shorter, and the risks lower. Micro-entrepreneurs rarely have the physical or financial collateral or credit history desired for formal scoring. As such, it will be important to examine the feasibility of a distinct credit system for micro-entrepreneurs to establish themselves. The approach should consider the micro-entrepreneur as a client with high long-term potential if lower-risk short-term needs are met, not as a nuisance or high-risk liability. Indeed, some argue that the current multilevel credit system meets current credit needs of micro enterprise.

Conversely, small and medium enterprise is often a higher risk, but have the greatest potential to become significant economic drivers for a village, region, or country. This requires a credit system that is efficient, reliable, adaptive, and specialized to support, not hinder, entrepreneurial energy across often sectors.

Suggestions to increase the role of credit scoring for M/SME financing and development in Egypt include:

1. Establish separate objectives for micro enterprise credit and small/medium enterprise credit, but ensure the micro-credit record can be easily integrated into the small/medium enterprise credit system.

2. Evaluate current NGO capacity (including the ABA) and potential to apply a Grameen Bank-style micro-credit approach in rural- and urban-poor areas (valuing social collateral and informal credit history as much as possible.) Support micro credit institutional growth if necessary (with a plan for full repayment and independent sustainability), and ensure credit tracking can be integrated into a nation-wide database.

3. Develop a national credit bureau with the backing of international technical support.

4. Through a national credit bureau, create “entry level” risk assessment models that reflect small business objectives and allow micro-entrepreneurs to “graduate” toward small business financing with little collateral. These models could be used “outside” of a credit bureau system.

5. Minimise the government bureaucracy associated with micro and small enterprise credit terms, and develop governmental policies (land reform, taxation, etc.) with careful consideration for its effect on entrepreneurs working to become part of the formal economy.

6. Provide training for loans officers and managers to give them the understanding and skills necessary to manage a M/SME loan portfolio and related credit rating tools.
10.2 M/SME Implications

Credit bureau proponents argue that credit bureaus will benefit micro enterprises by:

i. lowering loan costs (through more efficient loan approvals and improved risk assessment);
ii. improving lending terms (because there will be increased competition for clients between micro finance institutions); and
iii. better disciplining borrowers to keep repayment schedules (for fear of being tracked through a credit bureau and eventually locked out of formal credit markets for recurring defaults).

- There has been little research documenting the impacts of targeted micro credit programs on the economic behaviour of credit recipients. A summary of 32 micro credit project evaluations in developing countries found that, at the enterprise level, there is consistent impact on output and income, and less consistent influence on asset accumulation and employment.

- All credit applicants will need a unique identification number and possible registration with government authorities – which many micro entrepreneurs will continue to avoid.

- Where a micro-enterprise has a track record with an NGO for micro credit, the NGO could serve as a co-applicant or sponsor for advancing into small enterprise credit through formal lending institutions. Credit scoring could examine both the micro/small entrepreneur and the NGO’s joint creditworthiness. This may also increase the onus on NGO’s to further develop institutional stability.

- Credit scoring and financing approaches should distinguish between the risk, needs, and potential of M/SME credit applicant’s in:
  i. traditional production sectors;
  ii. identified emerging market niches; and
  iii. “avant garde” high technology and other “new economy” industries.

- Those in traditional production sectors are most likely to benefit from group-lending approaches. Those in emerging market niches may be best served with lease-purchase financing and asset-based security. Those in “avant garde” industries pursue high-risk high-

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return ventures that can become economic drivers for Egypt in a global market – traditional lending is not suitable; venture capital is the most suitable financing model.\textsuperscript{69}

\section*{10.3 Banking/Financing System Implications}

Best practice includes:\textsuperscript{70}

- i. cover costs to ensure institutional survival and ongoing service delivery,
- ii. avoid subsidies so not perceived as a charity or dependent on inconsistent funding sources,
- iii. promote outreach and demand-driven service delivery: i.e., increasing access to quick and easy savings and loan services for low-income clients based on their cash flow, character, and social collateral, not on their assets and documents, and
- iv. maintain a clear focus: i.e., not mixing micro finance with social service provision.

- Credit bureau proponents argue that credit bureaus will benefit the micro enterprise financing sector by: lowering transaction costs, speeding up the credit approval process, reducing risk (thereby allowing for more accurate service pricing), and improving accounting transparency.\textsuperscript{71}

- Savings services for low-income micro entrepreneurs are very important. As such, some non-profit micro credit organisations are trying to convert into regulated financial institutions to offer more complete banking services\textsuperscript{72} (e.g., the ABA).

- \textit{Financial viability} should be defined as: “the stage of financial operations where all the costs of the lender are fully met from the interest [or service] charges, and where such charges are not subsidised, partly or fully, from outside sources.”\textsuperscript{73}

- Banks can reduce transaction costs associated with a large volume of small loans by:\textsuperscript{74}
  - i. Recruiting loan officers from the areas where borrowers live.
  - ii. Making loan officers responsible for both granting loans and collecting repayments, so that they can develop borrower and industry knowledge.
  - iii. Providing adequate training on M/SME financing and credit rating tools and procedures to loan officers
  - iv. Rewarding loan officers for their performance – for example, paying a low base salary that can increase substantially based on the number of new loans granted and repayments obtained.
  - v. Decentralising decision-making (e.g., to the level of the branch manager).
  - vi. Simplifying loan procedures.
  - vii. Using information technology to track borrowers and manage loan portfolios.

\begin{thebibliography}{9}
\bibitem{71} Haider, Elinor. 2000.
\bibitem{72} Goldmark, Lara. 2001.
\bibitem{74} Brandsma, J. and R. Chaouali. 1998. p.11.
\end{thebibliography}
10.4 Credit Rating Implications

Most micro finance lenders start with one of the following simple scoring models, gradually working toward the last one if all works well: 75

i. Predicting the likelihood that a loan currently outstanding or currently approved for disbursement under the standard loan-evaluation process will have at least one spell of arrears for at least $x$ days. This can guide risk-based pricing or spark a preventative loan officer visit.

ii. Predicting the likelihood that a loan $x$ days in arrears now will eventually reach $y$ days of arrears. This can help to prioritise visits by loan officers.

iii. Predicting the likelihood that a borrower with an outstanding loan in good standing will choose not to get a new loan once the current one is repaid. This can be used to offer incentives to good borrowers who are likely to drop out.

iv. Predicting the expected term to maturity of the next loan of a current borrower.

v. Predicting the expected size of disbursement of the next loan.

vi. A combination of information from the first five models with knowledge of the expected revenue of a loan with a given term to maturity and disbursement and with knowledge of the expected costs of drop-outs, loan losses, and monitoring borrowers in arrears.

- “Scoring systems should be integrated into the existing management-information system [so] they require little data entry beyond that already done as part of standard processes.” 76 The power and potential of the system relies on the thoroughness and quality of data from all institutions that contribute – and benefit.

- Micro credit systems will have to be managed in a way that preserves complex local economies while concurrently building personal and M/SME credit records.

10.5 Credit Bureau Implications

- Given the large number of banks, and large number of micro and small businesses, and their dispersion across the country, a national credit bureau system is unlikely to develop as a private sector initiative. It may develop as a joint public/private sector initiative if the major banks are all supportive of the concept. 77

- The effectiveness of a bureau depends on the quality of its database, the reliability of its rating system, the promptness of its service and the cost of its service. To support micro and small businesses, public and private partnership is likely to be necessary to build a reliable database. The rating formulae used by the major bureaus are not publicly available, but

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75 Schreiner, Mark. 2001. pp. 6, 7.
77 Miller, Magaret. 2000. pp. 10
alternative formulae and software are available in the public domain. General formulae may have to be adapted to fit specific micro and small enterprise development objectives.

- Reliable and prompt communication systems are essential. Bureau customers would have to have at a minimum reliable phone and fax access. Computer and Internet access would be ideal.

- Support from the majority of banks and lending institutions is essential both for data base reliability and for economies of scale. If costs are to be reasonable, the volume of micro and small loan clients will need to be “balanced” with as many medium and large clients as possible. To get this support it may be necessary to establish a reasonable loan limit that will include small businesses.

- Banks will have to “reliably” report information on their clients – both good and “problem” clients – if a bureau is to function as intended. Poor information will lead to poor results. A joint venture or public system would allow the government to require that inaccuracies or “missing data” be remedied and to provide sanctions for non-compliance. This quality control of data is more difficult to manage in a private sector model, especially if there is no competitive bureau providing information.

- The credit bureau system will have to provide a quality assurance process to the consumer either through provision of credit rating information to the consumer to cross check for inaccuracies, or to employ a rigorous “in-house” data base testing and analysis system.  

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78 see for example SAS software at [http://www.sas.com/offices/europe/uk/solutions/knowledge_credit_scoring.pdf](http://www.sas.com/offices/europe/uk/solutions/knowledge_credit_scoring.pdf)
79 Miller, Magaret. 2000. pp. 123
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Attachment A: Islamic Banking

Islamic Economy
An Islamic economy is a market economy guided by moral values. Economic activities are based on principles of cooperation and responsibility. Cooperation means that an economic exchange shall be beneficial to both parties involved. Transactions in which one party wins at the expense of the other are not permissible in Islam. Thus, monopolistic dealings, usury, and exploitation are prohibited. Transactions that allow both parties to win are permissible, and these include most types of activities needed for economic prosperity. Performance-based arrangements, like profit sharing or partnership, represent the most cooperative form of beneficial agreements, and thus are highly encouraged in Islam. Responsibility means that each individual is entitled for reward or return based on his effort and contribution. Thus gambling and lotteries are not permissible. Gambling allows an individual to gain based on pure luck, not on merit or effort. It shifts wealth blindly among participants leading to improper distribution of wealth. Gambling is a clear form of a zero-sum game where one party wins only if the other loses, and thus causes hatred and enmity among participants. A society where lotteries or gambling-like activities prevail is a zero-sum society, where the winner takes all, and the rest is doomed to fail.

Islamic Economics
Islamic economics is a framework for studying economic activities that allow mutual benefit of exchange to be realized. It provides proper tools and techniques for evaluating economic decisions, showing when and how to achieve win/win outcomes and avoid win/lose or lose/lose ones. Islamic economics is based on the principle that Allah the Almighty created this world with plenty of resources that satisfy the needs of everyone. Thus one person's success is not necessarily achieved at the expense or exclusion of the success of others. This "win/win" framework leads to better economic behaviour and performance, and thus promises better future for mankind. Islamic Banks are financial institutions established according to principles of Islamic Economics. They provide finance and financial services in a manner leading to mutual benefit. Although finance activities are deeply rooted in Islamic history, formal Islamic banking is a recent phenomenon, whereby the first Islamic bank was established around 1963. Since then Islamic banks have developed and proliferated, reaching total assets of around $137 billion held by more than 160 financial institutions distributed throughout the world.

What are Islamic Banks? 
Unlike their counterparts elsewhere, Islamic bankers do not expect to advance money and receive a predetermined sum on a fixed date in the future. Under the Shariah, the bedrock of the Islamic faith, they are instead responsible for ensuring that money is invested in viable projects, with reliable borrowers. If the project succeeds, the banker shares in the profit. If it fails he suffers the losses.

The Shariah, which dictates the activities of the banks as well as forming the basis of the daily lives of all Muslims, requires that rewards come from risk sharing. Profit must be justified through the creation of value that the banker brings to complement the value of the borrower's efforts and skills.

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81 NB: in places, bold text is added to highlight risk assessment and credit scoring issues.
Against a background of rapid growth in Middle Eastern economies over the last 20 years and a desire to increasingly compete internationally, Islamic banks have begun to change and develop to provide a range of alternative financial products - still firmly based on Islamic principles.

Islamic financial techniques have been employed successfully in a growing number of major projects in the West. Al Rajhi Bank has completed deals for the financing of ships and aircraft (using the Ijara - lease financing technique), and many industrial projects including the building of power stations, a refinery and schools, and the expansion of an aluminium smelter in Bahrain (using the Istisna - deferred financing technique).

It is important to understand that whilst the structures for Islamic financing are different from the conventional loan or debt markets, they are neither more complicated nor more difficult to close. The ability of some Islamic banks to take entire deals onto their books without the need to syndicate can make the negotiation process far simpler.

In order to provide a competitive range of alternative financing vehicles, Islamic banks will need to work together to develop and adopt the standards of disclosure and risk management that are expected in the international markets, and to educate western borrowers in the use of Islamic finance.

Given the huge potential for development in the Islamic world and the increasing amount of funds being invested according to the Shariah, it seems perfectly reasonable to suppose that the recent growth in Islamic banking will continue at an accelerated pace.

**Guiding Principles**

The guiding principles for an Islamic financial system is a set of rules and laws, collectively referred to as Shariah, guiding economic, social, political, and cultural aspects of Islamic societies. Shariah originates from the rules dictated by the Quran and its practices, and explanations rendered (more commonly known as Sunnah) by the Prophet Muhammad. Further elaboration of the rules is provided by scholars in Islamic jurisprudence within the framework of the Quran and Sunnah. In a sense, the combination of law and finance in Islam is inevitable.

Whereas the conventional financial system focuses primarily on the economic and financial aspects of transactions, the Islamic system places equal emphasis on the ethical, moral, social, and religious dimensions, to enhance equality and fairness for the good of society as a whole. The system can be fully appreciated only in the context of Islam's teachings on the work ethic, wealth distribution, social and economic justice, and the role of the state.

Undoubtedly, prohibiting the receipt and payment of interest is the nucleus of the system, but it is supported by other principles of Islamic doctrine advocating risk sharing, individuals’ rights and duties, property rights, and the sanctity of contracts. Similarly, the Islamic financial system is not limited to banking but covers capital formation, capital markets, and all types of financial intermediation.

A quick summary of the well-known principles of Islamic Finance and the wisdom inherent in them will be described in order.

1. **Making Money from Money is not Permissible**
One of the wrong presumptions on which all theories of interest are based is that money is a commodity. It is, therefore, argued that just as a merchant can sell his commodity for a higher price than his cost, he can also sell his money for a higher price than its face value, or just as he can lease his property and can charge a rent against it, he can also lend his money and can claim interest thereupon. Islamic principles, however, do not subscribe to this presumption. Money and commodity have different characteristics and, therefore, they are treated differently.

2. The basic points of difference between money and commodity
(a) Money has no intrinsic utility. It cannot be utilized in direct fulfillment of human needs. It can only be used for acquiring some goods or services. A commodity, on the other hand, has intrinsic utility and can be utilized directly without exchanging it for some other thing.
(b) Commodities can be of different qualities while money has no quality except that it is a measure of value or a medium of exchange. Therefore, all the units of money of the same denomination, are hundred per cent equal to each other. An old and dirty note of SR.100 has the same value as a brand new note of SR.100.
(c) In commodities, the transactions of sale and purchase are effected on an identified particular commodity. If A has purchased a particular car by pinpointing it, and seller has agreed, he deserves to receive the same car. The seller cannot compel him to take the delivery of another car, though of the same type or quality.

Money, on the contrary, cannot be pinpointed in a transaction of exchange. If A has purchased a commodity from B by showing him a particular note of SR.100 he can still pay him another note of the same denomination.

Based on these basic differences, Islamic Shariah has treated money differently from commodities, especially on two scores:

Firstly, money (of the same denomination) is not held to be the subject matter of trade, like other commodities. Its use has been restricted to its basic purpose i.e. to act as a medium of exchange and a measure of value.

Secondly, if for exceptional reasons, money has to be exchanged for money or it is borrowed, the payment on both sides must be equal, so that it is not used for the purpose it is not meant for i.e. trade in money itself.

In short, money is treated as "potential" capital. It becomes actual capital only when it joins hands with other resources to undertake a productive activity. Islam recognizes the time value of money, but only when it acts as capital, not when it is "potential" capital.

3. Prohibition of Interest
The most famous principle of Islamic Finance is the prohibition of usury or interest (Riba in Arabic).
There is a consensus among the scholars that even the interest paid by and to conventional banks is riba. Islam does not recognize loans as income-generating transactions. They are meant only for those lenders who do not intend to earn a worldly return through them. They, instead, lend their money either on humanitarian grounds to achieve a reward in the Hereafter, or merely to save their money through a safer hand. So far as investment is concerned, there are several other modes of investment like partnership etc. that may be used for that purpose. The transactions of loan are not meant for earning income.

The basic philosophy underlying this scheme is that the one who is offering his money to another person has to decide whether:
(a) He is lending money to him as a sympathetic act or
(b) He is lending money to the borrower, so that his principal may be saved or
(c) He is advancing his money to share the profits of the borrower.

In the former two cases (a) and (b) he is not entitled to claim any additional amount over and above the principal, because in case (a) he has offered financial assistance to the borrower on humanitarian grounds or any other sympathetic considerations, and in case (b) his sole purpose is to save his money and not to earn any extra income.

However, if his intention is to share the profits of the borrower, as in case (c), he shall have to share his loss also, if he suffers a loss. In this case, his objective cannot be served by a transaction of loan. He will have to undertake a joint venture with the opposite party, whereby both of them will have a joint stake in the business and will share its outcome on fair basis. Conversely, if the intent of sharing the profit of the borrower is designed on the basis of an interest-based loan, it will mean that the financier wants to ensure his own profit, while he leaves the profit of the borrower at the mercy of the actual outcome of the business. There may be a situation where the business of the borrower totally fails. In this situation he will not only bear the whole loss of the business, but he also will have to pay interest to the lender, meaning thereby that the profit or interest of the financier is guaranteed at the price of the destructive loss of the borrower, which is obviously a glaring injustice.

On the other hand, if the business of the borrower earns huge profits, the financier should have shared in the profit in reasonable proportion, but in an interest-based system, the profit of the financier is restricted to a fixed rate of return which is governed by the forces of supply and demand of money and not on the actual profits produced on the ground. This rate of interest may be much less than the reasonable proportion a financier might have deserved, had it been a joint venture. In this case the borrower secures the major part of the profit, while the financier gets much less than deserved by his input in the business, which is another form of injustice.

Thus, financing a business on the basis of interest creates an unbalanced atmosphere, which has the potential of bringing injustice to either of the two parties in different situations. That is the wisdom for which the Shariah did not approve an interest-based loan as a form of financing.

Once interest is banned, the role of "loans" in commercial activities becomes very limited, and the whole financing structure turns out to be equity-based and backed by real assets. In order to limit the use of loans, the Shariah has permitted to borrow money only in cases of dire need, and has discouraged the practice of incurring debts for living beyond one's means or to grow one's wealth.

It should be the last thing to be resorted to in the course of economic activities. This is one of the reasons for which interest has been prohibited, because, given the prohibition of interest, no one will be agreeable to advance a loan without a return for unnecessary expenses of the borrower or for his profitable projects. It will leave no room for unnecessary expenses incurred through loans. The profitable ventures, on the other hand, will be designed on the basis of equitable participation and thus the scope of loans will remain restricted to a narrow circle.

Conversely, once interest is allowed, and advancing loans, in itself, becomes a form of profitable trade, the whole economy turns into a debt-oriented economy which not only dominates over the real economic activities and disturbs its natural functions by creating frequent shocks, but also puts the whole mankind under the slavery of debt. It is no secret that all the nations of the world, including the developed countries, are drowned in national and foreign debts to the extent that the amount of payable debts in a large number of countries exceeds their total income. Just to take one example of UK, the household debt in 1963 was less than 30% of total annual income. In 1997, however, the percentage of household debt rose up to more than 100% of the total income. It means that the household debt throughout the country,
embracing rich and poor alike, represents more than the entire gross annual incomes of the country. Consumers have borrowed, and made purchases against their future earnings, equivalent to more than the entirety of their annual incomes. Peter Warburton, one of the UK's most respected financial commentators and a past winner of economic forecasting award, has commented on this situation as follows: "The credit and capital markets have grown too rapidly, with too little transparency and accountability. Prepare for an explosion that will rock the western financial system to its foundation."

4. Profit and Loss Sharing
The basic and foremost characteristic of Islamic financing is that, instead of a fixed rate of interest, it is based on profit and loss sharing. Islam encourages Muslims to invest their money and to become partners in business instead of becoming creditors. This encourages Entrepreneurship. In turn, entrepreneurs compete to become the agents for the suppliers of financial capital who, in turn, will closely scrutinize projects and management teams. The objective is that high-risk investments provide a stimulus to the economy and encourage entrepreneurs to maximize their efforts.

5. Gharar (Uncertainty or Speculation) is Prohibited
Another significant principle of Islamic finance is the prohibition of transactions involving gharar, or uncertainty. Under this prohibition any transaction entered into should be free from uncertainty and speculation. Contracting parties should have perfect knowledge of the counter values intended to be exchanged as a result of their transactions. Thus, options and futures are considered un-Islamic and so are forward foreign exchange transactions because rates are determined by interest differentials.

6. Investments Should only Support Halal Activities
The Shariah does not permit Muslims to invest in any business or activity that involves the production of items or pursuit of activities the shariah considers haram, or impermissible.

Scholars have devised a set of rules to govern such investments. Some of them are:

- The main business of the company in which the investment is sought to be made is not in violation of Shariah. Therefore, it is not permissible to acquire the shares of the companies providing financial services on interest, like conventional banks, insurance companies, or the companies involved in some other business not approved by the Shariah, such as those manufacturing, selling or serving liquor, pork, haram meat, or involved in gambling, night club activities, pornography etc.

- If the main business of the companies is halal, like automobiles, textiles, etc. but they deposit their surplus amounts in a interest-bearing account or borrow money on interest, the shareholder must express his disapproval against such dealings, preferably by raising his voice against such activities in the annual general body meeting of the company.

- If some income from interest-bearing accounts is included in the income of the company, the proportion of such income in the dividend paid to the share-holder must be given in charity, and must not be retained by him. For example, if 5% of the whole income of a company has come out of interest-bearing deposits, 5% of the dividend must be given in charity.

Financial Techniques and Terminology
A. Murabaha was originally an exchange transaction in which a trader purchases items required by an end user. The trader then sells those items to the end-user at a price that is calculated using an agreed profit margin over the costs incurred by the trader.

To be in consonance with the principles of Islamic finance governing exchange transactions every murabaha transaction must meet the following conditions:
**Murabaha** transactions may be undertaken only where the client of a bank, or financial institution, wants to purchase a commodity. This type of transaction cannot be effected in cases where the client wants to get funds for a purpose other than purchasing a commodity, like payment of salaries, settlement of bills or other liabilities.

To make it a valid transaction it is necessary that the commodity is really purchased by the bank and it comes into the ownership and possession (physical or constructive) of the bank so that it may assume the risk of the commodity so far as it remains under its ownership and possession.

After acquiring the ownership and possession of the commodity it should be sold to the client through a valid sale.

Some quarters have equated *murabahah* transactions to interest-based loans. However, there are many significant factors that distinguish a *murabaha* contract from a riba-based one. Some of them are the following:

In the event of default by the end user, the financer only has recourse to the items financed, and no further mark-up or penalty may be applied to the sum outstanding. This means that the amount to be repaid does not go on increasing with passage of time as in the case of amounts borrowed from conventional banks on interest.

Also, in conventional financing, the bank gives loans to its clients without ever being concerned how the money is being put to use.

In the event of a *murabahah* transaction, no money is loaned to the client. Rather, the financing party purchases the goods himself, based on the requirement of the client. This ensures that financing is always asset-based. In effect, this type of financing creates real assets and inventories.

Another major difference between a *murabahah* contract and an interest-based one is that the financer cannot be unconcerned about the purposes for which the asset being leased is to be put to use. Conventional banks have no compunction in lending to gambling houses or liquor companies, or even pornographic filmmakers.

Islamic principles of finance are based on a well-established rule which dictates that “The benefit of a thing is a return for the liability for loss from that thing”. Hence, in a *murabahah* transaction the bank or financier assumes the risk by purchasing the commodity before he sells it at a mark-up. This mark up is considered as the reward of the risk he assumes. Interest-bearing loans assume no risks whatsoever. In other words, because the bank takes title to the goods, and is therefore engaged in buying and selling, its profit derives from a real service that entails a certain risk. This aspect lends the transaction legitimacy.

Most scholars have ruled that, to serve as a deterrent to such as may willfully delay payments, the financer may get the buyer to agree, at the time of the contract, to make a pre-specified donation to an agreed charity in case of late payment of monthly installments.

These scholars, however, caution that this device should be used to the minimum extent and only in cases where *musharakah* or *mudarabah* are not practicable for one reason or another.

**B. Mudaraba** implies a contract between two parties whereby one party, the *rabb al-mal* (beneficial owner or the sleeping partner), entrusts money to the other party called the *mudarib* (managing trustee or
the labour partner). The mudarib is to utilize it in an agreed manner and then returns to the rabb al-mal the principal and the pre-agreed share of the profit. He keeps for himself what remains of such profits.

The following rules must govern all Mudaraba transactions:

- The division of profits between the two parties must necessarily be on a proportional basis and cannot be a lump sum or guaranteed return.
- The investor is not liable for losses beyond the capital he has contributed.
- The mudarib does not share in the losses except for the loss of his time and efforts.

Briefly, an Islamic bank lends money to a client to finance a factory, for example, in return for which the bank will get a specified percentage of the factory's net profits every year for a designated period. This share of the profits provides for repayment of the principal and a profit for the bank to pass on to its depositors. Should the factory lose money, the bank, its depositors and the borrower all jointly absorb the losses, thereby putting into practice the pivotal Islamic principle that the providers and users of capital should share risks and rewards.

Areas of Application: Islamic banks use this instrument to finance those seeking investments to run their own enterprises or professional units, whether they be physicians or engineers or traders or craftsmen. The bank provides the adequate finance as a capital owner in exchange of a share in the profit to be agreed upon.

It is worth noting that this mode is a high risk for the bank because the bank delivers capital to the mudarib who undertake the work and management and the mudarib shall only be a guarantor in case of negligence and trespass. Islamic banks usually take the necessary precautions to decrease the risk and to guarantee a better execution for the mudaraba and pursue this objective with seriousness.

However, it may be noted that, under mudarabah, the liability of the financier is limited to the extent of his contribution to the capital, and no more.

C. Musharaka is a partnership, normally of limited duration, formed to carry out a specific project. It is, therefore, similar to a Western-style joint venture, and is also regarded by some as the purest form of Islamic financial instrument, since it conforms to the underlying partnership principles of sharing in, and benefiting from, risk. Participation in a musharaka can either be in a new project, or by providing additional funds for an existing one. Profits are divided on a pre-determined basis, and any losses shared in proportion to the capital contribution. In this case, the bank enters into a partnership with a client in which both share the equity capital- and maybe even the management -of a project or deal, and both share in the profits or losses according to their equity shareholding. There are two basic types of musharaka:

i. *Sharikah al milk*: partnership based on joint ownership. This may be voluntary e.g. in the purchase of a ship, or involuntary e.g. as a result of inheritance.

ii. *Sharikah al uqud*: partnership based on a contractual relationship.

There are five subdivisions:

1. *Sharikat al Mufawadah* (full authority and obligation): a limited partnership with equal capital contributions, responsibility, full authority on behalf of others, and responsibility for liabilities, incurred through the normal course of business.
2. *Sharikat al Inan* (restricted authority and obligation): a limited partnership with unequal capital contributions. They do not share equal responsibility, and this reflects their share of the profits.
3. **Sharikat al Wujuh** (goodwill /credit worthiness): companies based on the reputation of one or both parties, typically small scale business.

4. **Sharikat al Abdan** (labour, skill and management): a company based on the contribution of human efforts, no capital contributions, again, typically small scale business.

5. **Sharikat al Mudaraba**: a mudaraba

**D. Ijarah** can be defined as a process by which "usufruct of a particular property is transferred to another person in exchange for a rent claimed from him/her". In many respects, *ijarah* resembles leasing as it is practiced in today’s commercial world.

The distinguishing feature of this mode is that the assets remain the property of the Islamic bank to put them up for rent every time the lease period terminates so as not to remain unutilized for long periods of time. Under *ijarah* the bank or the leasing company assumes the risk of recession or diminishing demand for these assets.

To be in consonance with the principles of Islamic finance governing financial transactions every *ijarah* transaction must meet the following conditions:

- It is a condition that the object leased must not be perishable or consumable.
- The lease is for the utilization not the consumption of the asset.
- It is a condition that the subject of the contract must actually and legally be attainable. It is not permissible to lease something that cannot be delivered.
- The lessee must ensure that the asset is used for the purpose it is made for. The lessee shall comply with the provisions of the contract. The lessee also shall not benefit from the asset in a way more than what has been agreed upon.
- It is not permitted to lease real estate to be used as an interest based bank or a bar. However it is permissible to lease property to those whose major activities are permissible or *halal* even if they include some secondary prohibited practices.
- The lessor must not only deliver the asset on time, on the date of commencement of lease, but also ensure that the lessor delivers those accessories as well which are essential for the lessee to benefit from the asset as per the norms.
- The lease contract must state the lease period clearly. Renewal terms must also be stated clearly, and things like the rentals for all subsequent years, after the first year, should not mention clauses like ‘left to the sole discretion of the lessor’ and the like.
- The rental must be money. The lease rent falls due from the receipt of the asset by the lessee, not the date the contract is signed.
- The amount and timing of the lease payments should be agreed in advance. However, the agreed schedule and amount of those payments need not be uniform.
- It is permissible for the two parties to agree during the lease period to review the lease period or the rental or both. That is because the lease contract occurs periodically unlike the sale contract where the transfer of ownership is immediate.
- The lessor bears the liabilities when leasing the asset such as damage to the asset, payment of premium cost and basic maintenance. There is no objection to authorizing the lessee to undertake all the above but the costs thereof must be borne by the lessor/owner.
- The lessor/owner bears all the costs of the legally binding basic maintenance and these are operations on which the permanence and suitability of the leased object depend. The lessor
also bears the cost of the replacement of durable parts. However, it is permissible to make
the lessee bear the cost of ordinary routine maintenance, because this cost is normally known
and can be considered as part of the rental.

- The conditions of usage of the leased items must be stated. The lessor must have full
  possession and legal ownership of the asset prior to leasing it.
- A price cannot be pre-determined for the sale of the asset at the expiry of the lease. However,
  lessor and lessee may agree to the continuation of the lease or the sale of the leased asset to
  the lessee under a new agreement at the end of the initial lease period.
- In the event of late payment of rental, the Ijarah may be terminated immediately.
- The lessor may claim compensation for any damage caused to the leased assets as a result of
  negligence on the part of the lessee.

Literally, Ijarah means to give something on rent. As a term of Islamic Fiqh, Ijarah can also refer to
wages paid to a person in consideration of the services rendered by him/her. In the above discussion, the
term Ijarah is used to represent the usufructs of assets and properties, and not to the services of human
beings.

E. Salam is one of the basic conditions for the validity of sale in Shariah that the commodity
intended to be sold must be in the physical or constructive possession of the seller. This condition has
three implications:

First, the commodity must be existing; a commodity that does not exist at the time of sale cannot be sold.

Second, the seller should have acquired the ownership of that commodity. If the commodity exists but
the seller does not own it, he cannot sell it to anybody.

Third, mere ownership is not enough. It should have come in the possession of the seller, either
physically or constructively. If the seller owns a commodity, but he has not acquired its delivery by
himself or through an agent, he cannot sell it.

There are only two exceptions to this general principle in Shariah. One is Salam and the other is Istisna.
Both are sales of a special nature.

Salam, or Bay-Salaam as it is also called, is a sale whereby the seller undertakes to supply some specific
goods to the buyer at a future date in exchange for an advanced price fully paid on the spot.
Here the price is paid in cash, but the supply of the purchased goods is deferred. The buyer is called
"Rabb-us-Salam", the seller is "Muslim ilaih", the cash price is "ra's-ul-mal", and the purchased
commodity is termed as "muslam fih".

The Shariah allows Salam subject to certain conditions. The basic purpose of this sale was to meet the
needs of the small farmers who needed money to grow their crops and to feed their family up to the time
of their harvest. After the prohibition of riba they could not take usurious loans. Therefore, it was
allowed for them to sell the agricultural products in advance.

Similarly, the traders of Arabia used to export goods to other places and to import other goods to their
homeland. They needed money to undertake this type of business. They could not borrow from the
usurers after the prohibition of riba. It was, therefore, allowed for them that they sell the goods in
advance. After receiving their cash price, they could easily undertake the aforesaid business. Salam was
beneficial to the seller, because he received the price in advance, and it was beneficial to the buyer also, because normally, the price in Salam used to be lower than price in spot sales.

The permissibility of Salam was an exception to the general rule that prohibits forward sales. Therefore, it was subjected to some strict conditions.

Conditions of Salam:

- It is necessary for the validity of Salam that the buyer pays the price in full to the seller at the time of effecting the sale. This is necessary because in the absence of full payment by the buyer, it will be tantamount to a sale of debt against debt, which is expressly prohibited. Moreover, the basic wisdom behind the permissibility of Salam is to fulfill the instant needs of the seller. If the price is not paid to him in full, the basic purpose of the transaction will be defeated.

- Salam can be effected in those commodities only whose quality and quantity can be specified exactly. The things whose quality or quantity is not determined by the specification cannot be sold through the contract of Salam. For example, the precious stones cannot be sold on the basis of Salam, because every piece of precious stones is normally different from the other either in its quality or in its size or weight and their exact specification is not generally possible.

- Salam cannot be effected on a particular commodity or on a product of a particular field or farm. For example, if the seller undertakes to supply wheat of a particular field, or the fruit of a particular tree, the Salam will not be valid, because there is a possibility that produce of that particular field or the fruit of that tree is destroyed before the delivery, and in the presence of this possibility the delivery remains uncertain. The same rule is applicable to every commodity whose supply is not certain. It is necessary that the quality of the commodity (intended to be purchased through Salam) be fully specified leaving no ambiguity that may lead to dispute. All the possible details in this respect must be expressly mentioned.

- It is also necessary that the quantity of the commodity be agreed upon in unequivocal terms. If the commodity is quantified in weights according to the usage of its traders, its weight must be determined, and if it is quantified through measures, its exact measure should be known. What is normally weighed cannot be specified in measures and vice versa.

- The exact date of delivery must be specified in the contract.

- Salam cannot be effected in respect of those things that must be delivered at the spot. For example, if gold is purchased in exchange for silver, it is necessary, according to Shariah, that the delivery of both be simultaneous. Here, Salam cannot work. Similarly, if wheat is bartered for barley, the simultaneous delivery of both is necessary for the validity of sale, therefore, the contract of Salam in this case is not allowed.

- It is permissible to draw a Salam sale contract on one whole thing but to be possessed at different times in specific parts.

- Salam sale is not permissible on existing commodities because damage and deterioration cannot be assured before delivery on the due date. Delivery may become impossible.

- Salam is permissible on a commodity of a specific locality if it is assured that it is almost always available in that locality and it rarely becomes unavailable.
- The place of delivery must be stated in the contract if the commodity needs loading or transportation expenses.

- It is permissible to take mortgage and guarantor on Salam debt to guarantee that the seller satisfies his obligation by delivering the commodity sold, which is a liability on the due date.

- It is not permissible for the buyer of a Salam commodity to sell it before receiving it because that is similar to the prohibited sale of debts before holding. It is known that the Salam commodity is a liability debt on the seller and not an existing commodity. Instead of that, it is permissible for the buyer to draw a parallel Salam contract without connecting it to the first Salam contract.

Areas of Application:

Salam sale is suitable for the finance of agriculture operations, where the bank can transact with farmers who are expected to have the commodity in plenty during harvest either from their own crops or crops of others, which they can buy and deliver in case their crops fail. Thus the bank renders great services to the farmers in their way to achieve their production targets.

Salam sale is also used to finance commercial and industrial activities, especially phases prior to production and export of commodities and that is by purchasing them on Salam and marketing them for lucrative prices.

The Salam sale is applied by banks in financing craftsmen and small producers by supplying them with inputs of production as a Salam capital in exchange for some of their commodities to remarket.

The scope of Salam sale is large enough to cover the needs of various people such as farmers, industrialists, contractors or traders. It can cover the finance of operational costs and capital goods.

F. **Istisna** is the second kind of sale where a commodity is transacted before it comes into existence. It means to order a manufacturer to manufacture a specific commodity for the purchaser. If the manufacturer undertakes to manufacture the goods for him, the transaction of Istisna comes into existence. But it is necessary for the validity of Istisna that the price is fixed with the consent of the parties and that necessary specification of the commodity (intended to be manufactured) is fully settled between them.

The contract of Istisna creates a moral obligation on the manufacturer to manufacture the goods, but before he starts the work, any one of the parties may cancel the contract after giving notice to the other. But after the manufacturer has started the work, the contract cannot be cancelled unilaterally.

However, the party placing the order has the right to retract if the commodity does not conform to the specifications demanded.

Istisna as a Mode of Financing: can be used for providing the facility of financing in certain transactions, especially in the sector of house financing.

If the client has his own land and he seeks financing for the construction of a house, the financier may undertake to construct the house on that open land, on the basis of Istisna, and if the client has no land and he wants to purchase the land also, the financier may undertake to provide him a constructed house on the specified piece of land.
Since it is not necessary in *Istisna* that the price is paid in advance, nor is it necessary that it is paid at the
time of the delivery, rather, it may be deferred to any time according to the agreement of the parties,
therefore, the time of payment may be fixed in whatever manner they wish. The payment may also be in
installments.

On the other hand, it is not necessary that the financier himself construct the house. He can enter into a
parallel contract of *Istisna* with a third party, or may hire the services of a contractor (other than the
client). In both cases, he can calculate his cost and fix the price of *Istisna* with his client in a manner that
may give him a reasonable profit over his cost. The payment of installments by the client may start, in
this case, right from the day when the contract of *Istisna* is signed by the parties, and may continue during
the construction of the house and after it is handed over to the client. In order to secure the payments of
installments, the bank, as a security, may keep the title deeds of the house or land, or any other property,
until the client pays the last installment.

The bank, in this case, will be responsible for the construction of the house in full conformity with the
specifications detailed in the agreement. In case of discrepancy, the financier will undertake such
alterations at his own cost as may be necessary for bringing it in harmony with the terms of the contract.

The instrument of *Istisna* may also be used for project financing on similar lines. If a client wants to
install machinery in his factory, and the machinery needs to be manufactured, the financier may undertake
to prepare the machinery through the contract of *Istisna* according to the aforesaid procedure. The same
principles will be fully applicable to the construction of a building for the industry.

Areas of Application:
*Istisna* contracts open wide fields of application for the Islamic banks to finance the public needs and the
vital interests of the society to develop the Islamic economy. *Istisna* contracts are applied in high
technology industries such as the aircraft industry, locomotive and ship building industries, in addition to
the different types of machines produced in large factories or workshops. The *Istisna* contract is also
applied in the construction industry for apartment buildings, hospitals, schools, and universities.

**Difference between Istisna and Salam:**
1. The subject of *Istisna* is always a thing that needs manufacturing, while *Salam* can be effected on
   anything, no matter whether it needs manufacturing or not.
2. It is necessary for *Salam* that the price is paid in advance, while it is not necessary in *Istisna*.
3. The contract of *Salam*, once effected, cannot be cancelled unilaterally, while the contract of *Istisna*
   can be cancelled before the manufacturer starts the work.
4. The time of delivery is an essential part of the sale in *Salam* while it is not necessary in *Istisna* that
   the time of the delivery be fixed.
5. The buyer may stipulate in the *Istisna* contract that the commodity shall be manufactured or produced
   by a specific manufacturer, or manufactured from specific materials. This is not permitted in the case
   of *Salam* sale.

**Difference Between Istisna and Ijarah:**
It should also be kept in mind that the manufacturer, in *Istisna*, undertakes to make the required goods
with his own material. Therefore, this transaction implies that the manufacturer shall obtain the material,
if it is not already with him, and shall undertake the work required for making the ordered goods with it.
However, if the customer provides the material, and the manufacturer is required to use his labor and skill only, the transaction is not *Istisna*. In this case it will be a transaction of *Ijarah* whereby the services of a person are retained for a specified fee paid to him.
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