IIUM Journal of Economics and Management 20, no. 1 (2012): 19-49

ISLAMIC MICROFINANCE – AN INCLUSIVE APPROACH WITH SPECIAL REFERENCE TO POVERTY ERADICATION IN PAKISTAN

Muhammad Khaleequzzaman[a] and Dr. Nasim Shah Shirazi[b]

[a]*Associate Professor and Head Islamic Banking Department, School of Islamic Banking and Finance, International Islamic University Islamabad Pakistan*
[b]*Senior Economist, Islamic Research and Training Institute, Islamic Development Bank.*

ABSTRACT

The paper attempts to highlight some issues of conventional microfinance leading to irrational results and suggests alternative mechanism of Islamic microfinance to alleviate poverty in more effective manner. The results of the research are based on extensive review of literature comparing both the systems and finding reasonable ground for Islamic microfinance to be more inclusive and viable. Owing to time constraint, data set of Pakistan Poverty Alleviation Fund was used to assess impact of conventional microfinance which suggested that change in poverty status of the poorest was not significant, rather the affluent poor benefitted the most. While making a case for Islamic microfinance, the paper suggests extending its scope through product diversification, innovation and downscaling operations of Islamic banks linking microfinance institutions, particularly for fund sourcing, Sharia' advisory, and technology transfer. The question of inclusion therefore needs to be addressed through Islamic poverty alleviation process, building assets of the target segments which could bring socio-economic change in their lives. An outline of a few Islamic products has been recommended in view of specific features of microenterprises and risk management.

JEL Classification: G21, P46, P51

Keywords: Microfinance, Islamic Microfinance, Product development, Pakistan

1. INTRODUCTION

Although various reports stipulate different magnitudes of population characterized as poor, there is firm understanding that sizable proportion lives in poverty in Pakistan[1]. It is also recognized that magnitude of poverty is much greater in rural than urban areas. Microfinancial services have been recognized vital to enhance capacity of the poor to utilize human effort for income generation and empowerment. However, access to financial services is as low as 11 percent while 56 percent are financially excluded, the rest having resort to informal sector. The women have even lower access (4 percent) than men (19 percent)[2]. Such state calls for to carryout situational analysis of poverty alleviation effort in Pakistan to see the impact of microfinance programs, if any, and to make a case for Islamic microfinance in view of inclusion and just effort to develop poor.

Over 40 institutions (microfinance institutions, rural support programs, microfinance banks, and microfinance units of commercial banks and leasing corporations) represented through Pakistan Microfinance Network (PMN) provide bulk of microfinance in the country. The Pakistan Poverty Alleviation Fund (PPAF)[3] is entrusted to provide whole sale funds to microfinance institutions (MFIs) and multi-sectoral organizations for a variety of development interventions including microfinance. According to Economic Survey (2007), microfinance institutions were estimated to have provided Rs. 6.6 billion to 1.0 million active borrowers by 2005-06 which worked out to less than 3 percent of total population living under poverty line. On the other hand, PMN records microfinance outreach to 18 percent of the estimated potential 8.3 million households in Pakistan. Microwatch indicates coverage to the extent of 13 percent. Disregarding difference in estimates, it can safely be concluded that substantial efforts are required to extend the current achievement in terms of funds, outreach, scale and commercialization PMN has forwarded an estimate requiring US$ 600 – 700 million i.e. Rs. 49 – 57 billion to be invested in debt, deposit, and equity to reach 3.0 million target.

Appreciating the limited operations of microfinance sector in Pakistan, some issues need attention. Although sustainability is crucial for the success of microfinance programs and their ability to alleviate poverty, evidence depicts that many programs do not fulfill this criterion, and cannot reveal operational and financial self sufficiency (PMN, 2007). Many institutions remain un-regulated, not allowed to collect and recycle savings, hence rely on donors' funds. A recent study (CSFI, 2008)[4] based on survey findings of 74 countries, including Pakistan, highlights factors adversely influencing effectiveness of microfinance programs like mission drift, poor management quality & governance, and lack of transparency.

The paper, with specific reference to Pakistan, attempts to bring out some issues of conventional microfinance leading to exclusion and suggests alternative mechanism of Islamic microfinance to serve the cause of poverty alleviation in sustainable manner.

2. ISSUES OF MICROFINANCE

Typically, social collateral of microfinance groups is considered much stronger commitment than collateralized transactions where the local groups provide cost effective peer monitoring and screening to ensure repayment and overcome enforcement problems. But, it is failing to deliver in many cases. The trust is breaking and microfinance institutions are experiencing multiple borrowing by their clients. These conclusions are true in both national and international context. Even the loans have been diverted to the people not targeted by the programs[5] (Baker, 2000) and the very sense of such collateral has been violated by the lenders themselves (Bastelaer, 2000) and contingent renewals were often enforced imperfectly, hence damaging credibility of the system.. The conclusion is further strengthened by a recent study which discusses the dynamics of microfinance in Lahore (Pakistan) and concludes that commission agents arranged applicant's access to loan at a fee ranging from 2–10 percent of the loan amount, possibly with connivance of the field staff of the MFIs, later being interested to increase their market share (Barki & Shah, 2007). The rent seekers were responsible to raise effective cost of loan to the customers. Therefore, there is need to evaluate the joint liability bond and formation of social collateral keeping in view these limitations. Further, the general practice of microfinance does not include the poorest and destitute rather enterprising clients. A significant proportion of poor in Muslim communities, otherwise too, demonstrate self exclusion owing to Sharia' prohibition of interest based transactions of conventional microfinance.

3. EFFECTIVENESS OF CONVENTIONAL MICROFINANCE

One of the most interesting generalizations emerges that poorest of the poor (the hardcore poor) borrow essentially for protection purposes, given lower and irregular nature of their income. This group, it is suggested, will also be risk averse to borrow for promotional purposes (that is, for investment in future) and will, therefore, be only a very limited beneficiary of microfinance schemes (Hulme and Mosley, 1999). World Development Report on poverty (World Bank, 2000) has also expressed the view that it is the poorest who were less likely to benefit from microfinance.

The evidence to the impact of microfinance on poverty alleviation is mixed. A few studies have also quantified the impact of microfinance on poverty alleviation. Hulme and Mosley (1996), employing counter factual combined approach, analyzed the impact of microfinance on poverty alleviation for Indonesia, India, Bangladesh and Sri Lanka and found that growth of income of borrowers always exceeded that of control group and that increase in borrowers income was larger for better-off borrowers. A research paper (Khandker,1998), based on double difference comparison between eligible and ineligible households and between program and control villages in respect of Grameen and Bangaldesh Rural Advancement Committee (BRAC) Bangladesh, found that microcredit alleviated poverty by percent annually. For Thailand village banks, using the same approach, no evidence of any impact of microfinance was found (Coleman, 999). Another study (Coleman, 2006), also reached the similar findings and concluded that programs were not reaching the poor as much as they reached relatively wealthy people. However, surveys conducted by Gallup Pakistan in 2003 to 2004 using counter factual combined approach, found positive impact of PPAF microfinance program on the consumption, income and assets of the borrowers (World Bank, 2005). However, the study did not explore the impact of the PPAF microfinance on poverty.

4. QUANTIFICATION OF THE IMPACT OF MICROFINANCE ON POVERTY ALLEVIATION

To quantify the impact of microfinance on poverty alleviation in Pakistan, Shirazi and Amanullah (2009) have used counter-factual combined approach to study the impact of PPAF micro credit on poverty status of the households. This method combines “with-without” and the “before-after” approaches. The former provides information on the poverty status of borrowers (target group) and compares it with the poverty status of non–borrowers (control group) while the later compares the change in the poverty level of both groups ex-antae and ex-post for the time period in which the borrowers benefited. The methodology used for the study enabled to capture the net impact of micro credit and to isolate the influence of other factors on the income level and thus on the poverty status of the households who borrowed. The net impact was assessed using following formula:

$$P^* = (Pb_{t1} - Pb_{t0}) - (Pnb_{t1} - Pnb_{to})$$

P^* is the net impact of micro credit on poverty status of borrower households.
Pb_{t1} is the poverty status of the borrower households with current income level.
Pb_{t0} is the poverty status of the borrower households with previous income level.
Pnb_{t1} is the poverty status of the Non- borrower household with current income level and,
Pnb_{to} is the poverty status of the non-borrower household with previous income level.
't_1' represents the duration from Jan 2004 to Jan 2005 and 't_0' stands for the duration from Jan 2003 to Jan 2004.

The authors have used the official poverty line of Rs.878.64 per adult equivalent per month for the year 2004-05 and the same poverty line has been deflated by consumer price index (CPI, published by the Federal Bureau of Statistics Pakistan) to get the poverty line of Rs.838.22 for the year 2003-04. The data collected by Gallup Pakistan (2005) of a sample of more than 3000 households (including 1500 borrowers who had taken at least one loan from PPAF) has been used. The other half of the sample comprised of non-borrowers, having more or less the same socio-economic profile as that of the borrowers. The poverty levels have been estimated in respect of both borrowers and non-borrowers for the years under consideration. The overall poverty level was further decomposed in different poverty bands and groups viz. extremely poor, ultra poor, poor, vulnerable, quasi non-poor and non-poor[6]. The results are given in Tables 1-4 in Appendix 1.

The extremely poor households showed improvement in both groups but the improvement in respect of non-borrowers was more (1.85 percent) as compared to borrowers (1.22 percent). Similarly, non-borrowing vulnerable poor could improve their status by 2.92 percent as compared to the borrowers (1.15 percent). The ultra poor among borrowers, however, improved the maximum (4.60 percent) as compared to non-borrowers (3.15 percent). The largest impact could, therefore, be observed in case of poor band while the least in case of extremely poor and vulnerable poor.

The net impact has been computed by taking difference of the change in poverty status of the borrowers and non-borrowers. The results reveal that PPAF micro credit enabled to reduce the overall poverty level by 3.07 percent and the household shifted to higher income groups during the reported period. The status of the extremely poor and ultra poor borrowers was marginally improved by 0.63 and 1.45 percent respectively. There was marginal net impact on extremely poor households. The results are consistent with the generalization that emerged from the literature that poorest of the poor households borrow essentially for protection purposes. The aforementioned studies clearly indicate that microfinance is benefiting more the better-off poor while the destitute are neglected owing not to be credit worthy and entrepreneurial.

5. INCLUSIVE ROLE OF ISLAMIC MICROFINANCE

The characteristics of Islamic modes of finance are common to the best practices of microfinance[7]. However, the microfinance institutions could not diversify into Islamic financial instruments and those Muslim populations remained self excluded which rejected interest based financial services. The following will help understand more the inclusive role of Islamic microfinance:

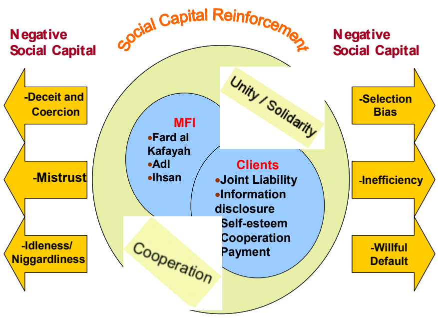
The question of inclusion becomes more significant when demand for Islamic finance is considered. Although no such estimates have yet been made in Pakistan, varying proportions of population (20-60 percent) in various Muslim countries demonstrated potential demand to access Islamic finance (CGAP, 2008). The respondents were even ready to pay higher price for Islamic products than conventional counterparts. Preference of Islamic microfinance vide various studies has been summarized at Appendix 2. A survey with limited scope of product development in Azad Kashmir, territory annexed to Pakistan (2009), indicated this demand to the extent of 98 percent. SBP Strategic Plan for Islamic Banking Industry in Pakistan expects that 4-5 percent of the microfinance clientele would prefer Islamic products by 2010 (SBP, 2008).

Rehabilitation of the poorest can be achieved by providing social safety net through Zakat where capacity can be developed to undertake business and sustain livelihood by the destitute. It is evident that inclusion is emphasized more in Islamic framework as the poor who do not possess required entrepreneurial skills are generally excluded from conventional microfinance. A systematic approach, meeting consumption requirements first and production requirements thereafter, through grant and finance respectively, can enhance inclusion of this segment. *Zakat* and *sadaqat*, the divine tools of poverty alleviation, can be used to achieve the objective. Microfinance institutions, following business model, can arrange such grants enabling clients to become bankable.

Debt is not preferred by Islam as usual practice to finance growing needs of clients. In present day practice, the possibility cannot be ruled out that amount of loan finds its way in a purpose other than targeted one or clients manage to pay previous loan with a fresh issue from same or other sources. Such state turns harmful to the economic goals of society. That is why Islamic finance favours asset creation and promotes entrepreneurship. Risk sharing principle helps improving efficiency and sustainability of micro enterprises. In addition, partnership modes of Islamic finance also prove advantageous for institution over conventional finance in economies with high rates of inflation where real worth of capital is maintained.

Islamic social capital, establishing trust between Institution and clients, can become instrumental in organizing coherent actions of all social and economic agents (Khaleequzzaman, 2007). Unity and solidarity can be cultivated among members and institution to understand better the principle of risk sharing instead of binding the clients only into a joint liability bond in case of conventional microfinance. Such a confidence-building measure would help disclosing full information, respecting transparency, and excluding agency problem and asymmetric information. Cooperation would be the binding force among these agents, at the same time, the clients watch necessity of re-payment as a sacred duty while institution extends respite in genuine cases. *Fard al kafaya, falah* and *Ihsan* become the motivating forces for all those (donors, institutions, clients, etc.) providing resources which may or may not entail return. Once these values are properly instituted, the negative social capital (deceit, selection bias, inefficiency, willful default, mistrust, etc) takes exit.

FIGURE 1
Diagram Representing Islamic Social Capital



6. REVIEW OF ISLAMIC MICROFINANCE EXPERIENCE

The experience of Islamic microfinance ranges from NGO operation to specialized development finance institutions, cooperatives and formal banking. The first formally known effort in this direction was Mit Ghamar savings project of Egypt established in late sixties. Islamic microfinance remained underdeveloped in Arab World for quite some time. Later, UAE achieved the position of financing centre for Middle East and North Africa (MENA) region. The microfinance network for Arab countries is represented through Sanabel having 64 institutions including Islamic programs of 12 Arab countries as members serving over 80 percent of the total microfinance clients in region (Allen & Overy, 2009). In Malaysia, experiences include Amanah Ikhtiar Malaysia (AIM) and Islamic Pawn Broking (*Al Rahnu*). Islamic rural banks and Islamic financial cooperatives (known as Baitul Maal wal Tamwil – BMT) are the major players in Indonesia (Obaidullah, 2008). Islamic Relief UK has launched Islamic microfinance programs in various countries ie. "First Islamic" of Bosnia & Herzegovina, START of Kosovo and Small Scale Enterprise Development (SSED) Program of Pakistan. Bangladesh is considered first country to formally introduce Islamic microfinance by using *Murabaha* and *bai Muajjal* while leading microfinance institutions include Islami Bank Bangladesh, Social Investment Bank Ltd. (SIBL) and NGOs like Al Falah and Rescue. In the non-formal non-corporate sector, SIBL also uses cash waqf certificates as source of donated capital (Mannan, 2007). At least seven banks were practicing *Murabaha*, *Mudaraba*, and *Musharaka* to finance micro enterprises in Sudan (Ibrahim, 2003). The Sudanese Islamic Bank (SIB) has successfully implemented *Musharaka* and *Mudaraba* (Harper, 1994) providing reasonable return on investment to both parties (the bank and the client). The main reason for SIB's success has been to work with productive families (defined as households' readiness to apply means of production to raise their standard of subsistence). SIB's experience in financing productive families illustrates to achieve dual benefit of realizing social objectives and profit. The bank disburses finance in a location from where the deposits are collected. A summary of such experiences is shown in Appendix 3.

In Pakistan, very few initiatives have been undertaken with very little coverage. Only a few NGOs suffering from insufficient/ piecemeal and inefficient operations are making efforts to operate on Islamic principles. The visible examples of Islamic microfinance in Pakistan can be counted as Islamic Relief Pakistan (IRP), Akhuat, Karakoram Cooperative Bank (KCB), National Rural Support Program and Muslim Aid. Information on use of products and scope of financing is given in Appendix 4.

7. LIMITATIONS OF ISLAMIC MICROFINANCE IN PAKISTAN

Islamic microfinance is mainly affected by resource and policy constraint, product concentration, and absence of requisite capacity, especially the *Sharia'* advisory. Like conventional banks, Islamic banks too have not perceived microfinance as viable opportunity. Neither, they have assumed social responsibility entrusted to them by those who provide funds to these institutions. The key principle of Islam that redistributive justice is achieved through support and empowerment of week has been grossly ignored. This problem intensifies in case of Islamic banks as they have not expanded their networks in rural areas. At the same time, inability of NGOs to recycle savings of their clients adds to the problem of sustainability. NGOs need to be linked to financial sector, mainly banks, to leverage their resources as well as make use of savings. Product base is not sufficient and concentration in *Murabaha* requires diversifying into other modes like *Ijarah* and Diminishing *Musharaka* to support asset building and use of technology. high frequency of supplies in small businesses.

The usual size of finance is not sufficient. Hence micro enterprises operate only marginally. The demands for installation of irrigation system, purchase of rickshaw/taxi, etc. though exist, but rarely met. Instances are there where businesses failed due to insufficient amount of finance. Micro entrepreneurs are risk-averse due to many reasons such as illiteracy, insecurity, lack of assets, natural hazards, poor economic management, and cultural barriers to use better technology. These risks can be reduced once their confidence is enhanced, especially when institutions undertake to share bad days if they claim right to realize the results of prospering business. The volume of financial intermediation envisaged to fulfill these requirements is quite large and it seems impossible unless mainstream banking is not involved. The Poor's capacity to save has already been established. They are forced to save in kind and encounter fungibility and liquidity problems given no or low access to the saving services. On the other hand, market return on savings could further enhance their capacity to save. Last, but not least, microfinance clients also face life and other risks which need insurance cover (microtakaful), benefiting both institution and clients.

8. APPLICABILITY OF ISLAMIC MODES IN MICROFINANCE:

Most of the Islamic products modes being used by Islamic banks can be adopted in microfinance with necessary changes to adjust informal environment. The MFIs are already familiar with fixed rate credit modes and can administer *Murabaha* and *Salam* with little effort and training. It is important to note that partnership modes like *Mudaraba* and *Musharaka* may be practiced only in selected cases and where client has already completed certain number of graduating cycles with *Murabaha*. In respect of partnership modes, it would be more appropriate to practice diminishing *Musharaka* in tangible assets as the institution is not required to rely on business results declared by client. The installment based DM can easily be operated to finance purchase of assets (machinery, equipment, transport vehicles), construction/improvement of houses, small tourist huts/café/restaurants, etc. Banks are frequently using this instrument and are in position to transfer this technology for microfinance.

9. PRODUCT DEVELOPMENT FOR MICROFINANCE

Not all products being used by Islamic banks are feasible for microfinance, as such. Sometimes, the structure requires changes while at other the institutions are concerned with meeting full credit needs and proper utilization of finance. Some examples can be considered. *Murabaha* and *Salam* can be combined where institution and client may enter two or more contracts, of course under master agreement, especially in agricultural/crop production activity. Of different maturity *Murabaha* and *Salam* contracts (depending on the length and type of financing) can be entered. Inputs/raw material can be sold through *Murabaha* while *Salam* can provide liquidity to meet financial requirements like hiring of tractor/labor, purchase of water, marketing and transportation, etc. Combining two contracts can effectively save from chance of misuse of finance while serving full credit requirements. The instrument like supplier's credit can also be developed. *Bai Istijrar*[8], a variant of *Murabaha*, is a supply side sale whereby the supplier agrees to supply the goods on an ongoing basis at an agreed price to be paid in advance or at a future date when repeated purchases are completed. Each time, there is no documentary offer or acceptance (as in case of *Murabaha*) or bargain. Settlement of price can be decided in any of the permitted ways.

While developing products, necessary safeguards should also be kept in view. It may not be possible for banks/MFIs to finance under *Musharaka* or *Mudaraba* and rely on the business results declared by the client. Better course could be to allow clients to gain sufficient experience in fixed return modes and then turn to the installment based Diminishing *Musharaka* for purchase of assets (machinery, equipment, transport vehicles), construction/ improvement of houses, tourist huts, small café/restaurants, etc. Banks are frequently using this instrument and are in position to transfer this technology for microfinance. However, selected clients with good credit history can be extended *Mudaraba*. Banks/ MFIs can determine number of graduating cycles where-after the clients can be financed under this mode. Good cases could be the small asset less farmers, commercial micr-businesses, livestock rearing, etc. Also, the business centers or groups of homogenous profession can be given equipment on *Ijara* (lease) for certain time period against fixed rent. Individual clients can be financed through *Ijarah wa Iqtina* enabling them to ultimately own the assets.

10. DOWNSCALING OPERATIONS OF ISLAMIC BANKS

Existence and operation of Islamic banks in urban areas reflects that underlying philosophy of distributive justice has been ignored. The instruments and services, as well as, financing criteria favor corporate and commercial sector. Such preference has set standards for clients having high rating, sizable turnover and creditworthiness. As such, Islamic banking has not been able to tap microfinance neither as business opportunity nor social obligation despite enabling framework provided by SBP. In order to be more effective, Islamic banks need to extend operation in this direction.

In view of above, there is a need to devise strategy for Islamic microfinance. The concern of sustainability of MFIs is crucial. Particularly in this context, a mechanism is required wherefrom the MFIs can benefit from savings of their clients (not contradictory to SBP regulations) and raise their equity. The savings of microfinance clients can be channeled to financing bank having *Mudaraba* arrangement with MFI, as described above. A higher than usual profit sharing ratio can be allowed in favor of MFI which will compensate MFI on account of its effort directing such savings to financing Islamic bank. Still, another approach of financing equity through Musharaka can help raising funds of MFIs.

The Sharia advisory is rare and expensive resource but is mandatory for operation of Islamic finance. MFIs may not be in a position to engage full time Sharia advisors owing to smaller scale of their business. Options can be considered to undertake this task. Islamic banks providing finance to MFIs can also provide Sharia advisory and internal Sharia audit with or without cost. Alternatively, a group of MFIs can engage full time Sharia advisor to supervise the operation. The banks can assist in product development process, too. The products already used and tested by Islamic banks can be modified to adjust the microfinance sector. The Islamic banks can help structuring new products and services compatible to the sector characteristics.

There is real need to establish Islamic microfinance banks providing microfinancial services in entirety, including saving, credit, insurance, payments, remittances, etc. Once Islamic microfinance banks are established, the financial discipline, corporate norms and access to financial market would be achieved.

11. CONCLUSIONS

Microfinance as practiced through conventional framework is unable to leave desired impact on poverty, also devoid of inclusiveness. Social capital, a microfinance innovation to safeguard against willful default, has not worked and is failing in many cases. Against this, Islamic values provide in-built mechanism of creating trust between MFI and client by building Islamic social capital where the latter shares the responsibility of loss sustained by the former. Further, Islamic microfinance does not ignore the poorest and helps build up complete livelihood program combining alms with financing. Specific needs of the clients, in view of the business cycles they operate on, call for product development process consistent with their requirements. Keeping in consideration the limitations of Islamic MFIs owing to shortage of funds, lack of Sharia' advisory skills and inability to tap saving resource, the Islamic banks have to play significant role by downscaling their oerations, not only out of the cause of social responsibility but also perceiving microfinance as business case for them.

12. RECOMMENDATIONS

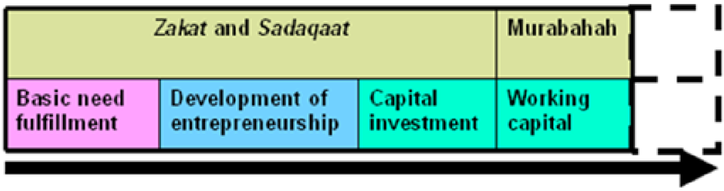
1. Downscaling Operations of Islamic Banks – Case of Corporate Social Responsibility and Business Opportunity:
    i. It does not seem possible to expand scale microfinance without participation of Islamic banks. The Islamic banks may provide required funds (either through *qarz hassan* or *Mudaraba* credit line), also facilitating technology transfer for capacity building. As a first step, Islamic banks, currently involved in urban centers, may use MFIs as outlets for Islamic microfinance. MFIs possessing necessary knowledge and experience of working with communities can become low risk intermediary for bank funds, besides undertaking usual job of social mobilization, appraisal of finance requests and enforcing social collateral in Islamic framework. *Qarz hassan* or soft *Mudaraba* placement by Islamic banks will allow MFIs to extend cheaper financing to clients and build their resources. At the same time, MFI can benefit from Sharia advisory, capacity development, and technology transfer under some contractual arrangement. In return, MFIs may direct savings of their clients to Islamic banks.

ii. MFI should direct its savings to Islamic banks. Islamic banks should invest these savings in usual way and share profit with clients/deposit holders. Since these savings would be collected without incurring any cost on account of marketing, a separate pool can be formed or larger than usual weight can be allocated to appropriate larger share of profit in favor of such customers.
iii. Islamic banks can also participate in equity of MFI augmenting the later's resource. Besides, this relationship would help MFIs to better govern and observe financial discipline.
iv. Similarly, *Qarz hassan* or soft *Mudaraba* would compensate MFI for directing savings to the bank affording any cost by the latter and building own resources to ensure sustainability.

2. Role of SBP**:** SBP in association with Islamic banks may establish Islamic microfinance entity to provide the following services:
   i. Maintain fund to be used as grant for capacity building of Islamic MFIs and MFBs maintaining Islamic microfinance divisions
   ii. Provide Sharia advisory and product development services to MFIs and MFBs
   iii. Maintain risk mitigation fund to be contributed by SBP and Islamic banks
   iv. Once sufficient tangible assets of microfinance are accumulated, the entity may help arranging Islamic securitization. Besides providing liquidity to diversify operations in microfinance, the process would enable microfinance sector to access financial market and diversify risk as well as expand operation.

Inclusion of the Poorest: There is clear understanding that microfinance efforts can effectively be supplemented by incorporating *zakat* into the system provided developmental goals are focused instead of mere handout distribution. It can enhance inclusion of non-enterprising poor by transforming them to self-sustaining active agent of change in society. Since livelihood needs of poor are of recurring nature, therefore, a part of *zakat* fund should be allocated for empowerment. By providing safety net in first place, business capacity can be developed by spending these funds for training and business support/startup capital. Financing for working capital however can be provided through *Murabaha*. Varying time frames can be set for different clients, depending on respective capacity to develop entrepreneurial skills. MFIs can, individually or collectively, establish *zakat* trust as separate entity and out of their own sphere where *zakat* can be collected and spent for both safety net and development of enterprise. The MFIs should also be concerned about disabled and frame some mechanism to benefit the latter out of *zakat* collection to meet consumption needs.

FIGURE 2
Mechanism of Transformation of Hard Core Poor



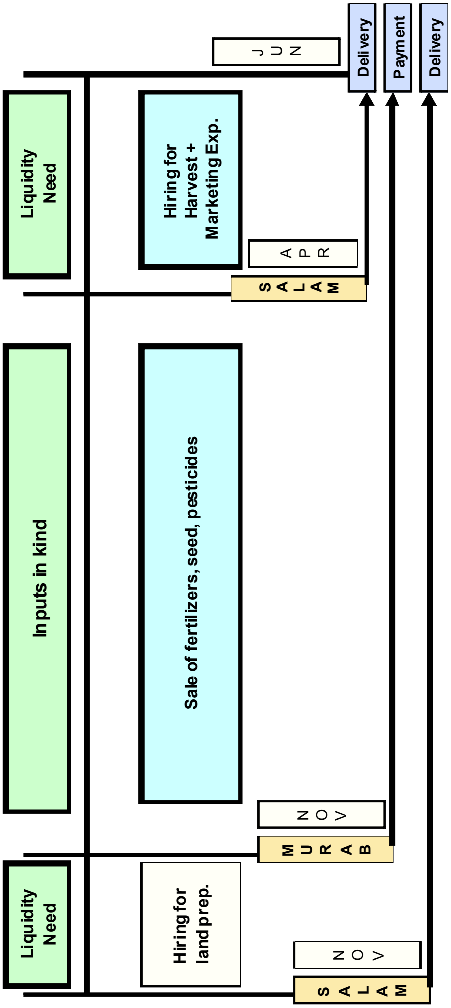
3. Product development for microfinance: Of course, developing micro enterprise specific products and services is the urgent need.

    i. Murabaha: To meet working capital requirement/purchase of supplies for micro-enterprises and farm & non-farm activities, Murabaha shall be the most frequently used instrument. Given the process flow of Murabaha and Sharia compliance, the instrument used by Islamic banks can easily be adopted for microfinance. The procedure and documentation can be simplified and conditions rationalized in view of social mobilization process and close monitoring of microfinance clients. Supplies of items in recurring demand could be maintained by MFIs or bulk purchases can be arranged for groups of clients. In case, Islamic banks intermediate through MFIs, the later would be in a position to physically acquire *Murabaha* goods and sell them to clients.

    ii. In case, the client requires supplies quiet frequently in many bits, it would be difficult to accommodate such requests by concluding a number of *Murabaha* contracts with the same client, besides increasing transaction costs and price risk faced by both the parties. The feasibility of Istijrar like instrument needs consideration[1]. *Sharia* advisors have also suggested that Islamic banks can enter Istijrar arrangement with supplier where the bank would pay the full or discounted market price and sell these goods to the client on the basis of *Murabaha*. They also suggest another alternative through which the bank can enter into Istijrar agreement with supplier for a certain time period wherein the agent of bank (ie. client) may take delivery of goods from time to time within that time period. Different clients can also be served through this arrangement. MFIs, however, can maintain inventory and sell goods directly to their clients as third alternative. There is therefore needed to make further consultations with Islamic banks and Sharia advisors to draw the structure of Istijrar to be used in microfinance operations. The consultations would focus on Sharia position of transaction in case the client takes possession of goods from time to time on behalf of Bank/MFI and through certain arrangement the price is paid later, at the same time realizing certain amount of profit in the transaction or the feasibility of Istijrar with advance payment be looked into where certain amount is kept with supplier and the client (or clients) take possession of goods as and when required within specific time period.

iii. Salam: It is ideal instrument for agricultural production activity and standardized manufacturing where client can be financed for both purchase of raw material/inputs and liquidity requirement. Banks and MFIs can arrange to collect commodity/ manufactured items. Alternatively, the client or managing committee of the group can be appointed as agent to sell on behalf of the bank/MFI once ownership of subject matter is acquired by MFI. Banks/MFIs can also enter parallel salam contract with third parties to dispose off the supplies. Close peer monitoring and surveillance by the credit officers is required to save from misuse of finance disbursed in cash. Salam cum Murabaha Financing: In case above products are used alternatively the risk of misutilization remains. Financing through Murabaha only may not cater liquidity requirement of farmers. On the other hand, providing salam capital may find way towards unproductive uses. More appropriate would be to suggest that bank/MFI may enter two or more separate contracts, of course under master agreement, with client especially in agricultural/crop production activity. Of different maturity murabaha and salam contracts (depending on the length of time period for which respective financing is required), not contingent to each other, can be entered at specific times

FIGURE 3
Combination of *Murabaha* with two different maturity Salam contracts



when the inputs or liquidity are needed and to save from any possible mis-utilization. Inputs/raw material can be sold through Murabaha while salam can provide liquidity to meet financial requirements like hiring of tractor/labour, purchase of water, marketing and transportation, etc.

4. Sharia' Advisory: Sharia' advisory is the crucial part, needed for contract development, devising operational strategy, *Sharia* audit, and routine operation of microfinance program. The linkage suggested above can be the effective way to achieve this objective.

ENDNOTES

1. According to Poverty Reduction Strategy Paper (GoP, Economic Survey 2006-07), 32.1 percent of total population was living below poverty line in 2001. More recently, the Economic Survey 2008-09 reports incidence of poverty as 24.5 percent estimated by Planning Commission and 36.1 percent by Task Force on Food Security. These estimates, however, exclude the transitory vulnerable poor. On the other hand, UNDP measures HPI-1 value of 36.2 percent for Pakistan, ranking 77th among 108 developing countries.

2. With a view to enhance access of the low-income communities to socio-economic and financial services, an independent professionally managed entity, PPAF was established in 2000 as a private, not-for-profit organization. PPAF aim to reach the poor through Non-Governmental Organizations (NGOs) and Community Based Organizations (CBOs), focusing institutional and capacity building measures to enhance their outreach and effectiveness of social infrastructure and microcredit programs. Over the last 10 years (as of June 2009), PPAF had disbursed funds worth Rs. 61.16 billion on account of various microfinance programs.

3. The study is based on a survey of 74 countries including Pakistan.

4. An impact study of flagship programs (Grameen Bank, BRAC, and BRDB) in Bangladesh concludes loan mis-targeting where the program officers bent the rules in an unobservable way and leaving conflicting conclusions about reducing income and consumption variation between program participants and non-participants. Rather the impact on education was reverse after correcting for selection bias.

5. Categorization of the households into different poverty bands is based on the definitions given in The Economic Survey (2006-2007), Mnistry of Finance, Government of Pakistan.

6. Both conventional and Islamic microfinance target poverty alleviation, do not require physical collateral, and promote self-esteem and entrepreneurship.

7. An agreement between the client and the supplier, where the supplier agrees to supply a particular product on an ongoing basis, for example monthly, at an agreed price and on the basis of an agreed mode of payment. However, the price can also be decided on conclusion of all transactions but based on some agreed market benchmark. Though hardly practiced, *Istijrar,* can provide solution to complexity of documentation in case of *Murabaha* when business cycle is too short to complete all documentation.

REFERENCES

Allen & Overy, "Islamic Microfinance Report for the International Development Law Organisation (2009): 15, http://upnews.kbu.ac.th/uploads/files/2012/04/02/7E.PDF

Baker, J. L, "Evaluating the Impact of Development Projects on Poverty- A Handbook of Practitioners", The World Bank, Washington D.C. (2000): 103 – 104.

Barki, Husna Bano and Shah, Mehr, "The Dynamics of Microfinance Expansion in Lahore", Pakistan Microfinance Network, Islamabad and ShoreBank International Ltd. Islamabad, Pakistan (2007): 17-18

Bastelaer, T. V., "Does Social Capital Facilitate the Poor's Access to Credit? A Review of the Microeconomic Literature", Social Capital Initiative Working Paper No. 8, The World Bank Social Development Department, Washington, USA (2000): 16-17

Centre for the Study of Financial Innovation, "Microfinance Banana Skins, 2008: Risk in a Blooming Industry", Heron, Dawson & Sawyer, UK (2008): 15 – 34.

CGAP, "Islamic Microfinance: An Emerging Market Niche", Focus Note No. 49, Consultative Group to Assist the Poor, World Bank, Washington DC, USA, 2008, 5-8.

Coleman, B.E. "The Impact of group lending in Northeast Thailand," Journal of Development Economics, vol. 60, (1999): 105-141.

Coleman, B.E., "Microfinance in Northeast Thailand: who benefits and how much?" World Development, Vol. 34, No. 9, (2004): 1612-1638.

Farook, Sayd. "On corporate social responsibility of Islamic financial institutions", Islamic Economic Studies, Vol. 15, No. 1, Islamic Development Bank, Jeddah, (2007): 31-46.

Govt. of Pakistan, "Economic Survey 2006-07", Finance division, Government of Pakistan, Islamabad, (2007)

Government of Pakistan, "Accelerating Economic Growth and Reducing Poverty: The Road Ahead (Poverty Reduction Strategy Paper)", Poverty Reduction Strategy Paper Secretariat, Ministry of Finance, Government of Pakistan, Islamabad (2003)

Harper, M; "*Musharaka* Partnership Financing - An Approach to Venture Capital For Microenterprise', Small Enterprise Development, Vol. 5, No. 4, England, (1994)

Hulme, D. and Mosley, P., "Finance Against Poverty", Vol. 1 and 2, Rutledge: London, (1999): 276-288.

Hulme, D. and Mosley, P., "Finance Against Poverty", Vol. 1 and 2, Routledge: London, (1996)

Ibrahim, Badr-El-Din A., "Sudan Economy Research Group Discussion Papers", Discussion Paper No. 35, Institute for World Economics and International Management (IWIM), Germany (2003), www.iwim.uni-bremen.de/publikationen/ pdf/ SERG35.pdf

Karim N, Tarazi M. and Reille X., "Islamic Microfinance: An Emerging Market Niche", Focus Note No. 49, CGAP, Washington DC, USA, (2008)

Khaleequzzaman, M, "Islamic Microfinance: Outreach and Sustainability", Conference proceedings of IIUM International Conference on Islamic Banking and Finance, 23 – 25 April 2007, Kuala Lumpur, Malaysia (2007)P 6-7.

Khandker, S., "Fighting poverty with microcredit: experience from Bangladesh", New York: Oxford University Press for the World Bank (1998): 61-62.

Mannan, M.A. "New Frontiers of Islamic Microfinance and Voluntary Sector Banking and Finance: A comparative Case Study Approach", Paper presented at the National Conference on Islamic Finance, Kuala Terengganu, Malaysia, November 27-28, 2007

Obaidullah M. and Tariqullah K., "Islamic Microfinance Development – Challenges and Initiatives", Policy dialogue Paper No. 2, IRTI, Islamic Development Bank, Jeddah, (2008): 3-22.

Obaidullah, Mohammed, "Introduction to Islamic Microfinance", IBF Net, The Islamic Business and Finance Network, (2008): 17-18, http://www.cwcd.org.pk/Knowledge-Center/mf-obaidullah.pdf.

PMN, "MicroWatch (October-December 2008)", Pakistan Microfinance Network, Islamabad, (2008)

PMN, "Pakistan Microfinance Review 2007", Pakistan Microfinance Network, Islamabad, (2007)

SBP, "Strategic Plan for Islamic Banking Industry in Pakistan: 2008", Islamic Banking Department, State Bank of Pakistan, Karachi, (2008), 14-15 www.sbp.org.pk/departments /.../ StrategicPlanPDF/Strategy%20Paper

Shirazi, Nasim S. and Khan Amanullah, "Role of Pakistan Poverty Alleviation Fund's Micro Credit In Poverty Alleviation: A Case of Pakistan", Economic and Social Review, Vol. 47, No. 2, 215-228, Lahore, Pakistan (2009): 215-228.

World Bank, "World Development Report 2000-2001", New York: Oxford University Press, 2001

World Bank, "Implementation Completion Report to the Islamic Republic of Pakistan for a Poverty Alleviation Fund Project", Report No: 32513, Finance and Private Sector Development Unit South Asia Region, Washington, D.C., 2005, 16-17

APPENDIX 1

TABLE 1
Poverty Status of the Borrower Households

2003-2004	Percent of HH	2004-2005	Perc of H
Poverty Line (PL) Rs.: 838.32 per month	30.58	Poverty Line (PL) Rs.: 878.64 per month	23.99
<u>Extremely poor</u> <50 percent i.e (below Rs.419.11)	2.82	<u>Extremely poor</u> <50 percent i.e. (below Rs.439.32)	1.6
Ultra Poor >50 percent <75 percent i.e (Rs. 419.11- Rs 628.66)	10.42	Ultra Poor >50 percent<75 percent i.e. (Rs. 439.32- Rs 658.98)	5.82
<u>Poor</u> >75 percent<100 percent i.e (Rs.628.66 – Rs838.32)	17.34	<u>Poor</u> >75 percent<100 percent i.e (Rs.658.98 – Rs878.64)	16.57

Vulnerable Poor >100 percent<125 percent i.e. (Rs. 838.32– Rs. 1047.87)	16.83	Vulnerable Poor >100 percent<125 percent i.e.(Rs.878.64– Rs1098.30)	15.68
Quasi Non –Poor > 125 percent < 200 percent i.e. (Rs. 1047.87– Rs.1676.64)	37.17	Quasi Non –Poor >125 percent< 200 percent i.e. (Rs.1098.3– Rs.1757.28)	40.42
Non-Poor >200 percent i.e. (Rs.1676.64 and above)	15.42	Non-Poor >200 percent i.e. (Rs.1757.28 above)	19.71

Note: (i) The poverty bands have been determined being recipient of income more or less than negative sign indicates a decline and a positive sign stands for an increase.

TABLE 2
Poverty Status of the Non-Borrower Households

2003-2004	Percent of HH	2004-2005	Perce[illegible] of HH
Poverty Line (PL) Rs.: 838.32 per month	29.32	Poverty Line (PL) Rs.: 878.64 per month	25.7[illegible]
Extremely poor <50 percent i.e (below Rs.419.11)	4.03	Extremely poor <50 percent i.e. (below Rs.439.32)	2.1[illegible]
Ultra Poor >50 percent <75 percent i.e (Rs. 419.11- Rs 628.66)	9.03	Ultra Poor >50 percent<75 percent i.e. (Rs. 439.32- Rs 658.98)	5.8[illegible]
Poor >75 percent<100 percent i.e (Rs.628.66 – Rs838.32)	16.26	Poor >75 percent<100 percent i.e (Rs.658.98 – Rs878.64)	17.7[illegible]
Vulnerable >100 percent<125 percent i.e. (Rs. 838.32– Rs. 1047.87)	18.50	Poor >100 percent<125 percent i.e. (Rs.878.64– Rs1098.30)	15.5[illegible]

Quasi Non –Poor > 125 percent < 200 percent i.e. (Rs. 1047.87– Rs.1676.64)	37.07	Quasi Non –Poor >125 percent< 200 percent i.e. (Rs.1098.3– Rs.1757.28)	41.4
Non-Poor >200 percent i.e. (Rs.1676.64 and above)	15.11	Non-Poor >200 percent i.e. (Rs.1757.28 above)	17.1

TABLE 3
Net Impact of PPAF Micro credit on Poverty Alleviation

	Last Column Table 1 (T1)	Last Column Table 2 (T2)	Diffe (T1
Overall			
	(-)6.61	(-)3.54	(-)3
Extremely poor	(-)1.22	(-)1.85	(+)[illegible]
Ultra Poor	(-)4.60	(-)3.15	(-)1
Poor	(-)0.77	(+)1.46	(-)2
Vulnerable	(-)1.15	(-)2.92	(+)
Quasi Non –Poor	(+)3.25	(+)4.42	(-)1
Non-Poor	(+)4.29	(+)2.04	(+)2

APPENDIX 2

TABLE 4
Potential Demand for Islamic Microfinance

Organization conducted survey	Surveyed Countries	Proportion of respondents] Islamic Microfinan
CGAP 2008	Jordan, Algeria, and Syria	20 to 40 percent
PlaNet Finance 2007	West Bank and Gaza	35 percent - West Bank 60 percent - Gaza
USAID 2002	Jordan	24.9 percent
IFC/FINCA 2006	Jordan	32 percent
Frankfurt School of Finance & Management 2006	Algeria	20.7 percent
IFC sponsored Study	Yemen	40 percent
IFC 2007	Syria	43-46 percent
Bank Indonesia 2000	Indonesia (East Java)	49 percent

Source: CGAP, Washington DC, USA, 2008

APPENDIX 3

TABLE 5
Operations of Islamic Banks in Sudan

Name of Bank	Percent of total finance	Mode(s) in use	Target group	Methodology and (conditions)
The Sudanese Islamic Bank (SIB)	74 percent	Murabaha, mudaraba, musharaka, and saving deposit	Productive families, small enterprises, crafts and informal sector activities.	Family affairs sections to prepai under productive family concep deal with investment, feasibility and project follow up in micro enterprises of farmers and small manufacturers (3-4 percent mon *Murabaha* margin. Up to 6 mon *Murabbaha* period)
Faisal Islamic Bank of Sudan (FIBS)	100 percent	Murabaha	Craftsmen/women:	Project evaluation and financing projects of purchasing machiner parts, means of transport, raw m agricultural implements and inst of electric bakeries (3-4 percent *Murabaha* Up to one year *Mura* Period)

Islamic Co-operative Development Bank (ICDB)	100 percent	Murabaha	Small producers And craftsmen	Urban - “Craftsmen Support Fu finance blacksmiths, carpentry, boats and oil mills.Rural - Clier financed through productive far concept for poultry, cows and m looms. Small-scale projects - oi tailoring, needlework, soap mak grain-mills and sweet making (3 percent monthly *Murabaha* Up oneyear *Murabaha* Period)
Nelein Industrial Development Bank Group (NIDBG)	100 percent	Murabaha and mudaraba	Small enterprises And productive families	Feasibility of projects against cc client. Projects food processing yoghurt, *Kisra* (flat brad), biscu sweets and rural oil mills); tailo needlework, leatherwork, soap- building materials and engineer workshops, building and packin services, tire repair workshops. percent *Murabaha* margin for amount up to 1500 thousands. 2 percent *Murabaha* margin for amount more than 1500, but les 2000)

APPENDIX 4

TABLE 6

Islamic Microfinance Programs in Pakistan

Name of Institution	Mode of Finance	Target Clientele	Range of financing (Rs.)	Purpose
Islamic Relief (Small Scale Enterprise Development)	Murabaha	Urban microentreprises	8,000 – 25,000	Working equipme renovati
Akhwat	Qarz hassan	-do-	10,000 – 20,000	-do-
Karakurm Cooperative Bank	Murabaha	Rural microenterprises	25,000 – 100,000	agricultu machine saw, sup microent material

National Rural Support Program	Murabaha	Rural microenterprises	10,000 – 20,000	Agricult inputs, L developr purchasi fattening creation home ap purchasi machine used for generati
Muslim Aid	Murabaha	Rural & urban microenterprises	10,000 – 20,000	Agricult supplies/ machine equipme