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Challenges Faced by the Model of Islamic Microfinance for the Development of Micro Entrepreneurs and SMEs in Rural Pakistan

Aasmaan Anam Najeeb Jamal [1] & Muhammad Azhar Sheikh[2]

Abstract

Latest studies indicate that rural credit institutions have not been successful enough, as was anticipated initially, in achieving their goals of social and economical growth and development as they are being plagued by various organizational structure and operational management constraints. Therefore, with the efficient implementation of the models of Islamic Microfinance and effective provision of skills and innovative ideas in the emerging financial market of today can assist in the development of the micro entrepreneurs of the rural areas who will then directly contribute towards the growth of the small and medium enterprises. Firstly, this research paper endorses the model of the Islamic Microfinance having comprehensive dimensions and regulatory framework for achieving social, financial, humanitarian and religious objectives of the micro entrepreneurs and SMEs which are being neglected by the traditional micro finance institutions. Secondly, the study will discuss some of the critical challenges, issues and hurdles that the Islamic models face during the development process due to the shortcomings of the current practical approaches adopted. The findings of this study are purely theoretical, based on extensive literature review depicting the true image and status of Islamic Microfinance and its models in rural Pakistan. It is postulated that proper realization and execution of the model of Islamic Microfinance has the capacity to restructure and redesign the socio economic conditions of the rural emerging entrepreneurs enabling SMEs to engender a culture of financial and operational self sufficiency.

Keywords: Micro Entrepreneurs, SMEs, Models of Islamic Microfinance, Challenges and Development, Rural Pakistan.

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[1]Aasmaam Anam Najeeb Jamal is Lecturer in the Dept of Commerce, The Islamia University of Bahawalpur. Email: aaasmaan@hotmail.com

[2]M. Azhar Sheikh is Lecturer in the Dept of Commerce, The Islamia University of Bahawalpur. Email: sheikhazhar2005@yahoo.com

1. Introduction

"Allah has permitted for you trade and prohibited interest" [2:275]. In this study we attempted to review the models of Islamic financing, "Modaraba, Musharaka, Murabaha, Sukuk, Ijara and Salam" as a source of Micro Financing. These models are contributing in the development of the micro entrepreneurs in rural Pakistan. This paper will be an input in existing literature on the considered topic as there is a large number of Small Manufacturing Entrepreneurs who are hesitant towards the availability of short term loans as they avoid financial institutions due to inaccessibility of adequate creditworthiness and collateral. Also the SMEs avoid interest based banking. It is a great challenge for a country like Pakistan, where, according to the statistics of the United Nations World Urbanization Prospective the urban population is 37% of the total population in 2012 and rural population is 63% of the total population and the per capita income is average. The Islamic micro finance models are struggling to achieve their goal, which are solely developed to meet the gap between the SMEs and the financial institutions that are unable to address the need of the market.

Islamic banking has gained separate entity recognition than conventional banking. For Islamic Finance to give out its support towards a sustainable growth of the countries' SMEs, it needs to regulate its products offering in the rural market. These products hold the nature of buying and selling of assets, investment management, partnership, leasing, Islamic bonds and insurance, agency and lastly contract of works. To evolve Islamic Finance in Pakistan, a regulatory framework has been synchronized as follows by the State Bank of Pakistan (2007):

i) Full fledge Islamic Banks,
ii) Islamic banking subsidiaries of conventional banks and
iii) Islamic banking branches (IBBs) of conventional banks.

Numerous microfinance and Islamic banks as well as the conventional banks, with Islamic window, are working under such structure and have nurtured and developed over the past few years. However, their success will only be ensured if their product offerings and services are microfinance specific and their coordination with certain agencies like Islamic Internal Rating Agency (IIRA), as well as the Islamic Financial Services Board (IFSB), The Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) and the General Council of Islamic Banks and Financial Institutions (GCIBFI) will develop a supportive outline to meet the challenges of attending the needs of micro credit holders. Besides, without the collaboration of the various stakeholders in the micro finance sector, they might face barriers to the development of micro finance services in the rural areas.

Table 1: Financing Mix by the Islamic Banks

Rupees in billion	**Mar-12**	**Dec-12**	**Mar-13**	**% Share**	**Mar-12**	**Dec-12**	**Mar-13**
Murabaha	83.3	96.1	90.4		40.1	39.7	36.0
Ijarah	22.3	22.4	23.2		10.7	9.3	9.2
Musharaka	1.6	1.9	3.6		0.8	0.8	1.4
Mudaraba	0.2	0.6	0.5		0.1	0.2	0.2
Diminishing Musharaka(DM)	73.0	87.5	89.7		35.1	36.2	35.7
Salam	8.2	7.3	13.0		3.9	3.0	5.2
Istisna	11.1	15.7	16.4		5.3	6.5	6.5
Qarz/Qarz-e-Hasna	0.0	0.0	0.0		0.0	0.0	0.0
Others	8.2	10.5	14.1		3.9	4.3	5.6
Total	**207.9**	**242**	**250.9**		**100.0**	**100.0**	**100.0**

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

Table 2: Financing Concentration-Percent share

	Mar-12	**Dec-12**	**Mar-13**	**Industry**
Chemical and Pharmaceutical	6.9%	7.4%	7.2%	3.6%
Agribusiness	3.3%	3.7%	2.1%	8.4%
Textile	21.1%	19.0%	18.9%	16.7%
Cement	3.1%	1.5%	1.6%	1.4%
Sugar	5.1%	3.8%	6.6%	2.5%
Automobile and Transportation Equipment	1.5%	1.4%	1.5%	1.3%
Financial	1.3%	1.4%	1.1%	1.9%
Insurance	0.0%	0.0%	0.0%	0.0%
Electronics and Electrical Appliances	1.6%	1.5%	1.4%	1.4%
Productions and Transmission of Energy	10.5%	10.3%	9.2%	11.7%
Individuals	15.2%	14.2%	14.8%	7.9%
Others	28.9%	34.9%	34.6%	42.5%
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**

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

Table 3: Client Wise Financing Portfolio (Share Percent)

	Mar-12	Dec-12	Mar-13
Corporate Sector	73.9%	73.5%	72.7%
SME's	5.1%	4.1%	4.8%
Agriculture	0.1%	0.1%	0.1%
Consumer Finance	14.6%	13.1%	13.4%
Commodity Financing	4.6%	7.3%	6.8%
Staff Financing	1.7%	1.7%	1.7%
Others	0.1%	0.2%	0.4%
Total	**100.0%**	**100.0%**	**100.0%**

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

The statistics of Islamic Banking Bulletin shows that the growth pace in the overall fiscal year has been slow. However, major share is taken by the Murabaha and Diminishing Musharaka (see in Table 1). On the other hand the Textile industry is having major financing concentration than other Corporate and Small Entrepreneurs (see Table 2). Moreover, the client-wise financing shows SME's share of financing as 4.8% which is far much lower than the financing in the corporate sector. Finances that cater the requirements of SME's will always contribute for its growth. As mentioned in the SBP prudential regulations for SME (2013) reports SME's are contributing 30% in the GDP and employs 78% of the non agricultural workforce. Therefore, it cannot be neglected as it is considered to be the backbone of the economy. The Governor of State Bank of Pakistan in his address to 7th Pakistan SME Conference on "Strengthening Institutional Ties for Increasing SMEs Access to Finance" (2013) said that "The SME sector is vulnerable to economic shocks and is perceived as a highly risky sector by the banks". Thus Shabrawy (2011) favours the Islamic Microfinance having one major advantage, namely risk, which is shared between financial institutions and beneficiaries, allowing the entrepreneurs to concentrate on what they do best. He further elaborated the true meaning of micro entrepreneurs as they are the owner of very small businesses with very low start up cost such as home based businesses. In emerging economies these types of entrepreneurs need to grow. Now the challenge is to develop socially oriented banks that will contribute in poverty alleviation and socio economic empowerment through the provision of sustainable Islamic financial services to the underserved and neglected. To add in Yunus (2008) says that Islamic finance helps the disorganized poor, who are socially and economically disturbed, to meet their credit requirements in order to help them generate income, employment and economic assets. Khaled (2011) complemented Islamic banking and micro credit programmes having a close relationship in ideological and practical terms. He said it will not only provide credit to poor entrepreneurs but also investment in microenterprises will lead to the opportunity for the investors in Islamic banking to diversify their solid return. Pakistan comprises of 98% of Muslim population and according to the Economic Survey of Pakistan 2011-12 the literacy rate of the country is 58%. Thus, the acceptability of Islamic finance is found more in the urban populace than in the rural one. However, the majority needs to understand the relationship between religion, banking, finance and insurance. Kazim & Haider (2012) suggests that a clear distinction between the Shariah compliant products and targeted clients needs to be drawn. Therefore, a model of Islamic finance needs to be designed according to the segmented society. They further presented a Waqf model, which has an interest free credit line to the borrowers and a Takaful model, which is an insurance against economic shocks. However, his models are challenged with respect to the implementation. A report prepared by Islamic Research and Training Institute by Obaidullah (2007) highlighted the challenges of the Islamic microfinance in three phases: Firstly, the micro level, where there is a need of product diversification. Secondly, the Meso level, where coordination between rating agencies is essential and lastly, there is a need to develop a uniform regulatory and policy environment at the Macro level. Further, Hassan (2011) presented a model of Musharakah Mutanaqisah (MM; diminishing partnership), which is a combination of Musharakah and Ijarah. It goes on by saying that this mode of Islamic financing has a concept of shared equity. Even then the model has hitches relating to law enforcement, double taxation dilemma and rental and share price complications. According to Akhter et.al (2009) Akhuwat (an Islamic Micro Finance Organization working in Pakistan since 2001) has been facing a decline in its loan portfolio and its financial stability can only be achieved by integrating the NGOs and NPOs (non profit organizations) , Zakah, Awqaf, and Takaful as well with the professional training and capacity building institutes.

In an international conference on Islamic banking and Economics Haqiqi (2010) said that Islamic finance growth momentum has moved from a more theoretical concept to a practical reality. Besides the challenges of financial literacy, sources of funds, legal structure, standardized Islamic financial products and Shariah procedures of audit assurances of the products, the key issues of the Models of the Islamic micro finance has been discussed by Hailey (2009). According to him the Riba free concept of Islamic Micro Finance institutions on the advancement of loan and saving accounts does not apply on the business model. Secondly, interest is reflected as mark up in Mudarabah model which needs monitoring and transparency. Thirdly, Takaful is subject to questions due to its speculative nature and lastly, the Islamic micro finance needs a social support system in terms of charitable contribution and investment.

2. Methodology

The method used was the qualitative approach of research, based on extensive literature review over the challenges faced by the models of Islamic microfinance for the development of micro entrepreneurs and small and medium enterprises. The study has taken into account the functioning of the models, how they are being operated, and a complete overview of their management, ownership structure, corporate governance regulations, risk portfolios and financial stabilities. Moreover, the secondary data was extracted from the articles, their abstracts and models. The articles were thoroughly read to extort the data relevant to the study of this research paper whereas articles relating to the Middle Eastern countries' application of the Islamic finance models were also comprehensively studied.

However, before continuing with the details of the study, we have laid it out into six sections. Firstly, the introduction briefs the current progress of the Islamic Micro Finance Institutions for developing rural SMEs in Pakistan as mentioned above. Subsequently, the Second portion has been comprised of the methodologies executed by the models of Islamic Microfinance to restructure and redesign the socio economic conditions of the rural emerging entrepreneurs. Thirdly, an overview of the definitions of the Islamic Micro Finance, SMEs and Micro entrepreneurs has been being discussed. It has been followed by the Fourth section consisting of the literature review that highlighted the models and their implementation on the SMEs. Further, a brief discussion of the Models of Islamic Micro Finance offered to the SMEs has been included there in. Moreover, the Fifth section has the elaboration of the challenges faced by Islamic Micro finance Model for the SMEs and micro entrepreneurs' development. Lastly, the Sixth section concluded with findings and a future perspective study.

3. Micro Entrepreneurs, SME And Islamic Micro Finance Definitions:

Entrepreneurship is a driving force of economic growth. It is a mechanism through which human creativity, skills and energy can be utilized into tangible outcomes for the enrichment of human welfare. (Baron, 2012). Entrepreneurship has a lot of contribution in the propagation of business cycle (Parker, 2011). Entrepreneurship is the most critical factor in sustaining regional economic growth (Karlsson, 2012). There is an emergence of Entrepreneurial economy where it is considered as an input to modern, highly developed economies by interlinking itself with modern institutions and policy aims such as education, finance, and regulations (Bonnet, 2012)

Small and micro enterprises are significantly contributing in economic development by creating employment in rural and urban population, providing flexibility and innovation through entrepreneurship (Mahmood). SMEs make a considerable assistance in the direction of GDP, income generation, fostering entrepreneurship heritage, paid work possibilities, earning for a lifetime, abilities development of human assets, hunger and poverty alleviation, and advancing the benchmark of dwelling and value of life (Qureshi, 2012).

The biggest barrier in the way of thriving is their challenge to access the finance. The SMEs do not have collateral without which the sanction of the loan from banks and lending institutes appears very difficult. SMEs appear deficient in accounting and financial information; they lack business plans or viability reports that are useful in assessing the cash flows of business and expected return on investment. SMEs employees' lack of managerial skills, lack of marketing, scarcity in capital goods, lack of data on the sector and resistance to change are some more challenges that drag them down.(Qureshi, 2012). Micro finance is a way out of these bottlenecks. Commercial banking is serving industries like Commerce and Trade, where the risk can be measured and the return is easy. However, the ignored sectors are agriculture and SMEs.On the other hand, financial exclusion is due to not considering the religiously sensitive community. Hence, the provision of appropriate Islamic Micro finance solves the problem and gains the trust of the community, that is deficient in credit, by not only providing them with the Shariah Compliant products but also supplying them with the range of services like savings, money transfer facilities and insurance (Obaidullah, 2008).

3.1 Overview of Islamic Micro Finance in Pakistan

The Micro finance banks have given out small loans for the growth of the small manufacturers, which has increased their income and helped in generating employment. Rahim (2007) says that Microfinance is an alternative for micro entrepreneurs who are not eligible to receive loans from the commercial banks. He further said that Islamic Finance Schemes are having the attribute that may benefit through integrating with the small entrepreneurs, as the attraction lies with the Islamic Microfinance because Islamic Microfinance is an alternative to conventional means of operating microfinance institutions, where the element of interest is omitted.

Over the years, Islamic Micro Finance has gained recognition amongst the people of Pakistan since it has the capacity to develop a valuable human capital base by satisfying the financial needs of the Muslim community and positively contributing to the economic growth as pointed out by Akhter, et.al (2009). There has been increase in the demand of Shariah compliant products. Today, more than 10 Islamic Microfinance Institutions are operating in Pakistan. As clearly highlighted in the guidelines of SBP for Islamic Microfinance Business by Financial Institutions under prudential regulation vide SMED Circular No. 10 dated June, 27, (2006) which allows the establishment of Islamic Micro Finance Institutions' Counters in the existing branches of the Conventional banks as well as the establishment of Independent Islamic Microfinance branches, subsidiaries with independent and professional board and management. It was further illustrated that NGOs and MFIs don't have a formal ownership structure and collaterals to secure the financing, therefore, the Islamic banks use Islamic mode of Musharaka and Mudaraba to cater such kind of financing needs. Moreover, a review on Pakistan Islamic Banking Sector (2007) states State Bank of Pakistan's guidelines for the provision of Islamic microfinance products and services by financial institutions. The guidelines provide the services of the Shariah compliant products of the micro finance through the following channels:

(1) Establishing Full fledge Islamic Microfinance Banks (IMFBs)
These cover:

- Licensing Requirements
- Application Forms
- Compliance with Legal Framework & Prudential Regulations for IMFBs

The following Islamic Microfinance Banks are currently operating:

- Khushali Bank Limited
- NRSP Micro Finance Bank Limited
- Tameer Micro Finance Bank Limited

(3) Islamic Microfinance Services by Full-fledge Islamic Banks

These cover:

- Mode I - Islamic Microfinance Counters at Existing Branches
- Mode II - Stand-alone Islamic Microfinance Branches & Mobile Banking
- Mode III- Establishing Independent IMFBs as Subsidiaries of Banks
- Mode IV - Developing Linkages with Islamic MFBs/MFIs

  The Banks working under such regulations are:

- Al Baraka Bank Limited

- Bank Islami Pakistan Limited
- Buri Bank Limited
- Dubai Islamic Bank Limited
- Meezan Bank Limited

(4) Islamic Microfinance Services by Conventional Banks.

These cover:

- Mode 1 - Islamic Microfinance Counters at Existing Branches
- Mode II - Stand-alone Islamic Microfinance Branches & Mobile Banking
- Mode III- Establishing Independent IMFBs as Subsidiaries of Banks
- Mode IV- Developing Linkages with Islamic MFBs/MFIs

Following Conventional Banks are operating under Shariah compliant policies:

- Askari Bank Limited
- Bank AL Habib Limited
- Bank Alfalah Limited
- Faysal Bank Limited
- Habib Bank Limited
- Habib Metropolitan Bank Limited
- MCB Bank Limited
- National Bank of Pakistan
- Silkbank Limited
- Soneri Bank Limited
- Standard Chartered Bank (Pakistan) Limited
- The Bank of Khyber
- The Bank of Punjab
- United Bank Limited

(5) Islamic Microfinance Services by Conventional Microfinance Banks (MFBs)

These cover:

- Eligibility Criteria.
- Islamic Microfinance Division
- Islamic Microfinance Fund
- Systems and Control

- Utilizing Conventional Branch Network
- Internal Audit
- Accounting Records and Disclosure
- Statutory Liquidity and Cash Reserve Requirements

The Conventional Microfinance Banks providing an Islamic Micro credit are as follows:

- Apna Micro Finance Bank Limited
- Kashf Micro Finance Bank Limited
- Pak Oman Micro Finance Bank Limited
- Rozgar Micro Finance Bank Limited
- The First Micro Finance Bank Limited.

(6) Other Islamic Micro Finance Institutions are:

- Akhuwat
- Al Huda Foundation
- Farz Foundation
- Center for Women Cooperative Development, Pakistan / Wasil Foundation. Source (Pakistan Islamic Banking Sector, 2007).

According to the Financial Stability Review on Islamic Banking (2009), Islamic banking industry in Pakistan is facing challenges regarding the jurisdictions such as need for standardization in Shariah related products and services and development of appropriate instruments for liquidity management etc. Therefore, their preferable strategic plan is to focus more on SME, micro finance and agri sectors since its borrowers constitute one-third of the total borrowers of the banking industry. Few of the banks are at an early stage of development as well and their start up cost has not yet been able to reach the break-even point. They have been enduring to place their excessive liquid funds with other financial institutions to manage their liquidity. Also, Islamic Banking Institutions do not invest in the fixed income government securities and their investments in Shariah compliant Sukuk lack a liquid secondary market, therefore most of their investments are generally not actively traded. Thus Islamic Banks are facing temporary liquidity stress, given their deposit base is small as well. Islamic Banking Institutions need to diversify and distribute more balanced advances to the sectors. Initially concentration on Murabaha has decreased and both the Diminishing Musharaka and Ijarah are emerging as the most popular modes of financing.

4. Literature Review On The Previously Proposed Models Of Islamic Microfinance

Pakistan's Islamic Ideology Council has sanctioned the elimination of Riba from a modern economy. Islamic banking and finance systems are to be reformed into a just Islamic model in which the equity based system is compatible with the Muslim and non Muslim countries. For instance, interest prohibition, monitoring and managing the accounting practices of the Shariah models, rise in the equity/loan ratio, bringing reform in the tax collection system, mobilization of idle capital, revitalization of the institutions like Zakat and Ushr, proper consumption of scarce capital resources and proposal of a system of profit sharing implemented on all institutions, as proposed by the model of Chapra (1986). According to Khaf (1999) Islamic Economic System is a market system which follows an Islamic legal code and their transactions are carried out on mutual negotiations. Khan and Phillips (2010) studied on the START, a loan advancing microfinance programme, which is based on the influence of religious orientation on the performance of the Micro finance programmes. Their study was to evaluate the intensity of faith in motivating the repayment. Consequently, it was difficult to measure faith. However, few beneficiaries of conventional banking said that they are only doing business with conventional based banking system due to unavailability of Shariah compliant products. Thus, outreach of such a programme was limited. It was further added that loans are mostly advanced to the existing businesses than to the newly establishing ones.

The Grameen Bank Model comprises of women groups. It is a group-based and graduated financing that substitutes collateral as a tool to mitigate default and risk. (Obaidullah, 2008). It uses the group-lending approach for micro financing. Schurmann and Johnston (2009) mentioned the main attribute of the group-lending model of microcredit is the use of social rather than material collateral. Loans are made to small groups or cooperatives, and peer pressure is used for ensuring that repayments are made. On the other hand, a village bank model involves agencies that establish individual village banks who are allowed for external financing. The banks repay the loan and their loan sizes are linked to their performances in accumulating savings. Thus, it gradually becomes a self sustaining and independent bank. The third model is the credit union micro finance model. It mobilizes saving and provides loans. The fourth model is the self-help group model which consists of members having a homogeneous income. They pool up their money and lend it to others. They also seek external funding to supplement internal resources (Obaidullah, 2008).

Rahman (2007) says that Islamic banking has not addressed the need of financing among the poor and micro entrepreneurs. He has supported Wakalah model as used by many Islamic Takaful insurance companies which has the potential to become an alternative structure for Islamic banks to offer Islamic microfinance instruments. This model is also known as power of attorney model.

In Indonesia, Shariah Rural Bank is using Wadiah contract whereas the model consists of depositors and banks where depositors allow the bank to use the deposit money and the bank guarantees the depositor for safe keeping of the deposited amount. Also, they are using Cooperative banking business model whose customers are retail and small business owners. It provides leasing, factoring, insurance and investment funds to the members (Zuhria). Akhuwat offers Qard ul Hassan which offers riba free loans given through donation. It is also known as a mosque based model. The second model is the Waqf model, which is also known as charity based model. Third is the Takaful model which is an alternative to insurance (Kazim and Haider, 2012). Kashf Foundation provides group collateral where a group of 25 women jointly insure each other against default (Kashf , 2013). Wasil Institution is also offering many Shariah compliant products like Salam, Istisna, Murabaha, Musharaka and Ijarah. Wasil foundation is also known as CWCD (Center for Women Cooperative Development) (Wasil, 2013). Deep Foundation is an asset based Islamic microfinance organization that ensures that micro credit reaches the SME and entrepreneurs for the achievement of their goals. (Deep, 2013).

MCCU and MCA (Muslim Community Credit Union Ltd, Muslim Cooperative Australia Ltd.) are the first financial service providers that operated on religious principles. They have been offering Zakat distribution functions and Qard ul Hassan. Thus, the model is completely community focused. Mirza studies on Australia (2003). Musharakah Mustanaqisah (MM), based on shared equity, is being used for home financing. Whereas the mode of Partnership and Ijarah (rent) is being used where the customer rents the house from the bank and pays the rent. The rent is used to increase the share of the customer. As the customer will pay the rent his share will increase and the bank's share will decrease. The advantage of MM is that it plays a safeguarding role against inflation. However, the issues are the determination of its rental rates and taxations. On the other hand, worldwide MM has been practiced by ISNA Housing Cooperative limited and Ansar Cooperative Housing Corporation in Canada, Amanah Home Financing in UK and American Finance House LARIBA (AFHL). AFHL is working on the basis of lease to purchase (Ijarah wa iqtina), on the other hand, Meezan Bank of Pakistan is offering "Easy home" which is the first home financing facility in the country (Hassan, 2011).

Tanzania eco-Volunteerism also consists of interest free loans, Wadiah and Takaful, where the TeV gives out beehives to the families which they sell to the market and pay back the loan amount to

TeV (Tanzania eco volunteerism, 2013). Alamal Microfinance Bank Yemen is the first microfinance bank in Yemen that is offering credit, savings, insurance, remittances, currency exchange and cash disbursement to the entrepreneurs in accordance with the Shariah as well (Alama Micro Finance Bank, 2013). On the other hand, Syria's Rural Community Development at Jabal Al Hoss has been supporting local institutions by providing them with financial services for the poor, most specifically for women, by including Islamic lending procedures (Burjorjee, Brandsma & Nasr, 2004). The Port Sudan Association for Small Enterprise Development (PASED) is a local NGO established and registered in the Red Sea State in October 2000. PASED has aligned its program specializing on the micro-credit delivery on the Islamic banking principles (Port Sudan Association for Small Enterprise Development, 2013).

4.1 Islamic Microfinance Models

(1) Musawama (cash spot payment): CWCD is selling it on retail outlet model which targets the rural and semi urban areas of Pakistan, and sells grocery items to clients on Musawama (Wasil, 2013).

(2) Murabaha (deferred / instalment basis): Is a sale and purchase of goods at the cost price added with an agreed profit margin (Sabita, 2007). Profit margin is negotiable and the payment is made in instalments. It is a popular method for banks in Islamic countries in order to promote interest free transactions (Kazim and Haider, 2012). The personal expenses of the merchant and other expenses are not directly involved with the goods and are not to be considered into the sale cost of Murabaha transactions (Imam & Zubaria). In Microfinance it is applicable in such a way that the microfinance programs buy the goods and then resell them to the micro enterprises at the cost plus mark up. The borrower pays in instalments and the goods are owned by the microfinance program until the last instalment is paid. The credit investigator is responsible for preparing a feasibility report mentioning the precise finance amount required by the micro enterprises and then he is liable to negotiate a price with the wholesalers of the commodities and after buying it from them he resells them to the enterprises (Shabrewy, 2011). In case of collateral, there is no such requirement. Instead, the borrowers must form a group of 5 micro entrepreneurs where all members will act as guarantor if there is a default among their group members (Rahim, 2007). This type of finance is commonly used for financing assets or working capital inputs such as raw materials, machinery or equipment. Thus the goods must be in tangible nature (Khan & Phillips, 2010). On the other hand, this financing is used for short term financing based on the conventional concept of purchase finance (Dhumale & Sapcanin).

(3) Musharaka (joint partnership): Is one in which there are more than one contributors of funds and all parties invest in varying proportion with respect to sharing in profit and losses in relation to their capital contribution. (Mirza & Halabi). This type of Model is used for medium and long term investments (Dhumale & Sapcanin, 1998). Thus, The borrower enters into a contract with the bank where capital is invested in a venture and the profits/losses are shared according to a predetermined ratio (Kazim and Haider, 2012). From there on the Islamic bank will enter into a partnership with micro entrepreneurs. If there is a profit, it will be shared, based on a previously agreed ratio, and if there is a loss, it will then be shared according to the capital contribution ratio. The most suitable technique of Musharakah for microfinance could be the concept of diminishing partnership or Musharakah Mutanaqisah. (Rahim, 2007). In Islamic Fiqh, the model is being divided into Shirkat ul Milk and Shirkat ul Aqd. Shirkat ul Milk (partnership by joint ownership) has two features namely Optional (Ikhtiari) where the relationship between the parties comes in to existence at their own discretion. The second is Compulsory (Ghair Ikhtiari) where the relationship comes into existence automatically without any effort. On the other hand, Shirkat ul Aqd (partnership by contract) comes in to existence with a mutual contract (Imam & Zubaria).

(4) Mudarabah: It is Trust financing. The Microfinance program and the micro enterprise are partners where the program invests in money and the micro enterprise invests in labour (Shabrewy, 2011). It is a contract in which the entrepreneur employs his managerial skills and the profit /losses are divided according to a previously decided ratio (Kazim & Haider, 2012). After the full settlement is made, the business entitlement will be owned by the entrepreneurs. In addition, the small entrepreneur (mudarib) in case of misconduct, negligence or breach of terms becomes liable for the amount of capital (Rahim, 2007). Sometimes, the money is given to the borrower to buy the items whereas the cost of additional staffing is excluded when the staffs accompanies the borrower to buy the goods. Also it uses Alwakala Alnaqdeyyah (a process where cash is issued to the borrower's guarantor who then purchases the commodities on behalf of the borrower (Khaled, 2011). The liability of micro entrepreneurs is limited to their time and effort. Their contract is known as the restricted Mudaraba. Further, fixing a lump sum amount is not allowed (Nadeem).

(5) Wadiah (demand deposits): It is rebranding the conventional saving account as Wadiah account. Wadiah in the legal sense signifies a thing entrusted to the care of another. The proprietor of the thing is known as Mudi (depositor), the person entrusted with it is known as muda or wadi (trustee) and the property deposited is Wadiah. It is a trust given to the trustee who has no right to use the money or trade or invest it. It is only given to him for safekeeping. Even though if the trustee is utilizing the money he will have to guarantee the deposits (Ibrahim& Noor, 2011).

(6) Muzarah: Is essentially a Mudarabah contract in farming where the bank can provide land or funds in return for a share of the harvest (Dhumale & Sapcanin, 1998).

(7) Musaqat: Is a specified type of Musharaka contract for orchards. In this case the harvest is shared among all the equity partners according to their contributions. (Dhumale and Sapcanin , 1998)

(8) Salam: Is a sale and purchase of goods by means of order, placed with certain requirements and full cash payment in advance (Sabita 2007). Bai Salam and Bai Salaf are similar to a forward contract. This is a forward contract where goods are paid for in advance on the promise of delivery of the goods to the buyer later on. Banks disclose beforehand that the goods are being bought with the intention of profit. (Kazim and Haider, 2012). Bai Salam provides advantage to the seller of receiving cash in advance and the buyer benefits from a lower cost price (Mirza & Halabi, 2003). The bank can demand guarantee in different forms like mortgage, hypothecation or personal guarantee to reduce lending risk. This results in shared risks as the seller through this contract transfers the risk of fluctuations to the buyer and the buyer transfers the business risk to the seller through guaranteed quantity and quality supply of output on an agreed future date (Rasheed & Mudassar).

(9) Bai Muajjal: Is deferred payment or spot sales in which the seller of a product accepts deferred payments in instalments or in lump sum. No charges are included (Dhumale & Sapcanin, 1998).

(10) Istisna: It is a contract for acquisition of goods by specification or order, where the price is paid progressively in accordance with the progress of a job completion. It is most commonly applied for home financing (Imam & Zubaria).

(11) Ijarah Muntahiya Bittmalik: Al bai (a buy and sale contract) and Ijarah wa Iqtina lease to purchase: This product is the Shariah compliant alternative to leasing where the organization first buys the good to be leased, and then determines a repayment schedule over time (Kazim and Haider, 2012). It is an elaborated concept of Ijarah where the transfer of ownership will take place at the end of the contract and previously agreed time between the lessor and the lessee. The title of the asset will be transferred to the lessee either by way of gift, token price, predetermined price, at the beginning of the contract, or through gradual transfer of ownership. The Islamic bank will purchase the assets required by the entrepreneurs and rent the assets to qualified entrepreneurs. In this case, the entrepreneurs can just rent the asset over a period of time and pay the rentals at regular intervals. The entrepreneur as a lessee will be responsible to safeguard the asset whereas the lessor will monitor their usage (Rahim, 2007).

(12) Ijarah: It is a long term contract of rental subject to specified conditions as prescribed by the Shariah. The lessor (Islamic bank) not only owns the asset but takes the responsibility for monitoring the use of asset and discharges its responsibility to maintain and repair the asset in case of mechanical fault that are not due to wear and tear. The bank should purchase the asset prior to

execution of an Ijarah contract. The bank takes the possession of the asset and leases it to the customer (Rahim, 2007).

(13) Al Qard ul Hassan: Literally meaning "benevolent loan", this is an interest free loan given out in good faith to those in need. There is no interest on these loans and the only extra cost that maybe charged on these loans is the amount of money required to cover the administrative and processing cost (Kazim and Haider, 2012). The borrower has the right to reward the lender for the loan by paying any amount above the amount of loan (Imam & Zubaria).

(14) Wakala (Procurement): This model has been used by many Islamic Takaful insurance companies, which has the potential to become an alternative structure for Islamic banks to offer Islamic microfinance instruments and mitigate its inherent risk (Rahim, 2007).

(15) Takaful: A fund is set up which insures the members of the fund in case an unfortunate incident occurs (Kazim and Haider, 2012).

(16) Sarf (Money Exchange): The exchange must be of equal quantity and quality and it must take place on the spot whereas the forward contract is not allowed (Islamic Finance, 2013).

(17) Kafala (Sponsorship/ Guardianship): It is the system which allows the workers to enjoy their rights in the foreign land and their security is guaranteed by the Kafil (person who sponsors). This system allows secure labour mobility (Bajracharya & Sijapati, 2010).

(18) Hiwala (Money Transfer): It is the transfer of money from one party (muheel) to another (muhal alaihi) by order of the creditor (the muhal) at relative ease. However a person needs to get license to run such a system (Faith, 2011).

(19) Bai al Inah and Bai al Dayn (Designed for Islamic Bonds): Also known as asset securitization, the financier purchases an asset from the issuer and sells it back to the same party at a credit price. This buy-back agreement will ensure that the issuer will receive the money in cash while the financier will be paid a prefixed or contracted amount on a future date. Debt payments will be made by instalments through bond issues. Sale and purchase of the debt securities to the issuer or the third party, if the secondary market exists, at the discount rate is called Bai al Dayn (Rosly, Sanusi)

(20) Sukuk: Is equivalent to a bond in conventional finance. It is a financial certificate which can be used to raise capital by Islamic banks without having to engage in interest bearing certificates (Kazim and Haider, 2012).

(21) Joalah: it is a service charge that occurs when the buyer of a service agrees to pay the provider a specified fee according to a contract (Dhumale & Sapcanin, 1998).

5. Challenges Faced By Islamic Microfinance Model For The SMEs And Micro Entrepreneurs' Development

For Islamic banking to survive in Pakistan it will have to focus on promoting Islamic values and norms (Khattak, Rehman and Sofwan, 2011). Currently the SMEs are facing problems like lack of collateral, deficiency in accounting and financial information deliverance, lack of viable reports for the assessment of cash flow, inefficient marketing skills, inadequate standardized procedures and scarcity of capital goods and majority of the population is resistant towards change (Ahmad, 2012). The challenges Islamic Microfinance are facing are the non affordable prices of the products being offered, lack of trained and skilled management and administration, operational inefficiency, low management towards business risks, and their inability to access the poor (Akhtar et.al, 2009). On the other hand, financial institutions that are willing to expand have been stinted with the slow technologies, weak legal foundations, unsuitable financial processes, products and poor socio economic conditions, gender biasness and low level of education. Moreover, lack of financial literacy remains the primary barrier for the financial institutions. Further, the Islamic microfinance institutions lag behind their counterpart conventional institutions and their means of financing in terms of raising funds through deposits. Additionally, the repayment schedules are complex, the cost of loan administration and monitoring is high for the rural population. The NGOs are limited to use Musharaka model as they cannot take profit. On the other hand, many of the Islamic finance institutions are not registered as there are many cases of frauds and misconducts; therefore, they automatically influence the credibility of the registered Islamic microfinance institutions. Furthermore, there is divergence of opinion amongst the religious scholars and most of them are not satisfied with the Murabaha and Ijarah model of financing. In case of Musharaka, some people are not willing to disclose the amount of profit sharing. Therefore, it leads to agency problems. Besides, the weekly fluctuation of the profit makes it extremely difficult for the institutions to predict the cash flows, since each time a new amount of loan repayment is done it causes confusion between borrowers and loan officers. What is more, there is an absence of credit guarantee system, portfolio guarantee system, capital market and rating agencies. Lack of transparency causes more problems (Obaidullah, 2008). In case of Mudarabah model there is a problem to determine the actual total profit to be shared because micro entrepreneurs do not have proper accounts of financial statements (Dhumale and Sapcanin, 1999). Mudarabah and Musharaka techniques are prone to face capital impairment risk. Also, Murabaha is exposed to delivery risk and Ijarah is exposed to settlement risk (Rahim, 2007). To elaborate, Mudarabah has been facing fiduciary risk and displaced commercial risk. Whereas fiduciary risk is where management is involved for misconduct and displaced commercial risk is where the bank under pressure smoothes the rate of return to remain in competition (Alexakis, 2009). It is said, Murabaha model is overall more effective than Mudarabah model as it has low error margin and provides immediate collateral. Also, microfinance institutions own the goods until the last instalment is paid (Dhumale & Sapcanin, 1998). In case of the limitation on Bai Salam and Bai Muajjal the bank deals with money instead of the commodities, thus, the bank has to work as an intermediary between the seller and the buyer (Rasheed and Mudassar). Diminishing partnership has operational problems of rental rates complexities, taxation and land laws issues. Since it is unilateral model of financing, therefore, it can be terminated by either of the party at any time (Smolo, 2011). The issue with the housing models of financing is that they involve double taxation as there should be a single charge on single purchases (Ahmad, 2009). Due to lack of standardized interpretation on various instruments by different jurists and the reason that each Islamic institution elects its own religious board consisting of religious scholars, belonging to different schools of thought, may give opinions that are different from one another. There is a dire need of standardization and financial engineering as well as attitudinal uplifting and market participation in terms of securities (Shabrawy, 2011). The challenge with the Bai al Inah and Bai al Dayn is their acceptance in Pakistan and their introduction to the micro entrepreneurs instead of big investors (Rosly and Sanusi)

6. Findings and Conclusion

The integration of microfinance institutions with the professional training and endowment structuring institutions in Pakistan can surmount trials such as providing Islamic microfinance services to the underprivileged. Ethical and moral motivational programs have to be undertaken by both field supervisors and the clients thereby, ultimately fortifying the monitoring and supervisory modules. Also, the Islamic financial processes need to be simplified according to the client segmentation and the products should be diversified at lower cost with minimum risk for the prosperity of the product market. For example, the incorporation of the model of Qard ul Hassan in the Islamic micro finance system will boost the confidence of the general public in the registered Islamic financial institutions, due to the wealth being distributed properly among established networks and individuals. Islamic microfinance institutions should not focus on individuals alone but also extend their services towards families as well as local communities. Islamic banks should directly deal with the entrepreneurs and concentrate on eradicating loopholes created due to misuse of Islamic products and services by black marketeers. Islamic microfinance institutions need to get acquainted with the present community’s socio economic background and challenges in order to get a better picture of the demands and requirements of the rural populace. This insight would in turn help them to improvise their formulated case specific training programs and models on the targeted clientele which could then be introduced and taught by holding workshops and awareness training programs on a regular basis to create awareness of Islamic regulations. Well reputable Shariah boards are required to include members that are experts in the field of Islamic financial institutions and have specialization in Fiqh for authenticity. To sum up, it has been seen that there are a lot of studies being conducted on the Islamic banking models working for the growth of the micro entrepreneurs whereas little data has been seen on the Islamic microfinance institutions working for the advancement of the micro entrepreneurs using the models in compliance with the Shariah. Therefore, the Islamic microfinance institutions solely are still on a critical stage of analysis.

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