4

Financial Inclusion and Poverty Alleviation in Muslim-majority Countries: The Role of Islamic Finance and Qard Hassan

Amin Mohseni-Cheraghlou

Abstract Global Findex database reports that 75% or about one billion adults among self-identified Muslims do not have an account in a formal financial institutions. The first part of this chapter suggests that overall access to Islamic financial products is positively correlated with levels of financial inclusion in Muslim majority countries. One such product is Qard Hassan and the second part of this chapter highlights its theoretical potentials in reducing poverty and increasing shared prosperity. This theoretical treatment is then complemented with the third part of the chapter where a case study of Akhuwat Foundation, a Pakistani Islamic microfinance organization operating on a Qard Hassan model is presented in some detail and its relative success in breaking the cycle of poverty through Qard Hassan is highlighted.

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A. Mohseni-Cheraghlou (✉)
Faculty of Economics, University of Tehran, Tehran, Iran
e-mail: amohseni@ut.ac.ir

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4.1 Introduction

The growing volume of theoretical and empirical findings over the past decade shows that access to diverse forms of financial services has positive impacts on economic development and growth, and if done in an equitable and responsible manner, it can also reduce poverty and inequality and boost shared prosperity (Beck et al. 2004; Beck and Demirguç-Kunt 2008; Levine 2005; World Bank 2007).

It is estimated that more than 50% of world's adult population or 2.5 billion adults do not have access to formal financial institutions and majority of them reside in emerging market and developing economies (EMDEs) (Demirguc-Kunt and Klapper 2012). The picture is substantially grimmer for member countries of Organization of Islamic Conference (OIC). According to Global Findex Database, 40 out of the 48 OIC member countries represented in this database have formal account penetration rates[1] that were less than the world average of 50%. The median account penetration rate among the OIC member countries was only about 20%, a figure that is significantly less than the global average. Also, in comparison with other regions, Middle East and North Africa (MENA) region had the lowest penetration rate of 18% (Fig. 4.1).

Furthermore, according to Global Findex, 75% or about 1 billion adults among self-identified Muslims do not have an account in a formal financial institution. In other words, about two in every five adults without a formal account around the world are Muslims. This may be one reason as to why efforts for reducing poverty or enhancing shared prosperity in many of the MENA and other Muslim-majority countries are not as successful as one would have desired them to be.[2]

Islamic teachings pay particular attention to (a) eliminating absolute poverty; (b) reducing inequality, relative poverty, and marginalization of the poor; and (c) enhancing inclusive growth, social solidarity and shared prosperity. Islamic financial institutions (IFIs) play a central

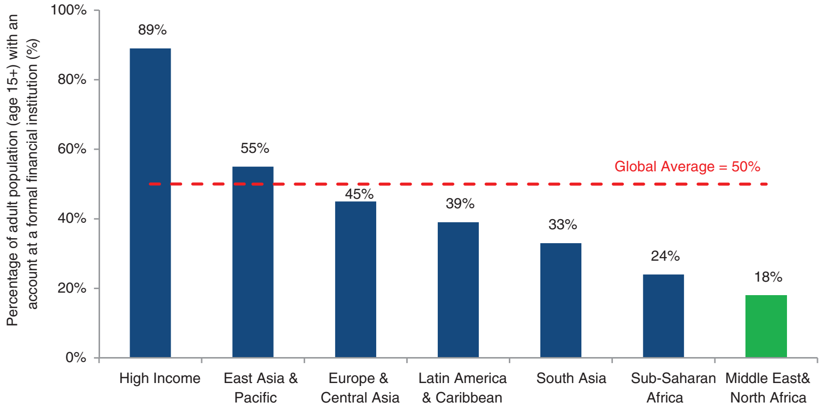

Fig. 4.1 Account penetration rates by regions, 2011. *Source* Global Financial Inclusion (Global Findex) Database

role in materializing these objectives through providing a diverse set of *Shari'ah*-compliant financial instruments that are designed to address the heterogeneous needs of their clients including those of the vulnerable and the poor. One such instrument is *Qard Hassan*. Often overlooked and not appropriately practiced by formal IFIs in most of the Muslim-majority countries, *Qard Hassan* (*QH*) is an interest-free loan (or *Qard*) that is also characterized by elements of goodwill, benevolence, and generosity (or *Ihsan*). This work suggests that if implemented appropriately, *QH* can potentially provide an effective mechanism to pave the path for the financially prudent and deserving poor who are unbanked or financially excluded to eventually become bankable and gain access to various forms of financial services and the many benefits associated with them. Additionally, *QH* could:

1. Distribute the limited financial resources designated for the poor (such as *Zakat* and *Sadaqa*) in a more productive and efficient manner.
2. Target the heterogeneous needs of the poor more effectively.
3. Encourage financial responsibility, creativity, and austerity among the receivers of *QH* (i.e., the vulnerable and the poor) as well as among the donors of *QH* (i.e., the non-poor).

4. Facilitate the transfer of knowledge and skills from the donors to the receivers of *QH*.
5. Increase the human capital, pride, and self-confidence of the receivers of *QH*.
6. Promote social solidarity and harmony between donors and receivers of *QH*.

The rest of the chapter is organized as follows. Through an empirical analysis based on data from Findex, BankScope, and World Development Indicator databases, first part of this work suggests that access to Islamic financial services is positively correlated with levels of financial inclusion in Muslim-majority countries. Therefore, the first part of the chapter provides support for the hypothesis that Islamic financial instruments can help reduce poverty and increase shared prosperity through enhancing financial inclusion among Muslim communities. The second part of the chapter will focus on the specific case of *Qard Hassan* (*QH*). First, a theoretical discussion around *QH* is presented, and its position vis-à-vis *Qard*, *Zakat*, and *Sadaqa* is analyzed in some detail. This theoretical discussion is important, as it will have significant practical implications for the sustainable operation of *QH* funds, an issue that is discussed next in this part of the essay. The third part of this essay will present a detailed case study of *Akhuwat*. *Akhuwat* is an Islamic microfinance institution in Pakistan that has been operating successfully based on a genuine *QH* model since 2002 and has been able to assist more than 900,000 poor families in various parts of Pakistan. A short conclusion ends this essay.

4.2 Islamic Finance and Financial Inclusion

Before analyzing the relationship between Islamic finance and financial inclusion, it must be mentioned that financial inclusion, if promoted responsibly, can result in significant benefits in terms of inclusive and equitable growth and poverty reduction. A 2013 World Bank report entitled *Financial Inclusion*[3] provides a rich and comprehensive synthesis of the existing literature as well as World Bank's own detailed research on this topic. The report concludes that:

- There is a notable level of inequality in access to financial services. "The poor, women, youth, and rural residents tend to face greater barriers to access financial services. Among firms, the younger and smaller ones are confronted by more binding constraints. For instance, in developing economies, 35% of small firms report that access to finance is a major obstacle to their operations, compared with 25% of large firms in developing economies and 8% of large firms in developed economies."[4]
- Financial inclusion is important for equitable growth and poverty reduction. "Considerable evidence indicates that the poor benefit enormously from basic payments, savings, and insurance services. For firms, particularly the small and young ones that are subject to greater constraints, access to finance is associated with innovation, job creation, and growth."[5]
- Financial inclusion must be done responsibly to benefit the targeted population. This does not mean finance for all at all costs. "Some individuals and firms have no material demand or business need for financial services. Efforts to subsidize these services are counterproductive and, in the case of credit, can lead to over-indebtedness and financial instability."[6]

Therefore, it should not come as a surprise that access to financial services is strongly correlated with productivity and income.

4.2.1 Reasons for Financial Exclusion

The reasons for financial exclusion, defined here as not having an account at a formal financial institution or being unbanked, are rooted in a complex set of economic, legal, social, political, cultural, and personal factors but can be classified into two main categories: voluntary and involuntary reasons. As shown in Fig. 4.2, some adults are financially excluded and voluntarily so because of religious considerations.

A 2011 survey, the Global Findex Database,[7] is the first international database that makes it possible to get a first glimpse at the various aspects of financial exclusion at the individual level. In addition to many other questions, this survey asks the unbanked respondents (i.e., adults

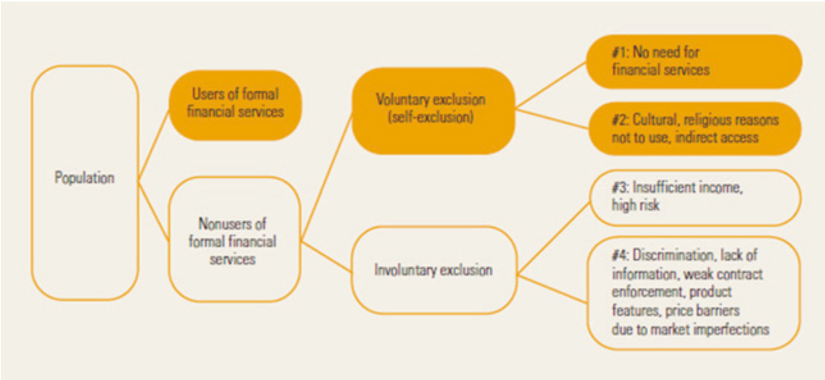

Fig. 4.2 Financial exclusion. *Source* Global Financial Development Report 2014

lacking a formal account) about the reason(s) as to why they do not have an account at a bank, credit union or other formal financial institution. The respondents could choose one or more of the following reasons:

a. They are too far away.
b. They are too expensive.
c. You do not have the necessary documentation (ID, wage slip).
d. You do not trust them.
e. You do not have enough money to use them.
f. Because of religious reasons.
g. Because someone else in the family already has an account.

Two notes are in order here. First, one can think of many more reasons for an individual not to have an account that are not part of the above seven reasons. For example, one can think of concerns with government taxes and identification of wealth, no need, preferences in using informal financial services, being illiterate and not knowing how to open an account as some other valid reasons for not having an account. Second, while allowing to select multiple reasons provides a more complete picture of the reasons behind an individual's lack of an account, it makes it impossible to identify the ultimate binding constraint facing the unbanked individuals who have provided more than one reason. For example, if a person has pointed to distance and costs

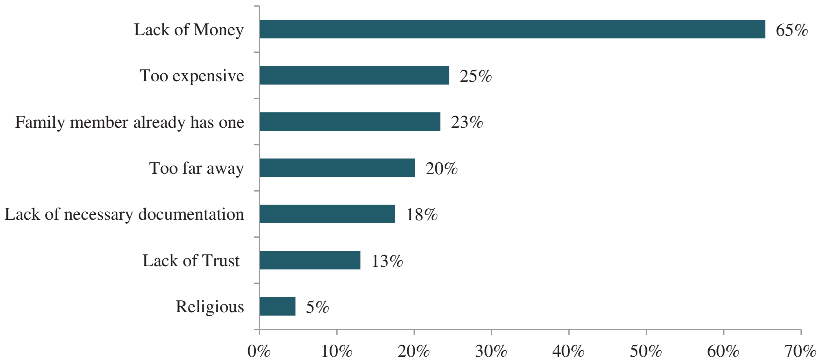

Fig. 4.3 Reasons for financial exclusion, 2011. *Source* Global Financial Inclusion (Global Findex) Database; author's own calculation. *Note* Respondents could choose more than one reason

(options a and b above) as her reasons for being unbanked, then one would have no way of knowing if the responder will remain unbanked if one of the obstacles (either distance or cost) is removed, presenting policymakers with a certain level of uncertainty.

Acknowledging these two caveats, this question nevertheless provides a valuable entry point for analyzing the reasons for which 2.5 billion adults around the globe have remained unbanked. According to this question, not having enough money is the most cited reason for being unbanked, followed by cost, another family member having an account, and distance (Fig. 4.3) with exclusion for religious reasons is the least cited reason.

Reasons of financial exclusion vary across regions (Fig. 4.4). While lack of sufficient funds was by far the most frequently cited reason for not having an account for the unbanked adults in all regions, there was no other common pattern in reasons of exclusion across all regions. For example, lack of trust was second most frequently cited reason for being unbanked in Europe and Central Asia (ECA), while being too expensive was the second reason in Latin America and the Caribbean (LAC), Middle East and North Africa (MENA), and Sub-Saharan Africa (SSA). Also, while religious factor was the third highest cited reason for not having an account in MENA (12%), it was the least frequently cited reason for the unbanked adults in other regions.

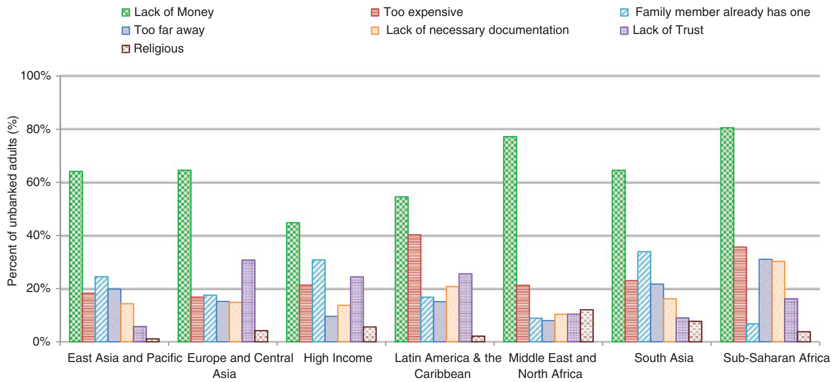

Fig. 4.4 Reasons for financial exclusion by regions, 2011. *Source* Global Financial Inclusion (Global Findex) Database; author's own calculation

The complex combination of social, economic, political, demographic, historical, security, and legal factors in countries would make reasons of financial exclusion also vary widely across countries. A look at Table 4.1 highlights the stark differences between different countries even when they are in the same income group or region. For example, one can point to Afghanistan and Bangladesh, two South Asian low-income economies that have widely different account penetration rates and differ widely on reasons of financial exclusion. Namely, 32% of unbanked adults in Afghanistan reported religious reasons for not having an account, while this figure is only at 4% in Bangladesh. This is despite the fact that both countries have comparable ratios of Muslim population (98% and 90% in Afghanistan and Bangladesh, respectively) and religiosity levels[8] (97% and 99% in Afghanistan and Bangladesh, respectively).

4.2.2 Financially Excluded for Religious Reasons: Who and Where?

About five percent (or 125 million) of the unbanked adults around the world reported religious reasons for not having an account. But who are these adults, which religion they adhere to, and in which region and countries they reside in? A review of Table 4.1 shows

Table 4.1 Reasons of financial exclusion by country in 2011. *Source* Global Financial Inclusion (Global Findex) Database; author's own calculation. OIC countries are in bold

Country	Adults with no account (% age 15 +)	Too far away (% unbanked adults)	Too expensive (% unbanked adults)	Lack of necessary documentation (% unbanked adults)	Lack of Trust (% unbanked adults)	Lack of Money (% unbanked adults)	Religious (% unbanked adults)	Family member already has one (% unbanked adults)
Afghanistan	**91**	**39**	**37**	**37**	**37**	**40**	**32**	**13**
Albania	**72**	**11**	**14**	**14**	**12**	**49**	**7**	**17**
Angola	60	18	30	37	21	48	11	15
Argentina	67	5	36	20	27	62	1	13
Armenia	83	8	23	17	24	74	0	5
Australia	1	0	0	0	0	34	0	24
Austria	1	0	4	1	3	20	0	8
Azerbaijan	**85**	**5**	**16**	**22**	**20**	**68**	**5**	**6**
Bangladesh	**60**	**13**	**30**	**10**	**9**	**71**	**4**	**23**
Belarus	41	20	14	13	28	65	3	24
Belgium	2	0	3	5	1	0	0	34
Benin	**90**	**23**	**26**	**37**	**24**	**91**	**2**	**5**
Bolivia	72	35	41	15	34	52	2	14
Bosnia and Herzegovina	**43**	**14**	**14**	**13**	**19**	**53**	**1**	**36**
Botswana	70	36	35	46	19	89	5	9
Brazil	44	15	42	25	19	62	1	29
Bulgaria	47	10	12	11	25	83	0	20
Burkina Faso	**87**	**30**	**28**	**21**	**9**	**90**	**1**	**2**
Burundi	93	15	39	9	7	87	2	1
Cambodia	96	15	10	10	15	87	4	2
Cameroon	**85**	**24**	**27**	**11**	**29**	**79**	**1**	**1**

(continued)

Table 4.1 (continued)

Country	Adults with no account (% age 15 +)	Too far away (% unbanked adults)	Too expensive (% unbanked adults)	Lack of necessary documentation (% unbanked adults)	Lack of Trust (% unbanked adults)	Lack of Money (% unbanked adults)	Religious (% unbanked adults)	Family member already has one (% unbanked adults)
Canada	4	20	30	1	11	16	0	44
Chad	**91**	**40**	**37**	**42**	**23**	**60**	**9**	**13**
Chile	58	10	45	23	37	65	2	11
China	36	13	8	7	3	57	0	31
Colombia	70	10	47	17	30	61	2	15
Comoros	**78**	**9**	**15**	**22**	**10**	**82**	**6**	**6**
Congo, Dem. Rep.	96	34	26	22	23	71	2	1
Congo, Rep.	91	11	13	26	9	81	0	2
Costa Rica	50	9	19	16	20	33	2	21
Croatia	11	10	11	20	13	53	0	36
Cyprus	**15**	**3**	**7**	**1**	**8**	**34**	**1**	**29**
Czech Republic	19	11	45	10	41	69	3	46
Denmark	0	0	0	30	0	30	0	30
Djibouti	**87**	**20**	**31**	**24**	**18**	**69**	**22**	**13**
Dominican Republic	62	4	15	14	11	73	1	6
Ecuador	63	18	38	21	29	53	4	14
Egypt, Arab Rep.	**90**	**1**	**13**	**5**	**2**	**95**	**3**	**2**
El Salvador	86	16	29	24	19	38	3	7
Estonia	3	16	14	6	8	36	2	40
Finland	0	9	9	0	0	0	0	9

(continued)

Table 4.1 (continued)

Country	Adults with no account (% age 15 +)	Too far away (% unbanked adults)	Too expensive (% unbanked adults)	Lack of necessary documentation (% unbanked adults)	Lack of Trust (% unbanked adults)	Lack of Money (% unbanked adults)	Religious (% unbanked adults)	Family member already has one (% unbanked adults)
France	2	17	3	21	0	21	5	51
Gabon	**81**	**20**	**32**	**30**	**15**	**84**	**1**	**2**
Georgia	67	7	18	17	12	80	1	9
Germany	1	4	4	20	16	17	0	28
Ghana	71	28	21	22	17	83	2	5
Greece	22	7	10	4	21	73	2	44
Guatemala	78	18	31	28	24	61	5	14
Guinea	**96**	**22**	**22**	**26**	**7**	**89**	**5**	**2**
Haiti	78	25	35	34	31	67	9	8
Honduras	79	20	24	19	21	52	4	13
Hong Kong SAR, China	11	31	37	46	27	77	14	57
Hungary	27	10	39	6	29	70	0	27
India	65	23	24	17	8	63	8	41
Indonesia	**80**	**37**	**43**	**27**	**9**	**83**	**1**	**9**
Iraq	**89**	**15**	**17**	**13**	**32**	**66**	**24**	**10**
Ireland	6	16	31	10	9	35	4	53
Israel	9	6	26	28	21	60	3	37
Italy	25	0	19	5	9	32	0	29
Jamaica	27	3	12	20	12	51	3	9
Japan	2	6	0	26	0	7	0	39
Jordan	**75**	**3**	**23**	**4**	**1**	**70**	**10**	**27**
Kazakhstan	**57**	**12**	**13**	**16**	**20**	**58**	**2**	**22**

(continued)

Table 4.1 (continued)

Country	Adults with no account (% age 15 +)	Too far away (% unbanked adults)	Too expensive (% unbanked adults)	Lack of necessary documentation (% unbanked adults)	Lack of Trust (% unbanked adults)	Lack of Money (% unbanked adults)	Religious (% unbanked adults)	Family member already has one (% unbanked adults)
Kenya	58	35	43	25	12	88	4	5
Korea, Rep.	7	13	9	14	7	30	0	45
Kosovo	55	12	17	12	12	40	10	33
Kuwait	**13**	**2**	**15**	**32**	**3**	**32**	**2**	**81**
Kyrgyz Republic	**96**	**32**	**18**	**11**	**21**	**73**	**7**	**3**
Lao PDR	73	21	13	8	7	85	1	8
Latvia	10	11	4	4	13	64	0	38
Lebanon	**63**	**2**	**27**	**1**	**7**	**82**	**7**	**19**
Lesotho	82	49	51	33	14	84	3	11
Liberia	81	36	29	43	30	71	6	12
Lithuania	26	6	12	11	28	71	0	40
Luxembourg	4	2	5	4	5	32	2	59
Macedonia, FYR	26	15	19	25	22	58	7	43
Malawi	83	13	25	17	10	89	1	2
Malaysia	**33**	**27**	**16**	**35**	**3**	**56**	**0**	**26**
Mali	**92**	**35**	**21**	**23**	**8**	**87**	**3**	**2**
Malta	5	1	5	2	9	38	0	32
Mauritania	**83**	**31**	**29**	**23**	**24**	**66**	**16**	**13**
Mauritius	20	7	8	19	8	66	2	31
Mexico	71	19	47	21	29	35	2	12
Moldova	82	12	29	12	28	87	2	7
Mongolia	22	18	5	8	7	61	0	49

(continued)

Table 4.1 (continued)

Country	Adults with no account (% age 15 +)	Too far away (% unbanked adults)	Too expensive (% unbanked adults)	Lack of necessary documentation (% unbanked adults)	Lack of Trust (% unbanked adults)	Lack of Money (% unbanked adults)	Religious (% unbanked adults)	Family member already has one (% unbanked adults)
Montenegro	49	5	13	18	19	65	5	32
Morocco	**61**	**18**	**49**	**36**	**22**	**60**	**25**	**32**
Mozambique	**60**	**13**	**18**	**27**	**10**	**78**	**2**	**10**
Nepal	74	25	25	9	6	71	1	18
Netherlands	0	0	8	0	0	8	0	26
New Zealand	0	13	0	0	75	13	0	75
Nicaragua	86	17	25	27	18	36	10	11
Niger	**98**	**68**	**54**	**59**	**37**	**92**	**23**	**4**
Nigeria	**70**	**30**	**37**	**40**	**13**	**83**	**3**	**8**
Oman	**26**	**13**	**17**	**21**	**19**	**56**	**15**	**54**
Pakistan	**89**	**14**	**13**	**14**	**8**	**71**	**7**	**9**
Panama	75	20	28	40	34	33	10	22
Paraguay	78	9	11	8	20	72	5	14
Peru	79	24	55	16	37	54	2	11
Philippines	73	34	51	42	14	78	7	26
Poland	29	11	24	15	24	68	1	27
Portugal	15	1	9	2	10	23	1	11
Romania	55	11	19	12	23	69	0	13
Russian Federation	51	12	15	13	38	69	4	22
Rwanda	67	24	38	19	6	88	1	7
Saudi Arabia	**53**	**5**	**12**	**13**	**10**	**45**	**23**	**51**
Senegal	**94**	**28**	**37**	**34**	**13**	**84**	**6**	**5**

(continued)

Table 4.1 (continued)

Country	Adults with no account (% age 15 +)	Too far away (% unbanked adults)	Too expensive (% unbanked adults)	Lack of necessary documentation (% unbanked adults)	Lack of Trust (% unbanked adults)	Lack of Money (% unbanked adults)	Religious (% unbanked adults)	Family member already has one (% unbanked adults)
Serbia	37	10	18	22	17	58	1	35
Sierra Leone	**85**	**37**	**44**	**42**	**20**	**82**	**9**	**7**
Singapore	2	0	16	0	6	71	0	28
Slovak Republic	20	15	44	11	29	75	0	41
Slovenia	3	5	24	21	6	63	0	66
South Africa	46	34	40	23	18	73	3	12
Spain	7	19	30	19	32	52	9	42
Sri Lanka	31	26	17	13	12	67	2	27
Sudan	**93**	**23**	**45**	**27**	**13**	**82**	**4**	**15**
Swaziland	71	30	34	38	13	72	6	10
Sweden	1	0	19	39	10	10	0	0
Syrian Arab Republic	**77**	**9**	**33**	**0**	**4**	**27**	**15**	**2**
Taiwan, China	12	7	9	10	7	43	6	44
Tajikistan	**97**	**28**	**18**	**22**	**21**	**78**	**8**	**4**
Tanzania	83	48	46	35	13	78	4	8
Thailand	27	13	9	4	3	57	1	47
Togo	**90**	**27**	**20**	**32**	**17**	**91**	**1**	**2**
Trinidad and Tobago	21	4	35	38	13	67	1	10
Tunisia	**68**	**15**	**25**	**17**	**18**	**73**	**26**	**20**
Turkey	**42**	**13**	**26**	**21**	**26**	**48**	**7**	**20**
Turkmenistan	**100**	**36**	**12**	**21**	**10**	**52**	**10**	**3**

(continued)

Table 4.1 (continued)

Country	Adults with no account (% age 15 +)	Too far away (% unbanked adults)	Too expensive (% unbanked adults)	Lack of necessary documentation (% unbanked adults)	Lack of Trust (% unbanked adults)	Lack of Money (% unbanked adults)	Religious (% unbanked adults)	Family member already has one (% unbanked adults)
Uganda	**80**	**42**	**54**	**38**	**23**	**85**	**3**	**7**
Ukraine	59	24	19	11	55	67	4	18
United Kingdom	2	20	29	10	32	21	6	13
United States	11	14	28	17	46	49	7	19
Uruguay	76	7	26	8	19	70	0	5
Uzbekistan	**77**	**19**	**7**	**16**	**15**	**60**	**6**	**9**
Venezuela, RB	55	8	16	3	16	75	0	15
Vietnam	78	13	8	13	9	50	1	12
West Bank and Gaza	**81**	**3**	**23**	**5**	**12**	**67**	**24**	**18**
Yemen, Rep.	**96**	**13**	**17**	**9**	**8**	**86**	**9**	**3**
Zambia	79	21	50	32	9	85	1	6
Zimbabwe	60	14	39	27	20	82	1	8

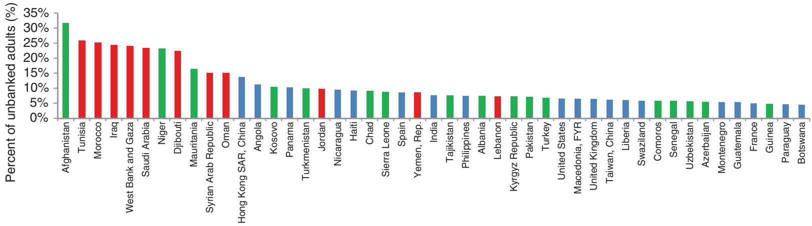

Fig. 4.5 Financially excluded due to religious reasons, 2011. *Source* Global Financial Inclusion (Global Findex) Database; author's own calculation. *Note* Green and red bars refer to countries where followers of Islam constitute at least 60% or more of the population. Red bars refer to countries in the MENA region

that compared to other countries, the unbanked adults in Muslim-majority countries tend to have higher likelihood of citing religious reasons for not having an account. This information is summarized in Fig. 4.5. As evident from this figure, 28 out of 47 countries where religious reasons were cited by at least 4% of the unbanked adults are countries where Muslims constitute majority of the total population (highlighted in green and red bars). From these 28 countries, 11 are located in the MENA region (highlighted in red bars). It is important here to realize that while about 5% of adults worldwide cited religious reasons for not having an account, financial exclusion rates because of religious reasons are above 20% for eight OIC countries, six of which are located in the MENA region. Furthermore, 13 OIC countries (which include eight MENA countries) have financial exclusion rates because of religious reasons at 10% or more. Overall, based on Global Findex, about 12% of unbanked individuals in the Arab MENA (or 17 million) and 7% of the unbanked in OIC member countries (or 47 million) reported not having an account because of religious reasons.[9]

Figure 4.6 also confirms that self-identified Muslims are about twice less likely to have an account in comparison with their non-Muslim counterparts (24% vs. 44%), and this gap is about 13% points in the MENA region.

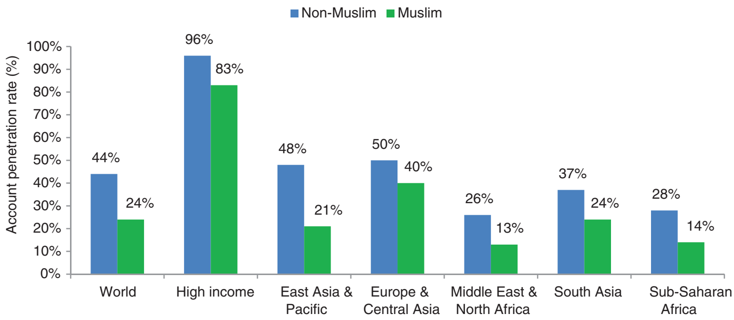

Fig. 4.6 Differences in financial inclusion between Muslims and non-Muslims, 2011. *Source* Demirguc-Kunt, Klaper, and Randall (2013). *Note* The difference between Muslims and non-Muslim is statistically significant at 1% level. Analysis is based on 64 countries. Countries with less than 1% and more than 99% Muslim population are excluded from the analysis

Cross-country regressions also support the idea presented in tables and figures above. Regression results in Table 4.2[10] and a close look at changes in R-squared values between different models and the size and significance of coefficients suggest that being in the MENA region followed by share of Muslim population in a given country is the most important determining factor for being financially excluded because of religious reasons.

Overall, the available data, albeit limited in scope, suggest that financial exclusion due to religious reasons is a phenomenon that is predominantly characteristic of Muslim-majority countries and especially those in the MENA region. In other words, in comparison with other religious and non-religious communities around the world, the followers of Islam are more likely to avoid formal financial institutions altogether because of religious reasons as the operations of vast majority of those institutions are primarily interest oriented.

4.2.3 Islamic Finance and Financial Inclusion

Based on the evidence presented thus far, it could be argued that enhancing the size of and access to *Shari'ah*-compliant financial

Table 4.2 Determinant of financial exclusion due to religious reasons

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8	Model 9
GDP (2005 Billion $)	0.000061	0.000255	0.000091	0.00028*	0.00034*	0.00158	0.00032*	0.00054***	0.00036*
GDP per Capita, PPP (2005 international thousand $)	−0.0694*	−0.0110	0.0152	0.0236	−0.0416	−0.0892	−0.0256	−0.123	−0.0666
Muslim Population (% total population)		**0.0927*** **		**0.0914*** **	**0.0762*** **	**0.0512*** **	**0.0755*** **	**0.0624*** **	**0.0626*** **
Religiosity (% adults)			0.0745***	0.0258	−0.0160	−0.00866	−0.0172	−0.0209	−0.0190
East Asia and Pacific dummy					−1.480	−1.907	−1.953	−1.674	−1.802
Europe and Central Asia dummy					−1.476	−0.233	−2.071	−1.487	−1.695
Latin America & the Caribbean dummy					1.291	0.499	0.978	0.915	0.646
Middle East and North Africa dummy					**6.493***	**7.997*** **	**5.906***	**9.447*** **	**8.926*** **
South Asia dummy					3.018	−3.642	2.044	2.789	2.982
Sub-Saharan Africa dummy					−0.224	−2.991	−2.382	−1.318	−1.322
Literacy rate (% people 15+)						−0.0964			
Life expectancy at birth							−0.116		
Commercial bank Branches per 100,000 adults								−0.00142	
Commercial bank branches per 1000 km^2									−0.00791***
Observations	133	133	102	102	102	83	102	86	86
R-Squared	0.024	0.361	0.071	0.364	0.455	0.536	0.459	0.500	0.546

Note OLS regressions with robust standard errors. * $p<0.10$, ** $p<0.05$, *** $p<0.01$. Dependent variable is the percentage of adults reporting religious reasons for not having an account, which is taken from Global Findex Database. GDP and GDP per capita are included in all models as proxies for the quality of institutions

Table 4.3 Density of *Shari'ah*-compliant assets and financial exclusion due to religious reasons

	Model 1	Model 2
GDP (2005 Billion $)	0.000527***	0.000420***
GDP per Capita, PPP (2005 international thousand $)	–0.0791*	–0.0405
Religiosity (% adults)	0.00559	0.0102
Muslim population (% total)	0.0718***	0.0623**
Middle East and North Africa dummy	11.97***	11.31***
Commercial bank branches per 1000 km2	–0.00748**	–0.00636*
Ratio of *Shari'ah*-compliant assets to total assets (%)	**–0.296*** **	
***Shari'ah*-compliant assets per adult (1000s $)**		**–0.563*** **
Observations	85	86
R-Squared	0.588	0.557

Note OLS regression with robust standard errors. * p<0.10, ** p<0.05, *** p<0.01. Dependent variable is the percentage of adults reporting religious reason for not having an account, which is taken from the Global Findex Database. Only those variables that were significant in at least one of the models in Table 4.2 were included in these regressions. *Shari'ah*-compliant (Islamic) assets and total assets are from BankScope

products can reduce voluntary financial exclusion because of religious reasons. In other words, if the earlier findings are true, one should expect to see a negative relationship between the density of *Shari'ah*-compliant financial services and the percentage of adults that are unbanked due to religious reasons. Table 4.3 provides some evidence supporting this hypothesis. The negative and statistically significant coefficients for two different measures of density of *Shari'ah*-compliant assets show that after controlling for other relevant factors, the percentages of people who report religious reasons for not having an account in formal financial institutions are lower in countries where Islamic finance has stronger presence in the formal banking sector. Put differently, one could expect that as the density of *Shari'ah*-compliant assets increases, the share of unbanked people because of religious reasons decreases.

This suggests that increasing the presence of formal *Shari'ah*-compliant financial services in countries with considerable Muslim population could reduce the level of voluntary exclusion from formal financial institutions because of religious considerations. At the very minimum, this is certainly true for at least 13 million adults who, according to Global Findex Database, cited only and only religious reasons for not having an account, more than 11 million of which reside in OIC member countries.

Table 4.4 provides some anecdotal evidence that increasing the share of *Shari'ah*-compliant assets vis-à-vis total banking assets in a country can help reduce the percentage of small firms who cite access to finance as a major obstacle for their operations. This is in line with the fact that small firms are often managed and operated by members of a family, where religious considerations are more likely to surface in their financing decisions when compared to medium and large firms, which are often operated by professional executives who might also be from non-Islamic backgrounds and thus have lesser or no care toward *Shari'ah*-compliant financing.

4.2.4 Islamic Finance and Financial Inclusion in Other Studies and Reports

In addition to the empirical results above, several recent case studies have also highlighted the potential role of Islamic finance in reducing voluntary financial exclusion among the Muslim population in both Muslim-majority and Muslim-minority countries. For example, Adeyemi et al. (2012) show that Islamic microfinance can in fact provide financial services to a considerable segment of Nigerian society whom for religious reasons avoid dealings with conventional financial institutions. Also, according to the 2006 Sachar Committee Report on the status of minorities in India, the share of Muslims in amount outstanding is about 4.6% while that of other minorities is about 6.5%, which is disproportionate to their share in India's population (13.4% for Muslims and 5.6% for other minorities). In a joint report prepared by Infinity Consultants and Ethica Institute of Islamic Finance, it is proposed that only through increasing the presence of Islamic Finance in India's financial fabric, the Indian government can increase the use of financial services by its largest minority group, the 180 million Muslims

Table 4.4 Density of *Shari'ah*-compliant assets and financial obstacles of firms

	All firms	Small firms	Medium firms	Large firms
GDP (2005 Billion $)	0.00527	0.00256	0.00437	0.0117
GDP per Capita, PPP (2005 international thousand $)	–0.648*	–0.670**	–0.466	–0.578
Religiosity (% adults)	0.0449	0.0903	–0.0282	0.0311
Muslim population (% total)	–0.0107	–0.0219	0.00266	0.00703
East Asia and Pacific dummy	–7.151	–4.761	–0.674	–14.36
Europe and Central Asia dummy	6.191	8.228	6.648	4.250
Latin America & the Caribbean dummy	2.243	3.251	5.120	–6.898
Middle East and North Africa dummy	14.63	21.39***	22.01	38.76
South Asia dummy	–2.692	–1.287	3.233	–7.182
Sub-Saharan Africa dummy	17.36*	20.30**	19.21*	0.186
Commercial bank branches per 1000 km^2	–0.0419	–0.169	–0.0225	–0.214
Ratio of *Shari'ah*-compliant assets to total assets (%)	**–0.0723**	**–0.157*** **	**–0.389**	**–0.744**
Observations	68	68	68	68
R-Squared	0.475	0.482	0.375	0.384

Note OLS regression with robust standard errors. * $p<0.10$, ** $p<0.05$, *** $p<0.01$. Dependent variable is the percentage of firms reporting access to finance as a major obstacle in their operations, which is from World Bank Enterprise Survey. Only those variables that were significant in at least one of the models in Table 4.2 were included in these regressions. Shari'ah-compliant (Islamic) assets and total assets are from BankScope.

residing in India.[11] This will add to the economic growth of India while at the same time increasing the well-being of and reducing poverty among its poverty-ridden Muslim population.

Over the past few years, an increasing number of Muslim and non-Muslim policymakers, central bank governors, and politicians have also shown growing interest for a more pronounced presence of Islamic finance in the global financial architecture because of its potentially important role in enhancing financial inclusion. In her Islamic Development Bank (IDB) Prize Lecture On November 2013, Governor Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), referred to the potential role of Islamic financing modes in enhancing financial inclusion.[12] Again, in November 2013, the governor of Central Bank of Nigeria, Mr. Lamido Sanusi, identified Islamic finance as having the capacity of increasing financial inclusion among a large segment of population in Nigeria. In September 2013, Mr. Nestor Espenilla, deputy governor of the Bangko Sentral Pilipinas (BSP), Philippines' central bank, laid out one of the most ambitious efforts in the world in introducing Islamic finance in a Muslim-minority country, in an effort to enhance financial inclusion among the Muslim population of Philippines.[13] Finally, on December 2013, IMF's Director of Middle East and Central Asia Department, Mr. Masood Ahmed, highlighted the fact that if properly regulated, faster expansion of Islamic finance in MENA can lead to higher levels of financial inclusion among religiously minded population.[14]

4.2.5 Concluding Remarks

Based on the above, it is safe to suggest that Islamic finance can play an important role in enhancing financial inclusion among the unbanked adults in OIC member countries. For example, risk-sharing contracts such as *Murabahah*, *Musharakah*, and *Mudarabah* as well as wealth redistribution instruments in the Islamic financial system such as *Zakat*, *Sadaqa*, and *Qard Hassan* are a few of the main mechanisms through which Islamic finance could promote financial inclusion, boost shared prosperity, and reduce poverty and inequality.

Shari'ah-compliant risk-sharing contracts can provide access to finance and insurance (*Takaful*) for micro, small, and medium enterprises (MSMEs). This is crucial because as pointed by World Bank's Enterprise Survey somewhere between 30 and 40% of all small- and medium-sized firms in the MENA region identify access to finance as a major constraint in their operations. Furthermore, built in the Islamic law and code of ethics is mandatory and voluntary almsgiving known as *Zakat* and *Sadaqa*, respectively, with *Qard Hassan* falling between the two (as discussed below). Through analyzing the available data for nine MENA countries, Mohieldin et al. (2012) find that if implemented effectively, *Zakat* funds in all these countries are more than sufficient to eliminate the extreme poverty (measured as having an income of less US$1.25 a day).[15]

It must be pointed out that while increasing the availability of Islamic finance is a necessary ingredient for increasing access to finance and insurance for the poor households and MSMEs, other supporting factors such as adequate physical, legal, financial, regulatory, and educational infrastructure must also be in place for Islamic finance to operate effectively and efficiently. It is a reality that most OIC member countries lack many of these necessary prerequisites, creating extra hurdles for growth and efficient operation of *Shari'ah*-compliant financial institutions in OIC member countries. As a result, community-based local financing schemes seem to be the most appropriate venue for boosting financial inclusion among the estimated 700 million poor residing in OIC member countries. *Murabahah* (cost plus markup sale contract) and *Qard Hassan* (benevolent interest-free loan) are examples of such locally oriented Islamic financing programs, which are also the most popular forms of Islamic microfinance schemes in the MENA region and other Muslim-majority countries such as Indonesia, Pakistan, and Bangladesh (Fig. 4.7). These schemes are practically risk-free financial instruments suitable for the vulnerable and the poor who would otherwise have no other opportunity of access to financial services. This would in turn increase the chance of the poor to move themselves out of poverty by potentially providing them with a temporary financial breathing space, increasing financial literacy and capability, and building credit history.

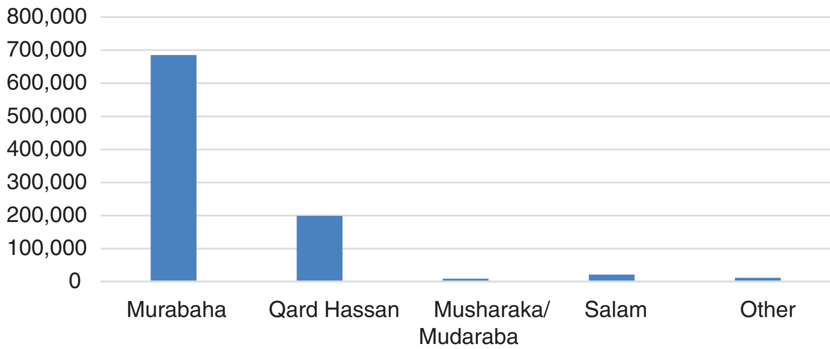

Fig. 4.7 Islamic microfinance schemes, number of active clients, by product type. *Source* El-Zoghbi and Tarazi (2013). *Note* Countries included are Afghanistan, Bangladesh, Burkina Faso, Cambodia, Cameroon, Côte d'Ivoire, Egypt, Iraq, Indonesia, Jordan, Kosovo, Lebanon Pakistan Palestine (West bank and Gaza), Saudi Arabia, Sri Lanka, Sudan, Syria, and Yemen

4.3 Qard Hassan

In order to gain a better understanding of *Qard Hassan* (*QH*), it is necessary to juxtapose this financial instrument with some of the other main Islamic financial instruments. Therefore, a brief list and explanation of each of the main Islamic financial instruments is provided below:

- *Mudarabah* (Profit-Sharing). Supplier of capital contracts with a working partner on the basis of sharing the resulting profits. Losses, if any, are considered loss of capital and borne by the owner of capital. The working partner, in that case, goes unrewarded for its efforts. This is the "loss" borne by the working partner, a feature of *Mudarabah* which has made some to characterize it as profit and loss sharing (PLS). The sharing contract when applied to farming is called *Muzara'ah* or sharecropping.
- *Shirkah* or *Musharakah* (Partnership). In partnership, two or more parties supply capital as well as work/effort. They share the resulting profits according to agreed proportions, but losses are to be borne in proportion to respective capitals.
- *Murabahah*. A sale agreement under which the seller purchases goods desired by a buyer and sells it to him/her at an agreed marked up

price, payment being deferred. It is also referred to as *Bay' Mu'ajjal* or *Bay' bi Thaman Ajil*. It is a modern adaptation of an earlier contract in which deferment was not necessarily involved. The higher price paid would leave a margin for the seller in order to reward him/her for expertise in bargaining and better knowledge of market conditions.

- *Wakala* (Agency). An agent appointed by the principal-owner manages business. Agent's compensation may take different forms.
- *Ju'ala*. Reward that is given on successful completion of a specified job. There is no compensation in case of failure.
- *Ijara*. It refers to the leasing of a property, capital good, or any other good.
- *Salam* (Future Contract). Payment is extended now for agricultural products to be delivered at a specified time in future with the price agreed upon now.
- *Istisna'*. *Salam* applied to manufactured goods, with the possibility of payment in installments as the goods are delivered.
- *Urboon*. Depositing a small fraction of price in a deal to be concluded in future. It binds the seller to wait but allows the buyer to back out of the deal, with the seller keeping the deposit.
- *Qard* (Interest-free Loan). The only acceptable loans in Islamic financial institutions (IFIs) which are interest-free loan.
- *Qard Hassan* (The Benevolent Loan). It is a charitable loan which, in addition to being a *Qard* (interest-free loan), also contains elements of goodwill, benevolence, and generosity.
- *Zakat* (Mandatory). Money or any form of capital donated to the poor on a mandatory basis, the rates and conditions of which are stipulated by the *Shari'ah*.
- *Sadaqa* (Voluntary Alms). In-kind or monetary donations to the poor on a voluntary basis.

From the above list, the instruments of *Qard*, *Qard Hassan*, *Zakat*, and *Sadaqa* are particularly fit to address the financial needs of the vulnerable[16] and the poor. This is because the poor are often highly risk averse and are therefore unwilling to participate in risk-sharing business contracts such as *Mudarabah* and *Musharakah*. Furthermore, the poor usually lack the necessary physical and human capital as well as basic financial literacy and capability to establish and maintain successful business and financial partnerships. As a result, *Qard*, *Qard Hassan* (*QH*), *Zakat*, and *Sadaqa* are the most appropriate financial instruments to address the financing needs of the vulnerable and the poor.

4.3.1 Qard Hassan: Qard and Ihsan

QH is composed of two elements that are clearly laid out in its name: *Qard* (interest-free loan) and *Ihsan* (goodwill, benevolence, and generosity). Mirakhor and Iqbal (2007) provide a detailed discussion of *QH* terminology and the relevant *Quranic* verses referring it. Below, some of the main *Shari'ah* guidelines of *QH* as it pertains to its elements of *Qard* and *Ihsan* are highlighted separately. First, let's highlight the main *Shari'ah* requirement for the *Qard* component of *QH*:

1. A contract is completed in accordance with Islamic guidelines.
2. The lender may ask the borrower for collateral or guarantee.
3. While the borrower has to repay the principle, he/she is not obligated to make any form of interest payments for the loan.
4. The lender cannot request a payment from the borrower prior to the agreed date stipulated on the contact.
5. If the borrower manages to make positive profits, the lender cannot expect to receive any portion of it.
6. The borrower may only use the loan for the agreed activity(s) stated in the contract. If the borrower fails to do so, the contract is voided, and the lender can request for an immediate repayment of the principle.
7. In the case of borrower's default, the lender may not take possession of the borrower's basic living needs (shelter, cloth, food, and the capital by which the borrower makes a living for himself and his dependents).

Now, some of the features associated with the *Ihsan* element of *QH* are highlighted. All of these features are rooted in the Islamic code of conduct (*Akhlaq*) that is driven from many *Quranic* verses and traditions of the Prophet Muhammad (i.e., *hadith*) and are only voluntary in nature:

1. The lender is willing to extend a *QH* loan without requesting a collateral and/or guarantor.
2. If the borrower, due to factors beyond his control, fails to adhere to the terms of contract, the lender is willing to be benevolent and flexible toward the borrower. Furthermore, if the borrower, because of unexpected events and factors beyond his control, defaults on the loan, the lender is willing to forgive or restructure the debt. This would essentially convert a *QH* into *Sadaqa*.
3. The lender is expected to reserve the usage of social[17] and legal enforcement mechanisms only for scenarios where the borrower is using the *QH* funds in an irresponsible and wasteful manner and in ways that are contrary to the original *QH* contract.
4. In cases of default or latency in the payment, if the lender does not forgive the debt, the borrower is expected to abide by the terms of the contract as soon as he is able to do so. An intentional failure in this regard by the borrower is considered to be a sinful (*Haram*) act and must be avoided.

From the above, one can safely argue that *QH* is an Islamic financial instrument that stands somewhere between *Qard* and *Sadaqa*. In other words, when *Ihsan* (or goodwill, benevolence, and generosity) is applied to a *Qard* contract, it will convert *Qard* into a *QH*. Furthermore, in case of unexpected and genuine financial hardships of the part of the borrower, through forgiving some or all of the *QH* loans, a *QH* can in turn be turned into *Sadaqa*; in such a scenario, *Ihsan* is clearly applied at its maximum level of forgiving the debt.

It must be emphasized that *Ihsan* elements of *QH* must not and in fact cannot be explicitly written in a *QH* contract and are practiced on purely volunteer basis by the lender. Therefore, a *QH* contract starts as regular interest-free loan (*Qard*) agreement, and only when the lender relaxes some or all of the terms of the *Qard* contract and acts in a charitable manner toward the borrower, the original interest-free loan *(Qard)* would be converted to *QH* and possibly *Sadaqa* (Fig. 4.8).

It becomes clear that there is a common misunderstanding in the literature where *Qard* is often seen and treated as synonymous to *QH*. While every *QH*, because of being an interest-free debt, is a *Qard*, the

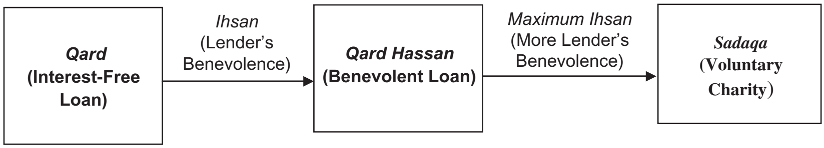

Fig. 4.8 Relationship between *Qard*, *Qard Hassan*, and *Sadaqa*. *Source* Author's own illustration

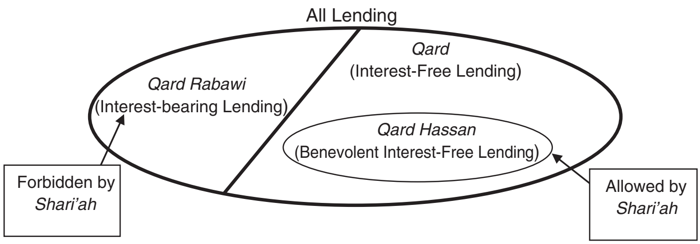

Fig. 4.9 Venn diagram of all lending: *Qard Rabawi*, *Qard,* and *Qard Hassan*. *Source* Author's own illustration

reverse is not true. Farooq (2010) discusses this issue in length and emphasizes the fact that an interest-free loan is simply a *Qard* and not a *QH* because *Shari'ah* requires every loan or *Qard* to be interest-free in the first place. In other words, *Shari'ah* does not recognize interest-bearing lending as *Qard*. Such lending is termed as *Qard Rabawi* highlighting the fact that the term *Qard* in *Shari'ah* is referring to interest-free lending, making *QH* to be something beyond interest-free lending (Fig. 4.9). So, in a nutshell:

- *Qard Rabawi*: is an interest-bearing loan that is considered as a grave sin by *Shari'ah* and thus forbidden.
- *Qard*: is an interest-free loan that is recognized as lawful by *Shari'ah*.
- *Qard Hassan*: is an interest-free loan (*Qard*) that has elements of *Ihsan* or benevolence added to the *Qard*.

Therefore, the majority of the so-called formal *QH* funds and institutions in Muslim countries actually operate on *Qard* principles as the elements of *Ihsan* are widely missing through the application of different kinds of fees including late repayment fees and the requirement of collateral.

4.3.2 Financial Needs of the Poor: Qard Hassan vs. Qard and *Zakat/Sadaqa*

The poor are heterogeneous in the factors leading to their poverty. Therefore, their financial needs are also diverse.[18] While in comparison with other Islamic financial instruments, *Qard*, *Qard Hassan*, *and Zakat/Sadaqa* are more appropriate mechanisms to address the needs of the poor and vulnerable, any of these instruments are more suitable in a given context.

4.3.3 Qard Hassan vs. *Zakat/Sadaqa*

Besides the many legal and contractual differences between *Zakat/Sadaqa* and *QH*, there are many differences between these two instruments in as far as their applicability and efficiency are concerned. First is related to the heterogeneous nature of poverty and characteristics of the poor. Given that *QH* funds are often much larger in size and less frequent than *Zakat/Sadaqa*, they are suitable to finance human capital investment and entrepreneurial activities of the poor and the vulnerable. As a result, *QH* is, and *Zakat/Sadaqa* is not, a suitable financing mechanism for those poor and vulnerable that are financially savvy and have financial and entrepreneurship capabilities but lack the necessary capital. Furthermore, in cases where one's poverty is a direct result of sudden adverse shocks,[19] *QH* is again a better form of financing, because in such cases the borrower has a higher likelihood to move out of poverty in the near future and thus repay the debt.

QH can and again *Zakat/Sadaqa* cannot be used to prevent potential poverty in the future among those people who are not currently poor but have high likelihoods of slipping into poverty if not financially assisted now. This is because, in the Islamic legal system, *Zakat/Sadaqa* funds are not to be allocated to those who are not currently poor. Students with little or no financial support are one clear example. If not supported throughout their schooling years, many borderline poor students would have to drop out of school and join the labor force, jeopardizing their future income trajectory and economic well-being, the negative impacts of which may also impact their future generations.

Zakat/*Sadaqa* are appropriate forms of financing for those poor who have little or no outlook, at least in the near future, to become economically productive and overcome poverty. Such people include the elderly, the children, the refugees, and the permanently ill and the mentally or physically challenged.

Second, while *QH* and *Zakat*/*Sadaqa* both depend on the benevolence and goodwill of the lenders and donors, when compared to *Zakat*/*Sadaqa*, *QH* is associated with a number of advantages as it motivates a more responsible set of decisions and behaviors on the part of the borrowers as well as the lenders. In comparison with *Zakat*/*Sadaqa, QH* is more likely to encourage financial responsibility, productivity, and hard work on the part of the borrower while there are no such mechanisms in *Zakat*/*Sadaqa*. The recipients of the *QH*, in order not to jeopardize their image and reputation in the local community and their creditworthiness for future financial contracts, would be more motivated to abide by the terms in a *QH* contract to the best of their ability. As a result, they will be more inclined to exert more effort and to be more cautious and prudent in their expenditures, investments, and other economic activities. On the other hand, such motivations are less or altogether missing for *Zakat*/*Sadaqa* recipients, as they have no financial and contractual obligations toward the donors, leaving them with no external pressures and monitoring. Therefore, while, in the long run, *QH* increases financial responsibility, prudence, and independence among its recipients, *Zakat*/*Sadaqa* may perpetuate financial dependence and recklessness.

QH may also encourage the benevolently minded donors or lenders to act in a more responsible manner. The expectation of getting repaid motivates the *QH* lender to be cautious in his benevolent lending practices and is more likely to extend *QH* loans to only those individuals who seem to be financially dependable and responsible and have a high probability of repaying the principle and abiding by the terms of the contract. As a result, a *QH* lender will be motivated to acquire as much information about a borrower as possible, his particular economic conditions and needs, and the ways in which he is envisioning to use the

QH funds. In the case of *Zakat*/*Sadaqa*, however, because the donors do not expect any repayments, they take little to no care on who the recipients are and how the *Zakat*/*Sadaqa* funds are to going to be utilized.

As a result of this lower level of care and prudence on the part of the recipients and donors, *Zakat*/*Sadaqa* donations, which are often much smaller in size but more frequently distributed than *QH*, have higher probability of being distributed inefficiently or even end up in the hands of those who are not truly deserving of alms. This fact is highlighted in a *Hadith* from the Prophet *Muhammad* (peace be upon him and his progeny) where he considers *Qard* (and by extension *QH*) as more preferable to *Zakat*/*Sadaqa*. In this *Hadith* reported by *Imam Ja'far Ibn Muhammad as-Sadiq* as well as by *Ibn Hisham* and *Ibn Majah*, the Prophet (peace be upon him) is reported to have said:

> It is written on the gate of the paradise: The reward for Sadaqa is tenfold and the reward for Qard is eighteen times; and Qard has become superior to Sadaqa because a borrower will not borrow except because of need, while a person who does not need Sadaqa may ask for it.

Third, compared to *Zakat*/*Sadaqa*, *QH* develops stronger sense of solidarity between the lenders and the borrowers. This is because *QH* lenders, in an effort to increase the probability of full repayment, are more motivated to get to know the borrowers at personal levels and to keep an open communication channel with the borrowers throughout the duration of the contract. Overcoming the communication and cooperation gap that often exists between the "haves" and "have-nots" will inevitably lead to the development of stronger solidarity between these two groups and transfer of knowledge, skills, and expertise. In turn, this would reduce the social barriers that have often perpetuated poverty and inequality in a community.

Fourth, *QH* can be more conducive for economic development and poverty reduction than *Zakat*/*Sadaqa*. This is because *QH* recipients are more likely to be financially deserving, prudent, and responsible than *Zakat*/*Sadaqa* recipients. Therefore, one could expect for *QH* to result into better allocation of scarce financial resources than *Zakat*/*Sadaqa*.

Moreover, the repayment element of *QH* makes it possible for these funds to be recycled and circulated among several individuals or families in need. Finally, being larger in size, the recipients of *QH* could benefit from the economies of scale. As a result, *QH* is more suitable for the purposes of human capital development as well as financing of small business ventures while *Zakat*/*Sadaqa* are often used for immediate consumption needs.

Final, and probably most important of all, is the issue of protecting the honor and dignity of the poor. There is little disagreement on the importance of protecting the honor and pride of the poor and in fact, many *hadith* refer to one's honor as the most important ingredient of human capital. Contrary to *Zakat*/*Sadaqa*, *QH* has the advantage of protecting the honor and dignity of its recipients, as they consider themselves borrowing on favorable terms and not receiving alms and charity.

Overall, *QH* is a more effective financial instrument to address the needs of the vulnerable or those poor who have a higher likelihood of moving out of poverty if financial helped now. On the other hand, *Zakat*/*Sadaqa* funds should mainly be channeled to those poor who have little or no likelihood of moving out of poverty or have pressing needs (such as food, medical care, and shelter) that must be immediately addressed.

4.3.4 Qard Hassan vs. Qard

As mentioned earlier, *Qard* refers to an interest-free loan contract that may also include other mutually agreed conditions such as the necessity of collateral and guarantor and penalties for late payments. Therefore, the element of *Ihsan* in *QH* makes this instrument more attractive to the poor than a pure *Qard* contract because in cases of unpredictable financial hardships, the poor can probably receive a benevolent treatment from a *QH* lender whereas such treatments are absent in a purely *Qard* contract. As a result, some of the poor who shy away from *Qard* or other financial contracts may in fact welcome *QH*. *Qard* is most suitable for the non-poor who are financially more stable and need extra sources of financing to cover unexpected expenditures or undertake a planned economic activity such as purchasing a real estate or starting or expanding a business. Also, many of the poor lack adequate collateral or guarantor, making it harder for them to access *Qard* contracts.

To sum, for the vulnerable and poor, *QH* has many economic, social, and psychological advantages over *Zakat*/*Sadaqa* and *Qard*. Keeping in mind the heterogeneous nature of poverty and economic vulnerability, *QH* and *Zakat*/*Sadaqa* are complements rather than substitutes. Each of these instruments is effective and efficient in addressing certain financial needs of specific groups of the poor and those who are socially and financially marginalized. While *QH* is associated with many economic, social, and psychological advantages, it is not implemented as a wide-scale potential mechanism for reducing or preventing poverty in Muslim-majority countries. What is being widely implemented in the name of *QH* is *Qard* where various elements of *Ihsan* are altogether missing making such financing schemes inaccessible to the poor and the vulnerable. In turn, *Zakat* and *Sadaqa* have been the dominant channels of assisting the poor and the vulnerable regardless of heterogeneous causes of their poverty and differences in the level of their human capital and capabilities, leading to serious misallocations of scarce resources that are set aside for the poor.

It can be concluded that *QH*, through the various reasons highlighted above, has the potential of paving the path for the unbanked population to eventually become bankable. In other words, while *QH* can increase financial inclusion among the poor and the vulnerable, *Zakat*/*Sadaqa* do not have such mechanisms built into them. This is because *QH* has the potential to increase human and physical capital of the less privileged and reduce their social and economic marginalization, making them better positioned to engage in *Qard* and other financial contracts in the future.

4.3.5 Qard Hassan and the Question of Its Sustainability in the Long Run

Serious practical challenges have hindered *QH* to be offered through formal financial institutions. The first main obstacle relates to the above-discussed misunderstandings surrounding *QH* and its widespread confusion with *Qard*. As a result, when extending "*Qard Hassan*," majority of formal IFIs in reality are offering *Qard* and therefore often collect processing fees and require collaterals and guarantors. Not only are these policies in clear contradiction with the element of *Ihsan* (benevolence and generosity) highlighted above, but they also discourage or make it difficult for the vulnerable and the poor to enter a *QH* contract, therefore increasing their dependence on *Zakat* and *Sadaqa* and reducing their chances of ever becoming financially included and independent. To address this issue, IFIs and Islamic finance training centers need to engage in concerted training and information disseminating campaigns to clearly and more accurately present *QH* to policymakers, financial institutions, and the general public and highlight its various features and potentials for the vulnerable and the poor while also explicitly distinguishing it from *Qard*.

The second challenge relates to the distinguishing element of *QH* from *Qard*: *Ihsan*. As discussed earlier, in genuine *QH* contracts, the lenders are willing to act benevolently and generously toward the receivers of the *QH* funds who face financial hardships beyond their control. This will clearly undermine the long-run sustainability and operation of *QH* funds as the sums lent out may not get fully recovered in timely manner, posing liquidity challenges for *QH* funds. One cannot ignore the effect of inflation on sustainability and effectiveness of *QH* lending, where the purchasing power of the sum lent out as *QH* is reduced in inflationary environments, which is characteristic of many Muslim-populated countries. The following few paragraphs will address some of these issues.

First, the novel definition of *QH* presented above, will permit *Zakat* and *Sadaqa* funds to also be employed for *QH* lending to the poor who have the potential of moving out of poverty if provided with adequate financial assistance to boost their human capital or jump-start their entrepreneurial activities. It is important here to emphasize here that *QH* lending using *Zakat* and *Sadaqa* funds would only applicable to the poor and not the non-poor who run the risk of moving into poverty. *QH* lending to the non-poor facing risks of poverty needs to be funded through other source of charitable lending.

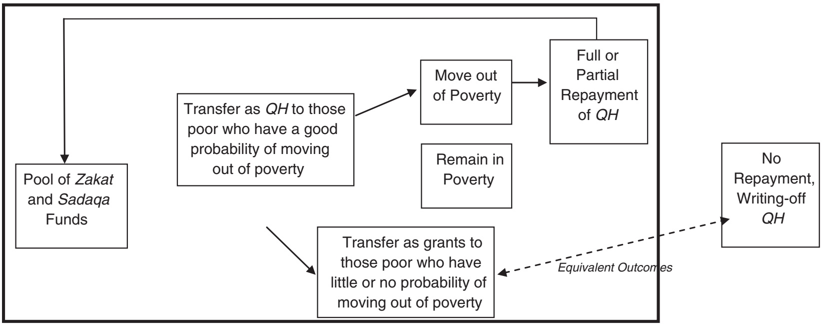

Fig. 4.10 Transfer of *Zakat* and *Sadaqa* through Grant and *QH* lending. *Source* Author's own illustration

Donors of *Zakat* and *Sadaqa* do not expect to get paid back, and their intention is to assist the poor through financial transfers. However, as discussed earlier, a group of poor, if financially assisted, have the potential of moving out of poverty and returning the financial assistance they have received. Considering this fact, *Zakat* and *Sadaqa* funds could be transferred to this group of poor in form of *QH*. Thereafter, the portion of *QH* loans that are recovered can again be transferred to other poor families in form of *QH* loans, and the portions that are not recovered are simply forgiven and translated into *Zakat* and *Sadaqa* from operational and *Shari'ah* perspective (Fig. 4.10). Through such *QH* lending process, a portion of *Zakat* and *Sadaqa* funds can reach more than one poor individual or family, not only increasing the coverage of the limited *Zakat* and *Sadaqa* funds, but also increasing their effectiveness in boosting human and physical capital through the channels highlighted earlier. Thus, the usage of *Zakat* and *Sadaqa* to fund *QH* lending to the poor will enhance the sustainability of *QH* lending to poor families in the long run.

Second, in an effort to protect the purchasing power of *QH* funds against inflation and therefore increasing the sustainability of these funds in the long run, these loans could be delivered in kind. The recipients of *QH* loans could then be requested to make repayments in kind or in the monetary equivalent of the goods they received as *QH*. Although this may seem equivalent to charging nominal interest rates equivalent to the rate of inflation, it is perfectly permissible under the *Shari'ah*. Furthermore, some *Shari'ah* scholars have permitted the charging of nominal interest rates up to the rate of inflation, arguing that money is not a commodity and is simply a medium of exchange, and it would be unjust for the donor of *Qard* or *QH* to experience loss of purchasing power due to inflation. Not only these measures would protect the *QH* funds against inflation, it will also encourage the borrowers to start repayment as soon as they are able to do so, therefore increasing the rate of recovery of *QH* funds.

Third, considering the multifaceted benefits of *QH* and its advantageous position over *Zakat* and *Sadaqa* to prevent and reduce poverty, local and central governments should establish publically funded but locally operated *QH* institutions. In this scenario, some of the funds allocated to public welfare programs can be channeled through *QH* lending to the poor and the vulnerable who are already qualified to receive public welfare assistances.

Fourth, efforts should be undertaken to change public's behavior and perception toward *Sadaqa*, *Qard*, and *QH*. Namely, the public should be actively informed of two facts:

a. In as far as Islamic teachings are concerned, *Qard* and *QH* are superior to *Sadaqa* and carry more rewards with Allah (SWT).
b. *QH* is a more effective form of financial assistance to the poor and vulnerable, and it has more potential to reduce and/or prevent poverty in a more sustainable manner.

Indisputably, religious scholars play a crucial role in this front. A shift of public perception in favor of *QH* over *Sadaqa* will channel some of the *Sadaqa* donations toward *QH* funds, increasing its funding base and therefore its sustainability.

Fifth, borrowers of *QH* are usually non-banked and do not have access to formal financial services for various reasons including lack of credit history. In such a scenario, if *QH* loans are considered and recorded as part of one's credit history, it can be employed as a gateway to access other formal financial services. Therefore, in an effort to protect their social as well as financial reputation and creditworthiness, borrowers of *QH* are motivated to abide the terms of the contract and try to limit the feature of *Ihsan* in a *QH* contract as much as possible. The establishment of agencies that keep track of borrowers' credit and financial history would be an additional source of motivation for borrowers to keep their credit history clear from any contract britches, therefore increasing the recovery rate of *QH* loans.

Sixth, *Waqf* funds dedicated for social welfare programs could be utilized to fund *QH* institutions and fill the funding gaps arising from default or late payments. For example, if a *Waqf* is to finance the education of the poor, a portion of that *Waqf* could be transferred in form of educational *QH* to those poor and vulnerable that have a high likelihood of repaying the loan.

Many of the suggested solutions above to increase the sustainability of *QH* funds are being successfully implemented in at least one Islamic microfinance institution, *Akhuwat*. *Akhuwat* has been offering *QH* loans to more than 900,000 families over the past 15 years. The next part provides a brief case study of *Akhuwat*, which is headquartered in Pakistan.

4.4 *Qard Hassan* Islamic Microfinance: A Case Study of Pakistan's *Akhuwat*

4.4.1 Background: Microfinance and Islamic Microfinance in Pakistan

Similar to the ratio of Islamic finance to conventional finance, globally Islamic microfinance constitutes less than 1% of the overall microfinance sector and so it is in its embryonic stages.[20] By the end of 2014, Pakistan's microfinance industry had assets above US$983 million and getting close to the milestone of 3 million active borrowers. The active borrowers have increased from 1.6 to 2.8 million with more than half of the borrowers being women. Operating Self-Sufficiency (OSS) and Financial Self-Sufficiency (FSS) increased by 121% and 120%, respectively, whereas the Portfolio at Risk (PAR>30) ratio has fallen to 1.1%.[21]

In 1998, Pakistan Microfinance Network was set up to represent and regulate the emerging microfinance institutions. In 2000, Pakistan Poverty Alleviation Fund (PPAF) was established with the help of World Bank to provide wholesale refinancing to microfinance institutions. The first microfinance bank, *Khushali* bank, was established in 2000. Three different platforms are followed in Pakistan: Microfinance Banks, Microfinance Institutions, and Rural Support Programs.[22] With only 14 Islamic microfinance institutions operating in Pakistan, this industry is still in its infancy stages in Pakistan.[23]

However, in Pakistan, the microfinance industry charges interest. Because of *Shari'ah* requirements and also the fact that interest-free loans reduce the financial burden on the poor, such loans are more popular among Pakistani society. Programs such as Punjab Rural Support Program lose the spirit of helping the poor when it charges interest rate of up to 20%, making the repayment of the loan impossible by many of the needy borrowers.

On the other hand, for the institutions giving out interest-free loans, sustainability becomes a major issue. The extensive growth strategy adopted by the sector results in huge investments in physical infrastructure and rapid increases in recruitment. This has led to high costs per borrower and low-efficiency ratios, creating challenges for the sustainability of these institutions.[24]

4.4.2 Akhuwat: An Introduction

To fill in the gap, a few organizations have been established with the primary objective of serving the poor through offering interest-free loans. Microfinance institutions providing *Shari'ah*-compliant microfinance products in Pakistan are *Akhuwat*, Centre for Women Co-operative Development (CWCD) and *Wasil* Foundation. The sources of financing for these intuitions include *Waqf*, *Zakat*, and *Sadaqa*.

Akhuwat is an organization that came into existence in 2001 in Pakistan by a group of civil servants. Dr. Amjad Saqib, who was then working for a Government project named Punjab Rural Support Program, was extremely disappointed by the exorbitant interest rates that were being charged on loans extended to the poor. Therefore, he and a few of his close colleagues decided to extend interest-free loans to deserving poor and vulnerable population, through founding the *Akhuwat*. Improving the welfare of the poor through social philanthropy is *Akhuwat's* main objective, which is accomplished through the following channels:

- To provide interest-free microfinance services to poor families enabling them to become self-reliant.
- To promote *Akhuwat*'s interest-free loans as a viable model and a broad-based solution for poverty alleviation.
- To provide social guidance, capacity building, and entrepreneurial training.
- To institutionalize the spirit of brotherhood, compassion, and volunteerism.
- To transform *Akhuwat* borrowers into donors.
- To make *Akhuwat* a sustainable, growth-oriented, and replicable organization.

In 2003, the non-profit organization was formally registered with the name of *Akhuwat*. The name meant brotherhood that was practically seen in Islamic history when Prophet Muhammad (pbuh) migrated from *Mecca* to *Madinah*. During that time, *Madinah* locals shared their wealth and property with the immigrants to help them settle down. *Akhuwat* has the same underlying model in which the public is asked to help their poor brothers and sisters in which brotherhood and sisterhood become means to achieving the goal of reducing poverty.

Akhuwat started his operations in Lahore but to date, it has expanded to Rawalpindi and Faisalabad with the help of Chambers of Commerce and Industry and philanthropists willing to work with them. It has also opened branches like Multan, Gujrat, and Karachi and smaller towns like Sharaq pur, Dijkot, Samundri, Chiniot, Lodhran, ehanian, Duniyapur, Krore Pucca, and Khairpur. Few more branches are under process being established in Rahim Yar Khan, Sarghoda, and Farooqabad. It is also constantly looking for partner organizations to help them establish branches in other cities.[25]

A board of ten members, consisting of philanthropists, civil servants, and businessmen, governs the *Akhuwat* and mobilizes funds for the *Akhuwat*. Moreover, every branch consists of a steering committee that undertakes initiative at the branch level such as organizing fund-raising events especially so before the holy month of *Ramadan*. Awareness regarding *Akhuwat* services is created through campaigns in poor localities, marketplaces, previous borrowers, and local press. Marketing campaigns are delivered at local mosques and churches in between congregational prayers. Any poor household is eligible for completing an application for a loan regardless of his/her religion, gender, disability, and political bias. To keep the cost low and operations effective, the personnel are from local communities as they are better situated to identify the truly deserving poor in a more efficient and effective manner in their own communities.

First loan was given to a female, and it was approximately US$1000 that was donated by one of the fellow members of the group. This was successfully recovered after 6 months, after which the fund's pool expanded to approximately US$40,000 within two years. These sums were recycled into US$1,000,000 worth of loans extended to 900 men and women with no defaults at all. Initially, everyone worked for *Akhuwat* voluntarily, giving out his or her leisure time to the organization; but by 2003, due to its rapid growth and high demand for its services, it became impossible to manage the organization on voluntary basis.[26]

After formalizing the system, an administration fee of 5% of the loan was started being charged to cover the cost of operations. This is a fixed fee, irrespective of the repayment period. Grants received are not used to cover these costs and are only used to extend lending. This fee also provides access to other services provided through *Akhuwat*, such as medical camps and educational support to clients' offspring. Borrowers are also required to pay an obligatory one percent insurance fee, covering death or critical illness, whereby unsettled loans are dismissed. Their poor family members are then compensated an equivalent of three monthly payments along with a onetime cash payment of about US$50.

In Pakistan,, 80% of microloans are lent through group lending methodology. Initially, *Akhuwat* followed the same model, and loans were given to groups of approximately 10 people with a designated leader. However, it was soon realized that often times group leaders exploited their powers in selecting group members and extorted illicit payments from them. Hence, in 2006 as a policy, the group loans were discontinued and replaced with household loans, which were in the name of couples in a given household. Over time, it was observed that individual household loans had a 99.9% recovery rate which was substantially larger than the recovery of group loans, which had a lower recovery rate mainly because of frictions between members of a group.

In addition to being interest-free, four other elements make *Akhuwat* loans genuine *QH* loans. First, its sources of funding are from charitable donations. In other words, donors of *Akhuwat's* fund do not expect to get paid back. Second, in case of defaults that could have been avoided, there are no financial penalties apart from the awareness that privileges for future loans will be removed. Third, collateral is not required, and fourth in addition to financial lending, *Akhuwat* attempts to increase social and human capital of the borrowers and bridge the social and cultural gap between the poor and non-poor.

Donors are generally residents of Pakistan, but a handful of them are living abroad who are motivated to remit funds to make a difference in their local communities. One does not have to be wealthy to be a donor. In fact, so many of the poor, who have managed to move out of the vicious circle of poverty through *Akhuwat*'s financial assistance, have turned into donors themselves as they have a sense of identification with the institution. The board avoids taking donation from official foreign sources as they often come with “strings attached.”[27]

Akhuwat not only provides monetary support but also helps training its clients with the required skills and updates them with the latest market information to make them more effective and successful in their business endeavors. Moreover, it organizes activities in collaboration with other NGOs and social welfare organizations. Two of the other successful projects *Akhuwat* are:

1. *Akhuwat* cloth bank: where used clothes are collected, repaired, washed, and packed to be distributed among the poor families.
2. *Akhuwat* health services: which aim at improving the health conditions among Pakistani poor by raising awareness, providing training, and focusing on preventive measures.

Akhuwat's lending procedure does not use collateral. Potential borrowers start by submitting an application form stating the amount of loan required and the potential business idea they want to invest in. Then *Akhuwat's* carefully screens them, making sure that their income is not greater than approximately US$10 per household member in a given month. The unit manager visits the applicant's house and interviews the family members, people in his/her neighborhood, and colleagues at workplace to have a better sense of the credibility, level of skills, and the reputation of the individual/household.

Next step is to ensure the borrower would be able to pay back the loan in timely manner. In this step, if the loan is to be used for micro or small business purpose, *Akhuwat* staff will study the feasibility and profitability of the business and provide expert consultation to the applicant. The loan is approved only after the mutual consent of the couple in a family, ensuring that both individuals are aware of the financial obligation the family is undertaking and agrees with it. Hence, both of the spouses are legal signatories. After the approval of the credit committee, the loan is disbursed in a mosque. It has been *Akhuwat's* experience that borrowers will be more in complaint with the terms of the loan when the contract is signed in a place of religious sanctity.

The disbursement of the loan has to be within 30 days from the day the application is submitted. Loans are disbursed twice a month in the local mosque where the applicant is accompanied by his/her guarantor(s).[28] Guarantors need not be wealthier. It would suffice for them to be respectable member of the community who are willing to stand behind the borrowers in case they have difficulty making repayments. Not requiring collateral as part of the loan application has made it possible for the poorest of the poor in Pakistan to gain access to the much needed *Akhuwat*'s interest-free loans.

After the loan disbursement, the applicant and his business are monitored with regular visits by *Akhuwat* staff to keep a record of the progress being made. The payments are due on the 7th of every month, and if delayed beyond the 10th, the guarantor(s) is (are) contacted. The above procedures and setup, which mainly based the concept of social reputation, have made the loan recovery rate to be at 99.9% which is the highest in the industry. Three observations can be made here. First, maintaining social capital, reputation, and credibility creates a strong motivation for families to pay their installments in a timely manner. Second, awareness of the fact that future loans are possible but are contingent on the timely repayment of the current loan makes borrowers more likely to abide the terms of the contract and make timely payments. Finally, in comparison with interest-bearing loans, interest-free loans reduce the financial burden of the poor borrowers, therefore reducing the possibility of their default. All of these have increased the recovery rate of an *Akhuwat QH* loan.

In 2015, average loan size was about US$200. The loans are renewed only if the previous loan was used appropriately, and the borrowers have made repayments in a timely manner. The maximum amount of loan is US$250. Loan terms are flexible with maximum of 18 months, but on average, loans are paid within 11 months with an approximate payment of US$10 per month.

4.4.3 Akhuwat Loans and Operations: A Brief of Presentation of Available Data

Loans are taken out for various reasons: family business loans, education loans, emergency loans, health loans, housing loans, liberation loans, and marriage loans (Table 4.5). As seen from Table 4.5, between 2006 and 2015, family business loans comprise 97% of *Akhuwat*'s total lending portfolio and are mainly used to set up or expand the business. Liberation loans are extended when the applicant has taken interest-bearing loans from other sources and is forced to pay exorbitant interest amounts. In this case, *Akhuwat* pays off the loan on behalf of the applicant, and the applicant compensates *Akhuwat* in installments. Housing loans are given once a year of approximately US$400 – US$500 and need to be repaid in two years. These loans are used toward rent, purchase, or repair of applicants' house.

The *QH* loans given for education, health, emergency, and marriage (only for girls) are part of *Akhuwat*'s multidimensional efforts to reduce or prevent poverty. Another type of *QH* loan, called the silver loans, refers to loans given to increase the size of an existing business. *Akhuwat*

Table 4.5 Composition of *Akhuwat* loans (2006–2015). *Source Akhuwat*

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total
Family business loans	6209	8470	11,103	13,036	19,219	31,425	64,786	153,486	228,296	329,489	865,519
Education loans	4	16	33	88	147	198	229	633	795	386	2529
Emergency loans	0	0	0	2	1	3	1	1	8	11	27
Health loans	9	23	24	58	142	235	243	459	497	292	1982
Housing loans	6	27	33	100	681	1193	870	1041	1350	780	6081
Liberation loans	20	81	100	366	519	627	748	2040	2353	970	7824
Marriage loans	16	57	95	171	364	513	806	1478	1584	900	5984
Total	**6264**	**8674**	**11,388**	**13,821**	**21,073**	**34,194**	**67,683**	**159,138**	**234,883**	**332,828**	**889,946**

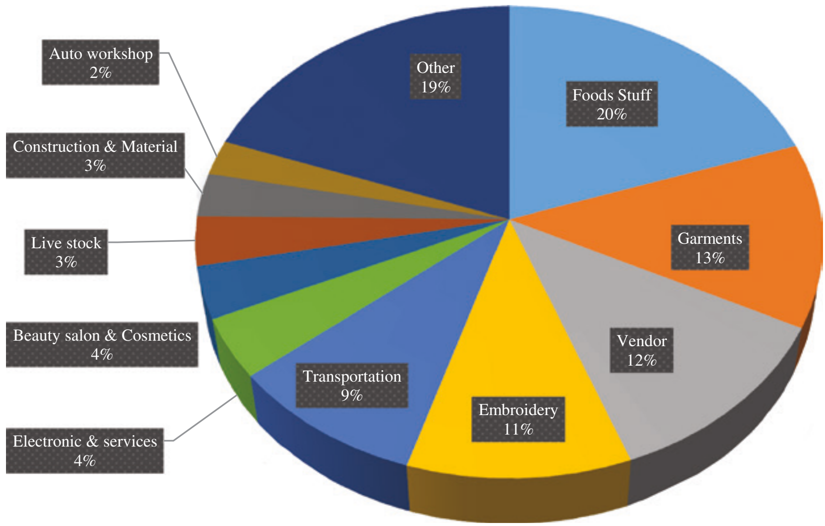

Fig. 4.11 Top ten industries that accounted for more than 80% of all akhuwat's family business loans. *Source* Author's own illustration

recently launched this new product. The average size of this loan is about US$500 and is given to those who have successfully completed three or more cycles of borrowing from *Akhuwat* and are interested to further expand their businesses.

Are there any industries in which the poor borrower is more likely to start a small business in using an *Akhuwat* loan? The answer is yes! Figure 4.11 identifies the top ten industries that accounted for more than 80% of all *Akhuwat's* family business loans. As evident from this figure, majority of these industries require little to no formal education and training which is in line with what is generally known about the education and skill levels of the poor in Pakistan.

Another important question relates to the gender of the borrower. Even though *Akhuwat* loans are "family-based" loans, and the loan contract must be signed by both spouses in a given family, nevertheless in as far as gender empowerment issues are concerned, it makes a substantial difference in which of the spouses is the primary applicant and borrower of the loan. This becomes more so important given

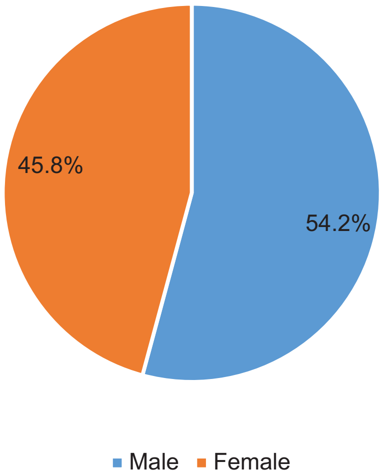

Fig. 4.12 Akhuwat's primary applicants. *Source* Author's own illustration

Table 4.6 T-test on means of average loans amount between female and male applicants (2003–2015). *Source* Akhuwat; author's calculation

Group	Mean	Std. Err.	Std. Dev.	[95% Conf. Interval]	
Female	19,040	30	7184	18,981	19,100
Male	18,272	34	8732	18,206	18,339
Combined	**18,624**	**23**	**8069**	**18,579**	**18,669**

Note The difference between Female and Male Groups is statistically significant at less than 0.0001% level

the inferior economic and social standing of women vis-à-vis men in Pakistani society, especially in the poorer segments of the population. As seen in Fig. 4.12, between 2003 and 2015, women accounted for more than 54% of *Akhuwat's* primary applicants. Furthermore, in comparison with male applicants, the loan amounts seem to have been 4.2% larger on average for the female applicants (Table 4.6). These findings point to *Akhuwat's* potentially important role in empowering poor women in Pakistan and in a way that is respectful to and cognizant of social norms and boundaries.

Not surprisingly, more than half of the female applicants used the *Akhuwat* loans to start micro-businesses in industries that were in

Table 4.7 Breakdown of industries in which female applicants started micro-businesses using Akhuwat loans (2002–2015). *Source* Akhuwat; author's calculation

Industry	Share of total female applicants (%)
Garments	18
Embroidery	16
Foods Stuff	16
Vendor	9
Transportation	9
Beauty salon & cosmetics	5
Livestock	4
Construction & materials	3
Electronic & services	3
Auto workshop	2
Dairy industry	2
Liberation loan	2
Decoration & gift	1
Furniture	1
Leather industry	1
Other	9
Total	**100**

line with their expected social roles in Pakistani society such as garments, embroidery, food, vendor, and cosmetics (Table 4.7). However, Table 4.7 points to another important point as it shows women applying for loans to start business in male-dominated industries such as construction, auto, electronics, and transportation. Given our understanding of the Pakistani society, clearly, such loans must have been channeled to other male members of the family. This again points to Akhuwat's potential role in increasing the bargaining power and socio-economic status of women in poorer population segment of Pakistan.

Table 4.8, the scale of *Akhuwat*'s operation and the number of families have been continuously and rapidly increasing over the past decade. This is one evidence pointing to the sustainability and effectiveness of its model. Below are some highlights of Table 4.8:

- As of May 2015, *Akhuwat* has 355 branches in more than 200 cities and towns in Pakistan.
- To date, about 900,000 families have benefited from *Akhuwat*'s *QH* loans with recovery rate of about 99.9%.[29]

Table 4.8 An overview of *Akhuwat* (2002–2015). *Source* Akhuwat

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Benefiting families	192	282	832	3124	6264	8674	11,388	13,821	21,073	34,194	67,683	1,59,138	2,34,883	3,32,828
Amount disbursed ('000s USD)	31.8	48.4	146.2	535.4	1097.20	1481.60	1738.80	2007.90	2956.20	4845.50	11,696.10	25,375.80	40,269.70	65,111.70
Average loan size (USD)	166	172	176	171	175	171	153	145	140	142	173	159	171	196
Cumulative due ('000s USD)	18.9	23.7	55.4	231.6	465.6	650.5	750.4	834.3	1211.60	2041.30	3867.90	10,116.40	15,811.10	18,725.40
Precentage recovery (%)	100	100	100	100	100	100	100	100	100	100	100	100	100	100
Active loans	154	271	802	2862	6156	8734	12,129	14,599	19,562	31,573	67,337	1,63,215	2,35,517	3,87,174
Outstanding loan porftfolio ('000s USD)	12.9	24.7	90.9	303.8	631.6	831.1	988	1173.10	1744.10	2801.90	7824.00	15,249.30	24,442.80	45,796.00
Number of branches	1	1	4	7	11	18	20	22	36	77	153	254	289	355
Number of cities and towns	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	200	210

- Every year *Akhuwat* has been able to reach more and more families. Just between 2013 and 2015, it has been able to reach twice more people, while its reach increased by a whopping 16-fold between 2010 and 2015.
- Since 2002, it has made US$160 million worth of *QH* loans, much of which was recycled from previous borrowers returning the sums they had borrowed.
- Number of branches increased by about tenfold between 2010 and 2015. Just between 2013 and 2015, the number of branches increased by 100 from 254 to 355, an increase of 40%.

Furthermore, more than 75% of *Akhuwat's* clients have been able to increase their monthly income by 30–40%, which is an important step in achieving its objective of moving the poor out of poverty.[30] One can highlight several factors (some of which already mentioned earlier) that have contributed to *Akhuwat's* thus far success, sustainability, and effectiveness.

One can highlight several factors (some of which already mentioned earlier) that have contributed to *Akhuwat*'s success, sustainability, and effectiveness thus far. First is keeping the operation cost as low as possible so that more and more of the donations are used toward extending loans to the poor. Cost to loan ratio is around 7%, one of the lowest observed in the industry. The 5% application fee helps cover 76% of the expenses, and the board of directors covers the remaining shortfall. While this may be a source of concern for the sustainability of *Akhuwat* in the long run, Harper (2008) thinks otherwise and argues "*Akhuwat* is sustainable in the sense of being able to survive and grow very fast…. It depends on the continuation of people's generosity rather than their greed. There is no reason to believe that generosity will wither away any more than greed will, we all share both sources of motivation" (132).

Infrastructural costs are kept low by operating at mosques, therefore avoiding utility bills and rents. Furniture is minimal, and sitting on the floor is encouraged. The institution owns no cars, and the staff are encouraged to use public transportation or motorbikes for visiting households and workplaces of the applicants. As for the cost of human resources, the senior management gets no remuneration, and the organizational setup has been kept simple. The staff hired are from the same community as the borrowers. Apart from that, the volunteer force working at *Akhuwat* is large, and a lot of students are trained as volunteers.[31] All of these combined with continuous generosity of donors have contributed to *Akhuwat's* low cost of operation and thus rapid growth rates in the past decade.

Second, "*Akhuwat* has managed to mobilize all members of the society to play their part in poverty alleviation in order to create a vibrant and economically strong society based on sharing resources" (Benedetto and Bengo 2014). One important example is that *Akhuwat* has been able to transform ex-borrowers to donors. In fact, it is the only microfinance model known in the world that encourages the borrower to become a donor and take part in uplifting the overall community. This is because *Akhuwat* goes beyond simply extending financial assistance. Rather, it engages with the borrowers throughout the life of the loan and establishes a trust-based relationship with them, similar to brotherhood, making the borrowers feel part of the *Akhuwat's* extended community.

Akhuwat's mandate extends beyond financial transactions as it makes every effort to guide, support, and empower the poor by providing social guidance, capacity building, and training to the poor. Therefore, when an ex-borrower moves out of poverty as a result of *Akhuwat's* financial, social, and technical assistances, he/she has the urge to support *Akhuwat's* cause in helping the other poor members of the community. Furthermore, in addition to financial donations, the better-off people in a community also volunteer their time, energy, and skills to advance the cause of *Akhuwat*.

All of the above bridges the existing gaps between the "haves" and "have-nots" of a community, therefore reducing marginalization of the poor and increasing social solidarity, all of which are in line with *Akhuwat*'s overall objective of alleviating poverty through the help of locals in a community.

Third, *Akhuwat* employs a "mosque-centric" model where all transactions including loan appraisals, disbursements, and collections take place at the local mosque and other religious centers. Hence, all activities revolve around the mosque and thus involve close interaction with the community. Moreover, faith-based activities increase social cohesion, solidarity, and inclusion. Furthermore, *Akhuwat* requires respectable community members to get involved in organization's activities as guarantors of loan applications. All of these elements increase the sanctity of the contract and raise the social and reputational stakes for the borrowers, therefore increasing the recovery rate.

Fourth, *Akhuwat* continuously seeks similarly minded local partners who support the objectives of *Akhuwat* and are willing to set up a local branch in their local community mosque or other religious centers. In such cases, *Akhuwat* provides training to the local staff and assists in setting up the branch. Leaving the operations to the partner organization, *Akhuwat* acts as a monitoring organization. A team from *Akhuwat's* head office regularly visits the branches for monitoring and training purposes. As a result of this inclusive and flexible view, it has been able to expand its branches by tenfold in the past five years from 36 in 2010 to 355 in 2015.

Fifth and as we saw from Table 4.5 above, 97% of *Akhuwat*'s QH loans are extended for the purpose of setting up a micro or small family business. Considering that a comprehensive analysis of the business plan is part of *Akhuwat's* pre-lending procedure and that providing technical assistance, client referral, and marketing services are part of the *Akhuwat's* post-lending strategy, almost all of the businesses that are established through *Akhuwat's* lending end up being successful enterprises. This makes it possible for the borrowers to repay the loan in a timely manner. This strategy has also lead to an ever-growing network of *Akhuwat*-assisted businesses that support each other, be it through marketing, client referral, using each other's services, or through information dissemination.

Although *Akhuwat* has shown strong signs of success over the past decade in meeting its objective of improving the welfare of the poor in the communities it is serving, one cannot assume that the future will be as promising for *Akhuwat* as the past has been. The success of *Akhuwat* in future decades will depend on its ability to make its growing operations and demand sustainable in the long run. In this sense, *Akhuwat* needs to tap into new sources of funding and offer new financial products to cater to the diverse needs of the households it is serving. The implementation of products such as micro-*Mudarabah*, micro-*Musharakah*, micro-*Murabahah*, and micro-*Takaful* may prove to increase *Akhuwat's* funding sources while also helping the plight of the poor and vulnerable. Nevertheless, the successful case of *Akhuwat* to this date demonstrates the fact that if *Qard Hassan* is genuinely and appropriately practiced, it can achieve much of the theoretical results highlighted earlier in this study: reducing poverty, promoting shared prosperity, increasing social solidarity, and in a nutshell improving the overall well-being of individuals and societies.

4.5 Conclusion

According to the 2011 Global Findex Database, more than 125 million adults around the world avoid interactions with formal financial institutions for religious reasons. The first part of this chapter and Demirguc-Kunt et al. (2013) show that Muslims and especially those residing in the MENA region are more likely to be financially excluded for religious reasons. The results show that percentage of unbanked adults due to religious reasons is positively correlated with being situated in the Arab MENA countries and with the share of Muslim population in a given country and negatively correlated with the density of *Shari'ah*-compliant financial assets in an economy. These findings point to the potential role of Islamic finance in enhancing financial inclusion, thus leading to its many benefits for reducing poverty and inequality among Muslim communities around the world and especially in some of the OIC countries, where financial exclusion due to religious reasons is among the highest in the world.

The second part of this chapter suggests that *Qard Hassan*, which is more than simply being an interest-free loan (*Qard*), seems to be the most effective instrument in Islamic finance industry to address the financial needs of the poor and the vulnerable and pave the path for their inclusion in and access to formal financial services. However, as of now, genuine *Qard Hassan* is not being widely practiced by IFIs, and therefore, its potential benefits for reducing/preventing poverty are not fully being realized. Through presenting a novel definition and view of

Qard Hassan and its multifaceted benefits for the vulnerable and poor and the long-run health of an economy, this work hopes to start a theoretical and operational discussion around this widely misunderstood and misapplied lending instrument in Islamic finance industry.

The third part of this chapter presents the successful case of *Akhuwat*, which is a Pakistani microfinance institution operating on *Qard Hassan* principles highlighted in the second part of this essay. The case of *Akhuwat* confirms much of the theoretical discussions herein and shows that if implemented in ways that are in accordance with its spirit, *Qard Hassan* can achieve much in the way of reducing/preventing poverty and enhancing shared prosperity and social/financial inclusion.

Notes

1. Account penetration rate is measured as the percentage of adults age 15 and above with account(s) in formal financial institutions.
2. It is important to note here that while lacking an account at a formal financial institution is not always tantamount to lacking access to financial services, it is nevertheless a good proxy for measuring access to financial services. This is because most if not all forms of formal financial services are often linked to accounts in formal financial institutions. Therefore, individuals or firms without a formal account are often forced to address their financial needs through informal financial markets, which are often associated with higher costs and risks and little to no legal protection against frauds or breaches in the contract.
3. http://www.worldbank.org/financialdevelopment.
4. http://go.worldbank.org/GWESKFYMY0.
5. Ibid.
6. Ibid.
7. See http://go.worldbank.org/1F2V9ZK8C0. The 11 out of 18 MENA countries included in this survey are Algeria, Djibouti, Egypt, Iraq, Jordan, Lebanon, Morocco, Syria, Tunisia, West Bank and Gaza, and Yemen.
8. Religiosity level represents the percentage of adults in a given country who responded affirmatively to the question, “Is religion an important part of your daily life?” in a 2010 Gallup poll. See Crabtree (2010).

9. The 17 million estimate is on the conservative side as it does not include countries such as Algeria, Bahrain, Iran, Qatar, Somalia, and the United Arab Emirates, which are home to about 140 million Muslim (about 10% of the global Muslim population). These countries were not represented in the Global Findex Database.
10. All models include GDP and GDP per capita to control for different levels development in economic, legal, social, and governance fronts. This is based on the fact that legal, social, and political developments are often strongly correlated with levels of economic development and the size of an economy.
11. See Infinity Consultants and Ethica Institute (2013).
12. See Aziz (2013).
13. See Lema and Vizcaino (2013).
14. See Ahmed (2013).
15. These countries are Algeria, Djibouti, Egypt, Iran, Iraq, Jordan, Morocco, Syria, and Yemen.
16. The vulnerable are defined as individuals or households who are not currently poor but have a high likelihood of slipping into poverty if not assisted in a timely manner.
17. Such as shame and reputation.
18. Some factors that contribute to the heterogeneity of the poor are:

    Biological/Physiological

    The poor have different needs and capabilities based on their gender, age, health condition, and genetics.

    Geographical

    Geography imposes its own constraint on the available options to the poor and explains some of the causes of poverty.

    Cultural

    Poverty is defined, interpreted, and looked at differently across cultures. Furthermore, different cultures have different mechanism for fighting poverty. Therefore, cultural differences play major role in the heterogeneity of the poor population.

    Durational

    Protracted poverty leads to highly different needs than temporary and unexpected poverty. Therefore, the duration of poverty is yet another characteristic that adds to heterogeneity of the poor.

    Personal

    Each person's background, personal experiences, outlook on life, and future goals are different from others. Therefore, even if a group of poor people were homogenous based on the above-mentioned factors, they are not homogenous at personal level.

19. Such as national/global economic shocks, unfavorable family circumstances, medical situations, natural disasters, accidents, loss of employment, theft, and simply a bad business decision.
20. See Ali (2013).
21. See Pakistan Microfinance Network (2014).
22. See Rauf and Mahmood (2009).
23. See GIFR (2012).
24. See Rauf and Mahmood (2009).
25. http://akhuwatonline.org/about_us_akhuwat-works.php.
26. http://www.akhuwat.org.pk/pdf/Akhuwat.pdf.
27. http://www.akhuwat.org.pk/akhuwatcaseStudy.asp.
28. http://akhuwatonline.org/about_us_akhuwat-works.php.
29. http://www.akhuwat.org.pk/progress_report.asp.
30. See Civil Services Pakistan & District Management Group (2007).
31. http://akhuwatonline.org/about_us_akhuwat-works.php.

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