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ISLAMIC FINANCE AND THE ROLE OF *QARD-AL-HASSAN* (BENEVOLENT LOANS) IN ENHANCING INCLUSION: A CASE STUDY OF *AKHUWAT*

Zamir Iqbal[1], Bushra Shafiq[2]
[1]World Bank
[2]State Bank of Pakistan1

***Abstract**: In contrast to conventional approach to social finance Islamic economic system is an integrated approach towards improving overall well-being of the society though this does not disallow individual's self-interest within the ambit of morals. In this background our paper reviews perspective of Islamic finance on financial inclusion and discusses the significance of one of its key redistributive instruments, i.e., Qard-al-Hasan (QH: benevolent loans) in reinforcing the social unity and cooperation. Our paper presents the Case Study of an Islamic microfinance organization, Akhuwat, (literary meaning solidarity) to illustrate how significant QH can be on the landscape of social and sustainable finance in developing countries. The paper in its final section suggests policy recommendations for capitalizing on the immense potential of QH towards the objective of social justice especially in Muslim dominated countries.*

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Introduction

This paper discusses the role and significance of one of Islam's redistributive instruments- *Qard-al-hassan* (benevolent loan) in the backdrop of today's appetite for ethical finance especially for poor. In the prevalent economic system, global thought leaders have long been unable to identify its structural drawback of being devoid of equity affecting the sustainability of growth and development. This failure is despite the fact that the originator of conventional economics, Adam Smith, had not ignored the element of ethical system for competitive market economy. However, at the inception of this millennium, the world has unanimously agreed upon fighting against poverty as was reflected in UN Millennium Declaration 2000. In this context, financial inclusion

[1] Zamir Iqbal is Lead Financial Sector Specialist in Finance and Markets Global Practice of The World Bank. He heads the World Bank Global Islamic Finance Development Center in Istanbul. Bushra Shafiq is Joint Director at Islamic Banking Department of the State Bank of Pakistan in Karachi. Views expressed in this article are the views of the authors and do not reflect the views of their affiliated institutions.

has been identified as one of the most efficient and effective channels towards poverty alleviation, which ensures a widespread participation in the development process. A target of universal financial access by 2020 has been announced by the World Bank (Naceur et al., 2015).

Financial inclusion, in general, implies the provision of adequate and affordable financial services to all segments of the society that are un-served or underserved by formal financial system; irrespective of whether the group is excluded voluntarily or involuntarily. Ironically though, measures/instruments/models of financial inclusion are now being criticized for excluding a certain segment of population - the poorest of the poor (economically inactive masses) (Kernani, A. 2007) due to their inability to cater to this group.

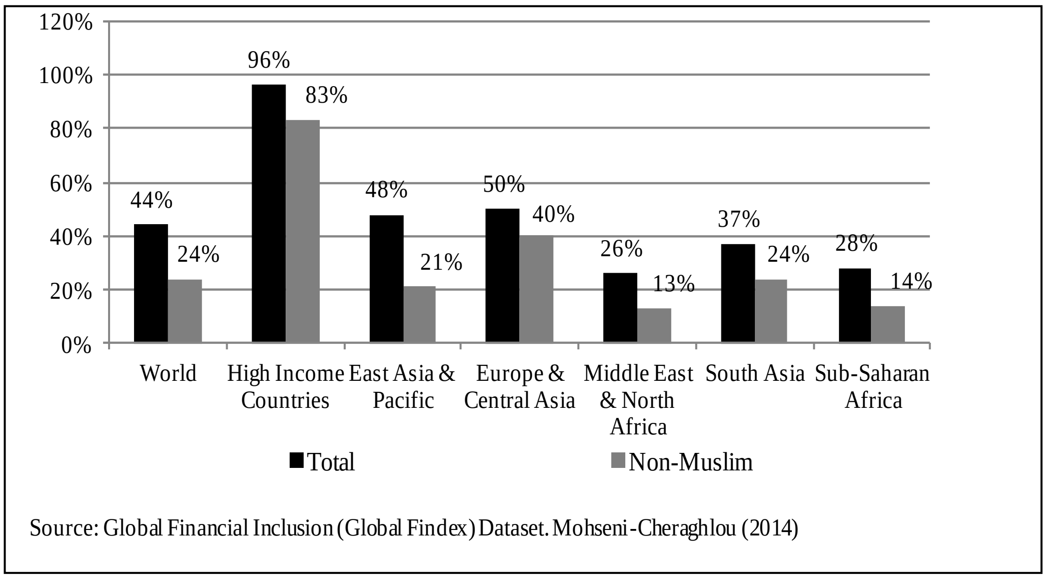

Figure 1 Differences in Financial Inclusion between Muslims and non-Muslims, 2011

Note: The difference between Muslims and non-Muslim is statistically significant at 1% level. Analysis is based on 64 countries.

Although, degree of access to finance is a serious issue for all developing countries, the problem is more severe for Muslim countries (Iqbal and Mirakhor, 2013). In a sample of 41,922 individuals in 39 countries with Muslim population between 5 and 95 percent of total population, self-reported Muslims are less likely (i) to have a formal account, and (ii) to save at a formal financial institution, after controlling for individual characteristics and country fixed effects.[2] Figure 1 compares use of formal bank accounts between Muslims and non-Muslims. Low level of access is attributed to several factors including the absence of Islamic finance.

In contrast to conventional economic system where focus on social welfare is one added element, the central focus of Islamic economic system is on economic and social justice and towards improving overall well-being of the society though this does not disallow individual's own pursuit of personal interest within the ambit of morals and wider interest of the society. The Islamic social financial infrastructure comprises of institutions and instruments that work on

[2] World Bank (2013).

principles of social justice, risk-sharing, and mutual co-operation. In effect, such an infrastructure minimizes the risk of unsustainability and ineffectiveness of targeted programs in improving overall welfare of the society. *Zakah, Sadqa, Waqf* and *Qard-al-hassan* are time-tested instruments of Islamic economics for distribution and redistribution of wealth and, if effectively used, can play a key role towards sustainable development process. With this background, the paper discusses the significance of *Qard-al-hasan* in the landscape and scale of social and sustainable finance due to its intrinsic strengths of achieving the objective of social justice.

Section II builds up the discussion on the role of *Qard-al-hassan* in enhancing inclusion with the brief introduction of this instrument, its underlying principles and its importance in light of *Quran* and *Sunnah* - the primary sources of Islamic finance. This is followed by the theoretical debate on the potential of *Qard-al-hassan* in establishing the foundations of Islamic concept of financial inclusion.

Section III of the paper presents the Case Study of *AKHUWAT*[3] to illustrate how significant *Qard-al-hassan* can be on the landscape of social and sustainable finance. Finally, Section IV concludes the discussion with the premise that despite the immense potential of *Qard-al-hassan* in reinforcing the social fabric recommended by Islam; it is currently not making significant contribution in improving/enhancing the social and financial inclusion in Organization for Islamic Cooperation (OIC) countries[4]. This section makes policy recommendations to institutionalize the instrument to enhance financial inclusion in OIC countries where due to market-failure; commercial based microfinance solution is not available.

Role of *Qard-al- Hassan* in Financial Inclusion

The core principles of Islam place great emphasis on social justice, inclusion, and sharing of resources between the haves and the have-nots. Islamic finance addresses the issue of financial and social inclusion from two directions: one by promoting risk-sharing contracts that provide a viable alternative to conventional debt-based (risk-shifting) financing; and the other through voluntary and involuntary instruments of redistribution of wealth in society. Both risk-sharing financing instruments and redistributive instruments complement each other to offer a comprehensive approach to enhance financial and social inclusion, eradicate poverty, and build a healthy and vibrant economy. The second set of instruments meant for redistribution are used to redeem the rights of the less able in the income and wealth of more able. Contrary to common belief, these are not instruments of charity, altruism, or beneficence, but instruments of redemption of rights and repayment of obligations (Iqbal and Mirakhor, 2013).

One of the primary tenets of Islamic finance is unconditional prohibition of interest in lending transactions. This prohibition implies prohibition of any debt or loan which carries a monetary reward tied to the time of lending. Thus, due to the prohibition of interest, the instrument of debt is prohibited. However, two kinds of loan (*Qard*) are permissible and one of these is highly recommended. Islam recognizes and permits a loan from one party to another with a promise to pay back the principal but without any interest or return or rent. This is a typical no-

[3] We are thankful to *AKHUWAT* for sharing the data with us. All figures are based on data provided by *AKHUWAT* unless stated otherwise.

[4] OIC contains 57 member countries.

cost loan for consumer and commercial purposes. However, the other kind of loan known as *Qard-al-hassan* (benevolent loan), identified as a loan for community members who are under financial distress and therefore, has special purpose in the Islamic economic system.

Qard-al-hassan is a loan mentioned in the Qur'an as "beautiful" (*hassan*), probably because in all the verses in which this loan is mentioned, it is stipulated that it is made directly to Allah (swt) and not to the recipient (see, for example, Chapter 64, verse 1, other relevant verses are 2:245; 5:12; 57:11; 57:18; 73:20). It is a voluntary loan, without any expectation by the creditor of any return on the principal. In addition, while the debtor is obligated to return the principal, the creditor, of his own free will, does not press the debtor for an exact timing of its return. Allah (swt) promises multiple returns to the "beautiful loan."

Key characteristics of *Qard-al-hassan* are as following:

- It is a non-rewarding loan (with no expectations of any monetary return) but the borrower is under moral obligation to repay the principal depending on the borrower's financial capacity to do so. The creditor would forego the demand for payment of principal if despite best efforts and good intentions by the borrower; he/she cannot repay the principal due to economic hardships.
- The incentives for lenders to extend credit based on *Qard-al-hassan* are clearly benevolent and spiritual as they are abiding by Allah's Command to supply such loans for benevolent purposes. The element of benevolence and expectation of reward from the Creator in this world or hereafter is the expected return instead of any monetary reward. For the lenders, no monetary reward can be monetized for such benevolent act. Sadr and Torabi (2015) make an interesting observation arguing that rational lenders optimize the return to their portfolios by constructing a diverse portfolio of *Qard-al-hassan* lending and investments in risky assets—thus optimizing return on their portfolio through combining monetary and non-monetary returns.
- The primary objective of *Qard-al-hassan* is to help poor get on their feet to become part of economic activities in a dignified and cost effective manner. Since poor do not have any material collateral, social capital is the only collateral for extending such credit. This also provides an incentive to poor to perform and be able to have access to such credit in the future.
- The practice of *Qard-al-hassan* has also been associated with enhancing harmony among poor and rich segments of the society which leads to more cooperative, collaborative, and caring society.
- The institution of *Qard-al-hassan* can be effectively used to eradicate extreme poverty through opportunities to poor to create new jobs market and business ventures by using their merits, skills and expertise.
- Finally, *Qard-al-hassan* can serve as tool to enhance financial and social inclusion in the society[5]. By extending credit to poor, they can be brought into the formal financial sector and as they come out of poverty, they are better integrated and included in the society. In this respect, *Qard-al-hassan* is one of the tools to achieve economic and social justice as envisioned by Islamic economics.

The experience with microcredit or microfinance has been mixed, as there is growing consensus that the expectations were overestimated. There are serious challenges in achieving

[5] For further details, see Mohieldin, Iqbal, Rostom, and Xu (2011)

sustainable impact on poverty alleviation. One of the key criticisms of commercial and conventional approaches to microfinance is the existence of high cost of borrowing as a result of high interest rate. These high rates are justified because of high transaction costs and high risk premium. However, this imposes undue stress on the recipient to engage in activities that produce returns higher than the cost of funding—which may not be possible in many cases.

While the advantages of microfinance institutions are undeniable, there are well known drawbacks to this method of financing for poor; the most serious one, from the point of view of Islam, is the cost of financing charged on microfinance loans. Whatever the justification and/or the reasons these are for high interest rates—and there are economically justifiable reasons—from an Islamic point of view high and at times exorbitant, interest rates are exploitative, unjust, and repressive especially for the poor and therefore are considered an abomination. The alternative of *Qard al-hassan* provides a viable option for the poor (Iqbal and Mirakhor, 2013).

Qard-al-hassan works on the basic axiom of Islamic development according to which, the poverty is an outcome of israf (overspending), itlaf (wasting), and the non-payment to lower segment of society (Mohieldin et al. 2011). The unique structure of Qard-*al-hassan* makes use of the distinguished feature of property rights as prescribed by Islamic economic system which offers rights in resources to all even to those who don't own them through the principle of distribution and redistribution (Mirakhor and Bao, 2013). This demonstrates *Qard-al-hassan* having great potential to meet the objective of enhancing financial inclusion as has been defined by United Nations in its blue book "Building Inclusive Financial Sectors for Development", as the "*access to the range of financial services at a reasonable cost for the bankable people and farms*".

Qard-al-hassan based lending has been practiced throughout the Muslim communities and it has been an established practice. However, formal use of *Qard-al-hassan* as a tool for microfinance and financial inclusion is relatively recent. There are several countries including Bosnia Herzegovina, Islamic Republic of Iran, Indonesia, Pakistan, and UK where *Qard-al-hassan* is being used for extending microfinance. In case of Islamic republic of Iran, large number of formal and informal funds have been established in mosques, organizations, and rural communities. In addition, practice of establishing such funds among families and peer groups is widespread.[6]

To summarize, *Qard-al-hassan* is a viable option to reduce financial exclusion by extending financing to poor especially those who do not have access to any commercial microfinance lending either due to lack of collateral or lack of affordability owing to high cost of funding or no credit history. Given wide spread poverty in OIC countries, *Qard-al-hassan* provides a complementary tool to fight financial exclusion. The next section provides a case study of a microfinance institution operating on *Qard-al-hassan*.

[6] For further details on Qard-al-hassan Funds in Islamic Republic of Iran, see Mirakhor (2002) and Sadr and Torabi (2015).

AKHUWAT Case Study

This section presents the case study of *AKHUWAT* (literally meaning solidarity) to illustrate how significant *Qard-al-hassan* can be on the landscape of social and sustainable finance. *AKHUWAT*, the pioneer Islamic microfinance institution in Pakistan, has successfully demonstrated the utility of the product of *Qard-al-hassan*. Based on the concept of "solidarity" or "fraternity", the organization is playing an instrumental role in redistribution of resources, and has also been able to run it on sustainable basis. However, the scalability of model can be affected with uncertain flow of funds. This model while establishing the viability of Islamic microfinance highlighted the significance of community based organisations. The model of *AKHUWAT* signifies that every community needs a customized version of programs /organisation for poverty reduction/alleviation that is consistent with the prevailing culture and norms. Customisation of program has been identified even by the World Bank as one of necessary conditions for poverty reduction (Haq & Shafiq, 2015).

Historical Background

The idea of organized interest free lending in Pakistan was conceived realizing high interest rate charged by microfinance institutions which is contrary to both, the principles of Islam and the primary objective of microfinance i.e. helping destitute and reducing poverty. This idea led to the establishment of a microfinance institution offering loans on the basis of *Qard-al- hassan* (interest free loans) in 2001. Derived from Islamic history the name of the organization; "*AKHUWAT"* meaning "*Muakhaat*", implying brotherhood was chosen to reflect the philosophy of the organization. This illustrates the concept of Islam that places responsibility on affluence of the society to share their wealth and resources with those who are deprived of these.

The success of the very first loan of Rs. 10,000 (US $ 100) to a widow borrower extended conviction to the viability of this alternate model of microfinance[7]. Consequently, donations to serve as equity to this fund started rising and within a period of two years donations raised to Rs. 1.5 million (US $ 15 thousand) from Rs. 10,000 (US $ 100) with 100 percent recovery rate. This modest success raised the need for a formal structure for effective and efficient utilization of these funds. Subsequently, *AKHUWAT* was formally registered in 2003 under the Societies Registration Act of 1860 and the very first branch was opened at Lahore. Since then, the organization has been growing and the model is spreading; exhibiting the miracle of "*Muakhaat*" by transforming borrowers into donors for the very first time in the history of microfinance.

AKHUWAT is working with the mission of "alleviating poverty by empowering socially and economically marginalized families through interest free microfinance and by harnessing entrepreneurial potential, capacity building and social guidance" towards achieving its vision; "A poverty free society built on the principles of compassion and equity"[8].

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[7] The borrower returned the loan within a period of six months while started successfully running her business along with marriage of her daughter.

[8] Source: Akhuwat website (http://www.akhuwat.org.pk)(accessed on Nov 10, 2014)

Organisational Structure[9]

AKHUWAT works under the supervision of Board of Directors (BOD) that consists of seventeen members including philanthropists, civil servants and businessmen. BOD works on honorary basis and the term is of three years. BOD is responsible for internal governance, strategic decisions, marketing and raising funds for the organization. The board meets quarterly to review organization policies. Under BOD there exists an Executive Committee that consists of three members. The committee meets every month to manage all administrative and operational issues of the organization.

The organizational structure has been kept very simple to keep operational cost low; it consists of four main departments; (i) Admin & HR Department (ii) Credit Department (iii) Finance & Accounts Department and (iv) Internal audit Department**.** The organization consists of Volunteers and Paid staff. Volunteers are encouraged at all levels from all groups irrespective of age, qualification, caste and group. For Paid staff *AKHUWAT* follows distinct recruitment policy where positions are well defined and minimum criterion is also available for recruitment at varying positions. The organization believes in training its staff before they start their job. Therefore new employees start their jobs as interns and after an extensive training of three months they are employed as regular staff.

Table 1 Loan Products Offered by AKHUWAT; Source: Akhuwat website (http://www.akhuwat.org.pk)(accessed on Nov 10, 2014)

Sr. No	Product Name	Loan Range (US Dollars)	Loan Range (Pakistani Rupees.)	Purpose
1.	Family Enterprise Loan	100-300	10,000-30,000	To establish business
2.	Liberation Loan	500 (max)	50,000(max)	To get rid of loans with high interest rate
3.	Education Loan	250 (max)	25000(max)	For education of dependents
4.	Health Loan	100-200	10,000-20,000	To bear the financial cost of health care
5.	Emergency Loan	50-100	5000-10000	To bear losses in business, health care expense, machinery repairs, motor vehicle repair, veterinary expense and admissions fee
6.	Housing Loan	300-700	30,000-70,000	Renovation of houses
7.	Marriage Loan	200 (max)	20,000(max)	Marriage of daughters/sisters
8.	Silver Loan	500 (max)	50,000(max)	Expansion of business (eligible clients are only those who have completed three or more borrowing cycle from *AKHUWAT*)

[9] Source: ibid

AKHUWAT is offering interest free loan in seven broad categories; (i) Family Enterprise Loan (ii) Liberation Loan (iii) Education Loan (iv) Health Loan (v) Emergency Loan (vi) Housing Loan (vii) Marriage Loan and (viii) Silver Loan (see Table 1 for details). In addition to these products, Special Person Loans and Grants to widows are being provided. Along with these products, *AKHUWAT* is offering services like capacity building initiatives, social events and *AKHUWAT* health services (affordable and quality health services to poor).

AKHUWAT: A Successful Model of Qard-al- Hassan

The model of *AKHUWAT* is a breather for Welfarist approach; the organization is sticking to the very basic and primary objective of microfinance - Poverty Alleviation – by following a community based structure. *AKHUWAT* works on the principle of building social cohesion through solidarity and by capitalizing on the distinguished feature of property rights as prescribed by Islamic economic system which offers rights in resources to all even to those who don't own them (Mirakhor and Bao, 2013). Owing to commitment with the aim of poverty reduction *AKHUWAT* adopts unique strategies in commercially run environment of microfinance for fund collection and its effective utilizations. This success can be mainly associated with the overall culture and strategy of the organization which is mainly driven by the metaphor of *AKHUWAT*/ brotherhood and what Khan (2011) calls "The Theory of Communal Viability". This culture could produce desired results to a larger extent due to available conducive environment because of its strong association with the faith of majority living in Pakistan (Clark, 2011 & Ghaffari et al. 2011).

What distinguishes *AKHUWAT* from other microfinance institutions is its distinct underlying four principles[10];

Qard-al- Hassan- Interest Free Loan (IFL)

This embedded element of IFL of *AKHUWAT* model serves two purposes;

i. Provision of financing without interest and with minimal Rs. 100 application processing fee to the segment of society which does not either have any access to these financing or the availability of financing is very expensive for them due to high interest rates (most microfinance institutions (MFIs) in Pakistan are charging between 30-40 percent interest rates) (Jawad, 2011) higher than what is prevalent in the formal banking sector for affluence group. This extention of loan on the basis of *Qard-al-hassan* (without any premium/interest) increases the probability of its recipient of loans to effectively use the funds and generate revenue to become sustainable rather than getting into debt trap owing to higher interest rates. This very principle of *AKHUWAT* of providing interest free loan addresses the major critique on prevailing practices of microfinance of making their clients more vulnerable instead of taking them out of poverty; Many research studies have concluded that expensive loans force microfinance clients of one organization to acquire financing from other microfinance organization to pay loan installment thus resulting into heavy debt trap—also known as debt recycling or circular debt.

[10] Source: AKHUWAT: A Decade of Hope -Journey of AKHUWAT', 2001-2010

Apart from offering interest free loans to new clients, *AKHUWAT* acknowledges the troubles of the poor who are stuck with heavy debt burden due to the exuberant interest rate on their loans. To address this issue, the organization is offering Liberation Loan; the whole principal amount is paid by *AKHUWAT* to money lender in one go while the client repays to *AKHUWAT* in installments, free of any interest.

(i) IFL enables the organization to offer financing in accordance with their faith even to the lowest segment of the society. More than 95 percent population of Pakistan is Muslim and Islam strictly prohibits *riba* (interest). A study on Islamic finance published by the State Bank of Pakistan (Knowledge, Attitude and Practices of Islamic Banking in Pakistan) clearly stipulates that given the choice masses in general across all income groups in Pakistan have preference for interest free financing. *AKHUWAT* is providing this preferred choice to microfinance clients with its network of 339 branches with more than 95 percent concentration in rural areas. Therefore it can be inferred that the organization is targeting poverty in terms of its most modern definition that explains poverty as lack of opportunities for any segment of population.

IFL with Element of "Plus": The interest free loan becomes more special with the element of "plus" in which *AKHUWAT* offers technical assistance to its clients along with credit, as the organization believes in making its clients sustainable through polishing their entrepreneurship skills rather than just relying on loaning. In this regard, the incentive program "*AKHUWAT* Entrepreneurship Development Award" to clients running successful business ventures is a great self-boosting drive.

Moreover, lending process of *AKHUWAT* complements its products as it has been designed in a way that it is cost effective, reaches to its target market and repayment is ensured through implementing various measures to avoid voluntary and involuntary defaults.

Lending Methodology: The loaning approval process (see annexure-I for graphical representation of process) mainly includes income of individual and the feasibility of business; income of individual is important to verify that the loan amount is reaching to the desired target market and feasibility of business is critical for ensuring sustainability of the client and also to minimize involuntary default. *AKHUWAT* has used the strategy of Group Lending in customized way by capitalizing on social capital of family via extending credit to family instead of a single individual or a group of some community members. Initially *AKHUWAT* was using group lending in traditional way. However, with time, it was learnt that in a typical group lending methodology the group leader may manipulate others. Further, group monitoring, particularly mutual responsibility in case of default, becomes very complex for a typical group lending. Therefore the group has been defined in the form of family while two guarantors from the same community are used as social collateral. This is used as an effective measure for securing the repayment of loan.

By forming family as a group for lending, *AKHUWAT* has also addressed another important challenge conventional MFI are facing; families of women beneficiaries of conventional microfinance exploit women one way or the other to take the amount these women receive as microfinance. By involving and making whole family accountable for loan repayment chances/probability becomes higher that all members of the family would work to make effective use of resources not only for repayment of loans but also for their own sustainable living.

After loaning the repayment is monitored through regular visits of loan officer to client's home or work place and reminders are made through guarantors if there is much delay in repaying due installment. In case of genuine reason extension can also be given though the installment has to be made by 30th of that month. After two years *AKHUWAT* writes off loans in its accounts but only for accounting purposes. (For operational purposes the organization keeps the waved off loan amount in its record as considers itself accountable to its donors and therefore makes all efforts for recovery of the amount).

However, the organization gives due consideration to involuntary default owing to external shocks which are not in control of client, however, these adversely affect his/her repayment capacity. The most significant service that *AKHUWAT* offers in this regard is when a client becomes handicapped or dies; in case of handicapped client loan amount is waved off along with additional support in the form of wheel chair and for deceased client the loan is waved off along with financial help to bear funeral expenses in addition to monthly stipend to the family of deceased for three months. These kinds of expenses are made from *AKHUWAT* Mutual Support Fund where borrowers, on optional basis, contribute 1 percent of loan amount at the time of loan disbursement, however, those acquiring loans below Rs. 4000 (US $ 40) are exempt from this contribution.

AKHUWAT arranges various social events for capacity building of its borrowers for running their jobs/businesses effectively and efficiently. Moreover, operations of *AKHUWAT* show that the organisation accepts the responsibility of social grooming of its clients; *AKHUWAT* extends exposure to its clients towards its social agenda which focuses on areas like girls' education, protection and improvement of environment, especially importance of plantation, observance of traffic rules and local laws and adopting the highest ethical values in business.

Admitting the prevailing scenario where MFIs quote high operational cost for charging high interest rate, operations of *AKHUWAT* appear idealistic. However, the growth and expansion of operations of the organization (see Figure 2)[11] is a proof of its success in terms of outreach. Active borrowers of the organization have increased from 802 in 2004 to 728 thousand in 2014 while the asset base has jumped from Rs. 10 million (Us $ 0.098 million) to above Rs. 4.95 billion (Us $ 49.5 million) over the said period (gross loan portfolio being the dominating component).

[11] All graphs in this paper are based on the data provided by AKHUWAT.

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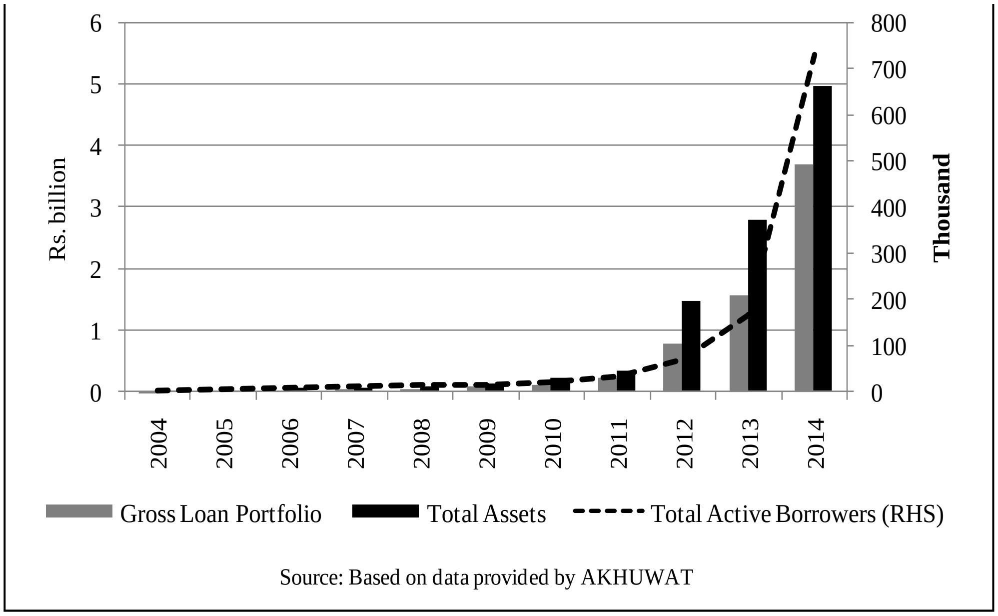


Figure 2 Growth (Assets & Borrowers)

Effective Utilization of Places of Worship

AKHUWAT has transformed the idealism of successfully extending IFL into reality by developing itself as a gross root level organization in real sense. Realizing high cost associated with the process of financing to the poorest segment of society, *AKHUWAT* has again taken inspiration from Islamic history and introduced its principle of increasing the role of community through institutionalizing religious places like mosques and churches. This unique feature has enabled the organization to be cost effective in offering its products and services (Harper, 2011).

By using already available infrastructure of religious places, *AKHUWAT* has been able to minimize its cost to a considerable level by reducing the huge expenses of rents as all main operations including marketing and disbursement of loans take place from these places. This is in contrast to traditional models where one person deals with whole group for group lending while for individual lending cost in terms of financial resources as well as human resources is huge. For *AKHUWAT* disbursement of loans takes place at these religious places 2- 3 times during a month where 100-150 loans are disbursed at one time. While marketing, promotional drives and awareness initiatives also become easy and cost efficient because of regular congregation at these places. Consequently, infrastructure of *AKHUWAT* has been kept simple and small, resulting in considerable reduction in overall operational cost for the organisation.

Disbursement of loan from these religious places increases transparency and accountability on both demand and supply side as masses in general consider themselves accountable to Allah for activities associated with these places. This reduces the problem of moral hazard and adverse selection and therefore minimizes the risk of voluntary default. High recovery rate of *AKHUWAT* is an indication of this phenomenon to work effectively. Portfolio at Risk > 30[12] over the years has adopted declining trend and throughout is lower than that of conventional microfinance

[12]PAR > 30 is the value of all loans outstanding that have one or more installments of principal past due more than 30 days.(Source: The MIX Market)

industry of Pakistan. However, operations from these religious places particularly from mosques raise two major concerns;

- Due to male dominance in mosques all across the country there is a greater possibility that beneficiaries of *AKHUWAT* would primarily be male. Though the organization claims to be equally responsive to both genders and the product of Family Loan minimizes the concern to some extent. Share of women beneficiaries in overall borrowers has increased over the last four years (see Figure 3) although it still constitutes only 28 percent[13] which is lower than the prevalent average of above 60 percent of conventional microfinance in the country.
- Second concern can be the possibility of discrimination on the basis of belief. *AKHUWAT* though is very clear in its idea of providing this facility without any discrimination to any belief. Loan disbursement from churches in few cities[14] , presence of non-Muslim clients as well as non-Muslim staff members validate the claim of organization. However, the perception of client can't be overlooked; a non-Muslim may not feel comfortable in getting services from mosques or a non-Christian from church.

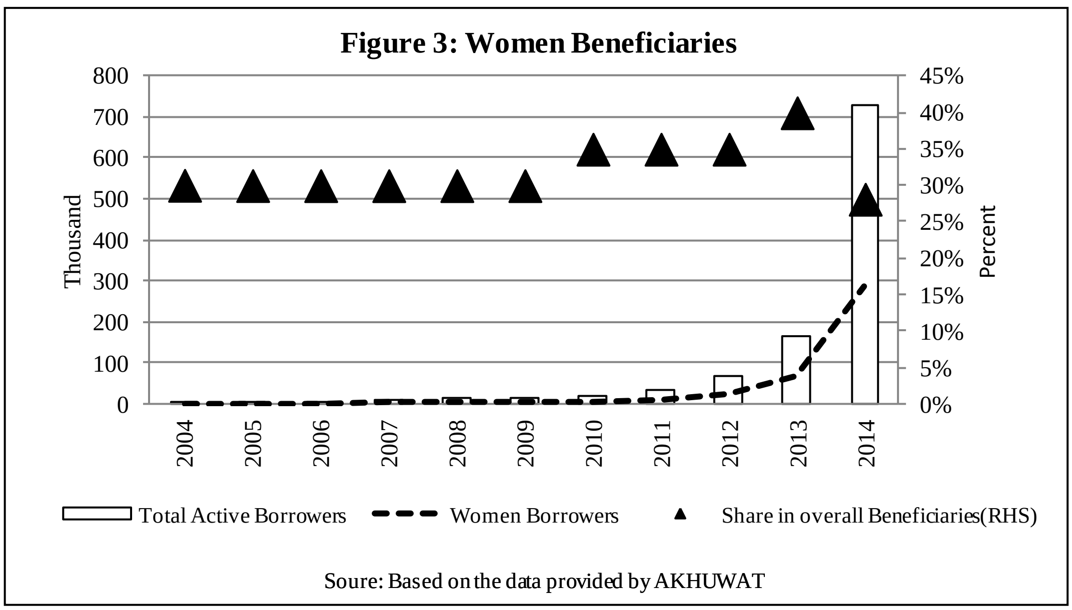


Figure 3 Women Beneficiaries

Volunteerism

Third distinguishing principle of *AKHUWAT* is "Volunteerism". The model of *AKHUWAT* explains how effective the role of volunteerism on both sides; staff and client, has played in making the organization as one of the largest microfinance institution extending interest free loans.

[13] 2014 witnessed sharp decline in share of female beneficiaries from 40 percent to 28 percent.

[14] Up till now four churches have been used.

Human resource of *AKHUWAT* is a combination of volunteers and paid staff. All senior management works on volunteer basis while staff on pay roll also performs many activities voluntarily. *AKHUWAT* being a proponent of community organization prefers staff from the same locality where it is operating (Jawad, 2011). Consequently, the organization is also known for commitment and determination of its employees as indicated by the low turnover of employees.[15]

Borrowers as Donors

Though clients are not charged a processing fee, however, they can contribute voluntarily. *AKHUWAT* started "Member Donor Programme" when borrowers themselves showed their wish to donate some money to the organization. This explains the fourth and the most unique principle of *AKHUWAT* where borrowers have transformed into donors for the very first time in the history of microfinance. This feature is a glorious example of solidarity and the true depiction of the metaphor of "*Muakhaat/ AKHUWAT*". Though this contribution is purely voluntary, however, over the years this has depicted a rising trend with considerable growth rate[16].

This is also interesting mentioning that borrowers of *AKHUWAT* who are running their enterprises successfully also get involved with the credit plus strategy of *AKHUWAT* by training new clients for establishing and running their businesses successfully.

Sources of Funding

Mostly MFIs in local as well as in international market are dependent upon funding or credit lines. Consequently, organisations having such source of capital are obligated to cater to objectives of donors to meet cost of capital and therefore these charge high interest rates. Hence, this is one of the most important reasons for mission drift of conventional microfinance from poverty alleviation to financial inclusion. However, *AKHUWAT* is sticking to Welfarist approach and associate microfinance with poverty reduction. Therefore, *AKHUWAT* has not accepted any international funding or donation to avoid any influence of profit motivated groups as well as to avoid any interest element embedded in credit line from conventional organization (Candland, 2011). The organization rather relied mainly on local donation and even for local donation the major portion was of individual loans till Punjab government in 2011 provided funds of Rs. 1 billion (US $ 10 million) on basis of *Qard-al-hassan*. BOD of the organization works extensively for donation collection through marketing initiatives and fund raising programs.

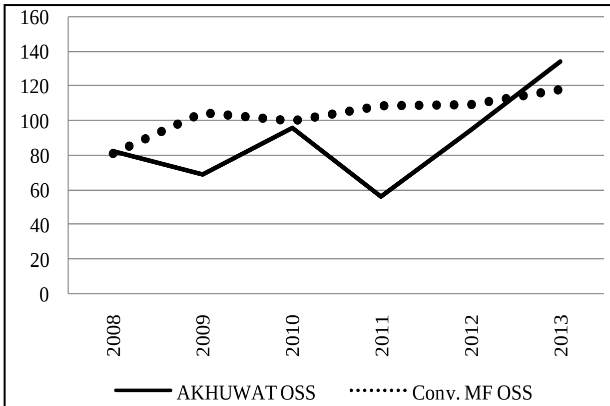
Sustainability

Organisations working under Welfarist approach face the problem of eroding funds as the high operational cost linked with provision of credit to poor segment of society cannot be ignored and no return/low return can be paid to fund providers (Khan, 2011). In similar regard there does not

[15] Source: AKHUWAT Microfinance with a Difference

[16] Akhuwat website (http://www.akhuwat.org.pk)(accessed on April 15, 2015)

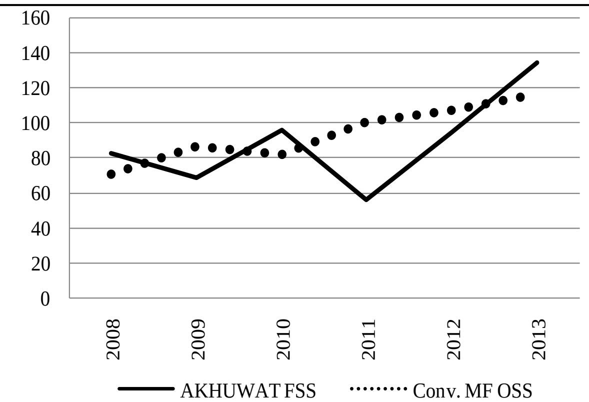
exist any guaranteed source of fund for *AKHUWAT* and no income is being generated through charging clients to cover expenses, hence, there can be concerns regarding the sustainability of the organization. However, *AKHUWAT* in general has improved its status of sustainability as indicated by two important indicators; Operational Self-sufficiency (OSS) and Financial Self-sufficiency (FSS)(see figure 4)[17]



Source:AKHUWAT data has been provided by AKHUWAT,PMN data has been used for Conv.MF data.

Figure 4(a) OSS-AKHUWAT Vs. Conv. MV

(percent)



Source:AKHUWAT data has been provided by AKHUWAT,PMN data has been used for Conv.MF data.

Figure 4(b) FSS-AKHUWAT vs. Conv. MF

(percent)

OSS of *AKHUWAT* (see Figure 4 (a)) has improved from 82.41 percent (below sustainability) to above 136 percent (sustainability) and in 2013 even has superseded the OSS of conventional microfinance industry. *AKHUWAT* FSS ((see Figure 4 (b)) is now also higher (134.26 percent) than that of conventional microfinance (116.5 percent). [18].

High recovery rate as depicted by low portfolio at risk (PAR > 30) (see Figure 5 (a)) which is 0.44 percent compared to 3 percent of conventional microfinance industry and lower percent of Write-offs to Gross Loan Portfolio (GLP) (see Figure 5 (b)) do have positive effect on the sustainability of the organization. However, *AKHUWAT* has been able to achieve sustainability in 2011 when the government of Punjab provided funds on no interest basis. This signifies the critical importance of continuous flow of funds for the sustainability of an organization.

Along with sustainability of organization, the sustainability of client is imperative which is generally overlooked in prevalent practices of conventional microfinance. While admitting financial sustainability of organisation as an important component of business of microfinance institutions *AKHUWAT* focuses on sustainability of its clients as well. Therefore its products and services are accustomed to faith sensitivity and the needs of its target market; the poorest of poor, and the most importantly available at cheaper price (Khan et al. 2010). In addition to these products, organisation is offering the “plus” element with the loan to enable its clients to

[17] Due to unavailability of data of sustainability indicator for 2014, data of 2013 has been used in this section.

[18] Source: “Pakistan Microfinance Review”, Annual assessment of Microfinance industry 2013, PMN has been used for data of conventional microfinance.

efficiently utilize loan funds to become sustainable. *AKHUWAT* has remained successful in bring improvement in lives of its clients as evident from transformation of its borrowers into donors[19].

However, despite having the sustainability at present mainly owing to the funds from Punjab government there still prevails uncertainty about the inflow of funds for *AKHUWAT* which is a potential threat for sustainability of the organisation and cannot be overlooked. Though the argument of economies of scale in lowering the cost further for loaning is valid and will have positive effect on the sustainability of the organization, the continuous flow of funds is a necessary condition for running the business.

It seems that the management of the organisation is cognizant of this premise and is making well thought move for managing future growth. The organisation for its expansion has adopted a dual track approach; (i) Traditional Approach-opening its own branches across various regions (ii) Partnering with other local organisations- training local partners who are in agreement with the philosophy of *AKHUWAT* and wish to replicate the same model (Jawad, 2011). In later case *AKHUWAT* not only trains staff of its local partners but also monitors their working through frequent visits to those branches.

As future plan *AKHUWAT* wants to develop itself as an apex organisation that can train local organisation, provide these with some initial funding to start their programs and to work for them as oversight body while expects those organisations to move forward in their distinct style rather than *AKHUWAT* clones. This strategy has a greater probability of success and effectiveness as it addresses the challenge of availability of huge funds for growth. This is also the ideal way of expanding the *AKHUWAT* model as it is a community based organisation and in every community there is a need for financial inclusion program specific to its own distinctive features. Norris et al. (2015) has also proven that effectiveness of policies for enhancing financial inclusion are subject to prevailing conditions of economy.

Policy Implications

Unfortunately, the full potential of the institution of *Qard-al-hassan* to mobilize substantial resources for the empowerment of economically weak or dispossessed in OIC countries has not been realized. This is primarily due to the lack of enabling environment which could develop trust in the societies for the creditor to extend low cost solution to enhance financial inclusion and to reduce poverty. Policy makers in OIC countries can take concrete steps to revive and strengthen this important instrument of redistribution. Here are some policy recommendations in this respect:

(i) **Incorporate poverty alleviation through *Qard-al-hassan* into public policy.** Public policy makers in OIC countries can collaborate on developing public policies to promote poverty alleviation through *Qard-al-hassan* based microfinance. OIC countries with surplus funds could develop funds dedicated for providing capital and funding for *Qard-al-hassan* based microfinance. At local level governments can make it a priority policy area through public sector intervention to provide guarantees, tax incentives, capacity building, training, and operating spaces. Tax incentives to the donors could give additional incentives to individuals and corporations to make more contributions.

[19] Source: AKHUWAT: A Decade of Hope -Journey of AKHUWAT', 2001-2010

(ii) **Develop enabling environment for *Qard-al-hassan* based microfinancing.** Policy makers should encourage such institutions through the development of an enabling environment. This requires development of new or revision of existing legal and regulatory framework to protect the institutions, investors, donors, borrowers, and the stakeholders. The emphasis should be on the development of *Qard-al-hassan* as an institution with strong roots. The element of social capital such as trust will only develop if there are strong institutions and legal and regulatory frameworks in place. Since, financing sources such as *Qard-al-hassan* are trust-sensitive; efforts should be made to enhance the general level of trust in the society. Currently, regulations for microfinance institutions in general and *Qard-al-hassan* based microfinance institutions are not very well-developed in several of OIC countries. Without effective regulatory and supervisory frameworks, further development of this sector cannot take place.

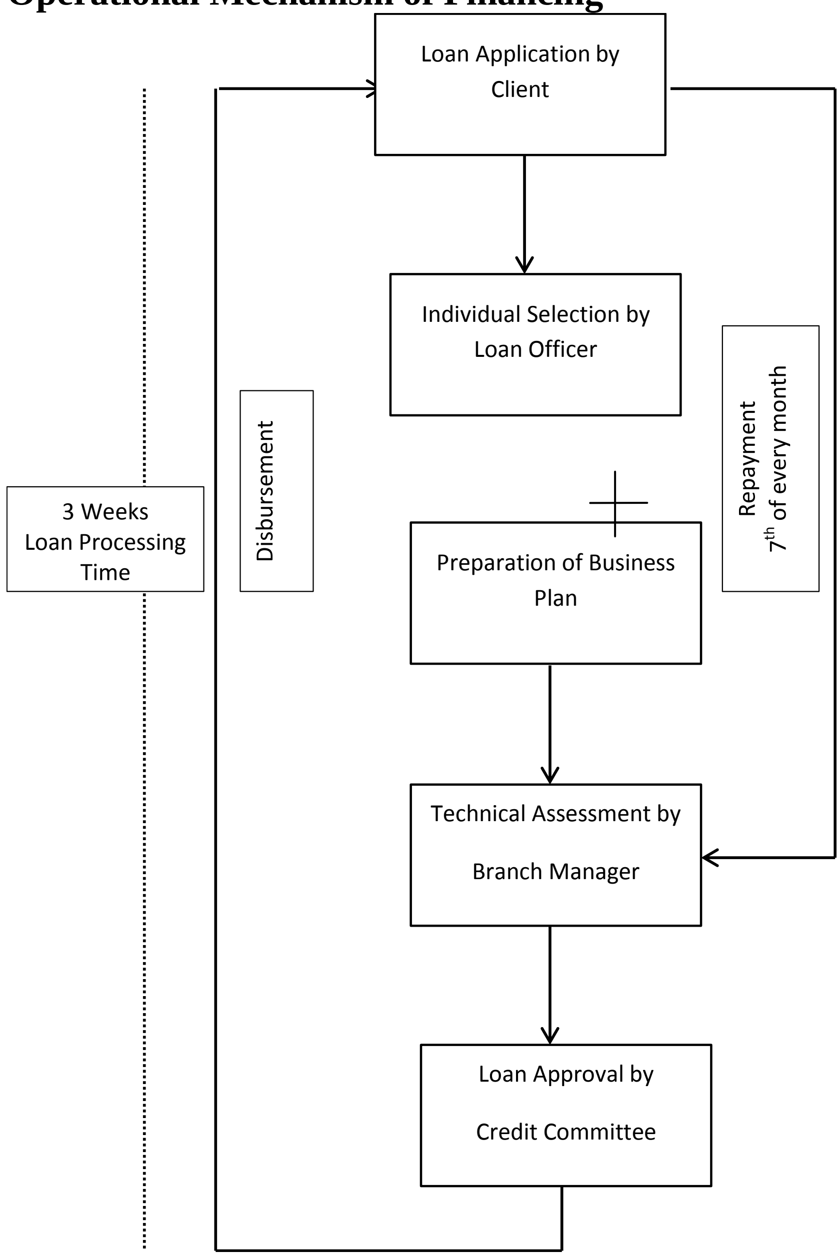
(iii) **Incorporate *Qard-al-hassan* into strategy to enhance inclusion.** Islamic economic system is a market-based economic system and does not deny the importance of market-driven commercial solutions to economic problems including financial exclusion. However, with current levels of poverty in OIC countries, market-failures are expected to occur and commercially viable solutions would not be available. Therefore, it is critical that the policy makers treat *Qard-al-hassan* based microfinancing a complementary tool to combat financial exclusion. This requires incorporation of *Qard-al-hassan* based solution in the national strategies for financial inclusion. With well-developed Islamic redistributive institutions, supplemented by formal and semi-formal sector financial institutions, a more effective approach to financial inclusion and poverty reduction could be undertaken.

(iv) **Promote transparent governance of *Qard-al-hassan* microfinancing.** Considering that an institution operating microfinancing based on *Qard-al-hassan* has dual responsibilities of providing low-cost solution to poor as well as fiduciary responsibility towards the donors to undertake a sacred duty on their behalf. This requires existence of comprehensive governance framework including *Shari'ah*-governance. The governance structure should ensure that decisions are made transparently, there is full disclosure of the financial activities, operating costs are kept under control, and adequate reporting is available. Enhanced governance structure will also enhance trust in the sector which will give more incentive to donors to participate more generously.

(v) **Utilize existing network of financial institutions as distribution channel.** It is worth considering to incentivize financial institutions to provide *Qard-al-hassan* based micro-lending as a corporate social responsibility. Financial institutions that manage funds for depositors and investors could also provide this additional service at low operating cost in utilizing existing network of branches. Mirakhor (2004) suggests that financial institutions could recover the operating costs by investing fraction of available funds in secure profit generating activities. There is need to develop such hybrid solutions where using techniques of modern portfolio management, a diversified low risk portfolio can be constructed to recover operating costs of running the operations of micro lending.

(vi) **Leverage on technology to enhance penetration.** Digital platforms can play a crucial role in bringing savers and micro borrowers together. This can not only reduce the cost of operations with branchless finance but can also lead to development of digital credit registries to establish track records of good performing borrowers. Advances in mobile technology and web-based solutions should be utilized to expand the penetration of services at low cost. Availability of funds through mobile technology has been successful in several countries and could play an important role in reaching out to poor in remote areas. At the same time, web-based solutions such as US based Kiva and Pakistan based Al-Huda can be expanded to attract potential donors. These technologies can be very effective in mobilizing funds from expatriates of OIC countries who are willing to help the poor in their motherlands and are looking for trustworthy and credible options.

Operational Mechanism of Financing



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