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ISLAMIC MICRO-FINANCE AND POVERTY ALLEVIATION: A CASE OF PAKISTAN

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ABSTRACT

This research paper recognizes Islamic micro-finance as an important component in poverty alleviation strategies. While conventional microfinance products have been successful in Muslim majority countries, these products do not fulfill the needs of all Muslim clients. While taking an overview of Islamic microfinance in Muslim countries, this research paper undertakes a case study of Akhuwat, an Islamic microfinance organization operating in Pakistan. Critical financial analysis of Akhuwat indicates that it is providing its services for all living below the poverty line including the "extreme poor" and Interest free loans can be used as a powerful tool against poverty. It recommends that integrating Islamic microfinance with NGOs, NPOs (non-profit organizations), Zakah, Awqaf and with Takaful as well as with professional training and capacity building institutions will enhance the financial statbility of Islamic microfinance institutions and will be helpful to achieving their aim of providing micro financial services to the poorest of the poor under one roof.

KEY WORDS

Islamic microfinance, Sharīʼah Compliance, Micro Financial Institutions (MFIs), Global Practices, Takaful, Poverty Alleviation.

INTRODUCTION

Microfinance refers to making small loans available to poor people (especially those traditionally excluded from financial services) through programmes designed specifically to meet their particular needs and circumstances (Khan, 2008; p.6). The needs of the poor in Islamic countries are no different from the poor in other societies except that these are conditioned and influenced by their faith and culture in a significant way. They need financial services because they are often faced with events that call for spending more money than might be available around the house or in the pocket (IRTI, 2007, p.20)

The Islamic world is enormous with over 1.2 billion people, stretching from Senegal to the Philippines. Poverty rate is quite high in all Muslim countries except a few countries in Southeast Asia and the Middle East. Poverty levels have also been associated with high inequality alongside low productivity. Half of the Indonesia population (about 129 million) is living below the poverty line of US$2 a day. While in South Asia two largest Muslim states - Bangladesh and Pakistan – alone account for 122 million each living below the poverty line where as 100 million Muslims of India are also living below the poverty line (IRTI, 2007, p.18).

Sources suggest that about 72 percent of people in Muslim countries do not use the formal financial services because financial system is interest based which is prohibited in Islam (Karim, Tarazi and Reille, 2008). This study attempts to give an overview of Islamic micro finance development in Muslim countries while focusing on its operations in Pakistan. It takes a case study of Akhuwat, an Islamic microfinance organization. It was established in 2001 and the objective was to help the people living in abject poverty with interest free credit The research paper analyses the financial performance of Akhuwat for the period 2002-2006 and gives recommendations for the future potential of Islamic microfinance in the country.

PROBLEM STATEMENT

Conventional micro financial services facilities do not meet the needs of majority of Muslim population in developing countries like Pakistan, Bangladesh, Indonesia as well as in developed countries like UK, USA and Australia. The reason is that conventional micro financial institutions charge interest on their loans provided to small and medium enterprises as well as women entrepreneurs. A vast majority of muslim population refrains from availing conventional micro financial services due to the element of interest that is considered repugnant to *Sharī'ah*. Over 470 millions Muslim population is living below poverty line (less than $2 per day) in four largely populated Muslim countries: Pakistan, Bangladesh, Indonesia and India (IRTI, 2007). In this scenario, Islamic micro finance has tremendous potential in these countries and could be used as a powerful weapon to fight against poverty. It can develop a valuable human capital base by satisfying the financial needs of Muslim community and positively contribute towards the economic growth in those countries.

LITERATURE REVIEW

Over the last few years micro-finance has been increasingly recognized as an important component in poverty alleviation strategies. Poor households face difficulty in generating regular and substantial income to save for future and are extremely vulnerable to economic, political, and physical downturns. A little drop in income or increase in expense can have a disastrous effect on their already low standard of living. They have limited access to health care facilities; have low literacy rate and poor living conditions. Death, sickness, or accident may force them to dispose their property or some of the productive assets, which in turn further decreases future income and current livelihood. The frequency of losses is also greater for the poor; many are regularly exposed to natural disasters (like flood), fire, and theft with limited means of recovery (Patel, 2004; Ahmad, 2007; Obaidullah, 2008).

Given the dominance of western culture and values as well as plight and vulnerability of today's Islamic world, there has always been an incessant conflict between the two civilizations. Muslims have always been struggling for decades at almost every walk of real life to retain their values and culture. The philosophy behind such struggle is underpinned in powerful expression of collective identity that is multiple and highly diversified following the contours of each culture and historical formation of each identity. The feeling of this collective identity has urged Muslim scholars to find solutions of current economic problems to make their lives compatible with *Sharī'ah* and to safeguard the Muslim *Ummah* against the perils of the western culture. (Yusuf, 2006; pp.56-63)

While conventional microfinance products have been successful in Muslim majority countries, these products do not fulfill the needs of all Muslim clients. Combining the Islamic social principle of caring for the less fortunate with microfinance's power to provide financial access to the poor has the potential to reach out to millions more people, many of whom say they would prefer Islamic products over conventional microfinance products. From affordable loans and insurance products to safe places to save, microfinance services have been powerful weapons in the fight against poverty, especially in Latin America and South Asia (CGAP News, 2008).

The World Bank estimates that there are over 7000 microfinance institutions, serving some 16 million poor people in developing countries. The total cash turnover of MFIs world-wide is estimated at US$2.5 billion and the potential for new growth is outstanding. The Microcredit Summit estimates that US$21.6 billion is needed to provide microfinance to 100 million of the world's poorest families.

Other estimates tell us that worldwide, there are 13 million microcredit borrowers, with USD 7 billion in outstanding loans, and generating repayment rates of 97 percent; growing at a rate of 30 percent annual growth. Despite all this less than 18% of the world’s poorest households have access to financial services (Grameen Foundation, 2007). Ahmad (2007) points out that Microfinance initiative is widely acclaimed as a new approach to alleviate Poverty, to bring about economic development and to improve the living conditions of the poor.

The application of Islamic finance to microfinance was first discussed in depth by Rahul and Sapcanin (1998). They demonstrate that Islamic banking, with its emphasis on risk sharing and, for certain products and collateral-free loans, is compatible with the needs of some micro-entrepreneurs. Viable projects that are rejected by conventional lending institutions because of insufficient collateral might prove to be acceptable to Islamic banks on a profit-sharing basis However, they concluded that from a microfinance standpoint the mudaraba model (profit-sharing) has more drawbacks than the murabaha model (cost plus markup). The murabaha model is overall more cost effective, has a lower margin of error, and provides immediate collateral for a MFI because the MFI owns the goods until the last installment is paid. Dusuki (2006) has presented the idea of Islamic microfinance initiative in the perspective of Ibn Khaldun’s concept of ‘Asabiyah or social Solidarity that emphasizes group efforts and loyalty over self-interests of individuals. He argues that Islamic microfinance can be promoted through group lending to the poor who are normally denied access to mainstream banking services.

According to Dr. Abbas Mirakhor, Executive Director of the IMF as refered by Chaudhri (2006): "[An] important function of Islamic finance that is seldom noted … is the ability of Islamic finance to provide the vehicle for financial and economic empowerment … to convert dead capital into income generating assets to financially and economically empower the poor..." Microfinance is already more structurally aligned to applying Islamic equity financing structures. As mentioned previously, microfinance programs are based on group sharing of risk and personal guarantee while maintenance of trust and honesty is tied to the availability of future funds (Chaudhri, 2006).

Ahmad (2007) opines that contemporary Islamic finance has been largely disengaged from microfinance. On the one hand, most microfinance institutions (MFIs) are not Islamic as their financing is interest based. On the other hand, Islamic financial system has been dominated mainly by Islamic banks. He further argues that MFI has to create various reserves to cover various risks arising due to the nature of its assets and liabilities. To protect from withdrawal risks, the MFI can use takaful and profit-equalization reserves to give depositors competitive returns. The paper shows that the proportion of waqf funds that can be allocated into microfinancing will depend on the takaful and economic capital reserves.

Obaidullah (2008) has identified that absence of institutional credit guarantee is an important factor that demotivates the commercial banks and IFIs to be involved in micro-credit activities for low income groups of society as well as small and medium enterprises. He maintains that it is essential to establish linkages among various institutions at micro, meso as well as at macro level for the growth of Islamic MF industry. He further asserts that if various organizations including Govt. agencies, Central Bank, Commercial and Islamic Banks, Takaful and Cooperative Companies as well as NGOs and NPOs could be interlinked, they can reach at ‘the poorest of the poor’ of a society and significantly contribute towards the development of micro-enterprises, enhancing the financial inclusion and alleviating the poverty from the gross-root levels of a society.

Frasca (2008, p.3) while focusing on the competitiveness of Islamic Microfinance, argues that Islamic finance could be potential ‘heaven’ for the investors who have become victim of current global credit crisis to relieve them from the speculative excess of the conventional system. Karim et. al (2008) conducted a survey, which includes 125 institutions in 19 Muslim countries. It shows that Islamic microfinance providers still reach only 300,000 clients, one-third of them in Bangladesh alone. They argue that to reach more people and build sustainable institutions, it is essential to focus on designing affordable products, training and retaining skilled loan officers and administrators, improving operational efficiency, and managing overall business risk.

According to IDLO Report (2009), microfinance remains less developed in the Arab world than, for example, in Asia, Africa or Latin America and, although it seems to have taken hold in many Middle Eastern and North

African (MENA) countries, it remains largely undeveloped in Saudi Arabia and in its infancy in the UAE. However, since 2006, the UAE has staged several high profile microfinance conferences showcasing microfinance initially as an alternative business model, in which participants might like to engage, and subsequently as an alternative asset class, in which participants might like to invest. On 17 January 2008 Noor Islamic Bank announced its commitment to serving the "unbankable" segment of the UAE population and, on 20 January 2009 at the Arab Economic, Social and Development Summit in Kuwait City¸ the League of Arab States announced the formation of a US$2 billion fund run by the Arab Development Fund that is set to include a microfinance programme that is aimed at helping small businesses through the credit crunch, extending credit to cottage industries and reducing unemployment across the Arab world.

The Table 1 shows the outreach of Islamic micro-finance CGAP global survey in 2007 as referred by Frasca (2008, p. 12) in which information was collected from over 126 Islamic MFIs and MFI experts in 19 Muslim countries. The survey reveales that Islamic MFIs have a total global outreach of 380,000 clients (or an estimated one-half 1% of total microfinance outreach). 80,000 of the above clients are served through a network of Indonesian cooperatives and another 100,000 of the total clients are served by two large MFIs in Bangladesh. It must be stressed that the MENA region is particularly underserved as CGAP's survey revealed that Islamic MFIs were concentrated in three countries Indonesia, Bangladesh and Afghanistan, accounting for 80% of the global outreach.

Frasca (2008) undertakes two seminal case studies in the use of Islamic finance instruments in MFIs: a) the Sanduq project in Jabal Al-Hoss, Syria; and b) the Hodeidah Microfinance Programme (HMFP) in Hodeidah, Yemen. He concludes that Islamic MFIs can be both competitive with conventional MFIs in the region and meet the reported demand for religiously tailored financial services for lower income groups. If we are to assume that microfinance in general can improve standard of living and alleviate poverty, Islamic MFIs appear to be doing as well as their conventional microfinance counterparts.

In Pakistan, the condition of people is pathetic as compared to other Muslim counties. Almost 80 percent of Pakistanis are poor according to the Economic Survey 2005-06 (defined as 'extremely poor', 'ultra poor', 'poor', 'vulnerable' and 'quasi-non poor'). The number of people in the lowest three of these income categories is over 36 million yet according to a USAID study, only 600,000 people in Pakistan received microfinance in 2005. Although this is significant growth from 60,000 in 1999, it leaves many people out. While some people not using microfinance are just not interested in it, many may opt out of conventional microfinance due to its reliance upon interest-based financing, prohibited by Islam as *riba* (Goud, 2007).
Apart from the banks, there are two notable Islamic microfinance institutions (IMFIs) in Pakistan: Akhuwat and Islamic Relief. This research paper takes an overview of functions and operations of Akhuwat in the country and attempts to see its contribution towards povety alleviation in the country based on its past performance.

AKHUWAT OPERATIONS AND FUNCTIONS: AN OVERVIEW

Akhuwat was established in 2001 with the objective of providing interest free micro credit to the poor so as to enhance their standard of living. Akhuwat is dedicated to improving the lives of the poor; those who are financially abused, abandoned and disregarded by society.

Akhuwat has developed a unique mosque-centered structure. Islamic microfinance is dispensed by small interest-free charitable loans (qard al-hasan) with an administration fee of 5 per cent in a spirit of Islamic brotherhood. There is no funding from international donors or financial institutions. All activities revolve around the mosques and involve close interaction with the community. There are no independent officers and loans are disbursed and recovered in the mosque. It uses collateral-free group and individual financing based on mutual guarantees. Anecdotal evidence suggests that the fact that loans are disbursed in a mosque, also attaches a religious sanctity to the oath of returning it on time (Karim, Tarazi and Reille, 2008).

SUSTAINABILITY

A lot have been written on the importance of sustainability issues of MFIs. Immediate thing that comes in mind about sustainability is its financial aspect - operational self sufficiency and financial self sufficiency. Actually financial and operational sustainability is only one major dimension.

After seeing the Figure 1, Critics would argue that AKHUWAT is not operationally sustainable with the given standards. AKHUWAT is not covering 100% of its operational cost.

Yes, it is true in financial terms but there are some other dimensions of sustainability where AKHUWAT is performing better. These different dimensions of sustainability are:

1. Microfinance services for all living below the poverty line including the “extreme poor”.
2. Interest free loans as a powerful tool against poverty.
3. The role of AKHUWAT is extending the helping hand and not doing business with poor.

FUTURE CAPITAL REQUIREMENTS

Figure 2 indicates that loan portfolio gorwth declines with the sharp decline of equity growth over the last 5 years. Constant growth in loan portfolio would be challenging for the akhuwat and need to be tackled in an effective manner.

COST STRUCTURE

Interest = Zero percent
Loan Processing Fee = Zero
Profit = Zero
Application Fee = Rs. 100 per application
Insurance Fee = 1% of loan amount (voluntarily)

CONCLUDING REMARKS

This research project recognizes Islamic micro-finance as an important component in poverty alleviation strategies. While conventional microfinance products have been successful in Muslim majority countries, these products do not fulfill the needs of all Muslim clients. Combining the Islamic social principle of caring for the less fortunate with microfinance’s power to provide financial access to the poor has the potential to reach out to millions more people, many of whom say they would prefer Islamic products over conventional microfinance products.

This research paper undertakes a case study of Akhuwat, an Islamic microfinance organization operating in Pakistan. Critical financial analysis of Akhuwat indicates that it is providing its services for all living below the poverty line including the “extreme poor” and Interest free loans can be used as a powerful tool against poverty. Yet Loan portfolio gorwth of Akhuwat declines with the sharp decline of equity growth over the last 5 years that might pose some constrainsts on its finanical stability in future. This challenge could be overcome by integrating Islamic microfinance with NGOs, NPOs (non-profit organizations), Zakah, Awqaf and with Takaful as well as with professional training and capacity building institutions in Pakistan to provide Islamic microfinanicial services to the poorest of the poor under one roof. It will help to uplift the living standard of people and ultimately contribute towards the economic development and enriched prosperity of the country.

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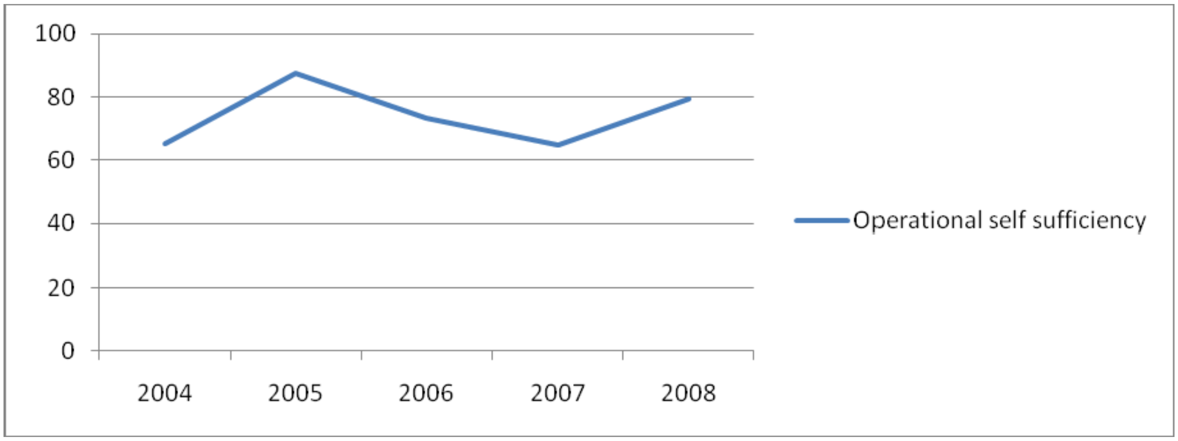
TABLE 1: OUTREACH OF ISLAMIC MICROFINANCE, BY COUNTRY

Region	**No. of Included Institutions**	**% Female (Avg.)**	**Total no. of Clients**	**Total Outstanding Loan Portforlio (US$)**	**Avg. Loan Balance (US$)**
Afghanistan	4	22	53,011	10,347,029	162
Bahrain	1	n/a	323	96,565	299
Bangladesh	2	90	111,837	34,490,490	280
Indonesia	105	60	74,698	122,480,000	1,640
Jordon	1	80	1,481	1,619,909	1,094
Lebanon	1	50	26,000	22,500,000	865
Mali	1	12	2,812	273,298	97
Pakistan	1	40	6,069	746,904	123
West Bank and Gaza	1	100	132	145,485	1102
Saudi Arabia	1	86	7,000	586,667	84
Somalia	1	n/a	50	35,200	704
Sudan	3	65	9,561	1,891,819	171
Syria	1	45	2,298	1,838,047	800
Yemen	3	58	7,031	840,240	146
Total		59	302,303	197,891,882	541

Source: CGAP Survey, 2007 as referred by (Karim et al., 2008)

FIGURE 1: OPERATIONAL SUFFICIENCY OF AKHUWAT



Source: Author's own compilation (Data taken from audited annual reports (2004-08) of AKHUWAT)

FIGURE 2: EQUITY AND LOAN PORTFOLIO GROWTH OF AKHUWAT

Source: Author's own compilation (Data taken from audited annual reports (2004-08) of AKHUWAT)