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Potential of Islamic Microfinance in Pakistan

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Abstract

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Poverty alleviation is high on Pakistan's state reforms, conventional microfinance has been one of the main tools selected to deal with this. However to date, overall outreach has only served 5% of its prospective audience. One of the reasons for this has been lack of sustainable microfinance providers which harbour low interest rates. Although commercialising microfinance is on the industry's agenda this would shun the extreme poor, another route suggested by this study would be to provide Islamic alternatives as presently many potential Muslims are restricted from entertaining traditional microfinance.

In order to gain an in-depth understanding of the potential of Islamic microfinance in Pakistan, qualitative research in the form an explorative study was used. Microfinance facilitators and recent growth in this industry were high. Conventional microfinance has claimed many benefits, some of which are true if implemented correctly, but there are also many concerns; informational asymmetry issues with women taking loans on behalf of male relatives, high interest rates and outmoded group lending methodologies. Islamic alternatives could replace interest with equity based products and encourage household lending to promote family unity. Additionally Pakistan's expertise and knowledge in Islamic banking and finance places it in a good position to move towards a riba free economy which should heighten the requirement for Islamic microfinance.

A case study approach was also adopted which shows that Akhuwat have many avenues of funding which remains untapped and they have also not applied the array of Islamic financial instruments. Most importantly this study has challenged the financial lending approach that unlimited funding resources are not only available to the private sector, zakah and philanthropy can also play a big role in achieving sustainability and meeting social objectives of serving the extreme poor..

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In God the Almighty' we confide-to guide us to the righteous path.

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ABBREVIATIONS

ACE	Association for Creation of Employment
ADB	Asian Development Bank
AKRSP	Aga Khan Rural Support Programme
BoK	Bank of Khyber
CGAP	Consultative Group to Assist the Poor
DFID	Department for International Development (UK)
FMFB	First MicroFinanceBank
FSSP	Financial Sector Strengthening Programme
GOP	Government of Pakistan
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
I-PRSP	Interim Poverty Reduction Strategy Paper
MBB	Micro-Banking Bulletin
MDG	Millennium Development Goals
MF	Microfinance
MFB	Micro-Finance Bank
MFCG	Microfinance Consultative Group
MFI	Microfinance Institution (in this study, used only for MFIs licensed under the MFIO, 2001: see Appendix I)
MFIO	Microfinance Institutions Ordinance
MFP	Microfinance provider
MIX	The Microfinance Information eXchange
MSDP	Microfinance Sector Development Programme
NABARD	National Bank for Agricultural and Rural Development
NGO	Non-governmental organisation
NRSP	National Rural Support Programme
NWFP	North West Frontier Province
OPP	Orangi Pilot Project
PCP	Pakistan Centre for Philanthropy
PIR	Performance Indicator Reports
PMN	Pakistan Microfinance Network
PPAF	Pakistan Poverty Alleviation Fund
PRSP	Poverty Reduction Strategy Paper (2003)
PSIA	Poverty and Social Impact Assessment
ROSCA	Rotating Savings and Credit Association
RSP	Rural Support Programme
SBP	State Bank of Pakistan
SDC	Swiss Agency for Development Cooperation
SHG	Self Help Group

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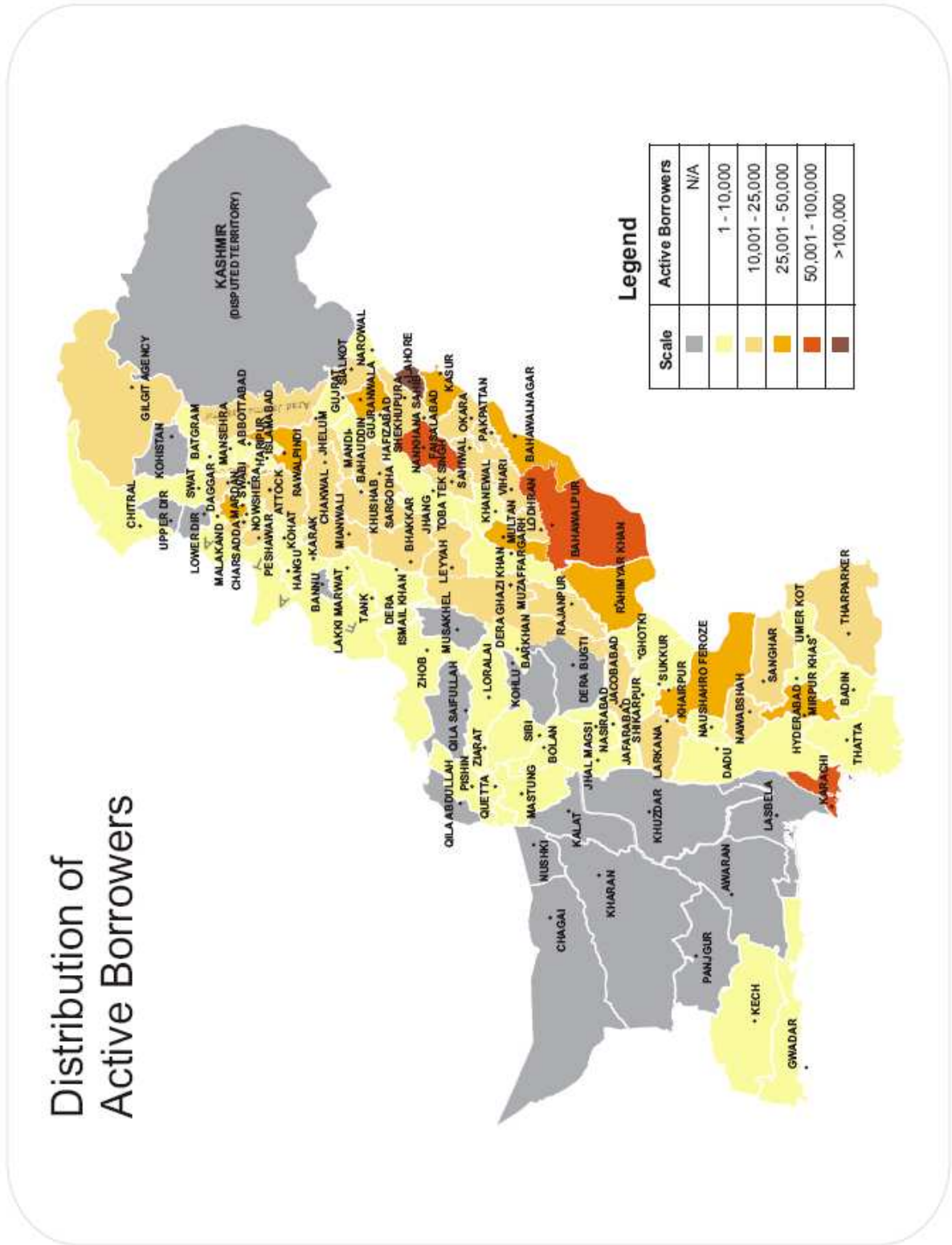
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Source: Distribution of microfinance clients in Pakistan (Haq, 2007:2)

CHAPTER ONE

I Introduction

Microfinance is a tool that is expected to help with poverty alleviation, by providing financial assistance to the poor, giving them a chance to help themselves and if substantial outreach is realized it can promote economic development. This tool has been selected by the Pakistani government in conjunction with their poverty reduction strategy, but presently the majority of Micro-Finance Providers (MFP¹) offer principally interest based finances. Muslims maybe deterred from participating in this program as *riba* (interest) is forbidden in Islam (Saqib, 2006:2). On the other hand, there are few Islamic alternatives available to the poor; so many Muslims are obliged to deal with interest-based transactions just as they are forced to deal with exploitive informal moneylenders.

There appears to be a missing link where microfinance needs to provide products that are more suitable to their Muslim clients and Islamic finance needs to prove it is just and socially responsible and can cater for the needs of the poor as well as the wealthy. Islamic finance is based on abiding by Islamic law (Shariah) and underlines “ethical, social, and religious dimension of financial transactions to enhance equity and fairness for the general good of society” (World Bank, 2005). Expelling *riba*, unwarranted uncertainty, speculation, and promoting economic justice and trade will achieve this. These qualities especially the latter two should link in well with microfinance.

This study is focussed on whether or not Islamic microfinance is a viable option in Pakistan and a good alternative to current microfinance. Although the author recognises the usefulness of commercialisation, there is also concern of welfare of the poor, which is why an NGO known as Akhuwat will be examined, as not only does it offer Islamic microfinance but it provides a new model for the microfinance amphitheatre. Institutions like Akhuwat are not only fulfilling the financial needs of the poor, but they are also attempting to instil the basic moral/social values back into society.

¹ According to Microfinance Ordinance 2001 (Pakistan microfinance regulations), MFP are for all organisations that provide microfinance services, whereas MFI are only referred to licensed microfinance institutions (refer to appendix I)

The rest of this study is organized as follows;

- Chapter 2 provides the research methodology adopted, along with the aims, objectives and the rationale behind this study.
- Chapter 3 explores the extensive literature on microfinance with regards to approaches, poverty and a brief review into Islamic microfinance.
- Chapter 4 focuses on conventional microfinance, highlighting the problems that MFP should ascertain preceding the adoption of Islamic financial services.
- Chapter 5 explores the status of microfinance in Pakistan, and contextualises the development for Islamic microfinance in Pakistan.
- Chapter 6 examines a case study of an Islamic MFP (Akhuwat) with recommendations on how to maintain sustainability.
- Chapter 7 concludes and provides further recommendations.

Throughout this study, abbreviations have been heavily utilised, hence ease of the readers an abbreviation list (see page V) has been provided for extra guidance.

CHAPTER TWO

II Research methodology

2.1 Introduction

The purpose of this chapter is to concisely explain the research methodology applied in this study. It has been divided into a number of sections beginning with foremost, the aims and objectives, then the rationale and motivation behind this study. It continues by explaining the heart of this section the research methodology, then the research design, strategy and method and finally limitations and difficulties.

2.2 Aims and objectives

The main purpose of this study is to investigate the Islamic microfinance potential in Pakistan by appreciating the need to improve outreach. This in turn will assist with poverty alleviation at a macro scale by providing equality of opportunity to the poor via access to Islamic financial services.

The objectives of this study include the following;

- Ascertain the main problems with conventional microfinance, so the industry can take up valuable lessons learnt rather than completely reinvent the wheel for Islamic microfinance practices.
- Evaluate microfinance status in Pakistan to understand the trends and support within the industry.
- Identify Pakistan's stance on a riba free economy, if Pakistan is still interested in moving to an interest free economy this will strengthen the requirement of Islamic microfinance.

- Examine a Pakistani Islamic microfinance provider; Akhuwat and identify the strengths and weaknesses, then advise on possible Islamic finance solution that suit their clients and helps Akhuwat achieve sustainability.

2.3 Rationale and motivation

Islamic microfinance is a new area of interest within both the Islamic finance and microfinance field of study. Theory and practice within this area has been limited, but there appears to be a lot of growing interest in forming an affiliation between the two promising industries. Especially, since they both appear to share many common characteristics like risk sharing, promoting entrepreneurship and striving for economic justice. The concern is that Islamic finance serves mainly bankable people just like most of their conventional counterparts in the banking arena. It has, to date, primarily ignored the poor or not been very successful in offering Islamic microfinance. Surprisingly though this is in conflict with what Islam teaches, which is to encourage Muslims to offer benevolent loans or to give in acts of charity (zakat, sadaqah and waqf).

This is not to say that microfinance has been unsuccessful in Muslim countries, contrary to the belief, there are many successful institutions within these countries, but they do not really cater for Islamic financial products. Even though the consensus amongst Islamic scholars is that interest/riba is prohibited in Islam, practices in Muslim countries should discourage increasing debt building, especially among the poor and destitute. Nevertheless, very little has been done to deal with this issue. For a concept like microfinance to be truly successful in alleviating poverty, its practices needs to fit in with the social environment and the very beliefs of the people it is trying to reach (Segrado, 2005:4).

Islamic microfinance is an untapped market with huge potential, bottom line is that its benefits are twofold for Pakistan. It has the potential to improve the economy and be socially responsible by helping people who are in desperate need of financial assistance, but have very few avenues to turn to and thereby be able to generate income and employment. This can be emphasised from existing growth rates of 15% per annum for

microfinance and for the past five years for Islamic finance it has been 25-30% growth (Ferro, 2005:1). Ascertaining that Islamic finance and microfinance can be demanding as well as profitable ventures, correct implementation of the joint venture could give astounding results.

Pakistan has been selected as it is one such country where both microfinance and Islamic finance are working independently, although the government is eager to promote these industries in isolation, not enough has been done to ensure they work together to form a synergy. It is a real breath of fresh air to have development tools working well and residing in developing countries like Bangladesh. The hope is that Pakistan can become world leaders in producing microfinance institutions that are both commercially profitable and at the same are true Islamic alternatives tools for poverty alleviation.

2.4 Research methodology

According to Manunta, methodology is “a body of method, procedures, working concepts employed by a discipline” (taken from Asutay, 2006b:1). While research methodology can be defined as “the study of methods and principles and their applications in a given field of academic inquiry” (Asutay, 2006b:2). Social research has two approaches, qualitative and quantitative research.

This study intends to focus on qualitative research as microfinance, economic development and Islamic finance are all wide-ranging disciplines with a range of interpretations and a qualitative analysis would ensure an in-depth understanding of the subject matter. In addition, Islamic microfinance is a new phenomenon and practical applications are minimal especially in Pakistan, with the added constraints of time and money an impact study was not be a realistic course of research. Furthermore, this study is more concerned with the lack of progression of conventional microfinance in Pakistan and the proposition that Islamic microfinance is a worthy opponent to fighting poverty on a more equitable standpoint than interest rates. Muhammad Akhram Khan argues that all

forms of interest on loans are exploitive (1994:16) and hence an alternative should be explored.

This qualitative approach will allow this present study to “open up a colourful, deep, contextual world of interpretations” (Asutay, 2006b:6). Providing useful guidance and understanding to those stakeholders, wanting to gauge the Islamic microfinance market. Denzin and Lincoln explain that “qualitative research deploys a wide range of interconnected methods, hoping always to get a better fix on the subject matter at hand” (taken from Asutay, 2006b:3). A case study will be provided on an Islamic MFP in Pakistan and an exploration of whether or not Pakistan holds grounds to promote Islamic microfinance to attract further entrants in their struggle against financial inequality among the poor.

2.4.1 Research design

Nachimans & Nachimas defines research design as “the program that guides the investigator in the process of collecting, analysing and interpreting observations. It is a logical model of proof that allows the researcher to draw inferences concerning causal relations among the variables under investigation” (Asutay, 2006c:12).

This research has been divided into two parts; the first relates to an exploratory study into microfinance, their paradigms and problems, as well as the success of microfinance within Pakistan, in the presence of political instability with poverty alleviation being the country’s primary goals. Islamic banking and Pakistan’s standpoint on a riba free economy is also examined to reinforce the potential of Islamic microfinance. The second part of this study is a case study on Akhuwat (Islamic MFP), to identify the suitability and sustainability of an Islamic microfinance model in Pakistan.

2.4.2 Research strategy

Asutay defines research strategy as “the approach to the study of question” (2006c:6). Bell delves deeper into the components of strategy and states they are “ideas we bring to research, the tools we use which refers to methods and techniques, and lastly the way we use ideas and tools” (taken from Asutay, 2006c:6). This research has employed exploratory and inductive reasoning which is regularly associated with qualitative research and commences with specific to generalised theory (Austay, 2006c:7).

This study is enthused by the potential of Islamic microfinance in Pakistan, based on the interest and support of Islamic Banking and microfinance independently by the government, SBP and the industries themselves. With minimal Islamic microfinance models present in Pakistan and this being a new phenomenon, deductive reasoning is deemed inappropriate.

2.4.3 Research method

Methods are “specific research techniques” (Asutay, 2006a:11), or according to Murray and Lawrence are the “tools of the trade” (taken from Asutay, 2006a:11). Qualitative methods “test explicit explanations of social phenomena using textual or observational data” (Asutay, 2006d:3).

A case study approach was selected because it allowed an Islamic microfinance model to be studied in-depth within the timescales of this study (Bell, 1999:10) and formulate an increased understanding in Akhuwat and its unique methodology. This is where statistical data would not suffice, especially when Akhuwat does not conform to the standard best practices in conventional microfinance. A case study would allow a much deeper understanding of this particular MFP.

Tools used to collect data included extensive documentation review and electronic (email) interviews² (see appendix III and IV for mainly open-ended questions) of the Director of Akhuwat, Dr Amjad Saqib and Malcolm Harper (Author of numerous microfinance books and articles including case study on Akhuwat). Documentation review was vital to contextualise Akhuwat's position in the Islamic microfinance arena, comprehend its methodology and financial sustainability. The electronic inquiries were necessary to provide the deeper understanding of Akhuwat which would not be possible from documentation. Face to face interviews although more desirable, were not possible because both interviewees were overseas and time and cost would not permit travelling to them. Mr Harper would provide an independent perspective of Akhuwat, hopefully reducing any bias gathered from the director of Akhuwat.

This study also explored information from several secondary sources (books, journals, official documentation conferences and internet); these were critically analysed to identify main concerns with microfinance, microfinance status in Pakistan, and Pakistan's viewpoint on a riba free economy.

2.8 Limitation and difficulties

A field study on the impact of Islamic microfinance provided by Akhuwat would be useful and provide empirical support to this study, however, time and funds have been a constraint. In addition, no MFP are providing a range of Islamic finance products in Pakistan, restricting the scope of impact to one MFP which solely delivers interest free loans. The recent political instability in Pakistan would also make it unsafe to travel to Pakistan to conduct this field research.

Literature and practical examples of Islamic microfinance is very limited, therefore any assumptions were based on the individual fields of microfinance and Islamic finance.

² Interview responses are amalgamated in the main body there is no separate results section. Also note that Ahmed Siddiqui (Product development manager in Meezan Bank) and the Islamic division in the State Bank of Pakistan were also contacted via email for minor inquiries which were unavailable in literature format.

It was difficult to form direct communication with institutions like Pakistan Microfinance Network which are major players in the field of microfinance and gradually Islamic microfinance.

CHAPTER THREE

III Literature review

3.1 Introduction

The literature available is quite extensive especially when considering the numerous topics needed to be examined from conventional microfinance (approaches, models and concerns) to Islamic microfinance. Although many forms of literatures are available for microfinance and Islamic finance, the Islamic microfinance hybrid is less extensive especially practical applications.

3.2 Microfinance schism

There are two major contending schools of thought in microfinance especially in terms of achieving outreach, the Welfarist perspective (poverty lending approach) and the Institutionalist standpoint (financial lending or profitability approach) (Robinson, 2001:2; Fisher, 2002:19; Woller et al, 1999:30). Morduch termed these opposing points of views the microfinance schism (2000:617), an ongoing debate shaping the future of microfinance.

3.2.1 Welfarist approach

The primary goals of Welfarist MFP's are recognised as being poverty alleviation and empowerment of the poor, especially women. This is achieved even if this entails accepting aid/subsidies to reach this aim. This viewpoint centres on the depth of outreach and social impact, where micro-credit is just a means to an end, and the focus is on the welfare of the poor. The most well-known poverty lending institutions and models imitated around the world is Grameen Bank (in Bangladesh). Savings mobilization is not a common feature of this poverty approach, but compulsory savings is required to be able to obtain a Grameen loan (Robinson, 2001:22).

The Welfarist MFP is not so enthusiastic about sustainability and profit-making. Yet, without sustainability this could lead the MFP into despair with reduced number of the poor being served and continued losses could even lead to closure. Microfinance should be about establishing lasting local financial institutions. Additionally, Robinson had claimed that “most institutions that provide subsidized credit fail. And even successful institutions following the poverty lending approach, in aggregate; can meet only a small portion of the demand for microfinance” (2001:23). Also it is unlikely that donors would provide long-term funding (Woller, 1999).

3.2.2 Institutional approach

The main purpose of Institutional MFP is to provide the poor, access to financial services while simultaneously achieving financial sustainability. Microfinance had proved that the poor are creditworthy and in some instances even profitable. Institutional centres on breadth of outreach, savings mobilization and financial sustainability (abstaining from subsidies) by commercial means.

It is a financial deepening, market orientated approach, excluding the extreme poor and any social objectives are a by-product that holds little credibility with sustainability. Rhyne reiterates that, access to financial services in a sustainable way is more important than goal of reducing poverty (taken from Robinson, 2001:23). Therefore for donors, the objectives of a MFP should be clear, especially if they hold social interests rather than financial ones. There is much literature supporting the Institutional perspective³ (Woller et al, 1999:31). Some of the best Institutional MFP's are “Bank of Rakyat Indonesia (BRI), BancoSol in Bolivia and the Association for Social Advancement (ASA) in Bangladesh” (Robinson, 2001:22). Although the institutional approach is promoted, CGAP found 5% of worldwide MFPs are financially sustainable, while IMF claimed there is only 1% (Wrenn, 2005:13).

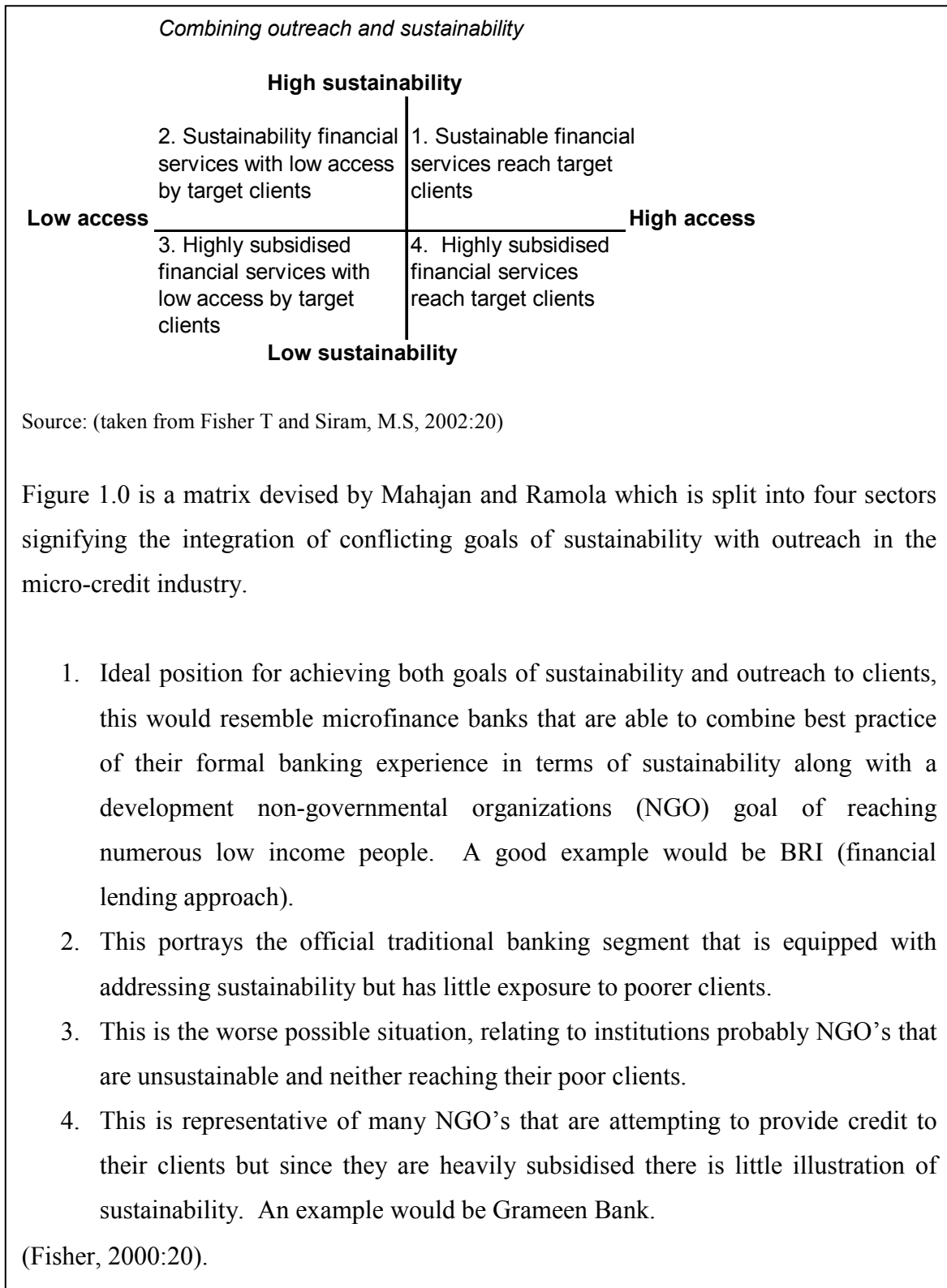
³ “Ohio State University Rural Finance Program, the World Bank and the Consultative Group to Assist the Poorest (CGAP) in the World Bank, and USAID” and “the writings of Maria Otero (ACCION International) and Elisabeth Rhyne (formerly of USAID)” (Woller et al, 1999:31).

Thousands can be supplied by either approach, however to achieve a greater outreach on a long term basis in the region of millions, commercialisation of institutions are required which falls under the Institutional approach (Robinson, 2001:23). Rhyne argues that the institutional perspective centres on the means (sustainability) to achieve the goals rather than the goal (outreach) (taken from Robinson, 2001:23); which could also restrict the goals by focusing too much on sustainability and not the poor client (Robinson, 2001:23), (Fisher, 2002:19).

Robinson reveals Welfarist approach focuses on alleviating poverty by solely offering credit (2001:22). Savings and insurance are just as important if not more necessary for assisting with this mission. According to Robert Vogel, savings has unfortunately been neglected, while Dale Adams argues it is actually more necessary to the low income people than credit (Robinson, 2001:224). Additionally, Insurance reduces risks, crucial for poor people as they are more vulnerable.

Position one (in fig 1.0) highlights the tendency for microfinance banks to focus primarily on sustainability and profiting, with the needs of the poor taking a back seat (Fisher, 2000:20) thereby marginalising the extreme poor and reducing the effect, microfinance has on poverty. There needs to be a balance between social and commercial objectives, Morduch claims this can be achieved if the MFP is administered well and the market and clients needs are understood (Wrenn, 2005:13). Simanowitz and Walter argue that “it is now time to innovate and design services that maintain high standards of financial performance, but which set new standards in poverty impact” (Wrenn, 2005:13).

Figure1.0 Outreach and Sustainability Matrix



3.3 Poverty alleviation

Littlefield, Murdugh and Hashemi found through various studies, that microfinance eliminated poverty, empowered women and enhanced education and health (taken from Wrenn, 2005:4). In addition, it improved clients income earning capacity, built their asset portfolio and reduced client susceptibility, with positive effects on poverty alleviation schemes in India, Indonesia, Zimbabwe, Bangladesh and Uganda (Wrenn, 2005:5). Microfinance also promotes consumption smoothing, economic growth and financial deepening (Ministry of Finance, 2003:81). Although Hulme and Mosley concluded that most present day microfinance programs are not as effective as they could be (Wrenn, 2005:4).

Microfinance impact is often measured on increased household income which in turn results in reduced poverty. This is only applicable if the income accumulated from the microfinance activity goes towards improving clients economic status. Sharif concurs that “poverty,...is not only about having inadequate income or income below the “poverty line”, ... but is also about the inability to sustain a specified level of well-being”. (Wright, 2000:8).

As part of the Millennium Development Goals (MDG) set to cut poverty in half by 2015, sustainable microfinance was claimed to be a vital tool (Daley-Harris, 2002:2) to reach 175million⁴ of the poorest families (Wrenn, 2005:2). Yet, contrary to what many writers claim, those working in microfinance are aware that this tool does not hold all the answers to poverty reduction (Harper, 2003:7; Ledgerwood, 1999:7; Zafor, 2007:12). One needs to realise that poverty alleviation is a multifaceted problem which cannot be realised through the introduction of finance alone, it requires several solutions (Robinson, 2001:19). Even then, there are still many that perceive microfinance as one of the keys to resolving their poverty issues (Ministry of Finance, 2003:81; DIFD Briefing note,

⁴ Objective set by 2005 micro-credit summit, originally the target was 100m families set in the 1997 micro-credit summit

2006:2). If microfinance is implemented correctly it improves economic prospects, paving the way for better equality of income opportunity (Ahmed Z, 1991:32).

3.3.1 Target Audience

According to Robinson, credit or commercial microfinance is more effective when provided to ‘creditworthy economically active poor’, rather than the poorest of the poor that have to meet their basic needs (2001:20). Economically active poor basic requirements are satisfied and would like to invest in business ventures but don’t have the capital. Robinson defines economically active poor as people “who have some form of employment and who are not severely food-deficit or destitute” (2001:18).

However, there are “some people who work full time remain in extreme poverty because they are held in various forms of labor [sic] bondage under which they are not compensated for their work beyond the food they require to carry out the work” (Robinson, 2001:19). Although bonded labour is abolished in Pakistan, it is still present in rural areas, under the feudal families jurisdiction. These families are amongst the elite and hold significant political influence. According to Mehnaz Ajmal of the Sustainable Development Policy Institute, “the feudals are against physical or social development, thinking that if the people under them become more informed, aware or empowered, their own hold over them will diminish,” (taken from Ishtiaq, 2006:3). Microfinance will be insufficient; alternative employment (workers belong to their employers brought upon by debt) and land reforms would be required to deal this form of poverty (Ishtiaq, 2006:3). This is an area which requires further investigation to appreciate how poverty can be alleviated in these districts, but it is a vast topic and beyond the scope of this microfinance study.

3.4 Islamic microfinance

3.4.1 Basic principles of Islamic finance

“..They say: ‘Trade is like usury,’ but God hath permitted trade and forbidden usury..”.
(Quran Verse 2:275)

It is the consensus amongst scholars that usury refers to all forms of interest (Dhumale, 1999:2), trade and therefore profit have been sanctioned, but interest is strictly forbidden. Islamic finance covers many other aspects in addition to prohibiting interest, such as avoiding the following; *maysir* (gambling), *gharar* (uncertainty), hoarding, and investing in non shariah compliant activities (pornography, gambling and alcohol), but it encourages risk sharing, sanctity of contracts, social/economic via charity, entrepreneurship and regarding money as potential capital (Sait, 2005:10). These are all features if practised correctly would hopefully safeguard all transacting parties, specifically the more vulnerable.

3.4.2 Islamic microfinance in Pakistan

One of the main criticisms regarding conventional microfinance is the charging of high interest rates; in fact their rates are usually higher than commercial loans (Rosenberg, 2002:11) around 18-36% for micro-loans (Burki, 2006:12) and 14-16% per annum (Wright, 2000:183) for commercial loans. The reason for this has been twofold, that the administration to manage small loans are not in proportion to the loan (the transaction cost for \$50 maybe the same for \$250 loan) and that interest rates are the major source of income and need to be high so the MFP can recover their operational costs and continue to provide financial services to the poor (CGAP, 2003). There are also arguments against the use of interest generally from western theories “historically, interest has been opposed on the grounds of the social divisions it creates and the hardship to borrowers” (Dar, 2003:2). Most significantly, Islam forbids charging of any interest (*riba*) upon loans

which restricts a huge network of potential Muslim clients from using conventional microfinance (Segrado, 2005:4).

The Supreme Court of Pakistan in 1999 defined interest as: “any amount, big or small, over the principal, in a contract of loan or debt, is Riba, prohibited by the Holy Quran, regardless of whether the loan is taken for the purpose of consumption or for some production activity” (taken from Afroz, n.d.). Interest is the most prominent instrument of microfinance which can be exploitive, especially towards the poor. Muhammad Akram Khan found that “The higher the rate of interest the lower the volume of investment because it lowers the overall profitability of the business enterprise” (1994:15). It may then be worth reviewing alternative financial instruments that assist both with social justice and sustainability.

This is exactly the purpose of this present study which is concerned with introducing a synergy between Islamic finance and microfinance in a Muslim country. Pakistan runs on a dual banking system and to date the banking sector is principally conventional (Alford, 2007:22) which includes the microfinance sector. This study intends to examine the progression of microfinance in Pakistan in terms of infrastructure and trends, to uncover any existing religious barriers.

Association for Creation of Employment (ACE) organised a conference in reaction to the anticipated abolishment of interest rates in July 2001, authorised by the Supreme Court of Pakistan (Elahi, 2000:4). However, the courts overturned their original decision due to restricted time provided to the government to changeover within one year (Husain, 2001) Elahi contemplates that the initial step towards Islamic microfinance in Pakistan could eventually encourage further commercial banks to take up Islamic finance (2000:4). This study intends to review Pakistan’s current stance to transition to a riba free economy, as this would strengthen the regard to implement Islamic microfinance.

Dhumale and Sapcanin (1999), Zafor (2007), Ashraf (2007), Farook (2007), Chowdry (2006), Goud (2007), Ferro (2005) and Associated Press of Pakistan (2000) all highlight the need for Islamic microfinance especially as they share so many similarities like risk sharing, egalitarian views and as they are fairly new, they are probably more susceptible

to innovative ideas to ensure they remain competitive. In addition, there are many potential clients in Pakistan who prefer to remain poor than to pay/accept interest, this is because *riba* (interest) is forbidden in Islam (Elahi, 2000: 6). Yet there are some people who reluctantly accept the loans due to necessity. There is a lot of controversy surrounding MFP, due to exorbitant interest rates (1994:16) that according to Mwanza can go up to 117% in some countries like Uganda (2008), so this is an area that requires some attention.

In Pakistan many MFP charge very low rates in comparison to other countries as they may appear “usurious and counter to the movement’s mission of alleviating poverty” (DIFD, 2006:57), this will mean these institutions cannot be sustainable and have a “low cost low yield curve, running heavily subsidized programs” (DIFD, 2006:57). This concern and the perceived interest for a *riba* free economy makes Pakistan an ideal setting to examine the potential for Islamic microfinance. Poverty is of course a grave concern for state of Pakistan and they have selected microfinance as a tool to alleviate this (Ministry of Finance, 2003:81) which is most effective when it reflects the cultural/religious needs of the environment (Segrado, 2005:4).

The main and possibly only Islamic MFP situated in Pakistan is Akhuwat which provide clients with *qard hasan* (interest free benevolent loans). Although it is not as grand in terms of size and stature as Grameen Bank or Bank Rakyat Indonesia, it does adopt some interesting microfinance principles, like focusing on individuals/households and self help groups rather than solidarity lending groups (Akhuwat, n.d.). Group lending and joint liability appears to be quite successful with institutions like Grameen bank, but not so triumphant in places like Malawi which “caused some members to default based on unwillingness, not inability, to repay. In fact, in many cases groups actually performed better when they did not expect joint liability to be enforced.” (International Food Policy Research Institute, 2002:3). Other Akhuwat policies include avoidance of International aid and the desire to serve the poor while the need to achieve sustainability. This study will be providing a case study on Akhuwat to identify if there are benefits in providing Islamic microfinance to low income people.

There had been numerous literatures endorsing the use of Islamic financial institutions like *zakah*, *waqf* and *sadaqah* to support the MFP with sustainability and poverty alleviation (Ashraf, 2007:23; Zafor, 2007:15; Yusoff and Kechik, 2007:10; Ahmed H, 2007:20). Source of funding can be an issue for Islamic MFP, since the grants available from aid development agencies are predominantly interest based. This will be reviewed to see what funding is available to Islamic MFP like Akhuwat. However, Rhyne claims that “only private sector has plenty of resources and will stick with a moneymaking activity even if it is not in fashion” (taken from Robinson, 2001:25). It is assumed that subsidies may become out of fashion and are not a reliant source of income, although *zakah* can be a lasting source. Pakistan has an existing *zakah* institution in place, but its not used to its full capability and generally had been neglected by the state in terms of up-to-date regulations, practices and overall management of the system.

CHAPTER 4

IV Conventional microfinance

4.1 Brief background

Micro-credit began around 1960/70s but it centred on government providing subsidised credit to agricultural farmers to encourage production. This led to huge losses and the need for endless supply of capital for ongoing operations (Ledgerwood, 1999:2). Additionally, credit was not reaching the poor due to fraud and political corruption (Pakistan Country Profile, n.d.:2) additionally, political pressure enforced banks to write off huge debts (DIFD, 2006:16) rendering this form of credit financially unsustainable.

In the 1980s, more market oriented micro-credit had been introduced, giving rise to organisations like Grameen bank in Bangladesh and ACCION International in Brazil. It was from this point that microfinance was viewed as fundamental in providing the poor access to all financial services, credit alone would not be sufficient. However, there are still many MFPs that are entirely focussed on credit which was further reinforced when the United Nations nominated 2005 the year of micro-credit. While Robinson, Hulme and Mosley found savings in greater demand than loans (taken from Johnson, 1997:9) but these facilities are often unavailable due to lack of regulations and public supervision (Robinson, 2001:72). More emphasis should be placed on savings as they offer “security, convenience, liquidity, confidentiality, access to credit, good service and returns” (Robinson, 2001:29). Additionally, Rogaly et al found an array of financial services will secure the poor from vulnerability and improve their earnings (taken from Fisher, 2002:21).

4.2 What is microfinance?

Microfinance is the provision of small-scale financial services to the poor who were formerly assumed non bankable by conventional banks. In essence it allows low income people access to services like credit, savings, insurance and money transfers and so forth.

Previously the financial services available to the poor were restricted to family/friends, money lenders, employers and so forth. However, the informal (commercial) finance sector charge “nominal effective interest rates of 10% to more than 100% a month” (Robinson, 2001:16). Hence access to formal financial services whose rates are much lower maybe a better alternative than the exploitation from money lenders.

Conventionally, microfinance propagates micro-credit that is centred on interest based transactions. Normally the interest rate would be higher than their banking counterparts but lower than the informal sector of money lending. This is perhaps what attracts the poor clients, it appears to be much less exploitive and no physical collateral is usually required. Yet MFPs do have an alternative form of collateral, what is known as the social collateral. This is whereby the clients are arranged in groups to create a form of group pressure.

Microfinance is also viewed as an economic development tool which addresses concerns like poverty alleviation, gender and socio-political empowerment up to expansion of financial services to the poor. It moved away from development dogma into practicality, whereby some of the immediate tangible benefits could be ascertained at grass-root level and the poor were able to participate in their own well being. However, many countries are ploughing in millions of funds into microfinance, perhaps it is time to stop and reflect, and identify the assertions and apprehensions to distinguish reality from fiction in microfinance (Wright, 2000:3).

4.3 Problems with microfinance and possible solutions from Islamic perspective

The most important aspect that has emerged from microfinance is clearing the myth that the poor are non bankable. Clar de Jesus, Hulme, Mosley and Wright, contend to claims made that microfinance reaches the poorest of the poor and ultimately alleviates poverty as debatable (taken from Harper, 2002:188). Although microfinance can be beneficial to some members of society, the actual success it claims to achieve appears to be over-inflated.

There is far more literature on the potential benefits of microfinance, and much less on the potential drawbacks to the poor. Harper claims that in terms of MFPs the poor are dealing with substandard banking, and ultimately microfinance should only be seen as temporary solutions to poverty matters. According to Harper, and Hulme cases are not often highlighted by practitioners that credit can direct the borrower into debt far greater than they can bear sometimes which subsequently leads to suicide (taken from Neal, 2007) (taken from Harper, 2002:188). Hulme and Mosley also found that many poorer microfinance clients have endured “bankruptcy, forced seizure of assets, and unofficial pledging of assets to other members of a borrowing group. There have even been reports of suicide following peer-group pressure to repay failed loans” (taken from Johnson, 1997:11). It needs to be understood that microfinance is far from a flawless tool, it requires thorough examination to ensure it assists the borrowers best interest and if there are serious concerns a better alternative should be provided. This study will examine whether Islamic microfinance can be a better option to the poor.

This section will look into some of the main problems with conventional microfinance, this is necessary for two reasons; the first relates to the lessons that Islamic MFP can learn from the issues in microfinance to date in order to avoid these problems and the second is whether Islamic microfinance may hold some of the solutions to these problems.

4.3.1 Group lending and dropouts

Many MFPs like Grameen Bank use social collateral as a substitution for physical collateral, this applies peer pressure amongst the members to conform to making timely payments. In some instances this can prove quite successful, whereby tight knit communities act as deterrents to defaulters, reducing the monitoring and credit control effort and costs to the MFP. Islamic MFP can easily adapt such operational formats while instilling Islamic values (Ahmed H, 2002:9) and collectivists (brotherhood) attitudes.

However, there are many concerns, as traditional group methodology can lead to dropouts (Wright, 2000:45) which can be costly. New members weaken the group structure as they maybe inexperienced requiring training and they commence with smaller loans while they will be expected to co-guarantee their associates larger loans (Wright, 2000:43). Groups are used to reduce credit risk through peer pressure but there is much evidence supporting individual or household lending. In fact Bank Rakyat Indonesia successfully serves 14 million clients (Wright, 2000:43) without any collateral, as found in Islamic banks (Segrado, 2005:5). In fact, best deterrent to default is fear of losing access to quality financial services (Wright, 2000:42).

However, there are benefits of group lending, Augustin argues that “social collateral scheme palliates the asymmetric information problem” (2004:2) and according to Huppi and Feder, Morduch and Stiglitz it also lowers transactions costs (taken from Ahmed, 2002:5).

4.3.2 Information asymmetry

Stiglitz and Weiss describe the borrowers as the ones who are ‘the informed’ while the MFP has less knowledge about the client’s risk profile and their intended use of the loan (taken from Robinson, 2001:154). This can occur when production loans are used for consumption purposes which increase chances of default. Equally possible when revenue on small enterprises is not guaranteed but the client is still expected to pay the principle

plus interest (Ledgerwood, 1999:136). This is considered unjust in Islamic finance, as repayments/returns are dependent upon generating profit, financial losses are borne by the MFP and labour effort is lost by the client (Iqbal, 2005:31). The emphasis in Islamic finance is based on productivity rather than credit worthiness.

Many MFP focus entirely on women to enhance their economic status among the community and Rhyne and Holt have found that repayment rates among women are generally higher than men (taken from Ledgerwood, 1999:38). However, in some instances women are acting as the front for their male relatives who use up the loan and leave the women to bear the burden of the credit risk (Ahmed, 2002:7). According to Rahman, targeting women in this way can cause conflict among spouses and eventually lead to violence (taken from Ahmed, 2002:9) and not empowerment. On the other hand, Islamic MFP prefers to deal with the family (Ahmed, 2002:15) encouraging unity in the house, which also reduces duplicate loans per household.

Islamic microfinance reduces asymmetric information by using products like musharakah (joint venture) and murabaha (cost plus mark up). The MFP are partners in the former and so are aware of the business activities, they are able to play a role in management and the latter may use the loan to purchase the goods and then resale at a mark up to the client. While, conventional MFPs increase interest rates to safeguard against credit risk caused by asymmetric information.

4.3.3 Interest rates / charges

The interest rate for microfinance services or the price of funds should be made up of a combination of costs;

Cost of capital + Administration costs + Cost of default = Price of credit (interest rate)

(Johnson, 1997:51), there may also be an element for growth purposes.

According to Rock and Otero “Interest rate restrictions usually undermine an institution’s ability to operate efficiently and competitively” (taken from Ledgerwood, 1999:18). Hence interest rates need to be high enough to recover the full costs (Robinson, 2001:28)

(Ledgerwood, 1999:18), but ethically, should sustainability come at the expense of the poor. Evidence indicates that the poor are able to withstand high interest rates that can sustain the MFPs (Rosenberg, 2002:10) and if they are able to repay moneylenders, they should have no issues with micro-credit interest rates, which are much lower (Johnson, 1997:51). The other concern is that high interest rates can cover inefficiency; therefore every effort should be made by the MFP to provide an efficient and effective financial service.

Interest rates of any kind are a major concern for Muslims, since this instrument is forbidden in Islam (Khan M, 1994:16) restricting many religious devotees access to microfinance. Interest was also cause for concern in the old Christian and Jewish scriptures where, “interest is often equated with exploitation of those in need” (Dar, 2003:2). As it is usually the people that don’t have the means, that need the loan and charging interest on loans thereby takes advantage of this hardship. From an Islamic perspective, money is a medium of exchange, a store of value and a unit of valuation (Tag El-Din, 2007:4). It should not be the medium to earn more money especially with the attachment of time value of money. Profit is permitted because some ‘work’ effort or risk is shared by the capital provider, but interest entails no such effort and is undeserved income (Dar, 2003:2).

Unfortunately, microfinance has been applied to many Muslim countries, but with the lack of attention paid to religious barriers. This important condition may hinder many potential clients from accessing microfinance (Segrado, 2005:4) as expected to be the case in Pakistan. Other issues with conventional microfinance, is that it is debt based, Rahman found that Grameen borrowers supplemented their loan repayments by borrowing from other sources, leaving an endless trail of debts (Ahmed, 2002:8). Islamic finance counteracts this problem by delivering equity based or asset backed financial products.

4.3.4 Sustainability

Most microfinance organisations are heavily subsidised (Lindvert, 2006:24) which can hinder growth of sustainable financial institutions (Robinson, 2001:147), since borrowers are more likely to go for cheaper credit, it promotes unfair competition. The problem with this is that credit often fails to reach the poorer clients or loans are defaulted (Robinson, 2001:72) as they perceive it as a form of charity. This is the poverty lending approach which attains sustainability through dependency on external funding and centres on welfare of the poor.

An example is Grameen Bank and contrary to the financial lending standpoint that claim large outreach can only be achieved through fully self sufficient MFP (Robinson, 2001:23), Grameen Bank serves up to seven million customers (Yunus, 2006). Yet they are heavily subsidised (Harper, 2002:174) and without their grants they would be incurring losses (Harper, 2002:184). It is liable to take many years before MFP can become efficient and sustainable, during this period, grants and tax benefits can be advantageous to assist with the maintenance and expansion of the institution. This will be difficult to do on interest income alone, unless the interest rates are exceptionally high. Which can come down once economies of scales are achieved (Johnson, 1997:52). Islamic MFPs are dependent on the accessibility of external funding (like *waqf* and *zakah*) especially during the early phases of operation (Ahmed H, 2002:33) this can be replaced by regular savings and other commercial Islamic finance instruments.

Rhyne argues that long term sustainability and large scale outreach can only be obtained using the financial lending approach (taken from Robinson, 2001:23), whereby Bank Rakyat Indonesia are a prime example. However, the concern with the financial lending approach is their emphasis for profit may forsake their duty to the poorest clients to serve better off clients.

CHAPTER 5

V Potential of microfinance in Pakistan

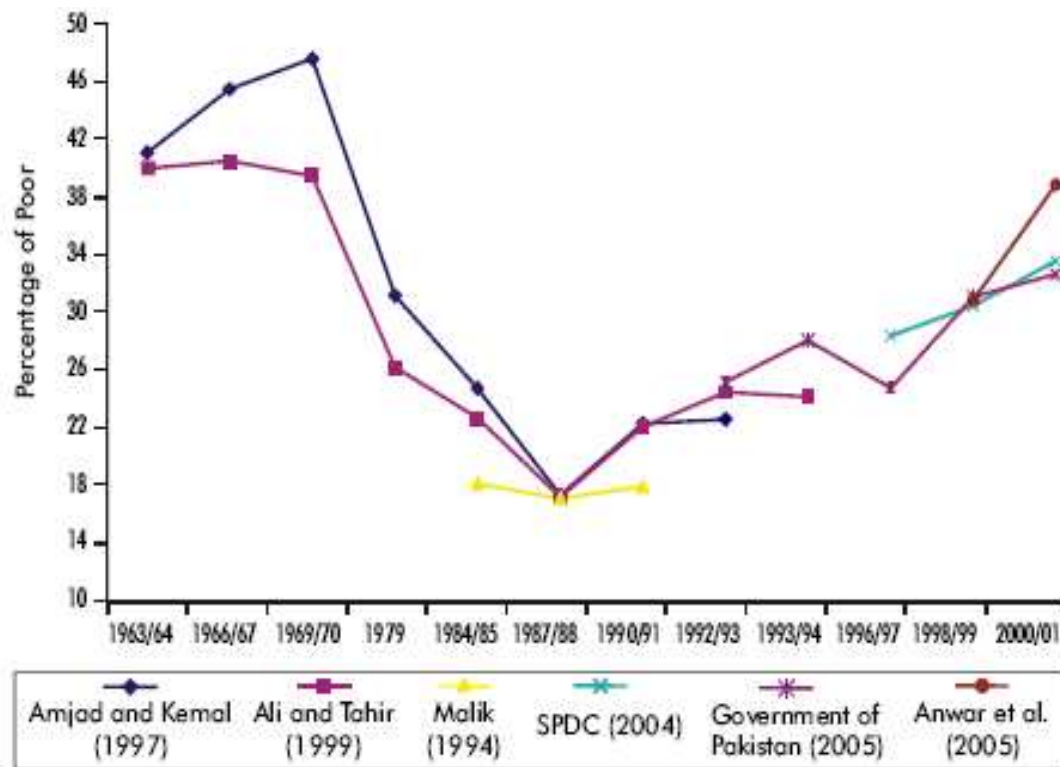
5.1 Poverty in Pakistan

Pakistan is predominantly a Muslim inhabited country with a population of 165 million people (International Data Base, 2007). Poverty is reported to be the highest in the rural parts of Pakistan (Duflos, 2007:11), where seventy five percent of the poor are located (Cheema, 2004:4). However, these areas are difficult to get to because of their “remoteness, cultural/religious barriers to traditional credit, gender bias and/or inappropriate delivery systems” (International Fund for Agricultural Development (IFAD), 2005:VI). Therefore, it would be more sensible for MFP to focus on these issues to ensure microfinance can be used effectively. Evidently the IFAD found interest based microfinance was a deterrent to potential borrowers. Hence, Islamic microfinance may be a better alternative to attract further clients (2005:5) since they can offer equity based products rather than debt focused which attracts further vulnerability.

In terms of poverty, one of the most disturbing periods in Pakistan’s history took place during the 1990s when poverty trends began to rise. It is an established fact that poverty is a multifaceted problem (Ministry of Finance, 2003:19), it is generally accepted that during the 1990s, poverty amplified in 1990-91 from 26.1% to 32.1% in 2000-01 (Ministry of Finance, 2003:1). This should be elaborated further by reviewing the rural/urban division in poverty, in 1990-91 poverty for rural and urban areas was 25.2% and 26.6% respectively. While by the end of 1998-99 poverty for rural and urban areas were 34.7% and 20.9% respectively (taken from Ministry of Finance, 2003:12). This demonstrated that poverty in rural regions which had fewer prospects for employment apart from self-employment (Pakistan Microfinance Network, 2002) had deteriorated over time, while urban regions had improved.

Figure 2.0 illustrates the poverty trends undertaken by six separate studies over various periods of time. The distinct differences in estimates are due to the separate methods used to measure poverty. It can be seen that poverty fell rapidly in the 1970s. This was mainly attributed to greater private agricultural investment, in addition too many people having migrated to the Middle East, which gave rise to huge foreign remittances and subsequently declining poverty patterns (Arif, 2006:23).

Figure 2.0 Historic Poverty Trends in Pakistan



SPDC = Social Policy Development Centre.

Source: (taken from Arif, 2006:10).

In figure 2.0, 1987/88 was a defining moment whereby poverty declining patterns reversed, hence poverty tendencies in 2000-01 were far greater than in the late 1980s (Arif, 2006:10). During this period income distribution deteriorated and due to this inequality, there was a greater Gini coefficient of 0.41 in 2001/02 compared with 0.35 in

1987/88 (Arif, 2006:11). To date, poverty is a core issue within Pakistan and President Musharraf had prioritised this on his agenda (Cheema, 2004:4).

In total, the state had invested \$22 billion over the past five years on the poor, to alleviate people from below the poverty line. In percentage terms, poverty moved from 33% to its current level of 24% in 2006 (Duflos, 2007:11). Even if the current levels of poverty had declined quite rapidly it was not much different to 1993 (see figure 2.0) and there is still much improvement to be made.

The government had selected microfinance to help them reduce poverty and empower the vulnerable (DIFD Briefing note, 2006:2). This strategy had been employed as part of the PRSP (Poverty Reduction Strategy Paper) in ultimately assisting Pakistan to reduce poverty in alignment with the MDG (DIFD, 2006:122). The PRSP centres on expediting economic growth while sustaining macroeconomic stability, increasing governance, aiming at reaching the poor and susceptible and finally investing in human capital (Ministry of Finance, 2003:27).

There are numerous policies the government had used to enable the microfinance industry, some of which included; facilitation of legal and regulatory framework for licensed MFP (Islamic and conventional), formation of Khushhali Bank , streamlining MFP and provision of long-standing system “for social capital build-up of poor households” (Ministry of Finance, 2003:81).

5.2 Political and macroeconomic stability of Pakistan

This section was included to appreciate the high political instability within Pakistan especially in the light of recent events (see appendix VIII for details), in order to achieve macroeconomic stability in Pakistan, the government needs to provide an enabling environment for microfinance, and this can only be achieved with a strong political system (Cheema, 2004:1).

Continued political instability could have negative implications on the macroeconomic stability. Hence it is necessary to stabilize, to ensure the successful growth of microfinance (CGAP, 2006:120). Presently SBP had reported the average economy growth over FY 2005-2007 to be around 7.4% (Akhtar, 2007a:1). The Asian Development Bank (ADB) had forecasted Pakistan's economic growth rate to remain around 6.5-7% in 2007 and 2008 reinforced by manufacturing and agriculture industries (Chaudhry, 2007). To sustain this growth pattern it is necessary to achieve democracy / political stability and therefore macroeconomic stability (Cheema, 2004:35). The success of microfinance within Pakistan is dependent on the government to facilitate the environment through support by maintaining regulatory frameworks and policies and ensure macroeconomic stability.

5.3 Microfinance status in Pakistan

Muhammad Yunus recognised the need to build a strong disciplined model, an institution independent from political influence (as specified in a 1983 ordinance). Although unusually the presence of landed elite in all villages reduced inequalities in terms of distribution of land ownership and bias with machinery (Grameen and the Question of Replicability, 2005). Perhaps for this reason Bangladesh are more receptive to microfinance, while Pakistan rural regions are still under the heavily influence of feudal elite families (Ishtiaq, 2006).

Overwhelming support had been received from SBP, NGOs, development agencies and the government, to accelerate the microfinance services. Yet in spite of the popularity from senior stakeholders, the outreach has generally been very low, meeting only 5% of the potential microfinance demand (Pakistan Country Profile. n.d:1). However, from Harper's interview responses, he contends that this outreach is still not that bad in comparison to Africa (2008). Nevertheless the goals to impact poverty can only be achieved if a greater market share is attained. In addition the government and SBP have set the goal to increase microfinance outreach "from one million to three million

households by 2010” (Associated Press of Pakistan, 2007). Hence, there is a clear need to develop the microfinance sector to reach the unmet demand of low income people and according this study suggests, a way to address this problem is by offering Shariah compliant products.

5.3.1 Microfinance infrastructure and enablers in Pakistan

There are many agencies which support the industry through funding such as the apex institution, Pakistan Poverty Alleviation Fund (PPAF) a non profit private company backed by the Pakistani state and financially supported by the World Bank. Its role is to endorse expansion of microfinance outreach by directing funds to the many MFP in Pakistan, although CGAP found that to date it had more financial resources than capable MFP to provide funds too (Helms, 2002:1). Up to now, PPAF have distributed “Rs 1.2 billion (US\$ 20 million) to 27 MFPs or supported loans for 125,000 clients cumulatively” (Pakistan Microfinance Network, 2002).

Other development agencies like Asian development bank (ADB) which began the Microfinance Sector Development Program (MSDP) in 2001, promoted the expansion of a regulatory framework which lead to the Microfinance Ordinance 2001. It assisted with the growth of Khushhali Bank (public/private ownership) and the restructuring of Agricultural Development Bank, now known as Zarai Tarqati Bank Ltd (Asian Development Bank -Pakistan Program, n.d.: 1). Furthermore numerous funds were used like Microfinance Social Development Fund, the Community Investment Fund, the Risk Mitigation Fund and the Deposit Protection fund and administered by SBP to improve the outreach within Pakistan.

The MSDP consisted of two loans from the ADB, the first loan of \$70 million assisted the development program of the microfinance industry and the second loan of \$80 million was for “microfinance services to the poor and institutional strengthening” (Asian Development Bank, 2000: 4). In 2003, ADB had moved onto providing loans for rural reform, specifically the Rural Finance Sector Development Program, as part of the states

strategy to hasten economic growth via access to rural finance. This fund supported innovations like rural insurance schemes, provided capital to MFP and encouraged “private owned financial sector” (Asian Development Bank -Pakistan Program, n.d.: 2).

In addition to funding, other facilitators of microfinance include Pakistan Microfinance Network (PMN), a group of institutions that encourage “diversity, quality and to build the capacity of the sector to apply best practices” (Pakistan Microfinance Network, 2002) thereby committed to improving the sustainability and outreach of microfinance in Pakistan. PMN was registered as a legal entity in 2001 under Section 42 of the Companies Ordinance 1984 (Pakistan Microfinance Network, 2005a) and their MFP members cover 96% of the microfinance market share in the private sector (Ahmed S, 2007:7). PMN is focused on capacity building by providing training and knowledge to MFP on best practice. PMN enhances transparency which is heightened by issuing Performance Indicator Reports (PIR) on a six monthly basis detailing performance measurements obtained from their MFP members which can be used as benchmarks, but unfortunately this data is not independently authenticated. PMN works closely with Microfinance Information Exchange, Inc (MIX) and their Micro-Banking Bulletin (MBB), MIX is the principal business information supplier and benchmark tool devoted to enriching the microfinance industry. Additionally PMN provide an enabling environment through their contributions towards policy making.

The SBP and government have also played crucial roles in providing an enabling environment for existing and potential MFP. The government propagated the Microfinance Ordinance 2001 to encourage admittance to sustainable microfinance for low income people and ultimately reducing poverty. With this goal in mind and to ensure the poor were being reached, the Ordinance had capped loan sizes to no more than Rs 100,000 (£814), however this restricts some MFP clients who need to go beyond this limit (Pakistan Microfinance Network, 2002). Other specifications of this law includes terms and conditions for microfinance banks and MFP, capital needs and ownership make-up (State Bank of Pakistan, n.d.). There are three types of categories with differing capital requirements; district level is 100 million, provincial level is 250 million and

national level is 500 million rupees. Nevertheless the prudential regulations set up by SBP allow these capital requirements to be supplemented by their loan portfolio. Even then this law should be reviewed as it is too strict with its capital needs and liquidity measures (Pakistan Microfinance Network, 2002).

SBP as central bank of Pakistan holds many additional responsibilities above their routine duties, like encouraging economic growth by “supporting the development of new financial institutions to promote financial intermediation. SBP has also directed the use of credit according to development priorities, providing subsidized credit” (State Bank of Pakistan, n.d.). Under the Microfinance ordinance 2001 the SBP are assigned with monitoring, regulation and licensing of Microfinance Banks. SBP have also formed a Microfinance Consultative Group (MFCG) consisting of prominent members of the microfinance industry discussing prudential needs (State Bank of Pakistan, n.d.). MFCG’s encompasses “policy and regulation, capital building, innovation and other issues as they arise” (Haq, 2007:5).

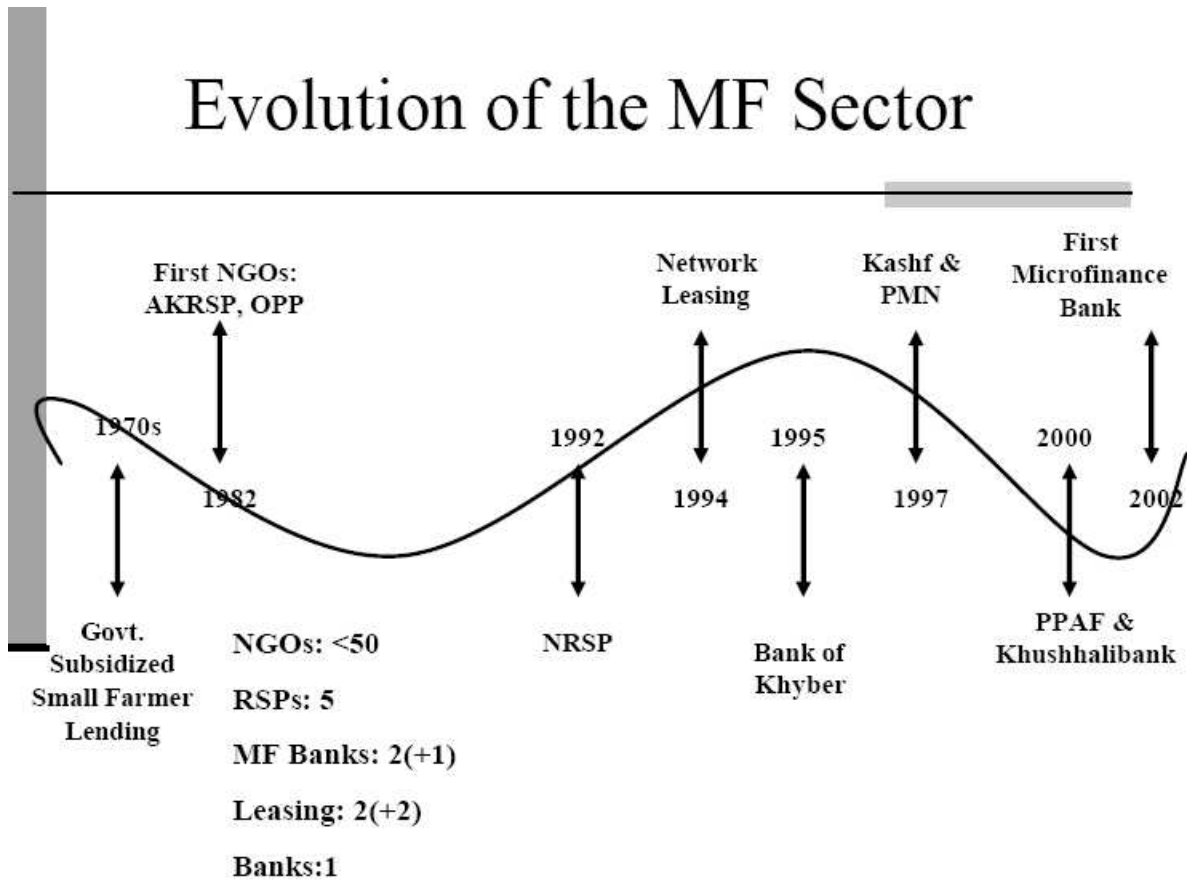
5.3.2 Microfinance trends in Pakistan

Apart from family/friends and money lenders, the other common source of informal credit is a form of rotating saving and credit association (ROSCA) termed the ‘committee’, in fact almost 83% of credit is supplied in this manner within Pakistan (Pakistan country profile, n.d.). Although it was found that 30% of these committees may dissolve before reaching a complete cycle, whereby some were able to benefit from credit while others lost out (Pakistan Microfinance Network, 2002). There are no regulations to safeguard committee member’s financial interests. From the author’s awareness there are incidences where committee members run away with the funds. This is why it is essential to have regulated financial services in place especially for the weak and vulnerable.

In the semi-formal sector the main promoters of microfinance is the rural support programs (RSP) whose role is to encourage rural (and urban) development by providing a range of services. NGOs are also quite active in microfinance, they are either specialised

in this service (termed microfinance institution (MFI)) or microfinance is one of many services they offer (see appendix II). The formal microfinance sector consists of licensed six banks regulated by SBP (see appendix II).

Figure 3.0



Source: (taken from Zafar, Roshaneh, 2004:9).

Figure 3.0 illustrates how microfinance had progressed from 1970s⁵ up till 2002. In the 1980s, Aga Khan Rural Support Program (AKRSP) was formed in the northern part of Pakistan (rural area) and Orangi Pilot Project (OPP) in Karachi for the urban population. From their success came other microfinance institutions like National Rural Support Program (NRSP) it had one of the best outreaches in Pakistan, Network leasing (offers leasing products to low income people), Bank of Khyber (commercial bank from North West Frontier Province), Kashf foundation replica of Grameen Bank model, followed by

⁵ Refer to section 4.1 for background to government subsidized credit.

organisations like the Pakistan microfinance network (PMN), the Pakistan Poverty Alleviation Fund (PPAF). Post Microfinance Ordinance 2001, licensed institutions were formed; Khushhali Bank and First MicroFinanceBank (FMFB) which was originally the microfinance division of AKRSP.

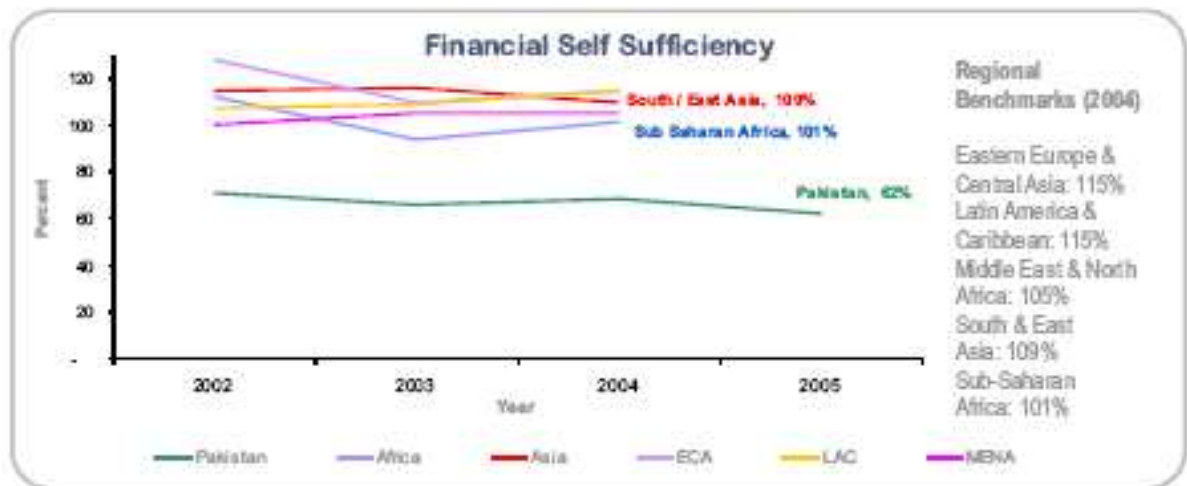
Over the years MFPs had a tendency to progress from providing several development services to focus specifically on microfinance to meet the needs of low income people (see appendix V). This may have been as a result of the promotion of microfinance by the government, SBP and PMN providing awareness that this concept can be an effective development tool to reduce poverty and so requires time and effort. Pakistan's microfinance is a nascent industry and is still developing, but overall, microfinance (or credit) has been growing quite well in the last few years, (see appendix VI) there has been a 40% growth during this period.

SBP believe with the current growth rate that the existing microfinance players have the capability to reach the three million outreach target by 2010 as set by the government (Associated Press of Pakistan, 2007). DIFD had proposed a £50m Financial Inclusion Programme to enhance outreach from 1m to 3m over five years with intended back up from the private sector and commercial banks (2007:2).

This can be further substantiated with plans from FMFB who have recently approved a memorandum of understanding with Pakistan Post which have over 4000 sub offices with coverage of rural and urban regions and additionally with FMFB 82 branches, this will increase their outreach greatly. In fact they are hoping to distribute "Rs 15 billion to over a million clients, in the next 3-5 years" (Haq, 2007:5). In addition IFAD is providing a \$35 million loan towards commercialising microfinance in Pakistan, increasing outreach to a further 160, 000 new clients of which 50% should be for women (Haq, 2007:5). SBP intends to issue draft guidelines on branchless banking through mobiles and retail agents (Haq, 2007:5).

Fortunately, Pakistan MFPs are constantly innovating to increase outreach and although sustainability is highly recognised by SBP, PMN and MFPs, more attention needs to be made in this direction. More institutions are also planning to apply for licenses from SBP, these include Kashf Foundation which has applied for Micro-Finance Bank (MFB) license it is under review with SBP (IFC, 2007) and Akhuwat is also hoping to apply for an MFI/MFB license (Saqib, 2008) which will then allow them to provide savings product. However, this would mean that they would be liable for corporation tax of 40% on any excess revenue and for Kashf to achieve sustainability it would need to increase their interest charge by one third from 20% to 27% (DIFD, 2006: 106).

Figure 4.0



Source: (Burki, 2006:13)

Figure 4.0 shows the financial sustainability of Pakistan’s microfinance industry, which is well below the South Asian benchmark of 109%. This may be due to the low interest rate charged by Pakistan MFP on average it comes to 18%. The reason for the low interest rates is the concern that high interest rates especially to poor clients can be considered exploitive and therefore falls into usury (DIFD, 2006:57), which of course is forbidden in Islam.

These low charges are resulting in lack of sustainability, and hence the need for grants to cover against losses, the current practice in Pakistan. These MFP are heavily subsidised which is negatively impacting sustainability; hence there is an urgent need to re-price products and services charged by the MFP (DIFD, 2006:10). Which otherwise would affect the future growth of microfinance and accordingly there is a strong recommendation to increase interest/service charges (Burki, 2006:15). Burki recommends that if current yield were to be increased from 18% to 34% (similar to rates charged elsewhere in South Asia) this will comfortably surpass costs and by 2015 hypothetically 12 million borrowers could access microfinance (2006:14).

Pakistan has been strongly inspired to move towards commercialisation, but progression in this direction has been slow even though there is consensus from SBP, PMN and other stakeholders that sustainability and growth are very important requirements which can be achieved through commercialisation (Akhtar, 2007:10), (Syed, 2007:15). Innovation and sustainability can also be inspired by the introduction of Islamic microfinance, although currently only Akhuwat is offering interest free loans in Pakistan (see chapter six). Other Islamic entry yet to join the industry is Meezan Bank (Islamic commercial Bank). Ahmed Siddiqui the Product Development and Shariah Compliance manager at Meezan bank confirmed they will be providing murabaha, ijarah and salam. Low income people will be targeted relating to “cattle farming with collaboration with some packaged milk providers” (2008). Meezan have just completed their research, so very little information is available until they actually launch their product. So for the purposes of this study, Meezan Bank will not be investigated.

5.3.3 National financial access study

Upon the request of the government and SBP a national ‘comprehensive’ survey of 10,500 respondents is currently being conducted by Nielsen Pakistan (Pvt) Ltd and FinMark Trust to examine the access all Pakistanis have to informal/formal financial services, which includes people of all statuses, urban/rural regions across the four provinces and Azad Jammu and Kashmir. Assistance is provided from UK DIFD, World

Bank and the Swiss Agency for Development and Cooperation (SDC) (Afzal, 2007). This study had been motivated by several development programs centred on alleviating poverty and the need to understand why many poor people are unable to access financial services which then impedes growth and wellbeing (Nielsen Pakistan (Pvt) Ltd, 2007:4). An unusual feature of this study is that it goes “beyond the physical infrastructure and price considerations” (Afzal, 2007) and examines psychographics and how it affects their financial behaviour (Afzal, 2007). This will be particularly useful not only for the microfinance sector, but to the financial services industry as a whole to assist them with delivering more suitable products/services to their clients.

Another important objective of this survey is to identify the barriers to access financial services in Pakistan, like religious constraints. To date Nielson found that there is some awareness of Islamic Banking but very little knowledge of what it entails and the participants are not convinced a bank can be completely shariah compliant (Nielsen Pakistan (Pvt) Ltd, 2007: 86). Additionally, interest/riba is the main religious barrier to formal financial services (Nielsen Pakistan (Pvt) Ltd, 2007: 68).

5.4 Islamic banking in Pakistan

5.4.1 Introduction

For Islamic microfinance to be successful in Pakistan it is important to understand the intentions and interests of the stakeholders towards Islamic banking and finance to grasp the available support MFP and clients can expect to receive. This study has found there is some inclination to move in the direction of interest free finance systems and ultimately an interest free economy. With conventional microfinance acting as a priority tool for development and expansion of financial services in Pakistan, an Islamic alternative would be greatly appreciated.

5.4.2 Pakistan's position on riba free banking

Pakistan currently runs on a dual banking system similar to Malaysia (Alford, 2007:22), but perhaps not as advanced as Malaysia⁶ or even Bahrain⁷. In fact, the Islamic banking arena in Pakistan is still premature in terms of progression and the question should be whether or not Pakistan can be as triumphant when their conventional banking markets are still very prominent (Alford, 2007:22) while Malaysia is ahead and has a fifty-fifty split of riba to riba free economy (Usmani, 2008:5).

Perhaps it is time for Pakistan to start setting the example, as it had attempted to, in the past, by working towards an interest free economy, which unfortunately due to lack of preparations, the changeover had not materialized (Afroz, n.d.:2). The discussions which took place in Pakistan during the realm of General Zia-ul-Haq for an interest free movement inspired other countries like Sudan and Iran to take the big leap into a riba free economy (Usmani, 2008:5). Ironically even though the dialogues first took place in Pakistan, they still don't appear to have benefited, from their own knowledge by

⁶ Malaysia are known to be the world leaders within the Islamic banking and insurance industry (Andreasyan, 2007:25)

⁷ Bahrain is reported to have the most Islamic financial institutions in the Middle East in conjunction with important establishments like the Accounting and Auditing Organisation for Islamic Financial Institutions ('AAOIFI'), Liquidity Management Centre ('LMC'), the International Islamic Financial Market ('IIFM'), and the Islamic International Rating Agency ('IIRA') (Central bank of Bahrain, 2007).

converting to an interest free economy. Nevertheless they can now take advantage of the practical experiences of Muslim countries that have applied a greater degree of Islamization than Pakistan on their financial market.

Usmani believes Pakistan has the capabilities of making an interest free economy a better success compared with other countries. This is mainly due to the research/knowledge acquired by Pakistan on this matter is vastly greater than any other country and the home grown economic/religious expertise available in this country. Which are rich from experience gathered from many countries by resolving both Islamic and Non-Islamic problems including the World Bank which has mostly Pakistani's working in the Islamic banking division (2008:5). Usmani also argues, that all that is required to move forward is 'firm determination' (2008:4) especially by those in power that can change policies and implement the changeover. Usmani extends this argument by stating there are three causes hindering riba elimination; ignorance, propaganda that the financial system is unable to work without interest and finally the sense of inferiority (2008:4). All of which require educating the stakeholders on the true issues and benefits of Islamic finance and interest free economies, the details of which fall outside the remit of this thesis.

It appears the religious scholars of Pakistan have struggled in their attempt to implement a riba free economy, especially from lack of support from the state which through petitioning had delayed and blocked any such conversion (Usmani, 2008:3). There may be a further concern with light of all the negative publicity Pakistan has received particularly from the period of post 9/11 to date is the sudden urgency from the government to portray Pakistan as a moderate democratic state, this may conflict with any vision to islamise the economy. On the other hand perceptions of Islamic finance have been very positive around the world as well as in the West, which can be measured by the Islamic finance industry's growth of 25%-30% per annum for the past five years (Ferro, 2005:1). The capitalist notion of potential wealth normally outweighs other priorities.

According to a report issued by the State Bank of Pakistan total Islamic banking assets increased by 24% in the last quarter of 2006 (taken from New Horizon, 2007:42). This shows that this is a fruitful market for Pakistan and they too can reap some of the benefits acquired by their Muslim and Western counterparts.

5.4.3 Evolution of Islamic banking

The Council of Islamic ideology in Pakistan which comprised of judges and scholars of Islam were given a presidential order on 29th September 1979 to plan a proposal for interest-free economic system bridging the gap between the vision of Ulama and bankers. (Pal, 1999:67). According to Dr Ishrat Hossain, Governor of SBP, this gave rise to the World's first main complete report on Islamic banking and finance; 'Elimination of Riba'. Subsequently this led the way to taking a hands-on approach to removing riba from the economy (taken from Afroz, n.d) and later in 1988 General Zia-ul Haq launched interest free banking (Pal, 1999:42). This supposedly commenced the islamization process of the financial markets (taken from Afroz, n.d.) and by 1999 the Supreme Court of Pakistan demanded the Islamization of the entire economic system. However, upon re-assessment of this order, this decision was later quashed in 2002 and this case had been submitted for fresh resolution (Afroz, n.d.). Mansur-ur-Rehman, executive director of SBP, believes the government preferred a steady move from conventional to interest free economy as that would be less disruptive (Kazmi, 2002).

Primarily it should be duly noted that the entire Constitutions of Pakistan have included, "within the principles of policy, the elimination of Riba as an important objective of the State policy" (Kazmi, 2002). Thereafter there have been numerous indications by the government, of their interest in an Islamic financial system, such as setting up the shariah board of SBP to deal with islamization of the financial system, and introducing a new full-fledged Islamic banking department in SBP. The government had also initiated research into adopting/developing Islamic accounting standards, updating regulations to open Islamic bank subsidiaries, issuance of guidelines and license for Islamic commercial

banks and issuance of government sukuk. Additionally, the SBP was also one of the founding members of the Islamic Financial Services Board (Afroz, n.d.).

Examining the Islamic banking industry appears to be completely consumed by the capitalistic system, which then contradicts with what Islam teaches about social justice.

Yet, there is a salient distinction with the secular and Islamic capitalist system, for the former entails commercial loans demanding a fixed return, while the latter consists of benevolent loans (*qard hasan*) where no return/interest is permitted. Although Islamic banks are market orientated and there is no link for it to be socially just because it offers an alternative to interest. The third sector/philanthropy in Islamic finance system should deal with social justice matters, during discussions with Dr Seif, he argues it is not how you acquire the money it is how you dispose of it.

Although interest is forbidden in Islam, trade has been permitted, which then allows for alternative financial instruments like *murabaha* (cost plus mark-up), *musharakah* (joint venture), *ijara* (leasing), *mudarabah* (trust financing, profit sharing), *salam* (forward buying with immediate payment) and *istisna* (manufacturing contract). The most commonly used Islamic finance instrument in Pakistan is murabaha and then Ijara, accounting for 40% and 30% of total Islamic banking products respectively (taken from New Horizon, 2007:42). These products are often criticised for providing similar net outcomes to interest based products, and there maybe some truth in this which is why many shariah boards may restrict their use, but there is a clear distinction in that murabaha and ijara are asset backed (Usmani, 1999:20). However, the early days of Islamic banking sector had experienced some instability with equity financing “after a series of shocks and bad investments, they became very conservative” (MacLean, 2007:3) and so a balanced set of debt and equity products may reduce risk.

CHAPTER SIX

VI Case study of Islamic microfinance provider; Akhuwat in Pakistan

6.1 Introduction

Countless microfinance literature advocates the institutionalist position; this is in contradiction to the paradigms followed by MFP in Pakistan. The preferred route to date has been the welfarist approach using interest based financial products. Kashf foundation is one such case, which is typical of a conventional MFP; it replicates the Bangladesh Grameen model and had been reported to be the fastest and most successful MFP within Pakistan (Schwab Foundation, 2006). At face value this accomplishment maybe seen as a benchmark for other MFP within Pakistan to emulate, yet they are heavily reliant upon donor subsidies.

This study will investigate a case study of an Islamic NGO known as Akhuwat which offers micro-credit, to identify whether an Islamic alternative would be a better standard. Although in size this NGO is quite small, but it has adopted some interesting policies which require further examination. It holds a unique position amongst MFPs as it does not fulfil all the categories which are covered under microfinance evident success, there are no high interest rates (in fact it charges no interest or even profit), preference is given towards individual lending (absence of social collateral in many cases), it can reach the extreme poor and most peculiar is the source of funding which to date is based mainly on local peoples generosity (philanthropy) rather than huge grants from government, development agencies and so forth.

6.2 Akhuwat's profile

Akhuwat, is based in the urban city of Lahore in Pakistan, the provincial capital of the largest province in Punjab and the second largest city in Pakistan with a population of about 10 million people (Geography profile, 2007). Akhuwat adheres to the poverty

lending perspective, whereby the welfare of the poor is their primary objective. This institution was first set up in 2001 by Dr Amjad Saqib and is registered under Societies Registered Act 1860, as well as the Pakistan Centre for Philanthropy (PCP) and PMN. Dr Saqib is a former general manager of Punjab Rural Support Program (non profit organisation that focuses on community driven development, it reduces poverty mainly with micro-credit in the Punjab province). Amjad soon identified flaws within the micro-credit system, firstly the charging of interest on loans or savings would act as a deterrent to many potential borrowers since it went against their religious beliefs and high interest rate of 20% per annum would burden the borrower at time of repayment (Harper, 2007).

With this analogy in mind, came the inception of Akhuwat, an organisation strongly placed on the Islamic principles of *mua'khaat* (brotherhood) as prescribed in the Quraan (in surah Anfal 8:72). Akhuwat prides itself on emulating the period of Prophet Muhammad's (pbuh), at the time when the Makkan Muslims (*muhajirun*) migrated to Madinah, the Muslims in this city (Ansars/Helpers) extended their hospitality by sharing their wealth with the *muhajirun*. The latter party had migrated leaving all their belongings behind, so they were in need of financial assistance (Akhuwat, 2007b). Although this may seem like a lifetime ago, there are constant reminders in the Quraan in surah's; 2:245, 5:12, 11:57, 18:57, 17:64 and 20:73 (Mirakhor, 2007:19) informing mankind of the values of benevolent loans which is practised widely amongst the Muslims, but less common perhaps with formal Islamic banking institutions (asset side). Akhuwat has extended this assistance to benefit the poor regardless of their religious faith (Akhuwat, 2007b). Conveniently as interest rates charged in Lahore by money lenders is said to be about 10% or more per month (Harper, 2007).

6.3 Products

Akhuwat is the pioneer of micro-credit based on Islamic principles in Pakistan. It offers interest free benevolent loans (*qard hasan*) of about 10,000 rupees (£81) primarily, then up to a maximum of 20,000 rupees (£163) on subsequent loans. Repayments are made over the year (the first month is excluded) at Rs. 1000 per month, but normally the maximum repayment period can extend to eighteen months. There are no financial

penalties for defaulting apart from the awareness that privileges for future loans will be removed, which to date has proven to be a sufficient deterrent.

However there is a 5.5%⁸ membership fee which is basically the service charge for processing the loan (Saqib, 2008) and it is not dependent upon the repayment date. According to Dr Saqib it makes the “process professional and not charity as people demand better services when they pay the fee” (Financial Sector Strengthening Programme (FSSP), 2006:7). This charge is applicable to loans over 4000 rupees (£32.50) as loans below this amount is considered to be for extremely poor people and hence they are not burdened with membership fees. Additionally, Dr Saqib confirmed in his interview response that this service charge allows its members access to free services like medical camps and educational support to member’s offspring (Saqib, 2008). These membership fees cover 76% of the operational costs, while the remainder are covered by Akhuwat’s board of directors. Donations are then used exclusively for loan purposes (FSSP, 2006:16). However, Akhuwat annual reports show that some surplus expenditure is covered by the grants received (2006:6).

The issue surrounding service charge can be a controversial one, as some accept the justification like Irfan ul-haq (taken from Hossain, 2004), Siebel (n.d.:3), (Dhumale, 1999:5) and Abdul Rahman (2006:12) who claim institutions are allowed to cover their administration costs, also the charge should not be linked to the loan amount or maturity. The problem arises when one wants to identify the specific cost for delivering that loan, which of course is not easily attainable. S.H. Amin and M. Azizul Huq, (executive vice president of Islamic Bank Bangladesh) argue that although it is understood that there can be some genuine expenses for providing the loan, it is the direct attributable costs which are more justified under Islamic law (taken from Hossain, 2004). However, this would be almost impossible to attain for a financial institution with many clients, but every effort should be made to keep the cost at a minimum.

Borrowers are also required to pay an obligatory one percent insurance fee, covering death or critical illness, whereby unsettled loans are dismissed. Their poor family

⁸ Nearly all sources show this to be 5%, but the 5.5% was the latest data taken directly from Dr Saqib.

members are then compensated with three monthly payments totalling Rs. 3000 along with a one off cash payment of Rs. 5000 (Harper, 2007). Fifty percent of insurance fees were claimed, while the remainder went towards insurance administering charge. This does not appear to be based on takaful (Islamic insurance), mutual assistance principles, which will probably be unacceptable under Islamic law. However, according to Dr Saqib the insurance premium is kept independently⁹ and there are future plans for Akhuwat to develop their own micro-takaful product (2008).

6.4 Lending methodology/ target market

There are two forms of lending methodologies in Akhuwat, the first relates to group lending; each Self-Help Groups (SHG) consists of ten associates, mainly women and the second refers to individual/household lending (male/female) introduced in 2003 (Akhuwat, n.d.), which requires two upright guarantors (two witnesses to oversee financial contracts are also a requirement set in the Quran, in Surah Baqarah) from outside their immediate family, as collateral, this is to make up for the lack of group pressure present in group lending. There had been some criticisms by Harper for the use of high interest group lending as “sad, shameful, substandard options “(taken from Neal, 2007) which unfortunately most MFP seem to adopt, because there is a lack of alternatives choices.

Problems had been identified with group lending such as group meetings were time consuming for both the staff and clients, a serious matter among MFP’s (Syed, 2005:31 and Mosedale, 2002:11), there was also concerns about abuse by group leaders accepting funds from people to join the group or undeserving people being selected, based on their high regard in the community rather than their actual need. Furthermore demand was also quite high for individual loans (joint loan agreement with family household has been established, rather than exclusively to individuals) and heightened awareness from the competing MFP’s that group loans were becoming outmoded and disliked. This meant the transition to individualistic loans maybe seen as a unique selling point for potential

⁹ Insurance funds kept in Muslim Commercial Bank (MCB) and Al Falah Islamic Bank (FSSP, 2006:10).

clients. Accordingly Akhuwat intends to phase into individual loans exclusively, especially when their recovery rates were higher at 99.7% while for groups they had been 97.8% (Akhuwat, 2007b).

Women are not primary targets for Akhuwat, although many MFP promote this target market, especially Kashf Foundation which had replicated the Grameen model to empower women by improving their economic status. Although Harper argues that Bangladeshi female clients incurred brutal treatment caused by man's patriarchal power being threatened, in some instances women were violently handled or acid¹⁰ was thrown at them (2007). Microfinance should be about protecting their client's welfare and uniting the family as a unit as achieved by Akhuwat with their household lending methodology. One male and one female member of the family both co-sign and benefit from the loan, this avoids conflict and duplication of loans (Harper, 2007).

Akhuwat have intriguingly targeted women from the sex trade in Heera Mandi (Lahore), a taboo subject matter in Pakistan. It works with an organization that assists prostitutes known as 'Sheed', to provide them with credit to set up small cigarettes/candy/food stalls (taken from Ebrahim, 2006) and make a positive impact in their lives.

6.5 Financial performance

Akhuwat clientele consisted of 90% which were considered extremely poor with earnings below Rs. 4000/month, and the remaining clients were slightly wealthier with creative entrepreneurial ideas that would benefit the community (Harper, 2007). Altogether Akhuwat supplied micro-credit to over twenty one thousand households of which fifteen thousand improved their monthly earnings by 30-40% (Civil Services Pakistan & District Management Group, 2007). However, Figure 5.0 shows that Akhuwat overall has not reached operational or financial sustainability. Nevertheless, the FSSP believed that due

¹⁰ Statistics on such attacks are collected in Bangladesh, unfortunately this is not the case in Pakistan, even though this form of abuse is present, but because it is mainly amongst the poor, it does not appear to raise enough attention (Popham, 2001).

to the low operational costs, “Akhuwat will be able to achieve sustainability in time” (FSSP, 2006:18). Harper adds “Akhuwat is ‘sustainable’ in the sense of being able to survive and grow, very fast.....it depends on the continuation of people’s generosity rather than their ‘greed’, their desire to maximise profits. There is no reason to believe that generosity will wither away any more than greed will, we all share both sources of motivation” (2008).

Figure 5.0 Akhuwat’s Sustainability Index

	2004	2005	2006	2007	Overall Average
Income	369,600	1,755,918	3,397,768	4,942,398	2,616,421
Expenses	521,314	1,731,552	4,425,507	6,920,242	3,399,654
Sustainability Index	0.71	1.01	0.77	0.71	0.77

Source: Author (Income and expenses data obtained from Akhuwat annual reports)

6.5.1 Cost /other benefits

Akhuwat operates in fourteen cities¹¹ in Pakistan, seven are located in urban city of Lahore (Saqib, 2008), while the remainder are outside Lahore comprising of sixty full-time staff, normally hired from local communities (Harper, 2007). This dual benefit allows costs to be kept at a minimum while providing employment opportunities for the very community they serve. Additionally, many staff volunteer their services bestowing a further cost benefit to the NGO.

¹¹ The cities covered are; Rawalpindi , Faisalabad, Multan, Karachi, Dijkot, Samundari, Chiniot, Lodhran, Jehanian, Dunya Pur, Gujrat, Khairpur (Sindh) and Sharaqpur (Saqib, 2008).

Traditionally the role of the mosque at the time of the Prophet (pbuh) was the hub of the community whereby they held numerous activities like judiciary proceedings, education, health centres and so forth. Akhuwat has revived this tradition slightly by utilising the mosque as a place for them to conduct their affairs to deal with the loan agreements and relevant meetings (churches were also used where available, but otherwise Christians attended mosques to acquire loans). This improved “participation, transparency, accountability and solidarity” (Saqib, 2006) as well as the spiritual sanctity these religious establishments holds to fulfil the promise taken to pay loans promptly (Canadian Asian News, 2007:5). These institutions also promote voluntary assistance and fundraising. The absence of offices had greatly reduced the overheads and placed operational costs at 7.5% of the loan amount, this is very low compared to other MFP in Pakistan which claim to be above 22% (Civil Services Pakistan & District Management Group, 2007). Akhuwat is distinguished from other models and viewed as exceptional, inviting keen interest from “two international universities¹² as a part of MBA microfinance curriculum”. (Civil Services Pakistan & District Management Group, 2007).

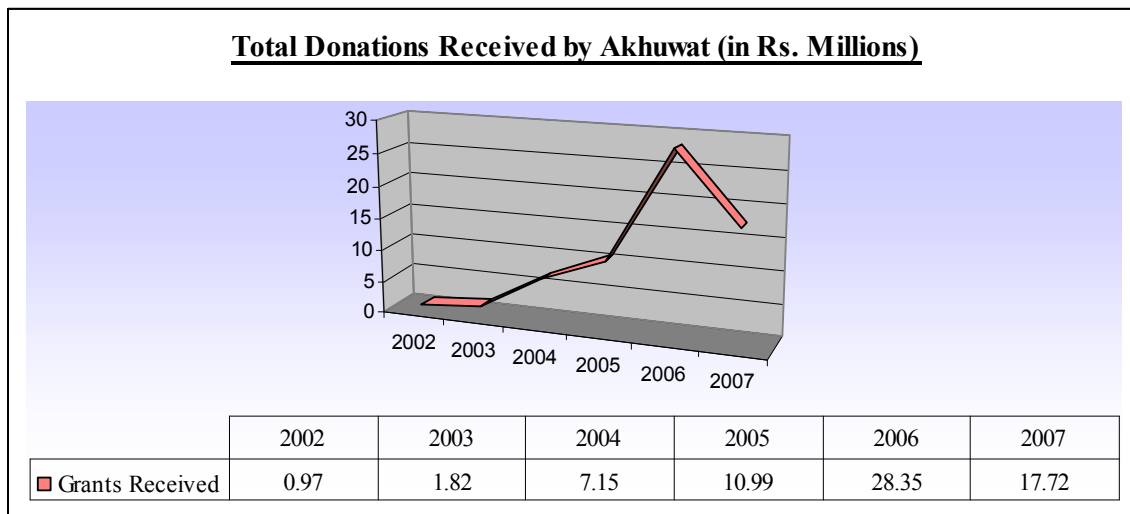
6.6 Sources of funding

Akhuwat obtains funding from their board of directors and local philanthropists (includes General Musharraf, Governor of Punjab), Dr Saqib clearly states that “unlike most NGOs that depend on international funding, it taps the spirit of volunteerism and tradition of giving that is central to Islam” (Ebrahim, 2006). A survey conducted in 1998 by Aga Khan Development Network identifying home-grown philanthropy in Pakistan (see appendix VII), in total over 70 billion rupees were distributed. According to prophetic tradition loans offered to the needy are better and more rewarding than charity (*sadaqah*) in fact the “reward by Allah s.w.t for *sadaqah* is ten times and that of *qard hasan* is 18 times” (taken from Mirakhor, 2007:19). Strong encouragement for people to provide credit to the poor, in preference to hand outs that can support dependency characteristics.

¹² University of New Hampshire USA and Lahore University of Management Sciences (LUMS)

Akhuwat are able to provide benevolent loans since the funding they receive are non refundable to their donors and without preset conditions apart from assisting the needy. Figure 6.0 illustrates the donations received by Akhuwat which has increased dramatically over the years, with an overall average of Rs 6.44m. However, outreach is limited to the amount of donated funds the MFP acquires, as their priority is the depth of outreach rather than the breadth. On the other hand Akhuwat is growing rapidly and achieving sustainability, but probably not to the extent required by the Pakistan’s microfinance industry. Harper does not see why Akhuwat cannot continue to grow with continued support from local donors and voluntary staff, provided extensive exertions are made in raising funds (2007).

Figure 6.0



Source: 2004-07 data taken from audited annual statements (Akhuwat, 2005-2007a) and 2002-03 data (taken from FSSP, 2006:18).

International development agency funding is not accepted by Akhuwat and consequently this would not work well with their product. Since the grant/aid charges interest and would require repayment, neither of which can be accepted by Akhuwat for two reasons; first and foremost interest is forbidden and second Akhuwat are supplying interest free loans with a small service charge. Therefore they would not be able to make these repayments or achieve sustainability.

6.7 Summary

Akhuwat is a bona fide institution that appears to care for the welfare of the poor and it is growing rapidly with realisable sustainability in the future (FSSP, 2006:18). Yet, this should not be left to chance; hence the next section proposes a solution to enhance Akhuwat's opportunities to attain financial sustainability, which will allow this MFP to continue to provide their services to existing and potentially new clients. Poverty is more extensive in rural areas, and although Akhuwat has some branches within these areas, a lot more effort should be made to ensure these low income people have access to financial services. This MFP has shown initiative in targeting unique sectors of the population like the sex trade, another daring consideration would be towards families living under feudal control.

The rate at which Akhuwat is growing is far from the requirement needed to meet Pakistan's outreach goals and naturally it would be extremely difficult for a small MFP to achieve this exclusively. Akhuwat on the other hand campaigns for replication of its model rather than expansion which is also highly recommended by Harper from his interview responses (2008). Its achievements to date should set a positive outlook for the microfinance industry in Pakistan. Ultimately Islamic MFPs can be effective solutions that address the needs of the poor, encompassing social justice goals and not just financial ones.

6.8 Islamic finance proposal

In terms of sources of finance, the following options will be explored for Akhuwat; development of their philanthropic funding, obtaining assistance from the state zakah funds and adoption of Islamic financial instruments that produce profit. Dr Saqib confirmed that Akhuwat are intending to apply for a MFI/MFB license in two/three years time, by which point they intend to offer savings and Islamic finance products (2008). The savings will also assist Akhuwat to achieve sustainability and expand their services.

6.8.1 Sources of funds

Although *qard hasan* has proved to be a beneficial tool for Akhuwat and their clients by reaching out to the extreme poor (Harper, 2007), this alone cannot assist Akhuwat to achieve sustainability. It is clear from the findings in this study, that financial sustainability is necessary for long term survival of the organisation and to achieve large scale outreach. Akhuwat are fortunate that their cost of borrowing is zero; the donations they receive are not required to be repaid to the donors and therefore can be reused to benefit other clients. This form of philanthropy is not expected to cease bearing in mind, benevolent loans are highly recommended acts of worship in Islam and the reward from Allah is eighteen times while giving charity is ten times (Mirakhor, 2007:19). Therefore, enticing Muslims to part with their funds for this cause, as *qard hasan* is more beneficial to society than acts of charity and the fact that these funds are continuously recycled, original donors benefit from this incessant reward.

Akhuwat is unique in that it is predominantly reliant on the generosity of local philanthropists and their board of directors. The Pakistan Centre for Philanthropy (PCP) (of which Akhuwat is a member) found that Pakistani's are inspired by their faith to give to the poor and needy directly, but people had very little trust in organisations to perform this duty. Nonetheless, philanthropy in Pakistan remains largely unexploited and has now been recognized as an approach in the poverty reduction strategy by the state (Ali, 2004). A one off study conducted in 1998 by Aga Khan Network found individual giving in Pakistan to be reasonably high and religion appears to be an important factor with regards to social giving (see appendix VII). About Rs 70.5billion were distributed by individuals, of which 46% went to charitable organisations.

Unfortunately, institutional Philanthropy is generally perceived as 'inefficient, dishonest, ineffective and inattentive' and information on philanthropic organisations is also limited to overseas Pakistani's (PCP, 2005:3). Nevertheless, philanthropy diaspora is still popular for overseas Pakistani's as found in a recent study conducted for PCP (2005:1). Fifty-two percent of American Pakistani's contribute more than half of their charitable contributions directly to causes in Pakistan while 44% give more than half their donations

to faith-motivated giving. Although the trend was to focus on donating to family/friends since there is a lack of trust with organisations (PCP, 2005:2).

Akhuwat needs to provide a large-scale publicised campaign targeting donors locally and overseas. It will not be an easy exercise to influence the already tainted perception of philanthropy organisations in Pakistan, but it is a fruitful source of funding once unlocked, as demonstrated by prominent organisations like the Edhi Foundation¹³ which is well known to nearly all Pakistani's. If donors are unaware of the MFP and their services, it makes it difficult for them to donate to this cause (PCP, 2005:3).

Akhuwat has decided upon abstaining from International aid, allowing them to continue business as they wish, without hidden agendas set by aid agencies. Additionally, institutions like PPAF, ADB provide interest based grants, which is unacceptable in an Islamic finance environment. The first concern is a matter of Akhuwat's policy and methodology; they have demonstrated success without the need for subsidised credit, so presently there is no need to implement any change in this policy. However, for the purpose of new Islamic microfinance entrants, the second concern can be resolved. In fact, World Bank and ADB are already taking an interest in the Islamic financial market (Usmani, 2008), (ADB, 2006). During General Zia-ul-Haq's era, International Finance Corporation (World Bank Subsidiary) had agreed to supply shariah compliant grants (Usmani, 2008). Hence the notion of obtaining Islamic financial grants is not a complete obstacle for institutions requiring international grants at the earlier stages of their MFP development.

Akhuwat should explore the use of *zakah*; a religious obligation upon Muslims to distribute a portion of their wealth annually to the poor and other righteous categories in the Quran¹⁴. Pakistan's government currently collects *zakah* on some assets at source and Akhuwat could negotiate a regular supply of these funds. *Zakah* funds are ongoing and

¹³ Largest welfare organisation in Pakistan formed by one man, Pakistani's have a lot of trust in the services provided by this charitable organisation and would donate to this organisation frequently.

¹⁴ In surah Tauba, it is stipulated that *zakah* can be distributed to eight categories of people. "Sadaqat (zakat) are only for the poor and the needy and those employed to administer it and whose hearts are made to incline (to truth) and (to free) the captives and those in debt and in the way of Allah and for the way-farer, an ordinance from Allah" [Al-Quran 9:60].

there is no requirement to repay the donors or any sign of this source diminishing. It will also ensure the extreme poor are being reached by Islamic microfinance (Ahmed, 2002:15). Malcolm Harper insists that if *zakah* funds were used with the flexibility to reach non-Muslims and avail funds throughout the year rather than in the month of Ramadan, the ‘sky is the limit’ (2008). *Zakah* is a lasting source of funds that will aid sustainability and is unlikely to go out of fashion as claimed by Rhyne (taken from Robinson, 2001:25).

Nevertheless, *zakah* may need to be used for specific purposes like replacing Akhuwat’s liberation loans and clearing clients of prior burdened debts. A reasonable amount can be undertaken for administering this *zakah* fund and for ease it maybe worthwhile keeping a separate *zakah* account to ensure it is used in accordance to categories permitted in the Quran. Although, there are some scholars like Qaradawi, Maududi that have permitted the use of *zakah* for qard hasan (taken from Ahmed, 2002:12). This is controversial since it does not transfer ownership of the *zakah* funds to the recipient (principle of *tamleek*). This is a stringent requirement of disbursing *zakah* under the Hanafi School which is followed by the majority of Pakistani Muslims (Clark, 1986:80). However, Zafor claims, many scholars have allowed for *zakah* funds to be used by the institutions and they do not need to be given to the recipients directly (n.d.:14).

6.8.2 Modes of financing

This study does not intend to go into the detailed mechanics of Islamic finance products as the concern is more to do with the suitability and benefits of Islamic microfinance than how they work. The following instruments will be reviewed; *mudarabah*, *musharakah* and *murabaha*, the first two are equity based while the last instrument is debt based (but asset backed).

Mudarabah is a profit sharing contract between the MFP (*rabb al-mal*) and the entrepreneur client (*mudarib*), the profit-sharing ratio is predetermined (no fixed lump sum), the *mudarib* is exclusively responsible for management, any financial losses are

absorbed by the MFP, while the entrepreneur's loss pertains only to their labour efforts provided there is no negligence on their part in which instance they would be financially liable. This is particularly encouraging for vulnerable clients who are already low on capital. However there are concerns like the increased paperwork required, but fortunately only 27.5% of Akhuwat's existing clientele had no formal education (Chapter five; Akhuwat, 2007). Mudarabah also requires the clients to be honest when declaring their profits and to ensure some control over the contract, Akhuwat can set some conditions; this will then become a restricted mudarabah.

Akhuwat could also adopt musharakah (profit sharing contract), a joint venture/partnership whereby all parties involved, provide capital and share management duties which reduces informational asymmetry. Profits, losses and investor's rights are apportioned in accordance to capital provided. The majority scholarly opinion is that the capital should be monetary rather than commodity form, as it is easier to share and divide money than assets (Usmani, 1999:39). Any partner can dissolve the partnership by leaving the contract upon giving notice to other members or upon death or insanity of a partner (Usmani, 1999:42).

As part of Harper's interview response he believes musharaka to be the purest form of Islamic finance instrument for its equitable properties of sharing gains and losses, "its built in protection against inflation, and its religious acceptability" (2008), but he also recognised concerns regarding "dependence on trust and ability to measure profits of micro-enterprises, the time and cost taken to assess profits in relation to the scale of lending... and its association with a religion which has recently attracted lots of bad publicity because of the destructive behaviour of a few of its adherents" (2008). Nevertheless, publicity in terms of Islamic finance should not be a deterrent, especially when the Islamic banking industry is reaping in profits which tend to be the main concern for providers.

Finally, murabaha entails the purchase of a commodity which is sold onto the client at a mark-up. It is among the simpler forms of Islamic finance tools, with a pre-determined fixed contract which requires no paperwork from the client, hence easier to implement.

In 2006, SBP found this to be the most common tool used by Islamic Banking institutions in Pakistan (Ahmad I, 2007:4). Additionally, Pakistan generally has a high illiteracy rate and murabaha is simple, it eliminates any ambiguity as it is clear of who owes what. Once the debt is paid off, the contract comes to an end. Nizam Yaquby prefers murabaha as there are more references in the Quran and Sunnah of deferred sales than profit and loss partnerships (taken from Goud, 2007:2). On the other hand many people had criticised murabaha claiming it resembles interest based financing, but ultimately it is a debt based instrument.

However, the adoption of Islamic finance may entail further costs and divergence from Akhuwat policy of using mosques to conduct financial affairs. Market dealings in mosques are prohibited, as reported by Abu Hurayrah in Al-Tirmidhi and al-Nisai that Prophet Muhammad (pbuh) said, “If you saw a man buying and selling in the mosque, say to him, ‘May Allah never make you trade profitable’” (taken from role of mosque, n.d.:9). Alternative voluntary premises maybe required, for Akhuwat to maintain low costs, an option could be to have a memorandum of understanding with the government’s *zakah* institutions¹⁵. They have many *zakah* offices and volunteers across Pakistan that can assist Akhuwat to reach many clients (including those in rural remote areas) as well as ensure some link to a religious institution of social welfare. Other options maybe to work with Meezan bank to increase replication of their model and ultimately outreach or like FMFB, Akhuwat could work with Pakistan post (4000 sub-offices) to address the low microfinance outreach.

¹⁵ Pakistan is made up of zakah committees consisting of up to ¼ million Muslim volunteers. There are 114 district zakat committees and 39,445 local zakat committees [Government of Pakistan, Ministry of religious affairs, zakat and ushr, 2006]

Chapter 7- Conclusion and Recommendations

There are mixed reviews on whether or not microfinance helps to reduce poverty, but what it does do, is attempt to provide the poor, with a range of financial services to improve their equality of opportunity. Microfinance is not a flawless tool; there are issues that one should not turn a blind eye to, group lending can at times be callous, medieval and lead to dropouts even though they help to reduce informational asymmetry and MFP costs. There are also informational asymmetry issues with women who are abused by male relatives to obtain loans (Ahmed, 2002:7), therefore not all women are empowered. Conventional microfinance's answer to credit risk, informational asymmetry issues, and sustainability is to increase interest rates. Regardless of whether the poor are able to afford the repayments; it is still exploiting them as identified in Christian and Jewish scriptures (Dar, 2003:2). Microfinance should be about assisting the poor and not increasing their vulnerability.

The microfinance industry in Pakistan is still developing, and it tends to follow the welfarist paradigm offering mainly credit. However, SBP, government, PMN have identified the need to focus on sustainability, which they believe is best served through commercialising microfinance. The main reason for lack of sustainability had been due to the low interest rates charged by MFIs, because increasing these rates would be deemed usurious (DIFD, 2006:57). Financial access study is also expected to produce results on the financial access barriers the poor face, one presumed constraint has been religious obstacles (riba). Even though only 5% of the potential microfinance market had been served (which Harper believes is not bad (2008)), what is more worrying is that there are even fewer Islamic alternatives available to the poor.

SBP and the government have been crucial in providing an enabling environment for microfinance and this has been reflected in the assistance and regulations set for the industry. Macroeconomic stability is important for the success of microfinance but this can only be attained if political stability is maintained. Although progress has been slow,

the industry has reported a growth rate of 40% and there are still many innovative ideas being implemented like FMFB's agreement to work with Pakistan post counters, branchless banking and so forth. Meezan commercial Islamic bank is also expected to be the new entry into the microfinance industry.

Although religious scholars and Islamic economists are eager to develop Islamic banking and ultimately proceed towards a riba free economy, the support from the government is still lacking and this is even more the case with the current political instability. Nevertheless expertise and knowledge in this field are available in Pakistan, which gives it a better chance to changeover to a riba free economy than most countries, but in terms of Islamic banking progress it is still lagging behind Malaysia and Bahrain. However, the petition for an Islamic economy is still under review with the Supreme Court. Executive of SBP believe a phased approach towards Islamisation would be favoured by the government as its less disruptive (Kazmi, 2002). Additionally, there is a need to educate people on the benefits of islamising the economy, because in the financial access study to date people were found to be generally ignorant on these matters.

The main claim from the institutionalist school is that external funding is limited and therefore cannot assist with sustainability because according to Rhyne, "only private sector has plenty of resources and will stick with a moneymaking activity even if it is not in fashion" (taken from Robinson, 2001:25). This study has shown that Islamic MFPs have alternative means of funding like *zakah* which is unlikely to diminish. Akhuwat has also demonstrated in their methodology that the use of philanthropy especially among Pakistani Muslims can be a fruitful source of income. Cost of borrowing is zero, which greatly reduces the Akhuwat's costs, but their policy of using religious establishments to conduct business have also minimised costs. Most importantly Akhuwat have been able to reach the extreme poor and with further donations and outreach, they will soon achieve sustainability with greater economies of scale. However tapping into *zakah*, developing philanthropy (internationally) and introducing Islamic finance products as well savings once they gain their microfinance license should produce astounding results in terms of

achieving the double bottom line (social and financial objectives) for Akhuwat and perhaps for others who are willing to replicate this model.

In terms of future research, it is clear that poverty is heightened in rural regions of Pakistan, strategies to deal with this are either at their early stages or very little has been done to tackle this issue head-on. One of the constraints has been the control of the poor by feudal families, this is an area which requires further research, especially when some forms of labour / debt bondage is reminiscent. One of the main limitations of this study has been the lack of empirical support, this has been due to time and costs constraints, but this study could be used as a basis of future field studies of Islamic MFP in Pakistan like Akhuwat and Meezan Bank.

Appendix I Microfinance Ordinance Terminology

Box 3.1 Note on terminology: MFIs and MFPs

In many countries, the term ‘microfinance institution’ is used to designate any institution that provides MF services. Under the *Microfinance Institutions Ordinance 2001*, however, the term is restricted to ‘a company that accepts deposits from the public for the purpose of providing MF services.’ The Ordinance prescribes that ‘No person other than a licensed MFI shall use with its name the words “Microfinance Bank”, “MFB”, “Microfinance Institution”, “MFI” or derivatives of any words or letters which suggest that it is a microfinance institution.’ (Article 5(2)).

For the purposes of this PSIA, therefore, we have distinguished between:

MFI a microfinance institution licensed under the Ordinance

and

**MFP a microfinance provider: any institution that provides microfinance services
(which includes MFIs)**

Source: (taken from DIFD, 2006:35)

Appendix II

MFP ; members of Pakistan Microfinance Network

REPORTING ORGANIZATIONS

Category	MFP	Reporting Period	
		Quarter 2	Quarter 3
		2007	2007
MFB Microfinance Bank licensed and prudentially regulated by the State Bank of Pakistan to exclusively service microfinance market	Khushhali Bank (KB)	✓	✓
	Network MicroFinance Bank Ltd. (NMFB)	×	×
	Pak-Oman Microfinance Bank Ltd. (POMFB)	✓	✓
	Rozgar Microfinance Bank Ltd. (RMFB)	✓	✓
	Tameer Microfinance Bank Ltd. (TMFB)	✓	✓
	The First MicroFinanceBank Ltd. (FMFB)	✓	✓
MFI Microfinance institution providing specialized microfinance services	Akhuwat	✓	✓
	Asasah	✓	✓
	Kashf Foundation	✓	✓
	Orangi Pilot Project (OPP)	✓	✓
	Sindh Agricultural and Forestry Workers Cooperative Organization (SAFWCO)	✓	✓
RSP Rural support programme running microfinance operation as part of multi-dimensional rural development programme	Lachi Poverty Reduction Project (LPRP)	✓	×
	National Rural Support Programme (NRSP)	✓	✓
	Punjab Rural Support Programme (PRSP)	✓	✓
	Sarhad Rural Support Programme (SRSP)	✓	✓
	Thardeep Rural Development Programme (TRDP)	✓	✓
NGO Non-government organization running microfinance operations as part of multi-dimensional developed programme	Centre for Women Cooperative Development (CWCD)	×	✓
	Community Support Concern (CSC)	✓	✓
	Development Action for Mobilization and Emancipation (DAMEN)	✓	✓
	Jinnah Welfare Society (JWS)	✓	✓
	Narowal Rural Development Programme (NRDP)	✓	×
	Organization for Participatory Development (OPD)	✓	✓
	Rural Community Development Society (RCDS)	✓	✓
	Save the Poor (STP)	×	✓
	Sindh Rural Support Program (Srsp)	×	×
	Sungi Development Foundation (SDF)	✓	✓
	Swabi Women's Welfare Society (SWWS)	✓	×
Taraqee Foundation (TF)	×	×	
CFI Commercial financial institution providing microfinance services as separate function	ORIX Leasing Pakistan Ltd. (OLP)	✓	✓
	Bank of Khyber (BOK)	✓	✓

Source: (Haq, 2007:16)

Appendix III

M. Harper Interview Questions

- 1) Is microfinance an effective tool to deal with poverty alleviation? If not what benefit does it bring?
- 2) Which microfinance approach do you believe is best for poverty alleviation in Pakistan or in general?
- 3) Do you believe the answer to poverty alleviation is sustainable microfinance institutions? Please state why?
- 4) What are your thoughts on sustainability with regards to Akhuwat?
- 5) Do you think Akhuwat can be sustainable on a long term basis? Why?
- 6) What can Akhuwat do to achieve greater outreach?
- 7) Should Akhuwat adopt the financial lending approach? Please explain your answer.
- 8) Are you familiar with the Islamic finance products?¹⁶ (like qard hasan (interest free charitable loans), mudharaba, murabaha, ijara, salam, musharakah and so forth).
Yes _____ No _____ Other, please specify _____
- 9) What benefits or concerns can you envisage with Islamic microfinance? Bearing in mind Islamic finance has a number of financial instruments as mentioned above.
- 10) It has been claimed in Pakistan that only 5% of 65 million poor households have been reached by microfinance. Why do you believe the outreach has been so low in Pakistan?

¹⁶ Standard Glossary had been provided to interviewee for Islamic finance product terminology, but author did not feel it was necessary to be included as part of this section.

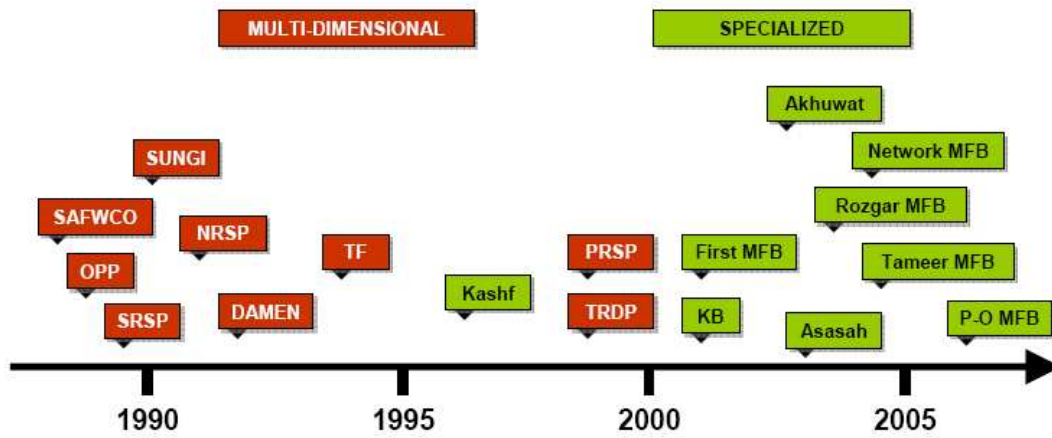
Appendix IV

Dr A. Saqib Interview Questions

- 1) Are the membership fees that you charge to your clients the same as service charges?
- 2) Do you offer savings program as this service can be of greater demand amongst the poor? In India, self help groups were able to deposit their savings at a designated bank. Are you planning any such collaboration with local banks?
- 3) Are you offering conventional insurance which is also compulsory with each loan
- 4) Are there any possibilities for you to offer micro-takaful services (Islamic micro-insurance)?
- 5) Do you plan to offer other Islamic finance modes, like musharakah (joint venture), murabaha (cost plus mark up), ijara (leasing) etc?
- 6) What are the selection criteria for your clients? And where are most of your clients located in Pakistan?
- 7) Apart from micro-credit and insurance, are there any other services offered by Akhuwat?
- 8) In what way can Akhuwat contribute to the microfinance industry in Pakistan in terms of achieving greater outreach?
- 9) Land and building was purchased in year ending 2007 (Rs 3,668,816), please confirm the function of these assets and how these assets were funded?
- 10) In terms of grants, what percentage comes from the directors and what percentage comes from local donors?

Appendix V

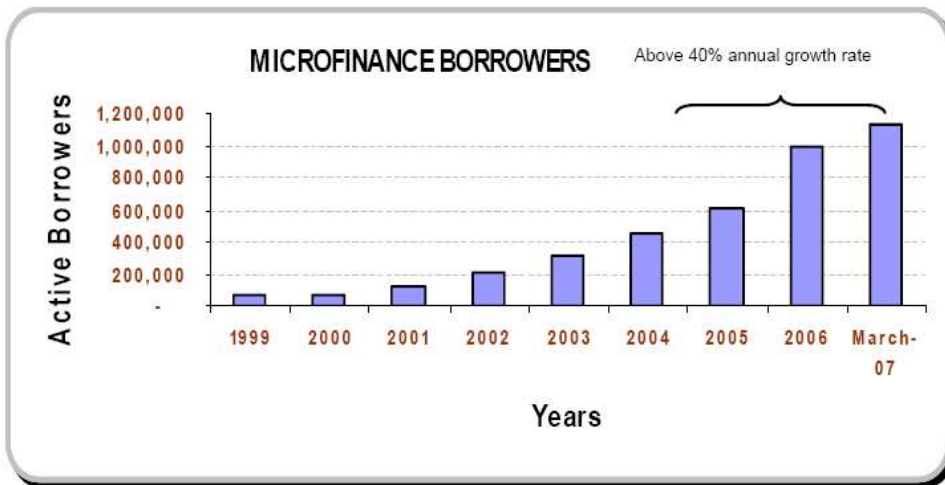
Trends in Microfinance - specialized institutions growing



Source: (Microfinance Sector Development and Regulation in Pakistan and Afghanistan, 2007:13).

Appendix VI Microfinance Growth in Pakistan

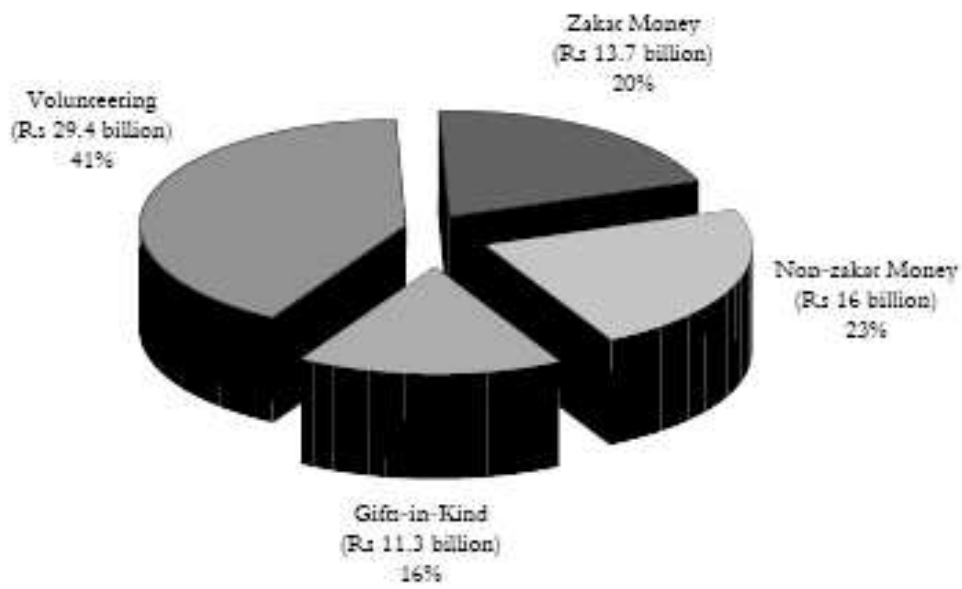
40% growth puts Pakistan in the top quartile globally



Source: (Microfinance Sector Development and Regulation in Pakistan and Afghanistan, 2007:12).

Appendix VII

Aggregate Giving by Individuals in 1998



Source: (taken from Gilani, 2006:75)

Appendix VIII

Political Instability Summary

Pakistan has had a lot of bad publicity recently with the country enduring great political unrest. Several events have led to this disarray; it started with the forced resignation of Chief justice by the government, then the downfall of the Red Mosque, return of exiled former prime ministers of Pakistan, Benazir Bhutto and Nawaz Sharif, the state of emergency enforced by the President/Chief of Army and then the most recent occurrence was the assassination of Benazir Bhutto on 27th December 2007 in Rawalpindi (Pakistan), this occurred literally two weeks before the elections of 8th January 2008 which were subsequently postponed. Many of the Pakistani public and the media have fiercely opposed the government, in particular the President, who from mounting pressure resigned from his dual role of chief of the army in Nov/Dec 2007. Additional concerns had arisen from the conflict the government had been fighting terrorism on what is seen as General Musharraf (President of Pakistan) support for Bush's western policies. This invited increasing opposition and conflict from the people of Pakistan as well as North West Frontier (who are claimed to support the Taliban). These issues multiplied after the downfall of the Red Mosque in Islamabad.

Source: Author (information gathered from several television news reports).

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