Challenges Faced by the Islamic Microfinance Institutions in Pakistan

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Abstract

Islamic commercial banking has now been in business for about four decades and has achieved a spot in different parts of the world. However, there is still a need to devise financing products to fulfill the needs of financially excluded people of the society. In this context, Islamic microfinance can be seen as a tool to meet the demand of this sector. Islamic microfinance has been developing over the years and has the capacity to alleviate poverty. Though the conventional microfinance has been working for decades and has achieved much success. However, it still has its flaws. This study first discusses the difference between Islamic and conventional microfinance, the differences in models, and their operations. Secondly, this research discusses the challenges and the critical issues that the Islamic microfinance institutions are facing. The study uses semi structured interviews to collect data from the officials of Islamic microfinance institutions. The findings of this study suggest that IMFIs faces the issues of sustainability, moral hazard, lack of formal system, weak monitoring, and scarcity of field resources. There is a need for diversified products and awareness about Islamic microfinance.

Keywords: Islamic, Micro-finance, Challenges

I. Introduction

Development is a multidimensional process which involves greater amendments in not only the social and institutional structure but also in economic growth. Islamic economics and finance has been in use in different forms in many countries over the centuries. Islamic economics and finance in recent years has been re-developed in a modern form. The impact of globalization has made Islamic finance an institutionalized phenomenon. The basic expression of Islamic finance is its focus on a value based system where there is a great importance given to social justice and equitable distribution of wealth. The Islamic economy aims to reduce and alleviate poverty with the help of Islamic financial system.

The Islamic commercial banking has now been in business for decades and has achieved a spot in different parts of the world; there is still a need to devise financing products to fulfill the needs of the less fortunate people of the society. This can be seen, by a study conducted by Honohon (2007), that around 72 percent of the population of Muslim majority countries do not avail financial services. In such scenario, Islamic microfinance can be seen as a tool to meet the demand of this sector. The Islamic microfinance has been developed over the years and has the capacity to provide an opportunity for the ambition of Islamic economics. The objectives of the Islamic Finance can be achieved with the help of microfinance which helps the financial inclusion of the under severed population (Ledgerwood 1998). Therefore, this research focuses

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on Islamic micro finance institutions in Pakistan and aims to explore and evaluate the potential of Islamic micro finance institutions which act as an alternative to poverty alleviation. These institutions also aim to solve economic problem of the people which are otherwise not serviced by the financial sector. This study also aims to know the efficiency of the Islamic microfinance institutions. In fulfilling these aims the following objectives are developed.

1. To identify major issues and problems that are being faced by Islamic Micro finance institutions.
2. To examine the financial services offered by these institutions.

There is a lack of research on Islamic microfinance in the context of reducing poverty, so this research will add towards it. As the research aim and objectives identify, this research is also expected to provide a better understanding of the problems of the institutions and will identify them for future benefit.

The financial development of a country is related to the economic growth. Financial development is a broad category and can be achieved not only through the means of banks but also by non-banking financial institutions. The financial development can also be achieved through financial inclusion which aims at bringing in different sectors of the society in the financial realm, the sectors which are not served by the financial institution. The theories of financial development, in relation to the economic growth, provides the theoretical framework of this research.

In order to achieve economic development, it is necessary to alleviate poverty with the help of financial inclusion. An important tool in financing economic development using conventional finance is microfinance, usually through interest-bearing micro-loans. Islamic microfinance, its *Shari'ah* compliant counterpart, is growing, although it is not yet widespread. The sector of Islamic micro-finance can play a vital role in financial inclusion by profit and loss sharing, distribution of wealth and sharing risk (Obaidullah, 2008). The Islamic microfinance institutions not only provide financial inclusion but also provide alternate to interest based financing, which the people otherwise avoid, and provide *Shari'ah* compliant services. The financial inclusion and poverty alleviation should be part of the economic development.

II. Literature Review

What is Microfinance?

The history of microfinance can be traced back to the 18th century, however the current form of microfinance has started developing in the early 1970s, when the governments of developing countries started giving subsidized credit to help the poor e.g. incorporation of ZTBL. These funds were mostly distributed with the help of government institutions in the local areas and were utilized by the poor in setting up business, and for agriculture purposes. Microfinance includes small loans to very poor self-employment projects that generate income, allowing them to care for themselves and their families. It is the provision of financial services such as savings, loans and insurance to poor people living in both urban and rural settings who are unable to obtain such services from the formal financial sector.

Microfinance in Pakistan

In Pakistan, the poor people have relied mostly on the informal sources. The informal credit market is mostly served by friends and families, landlords, moneylenders, traders, Aartis, or commission agents. These services are most common in Sindh and Southern Punjab. It is estimated that 65% of outstanding debt of all rural households was provided by non-institutional or informal sources (Agriculture Census, 2000). In the formal sector Zarai Taraqiati Bank Limited (ZTBL) formerly known as Agriculture Development Bank of Pakistan (ADBP) was incorporated in 1970s. The purpose of the bank was to provide agricultural credit to rural farmers on subsidized rates. Later in the 1980s, Agha Khan Rural Support program (AKRSP) along with other microfinance institute Orangi Pilot Project was established. The objectives of these two institutions were to alleviate poverty and provide credit to the poor people. The AKRSP success in the areas of Northern areas and Chitral made way to creation of Rural Support Program (RSP) in 1991, which focused and worked on the national level (Rauf & Tahir, 2009).

In the 2000, Khushali Bank the first microfinance bank was established as a part of the Government Poverty Reduction strategy. The objective of the bank is providing microfinance services and to help in developing and progress the microfinance services. The Microfinance Sector Development Program (MSDP) which is used by the Khushali bank was developed with the assistance of Asian Development Bank along with the provision of US$ 150 million to support its operations (Ghani & Imran, 2009).

Goals of Microfinance

According to Ledgerwood (1998), the goal of microfinance is, as a development tool, not only to provide financial services to low income clients, but also to overcome the needs of underserved markets as a means of meeting development objectives. These development objectives include helping reduce poverty in the society, promote employment, empower women and other underprivileged groups, and to help clients expands their businesses. The goals also include sustainability, which is to help the clients achieve sufficient returns that covers costs and has a surplus.

Microfinance Literature in Pakistan

There has not been a lot of research done on the topic of microfinance in the context of Pakistan. Due to the lack of empirical studies the impact of microfinance in Pakistan is not known (Ahmad, 2008). However, like studies conducted in other areas suggests, the impact of microfinance in Pakistan will be positive given the certain aspects that hinder the process of microfinance are taken care of. The primary reason hindering the progress of microfinance is the aspect of interest *(*or *Riba)* which is forbidden in the Islamic teachings; so many people avoid taking the micro credit and microfinance because of their religious beliefs.

Ahmad (2008) suggests that apart from religious reasons, another obstacle is the low efficiency of microfinance institutions and borrowers. Loans are either not given to the targeted audience or are not utilized by the borrowers in the desired capacity. On top of this the aspect of interest bearing in conventional microfinance makes the loan unbearable and unable to be paid. This obstacle can be tackled with by the introduction of Islamic based microfinance. Akhuwat which is an Islamic microfinance firm in Pakistan is doing so by providing microcredit without interest bearing.

The microfinance institutions are trying to alleviate poverty, however, they're not being able to do so because of the following reasons (Ahmad, 2008);

- The amount of loan disbursed is too low.
- The loan disbursed is not used for the purpose in the first place.
- Little understanding of micro finance among the people.
- Lack of support from the government.

Another study conducted by Adnan and Alam (2010), argues that microfinance has a positive relation with income, employment rate, and production capacity of the poor. They suggested that it is an important foundation for the financing of the poor and underserved strata of Pakistan. The microfinance help improves quality of life and achieve the target of financial inclusion. The study suggests that though microfinance is developing in Pakistan, more than half of the country's population lives in the rural area, so there needs to be plans to help the rural population in regards of financial services.

Islamic Microfinance

As microfinance refers to the provision of financial services to the poor and more than just small loans, which includes saving and micro insurance, as it is quite understandable that a household might need credit but they should also be able to save and insure. Microfinance cause a due debt, and although Islamic view permits taking loan in the time of need, it does not allow charging of interest which is termed as (*Riba*). Islam also disapproves the charging of fixed high interest rate. As it is the objective of microfinance to alleviate poverty, charging of interest get the poor into debt and difficulties (Obaidullah, 2008). This factor was also discussed by Armendariz and Morduch (2010) that the weakness of conventional microfinance by charging high interest rates has made the Islamic microfinance come into existence.

In contrast to conventional microfinance Islamic microfinance offers more feasible solution by offering not only debt based financing, but also assets based (Riwajanti, 2014). Islamic microfinance is simply the provision of financial and non-financial services based on Islamic values with the aim to promote justice for all (Riwajanti, 2014). Since the aspect of interest is not present is Islamic microfinance, Ascarya (2014) sees Islamic microfinance as a tool to alleviate poverty where the target audience is not only the poor but also the extreme poor who are not reached by the conventional microfinance. Rahul & Sapcanin (1999) while discussing the application of microfinance suggests that Islamic finance can be used to achieve the objective of microfinance. They argue that since Islamic finance, which give prominence to risk sharing and collateral free loans can be used to meet the needs of the micro-entrepreneurs.

Though the objective of both the conventional and Islamic microfinance is same, that is to achieve economic and social development and help achieve a better life for the poor, both aims to help promote entrepreneurship. Dusuki (2006) has linked Islamic microfinance idea of Ibn e Khaldun's "Asabiyah" concept which is unity among individuals with a common interest or mutual support within a group. In the same manner he suggests that Islamic microfinance can be used through group lending to the poor but also the extreme poor.

Operations

The accumulation of funds in Islamic microfinance is important and can be achieved through different means. Wilson (2007) suggests that instead of raising funds from financial institutions the Islamic microfinance institutions should do so by with the help of Waqf and Zakat**.** The Islamic microfinance institutions then uses Wakala model to manage these funds, which comes from donors, and disburse them. Obaidullah (2008) also proposes that the funds used by Islamic microfinance institutions can be raised with charity which includes:

1. Zakat
2. Sadaqqah
3. Awkaf (gifts that include Hiba and Tabarru)

The funds can also be collected through deposit based which include Wadiah, Qard e Hasna and Mudarabah and also on equity based i.e. Musharakah (Obaidullah, 2008)**.**

Financing instruments

As discussed that the loans/ finances can be disbursed to the entrepreneurs/poor both through equity and debt based, the following are the products and contracts that can help achieve it.

1. ***Profit and Loss sharing:*** It includes both Musharakah and Mudarabah, however in this case/Product/contract there is involvement of risk towards both the institution and the borrower.
2. ***Lease:*** It includes the Ijarah contract where physical assets are leased to the borrower. The borrower has low risk compared to the institution providing it.
3. ***Qard e Hasna:*** This includes disbursement of loan with zero nominal return, where the risk of both the institution and the borrower is minimum.

III. Research Methodology

Considering the aim and objective of this research, it is suggested to employ a qualitative research methodology. As the study wants to gauge the perception of the participants in their field, which is the impact of Islamic microfinance on economic growth and financial inclusion and also the perception of the participants about the problems facing the Islamic microfinance institutions. Since the research is qualitative in nature, the data has been collected through semi structured interviews and the answers were recorded and transcribed on a questionnaire form (attached in Annexure A). The respondents were selected from the Islamic microfinance institutions and were visited in the respective branches. There were 5 interviews conducted in 4 branches and the interviewees included four branch managers and an assistant manager.

IV. Findings

Compared to the conventional microfinance, Islamic microfinance faces challenges as well. Below are some of the challenges and problems that were identified by the officials of the institution in the semi structured interviews.

1. **Lack of Islamic Microfinance Institutions:** There are 4 Islamic microfinance institutions working in Pakistan, there is only one providing its services in Peshawar. These institutions are as follows
    1. Akhuwat
    2. Al Huda Foundation
    3. Farz Foundation
    4. Wasil Foundation formerly CWCD, Pakistan

Among these Islamic microfinance institutions in Pakistan in working, there is only one institution i.e. Akhuwat working in Peshawar. This institution is providing its services through four branches in Peshawar city, which are located in the following areas:

1. Nothia
2. Faqeerabad
3. Ghareebabad
4. Kareem Pura

According to respondent 1, these four branches are not enough to provide the microfinance services to population of Peshawar.

Lack of Understanding of Products: There is a general lack of understanding about the Islamic banking products among the clients. The clients belonging to the lower strata of the population and being mostly uneducated, doesn't know about the *Shari'ah* compliant modes of finances like *Murabaha, Mudarabah, Salam* and *Istisna*. Respondent 2 said:

> *"that the clients that come to get the loan doesn't have any idea about the Shari'ah Compliant products, the only information they have is that our institution is offering interest free loan".*

The lack of information about the availability of products causes problems in addressing the clients and grabbing their attention.

Product Diversification: Though there are many proposed models for the Islamic microfinance, but there is general lack of diversification in the institutions. According to respondent 3:

> *Akhuwat the Islamic microfinance institution only offers loan through Qard e Hasna.*

Though this model is very suitable for the provision of loans and there is less risk involved but there are other models which can be used as well. The model of *Qard e Hasna* is unsustainable in the long run, whereas models like Musharakah and Mudharabah would have long term benefits.

Group Based Approach: Akhuwat the Islamic microfinance institution doesn't employ the group based approach. Akhuwat provide individual loans. However, they form groups as a form of social collateral where all the members of the group take responsibility of each other. In the group based approach there can be 3-6 members. There are other conditions that are being implemented on the group which are the following:

1. The group members cannot be members of the family
2. They must reside within a distance of Five minutes from each other's.

The reason for group based approach being employed by the Akhuwat is that members of the group must take responsibility of each other and helps ensure that there is not any misappropriation of funds. However, the conditions have their own adverse impacts. The condition that the members of the group cannot be family members hinders many of the applicants to acquire the loan. As there is already a trust among members of the family and can be used to take responsibility of each other's. Most people will be unwilling to take people other than their family members because of lack of trust. This is tackled by introducing the second condition where the members of the group have to be in walking distance so that they know and vouch for each other's. However, if one cannot form a group they are unable to get loan.

Criteria to give loan: The Islamic microfinance is designed for the poorest of the population. Therefore, there is no concept of collateral to be asked from the borrower. This helps the borrower because most of them cannot afford to provide so. According to (Respondent 4):

> *Though Akhuwat does not ask for any collateral, the institution conditioned it that the borrower has to live in his own house, so if the borrower is living in a rented house, he or she is not eligible for the loan.*

This criterion is set to make sure that the borrower doesn't default on the loan and then leave the place of inhabitancy. However, many of the poor cannot afford to rent a house let alone own it, so many of the population that has ideas to start a new business left from obtaining the loan.

Evaluation of client: The client is evaluated that whether or not they are eligible for the loan. The evaluation is designed to conduct a social appraisal which consists of house visits of the members of the group and make sure that they own it and share the same locality i.e. they live at a distance of 5 min from each other. This evaluation takes time and makes the selection process lengthier. It takes about a month from the application date to the case being selected or rejected.

Sustainability: *Repayment:* According to respondent 2:

> *"The repayment rate of Akhuwat is very high ~ 99 percent however late repayments are quite often"*.

Since Akhuwat is offering Qard e Hasna which is debt based and there is no return, the late repayments arise a lot of problems. The repayments are used to make fund and then redistributed among other clients. If one repayment is delayed the whole process of giving out a loan is disturbed and delayed.

Shirakati fund: The Shirakati (which literally means Contribution) fund is a type of Takaful contract between the borrowers and the institution. A Sum of Rs. 200 is collected from each borrower when the loan is disbursed. This is a type of Islamic insurance (Takaful) where the members of the fund take responsibility of each other's losses. In case a borrower defaults in case of death or physical disability the loan is refunded on their behalf and the relatives don't have to worry about it.

Lack of Proper Systems: There is a lack of proper systems in the microfinance field including microfinance institutions. For instance, the Benazir Income Support Program offers debit cards where individuals can collect money whenever and wherever they want through automated teller machines (ATMs). In case of IMFIs, the borrowers are issued with checks which they have to claim at certain bank. This creates problems as most of the borrowers doesn't need the money at one time, and end up with cash which is hard to handle.

Monitoring and Field Resources: There are many obstacles that arise from the lack of field resources which in turn hinder the processes of monitoring and supervision. After the disbursement of loans, the official of the branch monitors the client that whether or not the funds disbursed are utilized for the aforementioned purpose. According to (Respondent 1):

> *"it is difficult and costly to monitor the use of the funds"*.

Moreover, the field resources allocated to the officials of the IMFIs are limited which makes the monitoring and supervision difficult. Most of the borrowers resides at different locations so the officials need to travel, the lack of vehicles, lack of personnel and physical distance hinder the monitoring process. Though this problem is mitigated by the group structure where members of the group monitor the work of each other and the peer pressure helps the repayment of the loan, however the problem still persists (Respondent 5).

Moral Hazards: There is a great possibility that the moral hazard problem might arise from the use of funds for purposes other than those intended. Since most of the IMFIs use Qard e Hasna to provide services to their clients. However, giving away cash to the borrowers instead of assets or supplying goods might result in deviation of funds to other purposes while causing moral hazard. In these cases, the borrower might not start the business for which they are taking loan or might use them in some other capacity. In modes of finances such as Mudarabah and Musharakah the problem might arise in case the client underreports the profit. Though there is supervision and monitoring being done by the employees of the institutions however, diversion of funds is possible because monitoring and evaluation are costly and require personnel and field resources.

The Islamic product of Murabahah financing can reduce the problem of moral hazard because in Murabahah financing the clients are provided with goods and assets instead of loan or cash. This product has the capacity of reducing the moral hazard problem because the goods and assets are intended to be used in a productive way. However, the professionals of Akhuwat has identified that the problem of moral hazard has been reduced due to the strong religious belief of the clients. As respondent-1 said that:

> *Many has refused to take the loan amount at the time of disbursement when they were introduced that they cannot use the loan for some other purposes other than what was specified.*

Skilled Staff: There is a scarcity of skilled individuals in the field of Islamic microfinance. The officials who join the organization gets a preliminary training of two weeks however there is no other on job training offered. The officials working in the branches of Peshawar had a preliminary training of 2 weeks. However, this is mostly due to the lack of diversified products in the institutions. As respondent 2 mentioned that:

> *"Though they're proficient in the products that are being offered by their institution i.e. Qard e Hasna, however there needs to be specialized training where they're informed about other Islamic based products like Mudharabah, Murabahah, and others".*

Legal Hurdles and Government Support: According to the officials of Akhuwat the weak legal structure in the country provide a hindrance in the operations of IMFIs. For example, if a client defaults on a loan then there isn't considerable way to recover the loan amount. However, in the recent past, the government has shown interests in investment in Islamic based microfinance. For instance, in June 2015, the governor of KPK Sardar Mahtab Ahmad Khan has announced to fund the people of FATA through Akhuwat. The fund consists of Rs. 500 million which would be used to open 10 branches across the whole of FATA (Bureau Report, Dawn 2015).

V. Conclusion

Though Islamic microfinance is in the developing stage, it has the capacity to meet the requirements and demand of underserved market. The clients either don't want to or are unable to get services from conventional microfinance institutions. Islamic microfinance has the ability to contribute towards the economic development and alleviate poverty. The main objective of this research is to explore the challenges that are being faced by the IMFIs. The issues facing IMFIs were discussed in the previous chapter. This chapter will summarize those issues and suggests what needs to be done. The research study finds that there is a lack of IMFIs compared to the need of the population. There is a great number of people living below poverty line but are in desire of microfinance to start small businesses and support them. There is a general lack of awareness which needs to be resolved. The government should step up and provide opportunities that will help both the institutions and clients. There needs to be a proper legal network to support the institutions. Though the government is supporting in other ways, it should prioritize the financial inclusion of the needy people. The product diversification problem is also the cause of others which include sustainability and moral hazard. The institutions need to come up with innovative products which would attract more individuals and minimize their risk. The institutions also need to provide the professionals with better field resources, and trainings which will in turn improve monitoring and evaluation of the clients. Considering the repayment rate, the IMFIs are performing really well however improvements can be done in the identified areas.

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Annexure A Questionnaire

Questionnaire for Finding the Challenges Faced by Islamic Microfinance Institutions

Name of Institution	
Address	
Organization Type	

1. In your opinion, do clients understand terms used in Islamic banking products?

   Yes No

Comments:

____

____

2. What type of financing approach have you applied?

   Group Individual Multiple others, please specify______________________

   If multiple approaches, please mention below

3. Reason for choosing that approach?

   ____

   ____

4. Types of financing products that are being offered?
   - Musharakah
   - Mudharabah
   - Murabahah
   - Istisna

- Ijarah
- Salam
- Qard e Hasna

5. Popular mode and reason of popularity?

____

____

6. How do you evaluate client before distributing loan to them?

____

7. What are your criteria to give loan?
   - Assets owned (collateral)
   - Annual revenue
   - Number of labor
   - Credit limit

8. Duration of loan
   - Maximum :……………months
   - Minimum: ……………... months
   - Average ………………months

9. How long is the time required to evaluate the credit request, from application until the clients get the fund (in working days)?

____

10. How often do you collect the payment from clients?
    - Everyday
    - Every week
    - Every months
    - Others_________________________
11. How much the collection/repayment rate in the last 5 years (in percentage)?
    - 2011
    - 2012
    - 2013
    - 2014
    - 2015
12. Do you ask for any collateral?
    - Yes
    - No

If yes, what collateral do you require?

____

____

13. Risk
    - Assets (home/building, land) certificate
    - Car certificate
    - Motorcycle certificate
    - Group reference/pressure
    - Others_____________________________
14. What are some of the risks that you have to deal with?
    ____
    ____
15. What types of moral hazard problems have you deal with?
    ____
    ____
16. What are the problems facing your organization? Please list the problems and provide a detailed overview.
    ____
    ____
17. What are your organization's sources of funds?
    ____
    ____
18. Does your organization experience lack of funds?
    - Yes
    - No

If yes, how often: ____

19. Does your organization provide trainings for personals?
    - Yes
    - No

If yes, how often: ____

20. What trainings have been delivered? List few of them.
    ____
    ____
21. Please provide a brief overview of other problems that are being faced by your institutions in regards of microfinance:
    ____
    ____