

ROLE OF ISLAMIC MICRO FINANCING IN POVERTY LESSENING AND SME'S DEVELOPMENT IN DEVELOPING COUNTRIES: A CASE STUDY OF PAKISTAN

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Abstract:

It has been observed that the popularity and acceptability of Islamic financing is increasing around the globe. The prime objective of this study is to explore the impact of Islamic micro financing on the poverty mitigation and SME's development in the perspective of developing countries (Pakistan). This paper is of conceptual type study and all concepts are discussed in the light of literature. Through whole analysis and discussion, it is revealed that concept of Islamic financing is strengthening over the time period and now a day becomes popular among non-Muslim countries due to high ethical values and low riskiness of its schemes. It is also found that government plays crucial role in bringing and implementing the Islamic concept of finance. This study revealed that Islamic micro finance helped the poor but skilled people to earn their livings and they also provide earning to others. Along it, Islamic micro financing become the source of effective and efficient utilization of local common resources. It promotes trust and brotherhood, equality and social justice in the society. Only discussion is made on available literature, no empirical results are drawn.

Keywords: Islamic Micro Financing, Poverty Alleviation, Small Medium Enterprise (SME's).

I. Introduction

Islam is biggest religion of the world and provides absolute code of life that is applicable in every era of human life. It does not only provide guidance about how to spend life but also told ways to fulfill material as well as spiritual needs to create balance, equity and justice in the society. It gives the concept of *Zakat* and *Waqaf* that eradicates the many social evils from the society. Similarly, Islamic financing is totally an Islamic concept to meet the financial needs of businesses. Islamic financing is Halal way of financing according to *Shari'ah* and in it interest free loans are provided to borrowers. Achieving socio-economic development as well as social justice among different groups of the society is the ultimate goal of Islamic financing. From library research, it is revealed that Muslim customers show great acceptance and willingness towards Islamic financing. As talk

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about the history of Islamic financial institutions, their base found in the Indian subcontinent during 1940s and interest free loans as well as saving societies etc. were products of such financial bodies. But history of provision of Islamic financing to microenterprises discovered in 60's (M. Akram, 2008)¹. Mit Ghamr Bank of Egypt was pioneer in providing the Islamic financial services in 1963 and attracts millions of Muslim customers. After it, in 1975 Dubai Islamic Bank was incorporated under the special law in order to assist micro enterprises financially. Approximately ten years later, in the Gulf countries, Sudan etc more than 27 banks were formed that had strong resemblance with Dubai Islamic Bank. In 2000, there is 200 Islamic financial institutions are operating worldwide having capital of \$8 billion, deposits of \$100 billion and assets of \$160 billion and now they are numbered as more than 250.

Islamic financing schemes: *Qarde Hassan*, *Murabaha*, *Musharakah*, *Takaful*, *Ijarah* etc. are ethical financing schemes and not only address the capital needs of microenterprises as well as play very important role in poverty eradication. Through Islamic micro-financing schemes, loans are provided to small skilful investors to sponsor the small businesses and other income generating activities that lead towards the establishment of SME's in the country. These micro-entrepreneurs not only earn for themselves but also provide jobs to others and help them to earn their livings.

Mostly, Islamic micro-financing schemes developed for the people living below the poverty line to eradicate the poverty from the society. As well as, Islamic micro financiers frequently conducts Islamic study circle, group meetings and by using group-lending techniques, build potential in human capital and strengthening the Islamic social capital of the community. In Pakistan, two banks are providing pure Islamic financing services named as (i) Meezan Bank and (ii) Al-Baraka Bank. While (i) Akhuwat, (ii) Islamic Relief Fund, (iii) Naymat Foundation and (iv) Wasil Foundation are non-banking Islamic micro financing organization that are currently operating effectively in Pakistan and providing micro credit facility to needy people according to Shari'ah.

a. Objective of the Study

The basic purpose of choosing this topic is that very little work is done on it especially in the perspective of Pakistan as well as it plays very positive role in poverty alleviation. The core objective of this study is to explore the impact of Islamic microfinance on the Pakistan economy through two sub-objectives:

- (i) To investigate the impact of Islamic microfinance on the poverty lessening in Pakistan Economy.
- (ii) To investigate the impact of Islamic microfinance on SME's development in Pakistan Economy.

II. Review of Literature

a. Islamic Micro-Finance

Micro finance is known as providing small loans to needy and poor people to improve their living standards by utilizing their skills and generating employment for themselves and others (Microcredit Summit, 2004). Similarly Islamic microfinance is known as provision of small loans (based on Islamic values and characters defined by Quran and Hadiths) to the poor class of the society in order to bring equality and justice in the society (Nur Indah Riwayatanti, 2013)². According study of Abdul Rahim & Abdul Rahman (2010), In Islamic mode of micro financing, loans are dispersed in society without charging interest (Riba) to promote the socio-economic development of the poor and small entrepreneurs. Furthermore, Islamic micro financing schemes not only make the micro-entrepreneurs prosperous but also develop the moral and ethical attributes in their businesses. The concept of Islamic finance is grounded on the prohibition of Riba.³

According Zia-ud-din (1991), prime objective of Islamic finance and banking is the provision of Islamic and ethical alternative of Riba based conventional banking system to the Muslim society.⁴The major difference between Islamic micro financing and conventional micro financing is not only Riba (interest) but on the basis of source of funding. Islamic microfinance not only uses the external funds and clients' savings but also use the Islamic charity such as Zakat, and Waqaf for providing loans (Ahmed 2002).⁵

Study of Abdul Rahim & Abdul Rahman (2010) proposed that following are most adapted Islamic microfinance schemes: (i) *Mudarabah*(partnership between microfinance institution and the small entrepreneur and equal distribution of profit while loss is bear by microfinance institution),(ii) *Musharakah* (like Mudarabah but profit is shared according the contracted ratio while loss is shared on the basis of debt/equity ratio),(iii) *Murabaha* (asset or business equipment purchase by microfinance institution and given to entrepreneur and instalments base repayment of the selling price),(iv) *Ijarah*(a long- term rental contract having Shari'ah specified conditions related to the maintenance and repair of the asset),(v) *Qarde Hassan*(an interest free loan) while "beautiful

loan” is the Arabic meaning as the Quran asserts: “these loans are made to Allah rather than to the borrower and this eases the pain of **tearing away** part of one’s wealth and lending it to someone in need.” In feasibility study of Islamic microfinance conducted by Dhumale and Sapcanin (1999) through World Bank funding, has evaluated the Murabaha, Mudarabah and Qard-e-Hassan Islamic financing schemes as highly potential schemes for Islamic microfinance.⁶

Islamic microfinance can be done through (i) casual micro financing (individual such as friends, neighbors, relatives, saving collectors, pawnbroker, traders, processors and input suppliers etc.), (ii) member based-organization, (iii) Non Profit Organizations, and (iv) formal institution (Obaidullah & Khan, 2008c: 23-24).⁷ Islamic microfinance has great impact both on society and economy. Societal impact is shown in the form of more desire for equality, brotherhood, and sacrifice for survival and well-being of each other in the society. Because through utilization of Zakat and Waqaf to support poor will strengthen them financially to increase their earnings and economic wellbeing and get involved in the pace of development (Obaidullah, 2008b: 4).⁸

IBBL’s (Islamic Bank Bangladesh Limited) studied the economic impact on rural poverty and finds that loans sanctioned under Islamic schemes of micro financing have bring considerable improvements in household earnings, output of fields and cattle along with disbursement and employment (Rahman and Ahmad, 2010). Rahman and Ahmad (2010) conducted a field survey of 1024 respondents, and it is revealed that the family income increased more than 33%, family employment level increased from 1.91 to 2.1 working members and all type of assets has also increased. These economic aspects might imply that Islamic microfinance has an advantage to offer.⁹

b. Poverty Alleviation

Poverty is one of the characteristics of every country but differs in its intensity. It becomes the biggest moral as well crucial challenge of this century. And government as well as development-oriented organization, are striving to eradicate it (Obaidullah, 2008b). According to Chapra study (2008: 10, 2007: 6), from Islamic point of view, Poverty has both material and moral sides because material and spiritual well-being is desire of whole humanity. Human well-being includes contentment, psychological peace and social harmony and to attain it integrity and human brotherhood without distinguishing on the basis of gender, race, age etc.is imposed.

Poverty hunting the Muslim world at a quite high rate is while few countries of South East Asia and Middle East are safe from its curse. Fifty percent of the Indonesian population (about 129 million) is living below the poverty line of US\$2 a day. On Contrary, in Bangladesh and Pakistan (two largest Muslim states in South Asia), 122 million population is living below the poverty line and in India it is accounted as 100 million Muslims (IRTI, 2007, p.18). Chapra (2008: 36) argues that currently Islamic microfinance has great potential to enhance capabilities of small enterprises to create employment opportunities for self as well as for others. Grameen model is based on assumption that the poor's skills are underutilized as well as charity will fail in effective poverty eradication if financing will unable to develop independency and initiatives among the poor.¹⁰ According to the Gibbons & Kassim study in 1990, 95% of the borrowers of Grameen Bank, Bangladesh, are females and in context of repayment of loan amount they are more reliable than men.¹¹

To study the uses of Islamic finance instruments in Islamic micro financing, Frasca (2008) undertakes two seminal case studies: a) Jabal Al-Hoss, Syria project named as Sanduq project and b) the Hodeidah Microfinance Programme (HMFP) in Hodeidah, Yemen. Due to satisfying the reported demand of financial services by lower income group leads towards betterment in their living standard and poverty alleviation it is concluded that Islamic micro financing schemes are competitive. Situation of poor people in Pakistan is highly pathetic as compared to other Muslim counties.¹²

According to the Economic Survey of 2005-06, as poverty defined in terms of a scale of extremely poor, ultra-poor, poor, vulnerable and quasi-non poor- approximately 80% of Pakistanis are poor. 36 million people are in the lowest three income categories according to a study conducted by USAID. While only 6 Lac people in Pakistan received microfinance in 2005 while it amounted up to 60,000 people in 1999. Major reason behind such encouraging growth in the number of microfinance users is limited reliance upon interest-based financing, prohibited by Islam as Riba (Goud, 2007) and introduction of concept of Islamic micro financing encourage them.¹³

Akhuwat is an Islamic microfinance organization operating in Pakistan and providing interest free loan to all categories of poor through utilization of Zakat, Waqaf and social capital. It will help the poor population of the country to uplift their living standards and make contribution in development and prosperity of the country (Dr. Waheed Akhter & Dr.

Nadeem Akhtar, 2009)¹⁴. Mughal (2012), reported in his study that “Islamic microfinance is an excellent tool to reduce the poverty level in both Muslims and non-Muslims economies through effective channelization of the financial resources”, and researchers of current century in favor of this statement.¹⁵

c. SME’s Development

SME’s (small medium enterprises) play the role of back bone in the development of the economy. In developing economies more than 90% of the firms are SME’s (Schapper, 2006).¹⁶ Pakistan is also one of the developing countries that pay much attention on the development of SME’s and to assist this objective almost 13 years ago, Govt. of Pakistan established SMEDA (small and medium enterprise development authority), to provide managerial support to SME’s. Pakistani economy has a great potential for SMEs. According to the Economic Survey of Pakistan (2010-11), SME’s are rapidly growing and has 40% contribution to GDP. In context of Pakistan economy, a company employing workers up to 250 having paid up capital of Rs. 25 million and annual sales of Rs. 250 million (SME Policy, 2007) is known as SME’s. Development, growth and successfulness of SME’s are highly relying upon the accessibility of finance (Ou & Haynes, 2006; Cook, 2001).¹⁷

Similarly, in Yemen less attention is diverted to strengthen the SME’s and resulted low contribution to GDP while SME’s constitutes a very high proportion of all businesses. Through deep analysis of Yemen economy, statistics showed that only 11% of the SMEs in Yemen have been financed by Islamic microfinance (Fararah & Al-Swidi, 2013).¹⁸ As mentioned earlier, limited access to external financial resources is considered as the major obstacle for SME’s to face. To channelize the flow of Islamic financing towards poor and small entrepreneurs, Chapra (1992) argued in his study that: “there is no doubt about the fact that poor have limited access: the most critical reason of failing to develop the broad-based ownership of businesses and industries, and thereby realizing the egalitarian goals of Islam.”¹⁹

According to the comparison study conducted by Obaidullah (2008), economic development and social objective are the major concerns of both Islamic microfinance and the conventional one. In both form of micro financing, basic purpose is the provision of quality life standards to whole society through promoting entrepreneurship along with encouraging risk sharing by involving poor in entrepreneurial start-ups. However, attaining social transparency, mutual understanding and cooperation are the

distinguishing features of provision of Islamic (financial and non-financing) services to improve microenterprises. Provision of micro financing, particularly Shari'ah financing to microenterprise has great potential to eradicate poverty.²⁰

III. Research Methodology

This is a conceptual paper. The core objective of this study is to conduct a qualitative analysis in the light of literature. Sources of literature are previously published articles and case studies in the proposed area. Published articles and case studies include both general one (from origin of Islamic micro finance concept to its adoption in different Muslim countries) and that are written in the perspective of Pakistan economy. To achieve the objectives of this study, firstly impact of Islamic micro finance is study on the Muslim world then precisely in Pakistan.

a. Results

In table-1, results of Aasmaan Anam & M. Azhar (2013) study is used and it is cleared the most common mode of Islamic financing used in Pakistani Banks is Murabahah and it is 36% of total Islamic financing in 2013. As well as, Musharakah and Mudarabah have least proportion in total Islamic financing. And Qarde Hassan is not used by Islamic Banks for the financing purpose. As well as, 4.8% of total Islamic micro financing done by Islamic banks in 2013 is attracted by SME's.²⁰

Table1: Financing Mix by The Islamic Banks of Pakistan

Types of Islamic Financing	Rupees in Billions			% age		
	Jun-12	Dec-12	Jun-13	Jun-12	Dec-12	Jun-13
Murabaha	83.3	96.1	90.4	40.1	39.7	36
Diminishing	73	87.5	89.7	35.1	36.2	35.7
Musharaka						
Ijarah	22.3	22.4	23.2	10.7	9.3	9.2
Istisna	11.1	15.7	16.4	5.3	6.5	6.5
Salam	8.2	7.3	13	3.9	3	5.2
Musharaka	1.6	1.9	3.6	0.8	0.8	1.4
Mudaraba	0.2	0.6	0.5	0.1	0.2	0.2
Qard-e-Hassana	0	0	0	0	0	0
Others	8.2	10.5	14.1	3.9	4.3	5.6
Total	207.9	242	250.9	100	100	100

Source: Islamic Banking Bulletin Jan-Mar 2013, State Bank of Pakistan.

Next, in table-2 result of another study done by M. Naveed (2014) is used to elaborate the Islamic micro financing role in lessening the poverty level and SME's development. In his study, all non-banking Islamic financing

institutions are studied and results declared it that Qarde Hassan and Murabahah modes of Islamic financing are mostly used by non-banking Islamic financing institutions.²¹

Table 2: Financing Mix use by Non-Banking Islamic Financing Institutions

Name of Organization	Product Name	Percentage
Islamic relief Fund	Qarde Hassan, Murabaha	16.7
Naymat foundation	Qarde Hassan, Murabaha, Musharaka, Salam	30
Wasil Foundation (Formally CWCD)	Murabaha, Salam, Ijarah, Diminishing Musharaka	36.7
Akhuwat	Qarde Hassan, Takaful	16.7

Non-banking Islamic financial institutions mentioned in table-2 are operating in both urban and non urban areas and near about 6-10 big districts. Respondents are 18% young female and 88% are young male while on the basis of education major proportion (63%) comprises on graduation and master degree holders are 33%. According to the results of questionnaire filled by employee of these institutions, Qarde Hassan and Murabaha, Salam are most important modes of Islamic micro financing that have major contribution in poverty alleviation with mean of 2.47, 1.73, 1.93 and standard deviation 1.347, 1.006, 1.191 respectively. Moreover, client responses (table-3) are also in the favor of Islamic micro financing. According to the results there is significant difference between financing made by Islamic banks and institutions and by conventional banks with mean value of 1.7 and $p < 0.05$. As well as, results are also supporting the claim that Islamic micro financing increases the client's income with mean value of 1.8, standard deviation 0.84 and $p < 0.05$. Along it also proved that Islamic micro financing schemes improve the living standards of clients. There is also a significant relationship between Islamic micro financing schemes and increment in employment opportunities due to the provision of funds to SME's.

Table 3: Results of Clients Responses

Question	Mean		Std. Deviation	Variance	Chi- Square	
	Statistics	Std. Error			P Value	Relationship
Is World economy moved towards Islamic finance in 2008 after	1.7	0.09	0.696	0.485	0.009	significance

world economic crisis?							
Is Islamic finance has considerable difference from conventional financing?	1.73	0.116	0.899	0.809	0.01	significance	
Is Islamic micro finance increased the monthly income of clients?	1.8	0.108	0.84	0.705	0.029	significance	
Is Islamic micro finance improved the standard of living clients?	1.8	0.103	0.798	0.637	0.016	significance	
Is Islamic micro finance increased the employment level in the country?	1.87	0.12	0.929	0.863	0.041	significance	

Results of Abdul Rahim & Abdul Rahman study also supportive to above results by declaring that Qarde Hassan (meet capital needs), Murabaha (equipment needs) and Ijarah (leased equipment's) schemes of Islamic micro finance are mostly used for financing to micro-entrepreneurs and poor that have potential to grow and earn for themselves and create earning opportunities for others. These schemes are given much preference due to their simplicity and easy management.

IV. Discussion

Islam is only the one religion in the universe that provides the comprehensive guidelines that are helpful and implementable till the end of the life on the earth. Principles of Islam help the human being to spend a successful life on the earth as well as be successful in the life after death. Similarly as these principles cover all aspect of a human life, concept of

Islamic micro financing is also part of them. The core purpose of micro financing is to assist the poor who are unable to earn their living due to lack of capital. Such assistance is provided by commercial banks and micro finance banks but at a specific interest rate. But being a Muslim, Riba (interest) is strongly prohibited in Islam, majority of poor people don't get loans from micro financing banks and living in miserable conditions. So, concept of Islamic micro financing is emerged with the ultimate purpose of provision of funds to needy and skilful poor to enable them to earn their livings. Initially, Qarde Hassan and Waqaf is the basic source of such financing.

According to the study of Jung (2007), concept of Islamic finance is emerging rapidly and Mit Ghamr Bank (Egypt) in 1963 is the example of its first experiment. As well as this emerging concept become so popular and capture the 1.6 billion Muslims across the world. The basic reason behind the rapid popularity of concept of Islamic micro finance is rooted in its eventual goal of attaining social as well as economic expansion and brought communal justice among different classes of the society. Practitioners of Islamic micro finance claims that due to availability of micro finance according to Islamic Laws and Shari'ah, huge amount of conventional micro-borrowers in countries like Indonesia, Syria, Afghanistan, and Yemen switch towards Islamic micro financing. From all above discussion it is revealed that in Muslim countries including Pakistan there is great demand and acceptability of Islamic micro financing schemes.²²

According Dusuki (2008), Islamic micro finance schemes have potential to fulfill increasing financing needs of the Muslim clients and have significant role in alleviating poverty from the society by helping the poor people in their suffering.²³ While, Farooq (2009) in his study claims that credit facility extended for one year is less effective in eradication of poverty as compared to series of long term loans.²⁴ From empirical study of Abul Hassan (2014), it is revealed that Islamic micro financing schemes have significant influence on the alleviation of poverty through building the social capital. Social capital is built up through the amount of Zakat, Waqaf etc. that is utilized to finance the skilful poor to improve their livings. From literature review and results of study it is clear that Islamic micro financing is play a key role in the eradication of poverty especially in the developing countries like Pakistan.²⁵ According to Anwar's study (2014), during last decade Islamic banking sector shown a promising growth rate that was the 10% of total banking industry of Pakistan. And

assets reported approximately Rs. 900 billion. As well as it is expected that rate will become double in 2020.²⁶

SME's sector plays the role of backbone in Pakistan's economy and it is revealed from Economic Survey of Pakistan (2010-11), 99% of enterprises in Pakistan are SMEs (urban area has 56% SME's while 44% are located in countryside area). According to study of Kamran A. Rabbani (2013), contribution of SME's in total GDP of Pakistan is 40% and they are counted for 80% employment in the country. 64% SME's are in Punjab, 18% in Sindh, 15% in KPK and 2% in Baluchistan. 30% of export income is generated by this sector. From all above information importance of SME's in Pakistan economy is realized. In Islamic micro finance, loans are given to poor that are living below the poverty line but are skilful.²⁷ The basic purpose to sponsor micro-enterprise and other income generating activities is to amplify the production and consumption capacities as well as effective utilization of local common resources. Mainly loans are sanctioned to workers of informal sector of the economy. Farmers, tailors and anyone else who labor and sell locally grown foodstuffs; make brooms, tailoring in their little shops, etc are collectively known as informal sector of the economy. When resources are effectively utilized, then it increases the income of the poor, improve their living standards and generate more employment opportunities that lead towards the uplift in socially deprived low class. As well as it brings social justice, equality in the society by controlling inflation and unequal distribution of wealth Chapra, M. U.(2007).²⁸

Islamic micro financing scheme sare relatively less risky than conventional but if Islamic Laws and Shari'ah is strictly followed then they are more productive as compared to conventional. Charitable products like Zakat, Waqafetc. are most important in poverty alleviation especially in developing countries by supporting poor to start business in which local resources are utilized and earn their livings as well as provide source of earning to others. From literature review and results it is clear that Islamic micro financing schemes have potential to promote SME's in the country in order to effective utilization of local resources, increasing income as well as employment in the country.

V. Limitations and Future Research

First and most important limitation of this study is time constraint. It is done in very short time period and in such tenure only literature survey is possible. Secondly limited literature is accessible for review. So, only few dimensions of Islamic micro financing in the perspective of developing

(Pakistan) economy are explore. Creditability of this study is questionable. From future perspective this study can be revised through administration of properly developed questionnaire. Then more effective and authentic findings will explore.

VI. Conclusion

After literature review and whole discussion, it is concluded that Islamic micro financing schemes great acceptance and popularity in both Muslim and non-Muslim countries. These schemes have potential to eradicate poverty from developing countries if these loans are sanctioned for long term to skillful persons that run the SME's utilizing the local resources. In this way income, living standards and employment increases in the country that leads towards the development of the society as well as the whole economy. Islamic micro finance also promotes the concept of social capital (originate from funds of Zakat, Waqaf, Charity etc.) that brought the sense of brotherhood, social justice and equality in the society. But existing efforts to build effective network of Islamic Banks and non-banking Islamic financing institutions in developing countries are insufficient. Due to less market penetration, high transaction cost and less awareness, these schemes are unable to meet their objectives. So, Govt. and regulatory body has to pay special attention to promote it in the country.

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