TOWARDS A FINANCIAL MARKET-BASED MICROFINANCE

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ABSTRACT

Microfinance has been recognized as a key tool in regional economic development and poverty reduction. But a significant challenge for microfinance, to achieve this objective, is to reach sufficient scale to fulfill demend for financial services. Microfinance sector is currently transforming from non-profit framework towards a greater degree of financial market involvement. The purpose of this study is to motivate a discussion for the potential involvement of financial institutions such as commercial banks, interest-free banks, and venture capital organizations in microfinance market, either directly or indirectly, through their capital market activities and venture capital-like approaches.

Key Words: Microfinance, Venture Capital, Interest-Free Banks

Jel Classification: G11, G21, G24, R51

FİNANSAL PİYASALARA DAYALI MİKROFİNANSMAN

ÖZET

Mikrofinansmanın bölgesel kalkınma ve fakirliğin giderilmesi konusunda önemli rol taşıdığı düşünülür. Bununla birlikte; mikrofinansmanın bu hedeflere ulaşabilmesi ancak finansal hizmet taleplerini karşılayabileceği ölçeğe varması ile mümkündür. Buna bağlı olarak; mikrofinansman sektörü; kar amacı taşımayan bir yapıdan finansal piyasa yönelimli bir yapıya doğru değişim yaşamaktadır. Bu çalışmanın hedefi ticari bankalar, özel finans kurumları ve risk sermayesi gibi finansal kurumların doğrudan ya da dolaylı olarak sermaye piyasası faaliyetleri ya da risk sermayesi yatırımları ile mikrofinansman sektörünün potansiyel tarafları olabileceklerini tartışmaktır.

Anahtar Kelimeler: Mikrofinansman, Risk Sermayesi, Özel Finans Kurumları

Jel Sınıflandırması: G11, G21, G24, R51

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1. Introductıon

Microfinance has been spread around the world as a popular poverty reducing strategy, but the traditional sources of microfinance may not be sufficient to allow microfinance institutions to provide maximum services and achieve this objective. Nevertheles, the microfinance sector is currently undergoing a significant transformation from a traditional donor-driven non-government dominated framework towards a greater degree of financial market involvement while sticking to its original mission of poverty alleviation and social development(Tulchin, 2004; Fehr, 2006).

The reasons are given that some microfinance institutions have begun to explore new funding opportunities and at the same time investors increasingly appreciate microfinance investments for their dual nature. While they allow investors to adopt a social investment strategy geared toward poverty alleviation and social development in developing countries, at the same time, they simultaneously offer an attractive risk-return profile. Some evidence even indicates that microfinance investments might be conducive to the efficient portfolio diversification(Krauss and Walter, 2006; Dieckmann, 2007).

From this perspective it is apparent that a subset of investor pool would consider investing in microfinance investment opportunities, being aware that they would not expect to earn the full economic rate of return that such investments would otherwise require. But, these investors may be willing to accept a reduced rate of return on investment, with the aim of satisfying social motives that they may consider(Fehr, 2006). In principal, socially responsible investments strive to consider both the financial return of an investment and its social, environmental, and ethical considerations(Dieckmann, 2007).

Overall, new capital sources are vital to address the shortfall in microfinance. The capital markets are an attractive option, albeit accessing investment has, to date, fallen short of expectations. For microfinance to engage financial markets, it must follow up similar production lines which are now consumed in that marketplace. In addition, much work is required for microfinance institutions to grow as an asset class and, thus increase investment potential(Tulchin, 2004). In this regard, shareholder-owned microfinance institutions form an increasingly significant part of the financial landscape in developing countries is the case. They have joined banks and other traditional institutions as full-fledged members of the formal financial sector. For instance, the segment of microfinance in which equity investment plays a role has grown very rapidly. There were 222 microfinance institutions around the world that are regulated, commercial, shareolder-owned institutions candidating for equity investment in microfinance in the year 2006 in comparison 124 institutions in the year 2004(Busch and Rhyne, 2004).

In spite of of this, equity investments still seem to be rarely included in commercially-oriented microfinance investment instruments because equity stakes in microfinance institutions are difficult to place at a reasonable price as they are perceived as more risky by investors and exit strategies, which might prove to be difficult until domestic capital markets develop further and become transparent in less developed countries. In the long term, in its current structure, the financial markets seems to have the resources readily available to allow for optimal growth. Throught the study, the term “financial markets” includes capital markets transactions and linkages with commercial banks, interest-free banks, and venture capital organizations(Kooi, 2001; Meehan, 2004; Dieckmann, 2007).

Microequity is comparable to venture capital in that the decision-making process, about whom to fund, is similar in both cases. Most startup businesses have as little initial access to bank loans as do many of the low-income people in developing countries because they lack the same requirements, such as credit history and collateral. Therefore many business startups look to venture capitalists who agree to share the risks as well as the rewards(Pretes, 2002). Leading social investors are increasingly following a venture capital-like approach(Network, 2006).

Commercial banks and other alternative financial institutions such as interst-free banks and venture capital organizations will enter the microfinance market directly, by downstreaming, and indirectly, through partnerships, bringing their own technology and productivity, as well as offering a wide range of hands-on services(Meehan, 2004).

Most commercial bankers have not regarded microfinance as a real option because of their concern about the lack of genuine profitability of microfinance. However, many of them in developing countries are beginning to test the microfinance market. Strong banking competition in many countries has forced some to diversify into new markets. Commercial bankers have not pursue microfinance because of that they have found it too risky, too expensive, and matters as socio-economic and cultural barriers(Baydas et al., 1997). Despite many advantages commercial banks and interest-free banks also can offer, they face significant barriers in reaching a market they have excluded or ignored. However, the mentioned institutions will do well to form partnerships and those partnerships could become well performing microfinance organizations(Baydas et al., 1997; Otero, 2005).

The availability of venture capital for entrepreneurship is commonly taken as a critical factor for new business startups and business expansion. It has helped to create many of today’s global enterprises(Bygrave and Timmons; 1992). However, rural entrepreneurs and small businesses have limited access to venture capital. This is as true for the US as it is in developing countries(Nageswaran, 2003). Venture capitalists do not aggressively seek investment opportunities in small metropolitan areas and nonmetro communities due to sparse deal flows, relatively high costs per investment, limited exit opportunities, and insufficient local business environments. They tend to focus on certain industries in relatively few regions of the country(Gupta and Sapienza, 1992). Thus, alternative types of venture capital providers have evolved to serve the venture capital needs of small market areas and traditional industries. Nontraditional institutions can function in these markets because of assistance or subsidies from public or private organizations or because of goals other than only maximizing fund profits(Baydas et al., 2001).

The concept of financing for the low-income people or microfinance by interest-free banks was not well developed despite the wide acceptance of interest-free banking worldwide. Most interest-free banks did not provide easy access to financing to the low-income people or microentrepreneur in this sense. A further pragmatic shift in interest-free banking and finance is the almost complete move away from supposedly “profit and loss sharing” banking to sales-based system. Interest-free banks in the vast majority avoid profit and loss sharing which is crucial for their investment activities. On the contrary, such activities are largely based on the contracts that are considered mark-up, relatively safe contracts, which are similar to lending on the basis of commercial banks in similar vein(Rahman, 2007).

It is argued that there is a nexus between interest-free banking and microfinance as many elements of microfinance could be considered consistent with the broader goals of interest-free banking. Interest-free banking has the potential to provide various schemes and instruments that can be advanced and adapted for the purpose of microfinance. Mudaraba has the potential to be adapted as interest-free banking microfinance scheme. Also, musharaka can also be developed as a microfinance scheme where interest-free bank will enter into a partnership with microentrepreneurs. In mudaraba, interest-free banking, with its emphasis on risk sharing and, for certain instruments, collateral free loans, is compatible with the needs of microentrepreneurs. Since it promotes entrepreneurship ideally, interest-free banking could foster development under the right application(Dhumale and Sapcanin, 1999; Segrado, 2005; Rahman, 2007).

There has recently been certain attempts to combine venture capital with mudaraba and/or musharaka modes of interest-free banking in the literature. It is claimed that venture capital and interest-free financing are based on similar ground, if not the same. Moreover, some argue that venture capital is a modern usage of mudaraba. There is a common belief that this Western version of mudaraba, venture capital, is in esence commensurate with interest-free banking principles(Cizakca, 1993; Dar and Presley, 2000).

In the study, first, in order to attract the financial markets to microfinance, a brief list of requirements will be explained. Then, issues related bank involvement in microfinance will be touched. Third, why interest-free banking should be a part of microfinance markets will be discussed. Fourthly, new developments in venture capital sector regarding to microfinance will be examined. And finally, the study will end with e nexus between venture capital and mudaraba mode of interest-free banking.

2. Attracting The Financial Markets To Microfinance

This section explains a brief list of major requirements for attracting the financial markets to microfinance. It also offers investors a perspective on what to expect from the microfinance industry and how to evaluate a microfinance equity investment.

1. *Characterizing Microfinance as an Investment Opportunity*:

The categorisation of an investment in terms of risk and return is essential for investors to evaluate the financial impacts of a potential investment, both from a solo and portfolio perspective, before investment decisions are made. To date, microfinance has not been systematically categorized as an investor category by investors. However, there is a growing evidence that microfinance not only offers investors an attractive risk and return profile but might also be conducive to the efficient diversification of investors' pools(Meehan, 2004).

Moreover, it is claimed that microfinance might even evolve into an assest class of its own over the long run(Dieckmann, 2007). Some preliminary findings indicate that microfinance investments exhibit a very low correlation to the return in mainstream capital markets and the general domestic economy in developing countries. This especially holds true when MFIs are compared to conventional banks in developing countries. Furthermore, a preliminary conclusion is drawn that the return of microfinance is detached to a large extent from major markets and macroeconomic developments that would impact on conventional banks(Krauss and Walter, 2006).

However, in order to overcome concerns about the ability of microfinance to offer financial returns and to fit traditional investment strategies, microfinance institutions will need to characterize microfinance as a commercial investment opportunity. Investors will see if attractive investments can be made in the microfinance industry only when this industry starts showing signs of maturing(Fehr, 2006; Kooi, 2001; Meehan, 2004).

The management of microfinance institutions should carry a clear vision and commitment to become a profitable microfinance institution. The investor wants to be sure that the management realizes its opportunities by building on the potential of its specialization in microfinance, and that the management is convinced that such opportunities can be materialized commercialy(Kooi, 2001).

Most of the investors in microfinance institutions have a medium or a longer-term investment horizon. Profitability is what fuels the growth and development of the institution. The investors will scrutinize the likelihood and impact of potential risks that could negatively influence the profitability of the microfinance institution. As medium to longer-term emerging market investments that bear a distinct set of risks for investors. On the one hand, investors face risks that are inherent to the nature of the microfinance sector, while on the other hand various risks emanate from the country risks typical of developing markets. Financial returns matter as much as social returns for investors. So, the management of microfinance institution must balance social drive with financial performance. For broad access to social investment markets, financial performance has to be competitive with investment opportunities of similar risk/return profiles. Microfinance institutions need to understand the investor rationale(Busch and Rhyne, 2006; Meehan, 2004; Tulchin, 2004; Dieckmann, 2007).

It should also be noted that most successful microfinance institutions were started by innovative social entrepreneur. Only a minority had prior experience in banking or finance. Therefore, most senior managers lack experience in applying traditional corporate finance tools. For this reason, microfinance institutions must present investors with financing strategies that systematically analyze current and future capital structure. Also, understanding what one's business is worth is a fundamental question asked by investors, especially equity investors(Dieckmann, 2007; Meehan, 2004).

2. *An Appropriate Ownership Structure*:

The preponderant ownership structure of microfinance institutions is a barrier to investment. Microfinance institutions as a financial intermediaries that seek to approach the financial markets must have a legal structure that can be clearly explained and understood by investors. Most microfinance institutions are, or at least start out as, non-profits. Ownership in non-profit is ambiguous. The board has fiduciary responsibility, but assets are considered to be for the public good. An ownership structure more familiar to investors is a private, incorporated, and legal entity. They understand this structure and the rules governing behavior are in line with those of their other financial relationships. Legal business are more likely to be regulated, this is a positive step for an investor(Tulchin, 2004).

With respect to the ownership structure, investors will focus on three main issues: reputation, liability, and protection. Investors prefer that the ownership structure consist of reputable shareholders who have an interest in the long-term added value of the institution. The liabilities relating to ownership of the microfinance institution and the rights of investors as shareholders must be transparent. Especially in case of a minority stake, the investors want to know what regulations can be agreed upon to protect their position as a minority shareholder(Kooi, 2001; Meehan, 2004).

3. *Standardize Reporting*:

Microfinance institutions might perform well, but need better documentation of activities. This includes up-to-date financial booking and a management information system that gathers requisite information to monitor performance.

Investors are interested in performance related measurs to their investments(Tulchin, 2004).

Proper management information systems should be in place to record, process, monitor, and control the cash flows. The filing systems are supposed to be effective and up to date. Reporting is expected to be timely and accurate, providing all data required by the different levels in the organization in order to manage and operate according to sound banking principles(Kooi, 2001; Tulchin, 2004).

A number of risks for investors might emerge from lower standards of financial reporting. The financial markets evaluate and price risk. Investors are interested in performance and how it relates to their investment. They care about the financial implications of information and management's analysis as it pertains to investment risk. If investors lack the information they require, they most likely forgo opportunities. Thus, increasing transparency in reporting and measuring risk seems a necessity fort he success of the sector(Fehr, 2006; Meehan, 2004).

4. *Focusing on Governance*:

The fundamental factor that determines the sustainability of access to capital markets over time is the institution's credibility as perceived by investors, whether as lenders or shareolders. If microfinance is to truly link with capital markets, the field must provide clear and solid answers to the critical issues of governance(Meehan, 2004).

The investor will require that the microfinance institution has a proper governance structure in line with sound banking principles. The investor will require that appropriate policies and procedures be in place to ensure proper governance and application of sound banking principles, such as code of conduct policy, operational policy, financial management policy, loan loss reserve policy, dividend policy, product policies, and environmental policy. Thus, in order to increase their attractiveness to investors, microfinance institutions need better governance(Kooi, 2001; Meehan, 2004; Tulchin, 2004).

5. *An Exit Strategy*:

Investors often require an exit strategy or sufficient comfort that such an exit strategy will appear timely. Clearly, the investors want to avoid having their investment being permanently locked into the institution. Microfinance institution shares are not typically tradebla in a liquid market. Lack of secondary market liquidity consideration will be important as microfinance iğnstitutions seek to attract financial market investmet and investors assess the microfinance market. Insufficient secondary market for microfinance investments limits the ability of certain investors to take a position in microfinance. However, this factor is likely to improve as the microfinance market matures(Kooi, 2001; Meehan, 2004; Dieckmann, 2007).

3. Banks In Microfinance

Baydas et al.(1997) take commercial banks as new actors in the microfinance world. In this study, interest-free banks are taken as natural actors in microfinance business as well. The reason for the inclusion of the information about commercial banks is also valid for the interest-free banks and should be taken into consideration by them.

Until recently, microcredit was mainly provided by non-governmental organizations and banks were hardly involved. It was seen by donors as an instrument in fighting poverty, and not as a financial service that could be part of the financial sector. A great deal has changed in that respect(Brouwers, 2005).

Commercial banks did not not pursue microfinance due to their concerns about microfinance market: being too risky, being too expensive , and socio-economic and cultural barriers. However, increasingly commercial banks in developing countries are beginning to examine the microfinance market. They are entering the microfinance market for not only because they see sustainable profit and growth opportunities but also commercial banks face increasing competition in their traditional retail markets. Besides, the competition among commercial banks is leading forward–thinking banks to explore new potential markets that can generate growth in client numbers at acceptable profit margins(Baydas et al., 1997; Brouwers, 2005; Dieckmann, 2007).

Banks appear well positioned to offer financial services to microfinance clients and earn a profit. They have several advantages over non-bank, microlending non-governmental organizations. These advantages could give banks a special edge over microlending non-governmental organizations in providing microfinance services(Baydas et al., 1997):

- Having regulated institutions fulfilling the conditions of ownership, financial disclosure, and capital adequcy that help ensure prudent management.

- Having physical infrastructure, including a large network of branches, from which to expand and reach out to a substantial number of microfinance clients;

- Having well-established internal controls and administrative and accounting systems to keep track of a large number of transactions;

- Ownership structures of private capital tend to encourage sound governance structures, cost-effectiveness, and profitability, all of which lead to sustainability;

- Since they have their own sources of funds, not having to depend on scarce and volatile donor resources as do NGOs due to their own sources of funds; and

- Offering financial products that are, in principle, attractive to microfinance clients.

On the other hand, it should also be noted that banks lack some key ingredients. Basically six key related issues are identified to be solved for banks in order to successfully enter the microfinance market(Baydas et al., 1997):

Commitment: The commitment of commercial banks to microenterprise lending is often fragile, and generally dependent on one or two visionary board members rather than based solidly in its institutional mission.

Organisational Structure: Microfinance programs need to be inserted into the larger bank structure in such a way that they have relative independence and, at the same time, have the scale to handle thousands of small transactions efficiently.

Financial methodology: Banks need to acquire an appropriate financial methodology to service the micrenterprise sector.

Human Resources: Given that microfinance programs differ so radically from traditional banking, banks must recruit and retain specialised staff to manage these programs.

Cost-effectiveness: Microfinance programsa re costly because of the small size of their loans and because banks cannot operate them with their traditional mechanism and overhead structures.

Regulation and Supervision: Banks must communicate with banking authorities to ensure that reporting and regulatory requirements take into account the specialised nature of microfinance programmes(Baydas et al., 1997).

4. Interest-Free Banking And Microfinance

The purpose of this section is to show how microfinance programmes based on interest-free banking principles can be established. The microfinance and interest-free banking form finance programmes which represent unconventional solutions to financial needs. Many elements of microfinance could be considered in line with the broader goals of interest-free banking(Dhumale and Sapcanin, 1999). At a very basic level, the disbursement of collateral-free loans in certain instances is an exampleof how interest-free banking and microfinance share common goals. The goals of microfinance and interest-free banking can be summarized such as a distinctive feature of interest-free banking and microfinance is to be their focus on developmental and social aims(Ferro, 2005). Both systems advocate entrepreneurship and risk sharing and believe that the low-income people should take part in such activities by forming finance programs represent unconvntional solutions to financial needs. Interest-free banking and microfinance programs may complement one another in both ideological and practical terms. Furthermore, the close relationship between microfinance and interest-free banking would not only provide obvious benefits for microentrepreneurs who would otherwise be left out of credit markets, but investing in microenterprises would also give investors in interest-free banks an opportunity to diversify and earn solid returns(Dhumale and Sapcanin, 1999).

The economic liberalization and increasing interdependence of the 1980s and 1990s highly influenced the political and economical choices of governments in Muslim countries. Interest-free banks have evolved and those banks developed ways to integrate Islamic law on usage of money with modern concepts of ethical investing. Consequently, a financing discipline has emerged with its own concepts, analytical tools and institutions(Segrado, 2005).

However, it has recently been strongly criticized that interest-free banks applications are very similar to those of interest-based banking system. The narrow frame of the current applications of the interest-free banking system is seen as a main reason of that criticism. For instance, mudaraba and musharaka are emphasized greatly as a proper modes of financing in interest-free banking, however, recent applications show that little attention has been given to them(Choudhury, 2001; Çizakça, 1993; Dar and Presley, 2000; Henry, 2001; Rahman, 2007).

Evidence proved that there is a need for a new approach on interest-free banking microfinance programmes for different reasons. First, microfinance is a very flexible tool, whose models can be replicated but require to be tailored on the local socio-economic and cultural characteristics. Second, microfinance and interest-free banking both constitute forms of finance that represent unconventional but effective solutions to financial needs, focusing on business activities that lack capital but are promising and show a potential. Third, the potential demand for tailored microfinance services is still largely unmet in countries where the majority of the population is constituted by Muslims. Fourth, there is a high demand for interest-free financing services in Muslim societies of interest-sensitive people. Fifth, microfinance and interest-free financing as a mode of socially responsible finance share common principles such as prohibition of all forms of economic activity which are morally or socially injurious; focus on the well being of the community as a whole, concentrating on the low-income group; aim at social justice; advocacy for financial inclusion through partnership finance; participatory approach; and risk sharing. Sixth, interest-free banking convictions on the responsibility of business go well beyond mere profitability goals, maximizing of social benefits as opposed to profit maximization, through the creation of unconventional financing approaches that can provide effective financial services. Seventh, the needs of financial innovation in the interest-free financing system(Ferro, 2005; Segrado, 2005).

Combining interest-free banking with microfinance, two basic instruments of interest-free financing could be built into the design of successful microfinance programs: Mudaraba and musharaka.

Mudaraba:

Profit sharing priciples for interest-free financing contracts are based on the mudaraba principle in which the capital owner provides funds to the capital-user or entrepreneur for some business or productive activity on the condition that profits generated will be shared between them. The loss, if any, incurred in the normal process or course of business and not due to neglect or mis conduct on the part of the entrepreneur is borne by the capital-owner. The entrepreneur does not invest anything in the business except his human capital and does not claim any wage for conducting the business. Profits are distributed according to a pre-agreed ratio. In the event of loss, the capital provider loses his capital to the extent of his loss, and entrepreneur losses all his labor. The willingness to bear the loss justifies a share in the profit fort he capital-owner. The profit sharing ratio mutually agreed upon between finance-provider and finance-user is determined by the market forces (Siddiqui, 2001).

Musharaka:

Musharaka involves a partnership in which both the bank and its client(entrepreneur) contribute to entrepreneurship and capital. It is an agreement whereby the entrepreneur and the bank agree to combine financial resources to undertake any type of business venture, and agree to manage the same according to the terms of the agreement. Profits are shared between the bank and the entrepreneur in the pre-agreed ratio. Losses are shared in the exact proportion of the capital invested by each party(Obaidullah, 2005).

5. Nontraditional Venture Capital

The availability of venture capital for entrepreneurs and business is believed to be as critical for new business startups and business expansion(Barkley et al., 2001). Even a communty's prospects for economic development are linked to local businesses' access to venture capital(Florida and Smith, 1990). Venture capital industry has been in existence in the U.S. over 50 years and it has helped to create many of today's global enterprises. It is well documented that companies supported by venture capital funds in their formative years outperform those that were not, on many parameters(Bygrave and Timmons, 1992).

However, nonmetropolitan area entrepreneurs and small businesses areas do not have similar access to venture capital and entrepreneurial support services as their urban counterparts. This is as true for the US as it is developing countries(Nageswaran, 2003). Venture capitalists avoid nonmetro community and rural area businesses because of the relatively high costs of finding, supporting, and liquidating deals in those areas(Barkley et al., 2001).

Impediments to Traditional venture capital Investment process: Traditional venture capital organizations choose not to operate in rural places and in many small metropolitan areas because of(Barkley et al., 2001:

- Investment opportunities with profit potential below that sought by traditional venture capital funds;
- Lack of investments to provide adequate deal flow;
- Insufficient infrastructure to support venture capital investment;
- Matters in defining a viable exit strategy;
- Physical distances between investment opportunities;
- Difficulty in attracting venture capital staff to the region; and
- Lack of interest by many small business owners in accepting the conditions set by the venture capital fund in order to get its money.

Florida and Smith(1990) and Gupta and Sapienza(1992) found that venture capital supply to be highly concentrated at the regional, state, and metropolitan levels. A study of Canadian markets found a similar pattern of spatial concentration of equity investments in a limited number of metropolitan areas(McNaughton and Green, 1989). Thus, the evidence supports the idea that equity investors focus on markets that are geographically close or have higher concentrations of high-tech, potentially high-growth firms. Nonmetropolitan, rural firms are less likely to have the high-tech characteristics necessary to attract the attention of national equity firms and face the additional obstacle of isolation from the major centers of venture capital supply.

The disadvantages associated with venture capital investments in nonmetropolitan, rural communities have encouraged the public policy makers and communities to invstigate nontraditional sources of venture capital(Barkley and Markley, 2001; Bates and Bradford, 2006). In the US, numerous nontraditional venture capital institutions were established to assisst entrepreneurs and businesses in regions and industries overlooked by traditional venture capital funds. While these nontraditional venture capital institutions rarely earn the same rate of return as do traditional funds, they can be profitable and can promote economic development in urban and rural communities. Similarly, in the UK, a vibrant new industry of social venture capitalists has emerged as a result of social need, venture funding and government policy(Gillin, 2006).

The absence of traditional venture capital can be offsetted by social or nontraditional venture capital organizations(Nageswaran, 2003). Nontraditional venture capital organizations are defined as funds or programs established to address venture capital needs and enhance economic development prospects in regions and industries underserved by traditional venture capital funds(Barkley et al., 2001). Nontraditional venture capital funds differ from traditional ones in the following aspects(Nageswaran, 2003):

- They tend to operate in areas where traditional venture apital funds are not interested in;
- They accept financial returns that are lower than returns targeted by traditional venture Capital funds; and
- They have a dual bottom line of acceptable financial returns with social and economic benefits to the areas served.

6. Venture Capital And Interest-Free Banking

It is well documented in the literature that raising and mobilising financial resources in interest-free financing economy must be guided by the interest-free financial instruments based on participatory form of loss and profit sharing methods(Cizakca, 1993; Bulut, 1997; Choudbury, 2001; Rahman, 2007). Such instruments are traditionally termed mudaraba and musharaka.

Venture capital and interest-free financing are based on similar ground, if not the same. Venture capital originates from mudaraba and musharaka. It is claimed that mudaraba and musharaka are, in fact, venture capital. Venture capital system is compared to the interest-free financial system on the aspect of infrastructural features and very much similarity between two financing is emphisized. Moreover, insisted that venture capital companies and interest-free financial institutions work according to same principles and interest-free financial institutions become as venture capital company as long as they use mudaraba financing technique(Cizakca, 1993).

Similarly, according to Al-rifai and Khan(2004) private equity and venture capital are perfectly aceptable modes of finance and investment provide they meet certain interest-free financing system guidelines. They take venture capital a simple and ready to use solution available for interest-sensitive investors. Moreover, Dar and Presley(2000) insist that venture capital is a modern and Western version of mudaraba.

Certain attempts have been made to identify both venture capital and mudaraba financing. We, in this study, combine mudaraba and musharaka with a new and complementary fininciing technique which is called solely mudaraba. The very similar infrastructure between venture capital and mudaraba financing will come to surface by differentiating both venture capital and mudaraba financing from other financing techniques in the whole financial system. Some of the common characteristics of venture capital and mudaraba financing are outlined below(Bulut; 1997).

- Venture capital and mudaraba financing fill the McMillan gap;

- Venture capital and mudaraba financing are based on profit sharing and loss carry. They both avoid interest-based financial contracts;

- Venture capital and mudaraba finance are a kind of equity capital for users(entrepreneurs);

- In both financing, users of the capital are not responsible to pay it back;

- Capital users do not give any quarantee as is the case that commercial banks require; instead, the project itself is taken as a quarantee in both in both financing;

- Venture capital and mudaraba financing systems comprises three main ingredients of investors, venture capitalists(interest-free banks in case of mudaraba) and entrepreneurs;

- In venture capital, investors are persons and/or a variety of institutions that pool the venture capital fund while, in mudaraba financing, investor pool the interest-free bank's mudaraba fund;

- Venture capitalists manage venture capital fund as agents for investors. Interest-free banks manage the mudaraba funds as agents for mudaraba fund investors. Both financing require some of investment banking activities.

- To avoid losses, investment portfolios are formed from stages and industries in both cases;

- Profit is shared as a percentage base not as a fixed amount between investors and venture capitalist and also between venture capitalist and entrepreneurs, while same applies between investors and the fund of interest-free bank and also between intrest-free bank and entrepreneurs;

- Profit sharing rate is predetermined; however, rate depends on the entrepreneur's project profitability and risk in both financing;

- Financial losses are born by investors while entrepreneur's loss by his labor in venture capital finance and in mudaraba financing as well;

- In both financing, conventional bank credit evaluation techniques are not important in selecting ventures to finance. Instead, the entrepreneur himself/herself and his/her product idea are criterions;

- Contrary to commercial banks, in venture capital and mudaraba, financial institutions carry an effective role on monitoring business operations of the venture;

- Reputational capital is very important for the financial institutions of both financing.

7. Conclusion

It has already been proven that many microfinance institutions can deliver financial services to microentrepreneurs and small businesses, either urban or rural, that otherwise would not have access to financial services. To date, microfinance institutions raise capital primarily from outright donor grants and government subsidies. However, due to the insufficient traditional sources for microfinance to supply maximum financial services, many microfinance institutions are attempting to move away from donor sources to more traditional financial market funding such as equity. In this sense, such innovative thinking needs to be presented to commercially oriented equity investors in microfinance.

This paper attempts to explore that some financial institutions such as commercial banks, interest-free banks, and venture capital organizations can close the bridge between investors and microfinance market as they are related to increased access to capital markets. It is argued that unless microfinance sector is integrated into a countriy's mainstream financial system, microfinance cannot reach its full or expected potential. However, it is apparent that there is a new set of investors concerning socially responsible investment. They take into consideration not only financial returns but also social and environmental matters.

Innovations in financial markets will be a great support for microfinance. Investors, in socially responsible investment, are increasingly leading venture capital-like approaches. In this regard, venture capital-like modes of financing activities for mentioned financial institutions but especialy interest-free banks are vital. Moreover, interest-free banks must get involve in microfinance as because the principles of interest-free banking are very much in line with those of microfinance.

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