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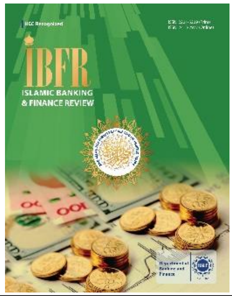

Title:	**Evaluating the Governance Framework of Islamic Microfinance Institutions (IMFIs) in Pakistan and its Compatibility with the Federal Shari'at Court Judgment**
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Evaluating the Governance Framework of Islamic Microfinance Institutions (IMFIs) in Pakistan and its Compatibility with the Federal *Shari'at* Court Judgment

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Abstract

Microfinance is a growing industry for the unprivileged segment of the society since it caters various forms of financing. However, governance and regulations still remain major concerns for both conventional and Islamic microfinance industries. Good governance is a vital need for the credibility and integrity of these industries and is greatly needed to accomplish its social, financial, and spiritual goals. Federal *Shari'at* Court (FSC), in its recent decision, declared *riba* as illegal and repugnant to Islamic law and asked the government to eliminate *riba* from the economy within five years. In this study, the governance framework of Islamic Microfinance Institutions (IMFIs) and its compatibility and reliability were evaluated in order to determine its compliance in letter and spirit with the FSC order. The study is survey based and also relies on secondary data of the whole Islamic microfinance industry of Pakistan as a sample size. Close ended interviews of the top management of IMFIs were conducted and then analyzed through descriptive statistics and frequency analysis. The results depicted that governance framework needs to be improved as per the changing environment, specifically, in the areas of acquiring the services of *Shari'ah* advisor(s), *Shari'ah* compliance, *Shari'ah* audit, impact assessment evaluation, reporting mechanism, and the identification of poverty stages. The existing regulatory guidelines also need to be improved in the context of financial support.

Keywords: Federal *Shari'at* Court (FSC), microfinance, Islamic Microfinance Institutions (IMFIs), *Maqāṣid al Shari'ah,* poverty alleviation

Introduction

The word governance primarily appeared in 1997 in the microfinance literature (Thapa, 2006) to explicate the affiliation between the Board of Directors (BOD) and the management of microfinance institutions (Lapenu,

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2006). The aim of incorporating governance was to broaden the scope of the study and include all concerned stakeholders including the BOD, managers, employees, shareholders, bank, customers, and donors (Galema, 2012). However, the respective roles of the said elements change in a diverse socioeconomic milieu. Governance in microfinance is based on two approaches. The first is an economic and managerial approach which emphasizes governance as the way to enhance efficiency and earnings and decrease cost. The second is a political/ethical approach which emphasizes the strategic vision and legitimacy of decision-making.

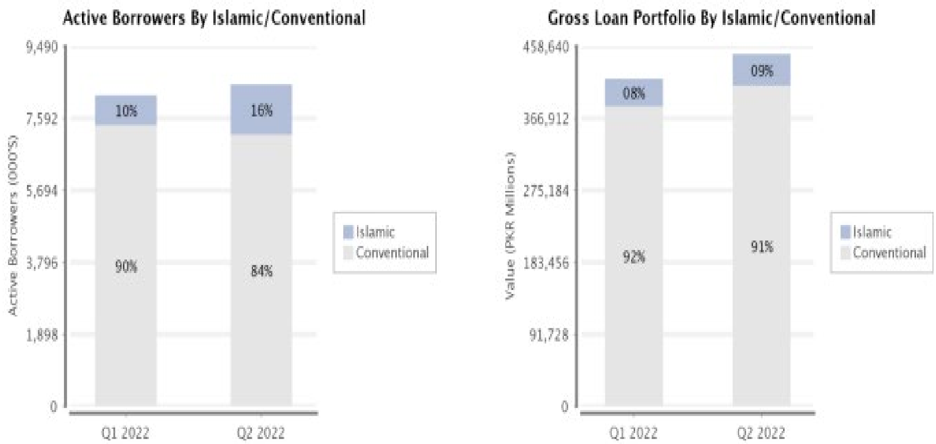
The level of formality in governance depends on the organizational structure as well the degree of oversight or government/regulator's supervision (Uchenna et al., 2020). Informal microfinance providers have a simpler organizational structure and they are not supervised by the government (CGAP, 2006). Public and private banks are formal entities with a proper organizational structure and they are regulated by regulators (Haq, 2008).

With reference to the Federal *Shari'at* Court's (FSC) decision dated April 28, 2022 on *Shari'at* Petition No. 30-L of 1991, the court declared *riba* in all banking and financial institutions as illegal and repugnant to the injunctions of Islam. The court also directed that all references to interest under local legislation be repealed and additional steps be taken by the Government of Pakistan to ensure an absolute *riba* free economy. In this way, all banks, financial institutions, investors, and individuals can only avail *Shari'ah* compliant financing. FSC specified December 31, 2027 as the last date on which the said decision would be completely executed and *riba* would be eliminated from Pakistan. Within this timeframe, interest-based economy should be converted into an asset-based, equitable, risk sharing, and interest free economy (Mansoori & Ayub, 2022).

As per the State Bank of Pakistan's (SBP) report 2011, microfinance industry has not been able yet to make a major breakthrough in order to become a dynamic participant in the financial industry (State Bank of Pakistan, 2011). The performance of conventional microfinance industry has improved after 2014 but Islamic microfinance still lags behind. According to Ahmed (2022), the 2nd quarter-2022 report of Pakistan Microfinance Network (PMN, 2022), showed that the portion of Islamic microfinance increased from 7% to 8% and 9% in the first and second quarters of 2022, respectively, in terms of gross portfolio. In terms of active clients, that has been reached to 10% at the end of first quarter 2022 (PMN, 2022). The portion of Islamic microfinance in the microfinance industry is given in Figure 1.

Figure 1

Islamic vs Conventional Microfinance at the End of Second Quarter of 2022



The above figure shows that Islamic microfinance is only 9% of the total microfinance industry[1]. This is a major challenge for *Shari'ah* compliant microfinance in Pakistan since the microfinance industry is required to comply with the order of FSC in a time span of five years only. Moreover, many organizations have started *Shari'ah* compliant microfinance but they face a number of challenges including governance, funding resources, and sustainability. Due to such challenges, some organizations stop or minimize their operations.

Therefore, the objective of the current study is to evaluate the governance framework of Islamic Microfinance Institutions (IMFIs), their regulatory steps, and the regulator contribution for the promotion of *Shari'ah* compliant microfinance. This study also evaluates the existing organizational structure and methodology used for impact assessment measurement in the light of the *Shari'ah*. Furthermore, it checks the compatibility of the governance framework and its effectiveness to comply

[1] https://pmn.org.pk/wp-content/uploads/2022/11/Microwatch-Issue-64-7.pdf

with the FSC order to eliminate *riba* from financial transactions of microfinance institutions.

The above objectives were achieved through survey along with empirical evidences. A self-administered interview questionnaire was build and its reliability was checked through Cronbach's alpha value. The questionnaire (composed of close ended interview questions) was distributed among all the institutions including banks, NBMFCs, and NGOs providing Islamic microfinance services. There are total of 17 institutions providing *Shari'ah* compliant microfinance services out of which 14 close ended interviews were conducted because the remaining three shortened their Islamic microfinance services due to multiple issues, discussed in the literature. The questionnaire was distributed among the top management of IMFIs who were well aware of the governance framework and the governance approach used in these institutions. Discriptive statastics and frequency analysis were used to to explain the resutls.

On the basis of responses, it was concluded that the governance framework of IMFIs in Pakistan is not up to the mark as per market demand and *Shari'ah* requirements. It needs to be improved not only at institutional level but also on a regulatory level. Regulatory instructions and guidelines are not adequate for IMFIs. They need to be improve and more support and arrangements are required for *Shari'ah* compliant capital and liquidity. Some IMFIs do not acquire the services of *Shari'ah* scholars. Most of them have no *Shari'ah* compliance and *Shari'ah* audit departments. Therefore, their claim of producing *Shari'ah* compliant products cannot be verified. IMFIs do focus on *Shari'ah* trainings and have a separate module for such trainings. However, some of them lack *Shari'ah* trainings. Only fifty percent (50%) publish their *Shari'ah* advisor/board report in their annual reports. Most of them have neither adopted any methodology so far for impact assessment evaluation nor impact assessment reports are presented to the management and BODs. Furthermore, *Shari'ah* scholars are also not a part of the impact assessment committee. Most of the intuitions do not define the stages of poverty.

On the basis of results, it is recommended that the regulators should introduce a new or revised governance framework for *Shari'ah* compliant IMFIs. More support is required from the regulator's side for the promotion of such institutions. Commercial banks may also support IMFIs technically and financially. All IMFIs are obliged to acquire the services of *Shari'ah* scholars.

Moreover, *Shari'ah* compliance and *Shari'ah* audit departments are also required to ensure *Shari'ah* compliance in their operations. Impact assessment is the core indicator of IMFIs to assess their performance. Therefore, a management committee may be set up which may report to the BOD and the proceedings of such committee may be published collectively in the annual report of the IMFIs. The stages of poverty should be identifiable and the financing cycle should be defined for each stage. A strong and effective governance of IMFIs would enable them to comply with the FSC order and eliminate *riba* from the microfinance transactions in the prescribed time.

Federal *Shari'at* Court Judgment-2022 and Microfinance Industry

Federal *Shari'at* Court (FSC) announced a verdict dated April 28, 2022 on *Shari'at* Petition No. 30-L of 1991 to resolve a 31-year pending case on *riba*. As per this verdict, FSC declared the prevailing interest based banking system as against the *Shari'ah*. This verdict elaborates *riba* as "every loan that extract any additional amount upon the principal from debtor". Hence any transaction that contains *riba* even at a slightness level, falls under the category of *riba*. According to Malik (2022) all the prevailing forms of interest, either in the banking transactions or in private transactions falls within the definition or *riba*.

FSC directed the government to eliminate *riba* from all types of transactions within five years. According to the FSC statement, five years is a reasonable time to completely comply with this decision. Therefore, it is the responsibility of the Government of Pakistan to convert the economy of Pakistan into an equitable, asset based, risk sharing, and interest free economy (Bhatti, 2022). Further, FSC announced that any interest stipulated in the government borrowings acquired from the internal and external sources was also *riba* and clearly prohibited by the Quran and Sunnah. Therefore, the Government of Pakistan is directed to adopt *Shari'ah* compliant modes in the future, while borrowing from domestic or foreign sources (Mansoori & Ayub, 2022).

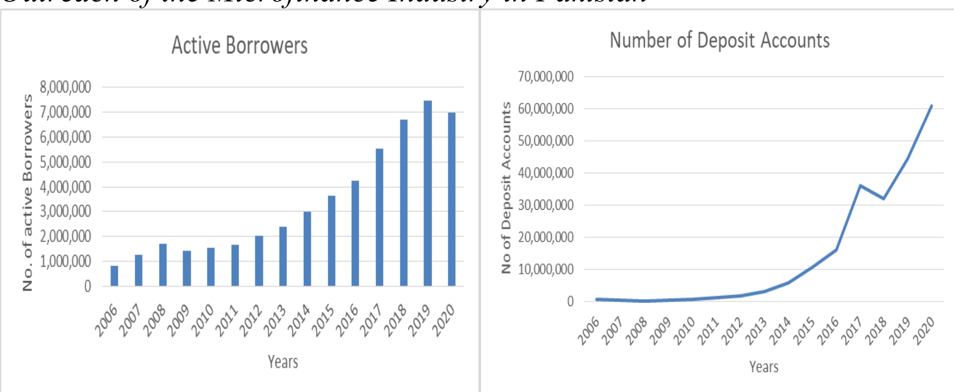
There are 11 microfinance banks registered as "Microfinance bank" with the State Bank of Pakistan (SBP, 2022), 25 non-banking microfinance companies (NBMFCs) registered with the Security and Exchange

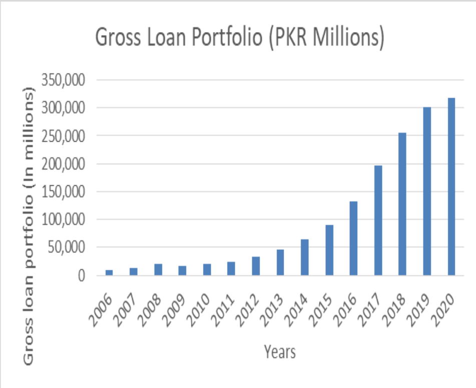
Commission of Pakistan (SECP) (SECP, 2022), 5 rural support programs, and the remaining are NGOs/NPOs registered under the Societies Registration Act, 1860 and Voluntary Social Welfare Agencies Ordinance, 1961 (Islamabad Capital Territory Adminstration, 2022). The core business of microfinance banks, NBMFCs, and rural support programs is to provide microfinance facilities; however, NGOs/NPOs provide microfinance in addition to their core work. Out of the whole industry, only 17 institutions offering Islamic microfinance services. The majority of the institutions are conventional but they offer Islamic microfinance services through a particular division, window, or a unit. Islamic microfinance share is only 9% of the whole microfinance industry (PMN, 2022) which is too low, while conventional microfinance has a huge portfolio.

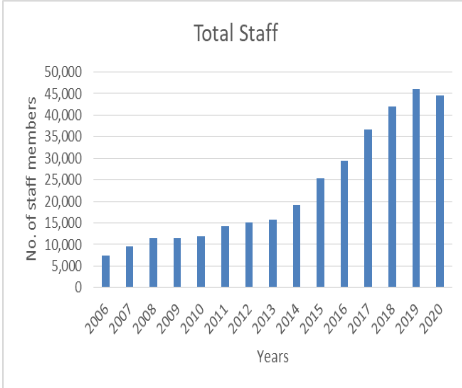
At the end of the second quarter 2022, the microfinance industry has 7 million credit customers, 60 million deposit accounts including branchless banking, and 318,533 million gross portfolio with 44,573 staff members (Ahmed, 2022), as shown by the figures given below. As per the FSC judgment of 2022, the industry has to change this remarkable portfolio with an impressive outreach of the *Shari'ah* compliant modes within five years, which seems to be a major challenge for the industry. Therefore, this industry needs to attract focus and concentration of all stakeholders including the SBP and SECP to find a solution for the upcoming challenges in the industry. A strong governance approach with a true spirit of the *Shari'ah* can make it possible.

Figure 2

Outreach of the Microfinance Industry in Pakistan







The above graphs show the industry progress and outreach during the last decade[2].

Shari'ah Concept of Good Governance, Social Development, and Microfinance

Good governance is considered as significant for the growth of human resources in any society. It has been stated by UNDP, IMF, World Bank, and numerous studies that good governance depends on institutional infrastructure and it is considered as a prime determinant of worthy governance (Naqvi et al., 2011). By default, every society builds an institutionalized setup to gain equilibrium in the magnitudes of socio-politics, justice, law and order, economy, education, leadership, and defense.

As Almighty Allah says in the Holy Qur'an:

"Behold, We established him securely on earth, and endowed him with [the knowledge of] the right means to achieve anything"- to the Almighty says. He answered:

> That wherein my Sustainer has so securely established me is better [than anything that you could give me, hence, do but help me with [your labour's] strength, [and] I shall erect a rampart between you and them!
>
> Bring me ingots of iron!

[2] The data collected from Pakistan Microfinance Review Report of 2020, published by Pakistan Microfinance Network.

Then, after he had [piled up the iron and] filled the gap between the two mountain-sides, he said: "[Light a fire and] ply your bellows! At length, when he had made it [glow like] fire, he commanded: "Bring me molten copper which I may pour upon it."

And thus [the rampart was built, and] their enemies were unable to scale it, and neither were they able to pierce it.

We can take the following aspects of good governance from the above verses:

i. Principles of the unity of command and direction.

ii. Pro-people policies and strategies implementation.

iii. Effective defense strategy.

iv. A challenge seeking approach adopted for the benefit of the people.

v. The nation was bound to obey Hadrat Zulqarnayn (**عليه السلام**).

vi. Masses were not disintegrated into political parties.

vii. Masses were required to obey due to his honest and sincere leadership.

The Holy Quran also remembers Ḥaḍrat Dawood (**عليه السلام**) for his justice and effective decision- making in Chapter 38 Verse 18 to 26.

As Qur'an says:

> And We strengthened his dominion, and bestowed upon him wisdom and sagacity in judgment. (20) AND YET, has the story of the litigants come within thy ken- [the story of the two] who surmounted the walls of the sanctuary [in which David prayed? (21)

As they came upon David, and he shrank back in fear from them, they said: "Fear not! [We are but] two litigants. One of us has wronged the other: so judge thou between us with justice, and deviate not from what is right, and show [both of] us the way to rectitude". (22)

"Behold, this is my brother: he has ninety-nine ewes, whereas I have [only] one ewe - and yet he said, 'Make her over to me,' and forcibly prevailed against me in this [our] dispute." (23) Said [David]: "He has certainly wronged thee by demanding that thy ewe be added to his ewes! Thus, behold, do many kinsmen wrong one another-[all] save those who believe [in God] and do righteous deeds: but how few are they!" And [suddenly] David understood that We had tried him: and so he asked his Sustainer to forgive him his sin, and fell down in prostration, and turned unto Him in repentance (24) And thereupon We forgave him that [sin]: and, verily, nearness to Us awaits him [in the life to come], and the most beauteous of all goals!(25) [And We said:]

> O David! Behold, We have made thee a [prophet and, thus, Our] vicegerent on earth: judge, then, between men with justice, and do not follow vain desire, lest it lead thee astray from the path of God: verily, for those who go astray from the path of God there is suffering severe in store for having forgotten the Day of Reckoning!(26)[3]

Hadrat Dawood **(عليه السلام)** was not an elected democratic leader. He inherited his kingdom from Ṭālūt after marrying his daughter (Sibtayn International Foundation, 2021). He ensured free of cost justice and command over human beings. He enjoyed the unity of command and control as king.

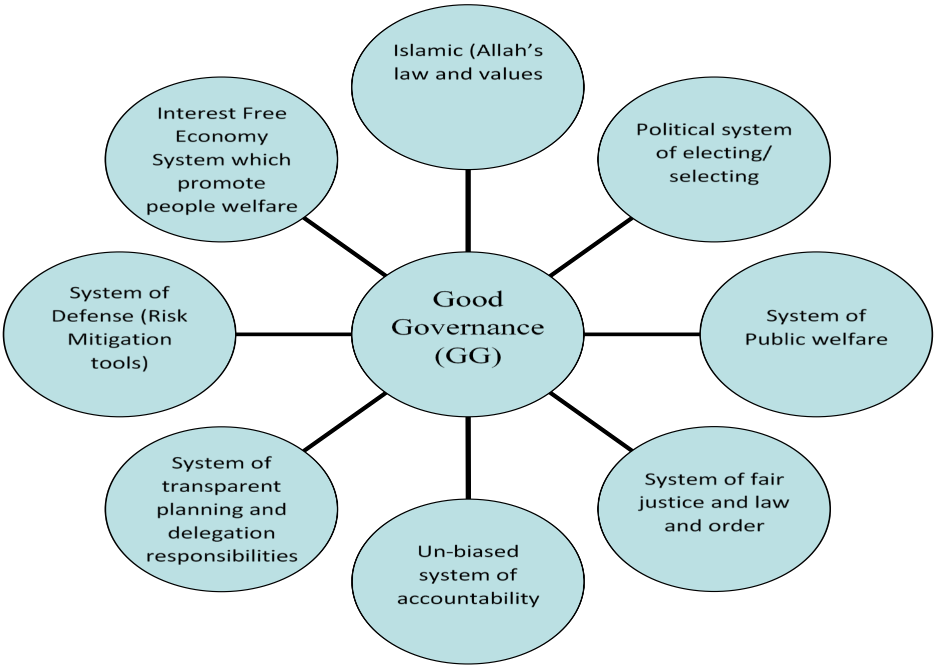
Hadrat Muhammad (PBUH) established a social setup in Madīnah after his migration from Makkah to Madīnah. There were various parameters of good governance identified by Islamic history. These parameters included free of cost justice, central command and control, a social welfare state, delegation of authorities among subordinates when required, a system of taxation, an effective system of defense, promotion of education, social security, participation of all stakeholders in all significant matters, social security and minorities rights, rule of law and discipline in the society, elimination of poverty, no political parties, effective international relations, freedom of expression, and an interest free economy. Masses were bound to obey Hadrat Muhammad (PBUH), the prophet of Allah.

The Holy Prophet was not the governor of only one state; rather, the Almighty Allah introduced him as the leader of the whole mankind of all the periods. Muhammad (PBUH) was the Head who was invited by the masses of Madina to govern them and the masses of Madina did so for the will of Allah (Naqvi et al., 2011). Muhammad (PBHH) laid down the foundation of good governance which was followed by his–companions (*Khulafa*). He (PBUH) ensured good governance in Madina through his

[3] Ibn e Khthir ,Tafsir ul Qura’an al Azim,,Dar Tayyibah , 2nd Edition ,1999, P: 669,Vol:1

personality and leadership. We can conclude the Islamic concept of governance through the following diagram.

Figure 3
Good Governance and Social Responsibility



Note. Naqvi, Aziz, Zaidi & Rehman, 2011)

Concept of *Maqāṣid al Shari'ah* for Poverty Alleviation

The word *Maqāṣid* [4] (مقصد) translates into an objective, purpose, principle, or goal. Maqāṣid (مقاصد) are the objectives/purposes in Islamic rulings and in Islamic laws that are considered as alternative expressions to *Māṣalih*[5] (public interest). Abdul Malik al Jawani (d.478 AH/ 1185 CE) was the most prominent contributor to *al Maqāṣid* philosophy (nowadays used *al Maqāṣid* and *al Māṣalih* interchangeable. Al-Qarafi (d.1285 AH/ 1868 CE) connected *Māṣalih* with *Maqāṣid* through a vital law that a *Maqsad* is

[4] Plural Maqāṣid.
[5] To acquire benefit of human being which are recognized by Shari'ah.

not effective unless it carries the fulfillment of certain virtues or the avoidance of certain mischiefs known as *Mafṣadah*[6].

Classical jurists in Islam mostly used traditional tools for *Ijtihad,* such as *Qiyās*, *Istiḥṣān,* and others without giving much importance to the intentions and purpose of law. However, another trend emphasized the importance of *Maqāṣid* and the purpose of law in legal reasoning for the treatment of modern Islamic legal issues. A *Mujtahid* should be fully aware of the higher purpose and objectives of the *Shari'ah*. Therefore, it is necessary that *Shari'ah* scholars should fully utilize *Maqāṣid al Shari'ah* in legal reasoning, while getting engaged in *Ijtihad* activities and getting involved in the issuance of *Fatwā* (Mansoori, 2004). *Maqāṣid al Shari'ah* provides the answer to "why", for instance, why do we need to pay *Zakat* and to avoid interest?

Modern jurists such as Younsaf al-Qardawi, Tahir Ibn e Ashur, Hamid al- Alim, Allā al- Fasi, Ahmed Al- Raysuni and others not only emphasized *Maqāṣid al Shari'ah* in the legal reasoning of *Ijthihad* but also increased the list of the *Maqāṣid* of Imam Ghazali. They added three more objectives including the elimination of poverty, social welfare and security, and equitable distribution of wealth. All these are directly related to the microfinance vision and mission.

Maqāṣid al Shari'ah and Microfinance

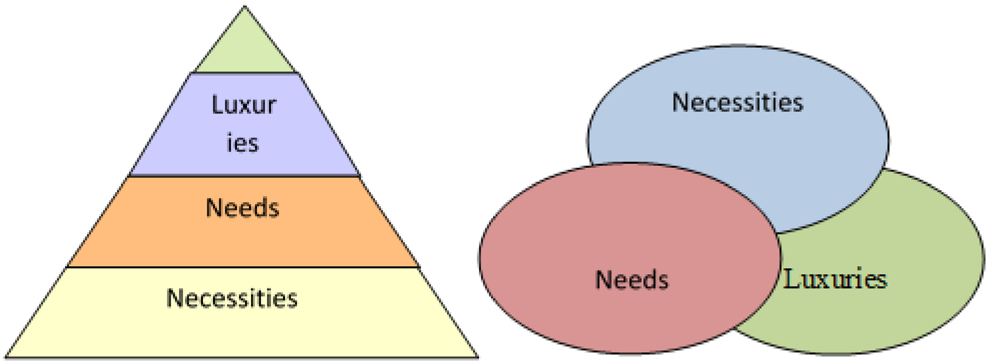
Maqāṣid al Shari'ah is the eventual aim of Islamic regulations that tends to protect the interests of human beings (*Maslahah*). These regulations are designed to preserve human interest in this life and the life hereafter. *Maqāṣid al Shari'ah* is not only related to Muslims but also related to all the human beings in order to uniform the innovation in human needs (Alam et al., 2015). The ultimate purpose of the *Shari'ah* is to encourage the well-being of human beings, which is connected with safeguarding faith *(Din)*, human life *(Nafs)*, intellect *(Aqal)*, posterity *(Nasl),* and wealth *(Maal)*. Whatever ensures to safeguard any of the above mentioned objectives requires public attention (Dusuki & Abdullah, 2007).

Theoretically, the principal of *Maqāṣid al Shari'ah* is similar to Maslow's hierarchy theory, where psychological needs are sited on the

[6] To repel the dangers of human being which are recognized by Shari'ah. Every benefit for human being is maslahah and every danger to it is mufasdah.

lowermost level, while the need of self-actualization is placed on the top (Ahmed et al., 2011). The prominent Islamic scholar, Al-Shatibi and Al-Ghazali, divided the human wants into three main stages, namely al-*Daruriyyat* (necessities), al-*Hajjyyat* (needs), and al-*Tahsiniyyat* (luxuries). The first stage al-*Daruriyyat* is placed in the lower order which is essential for human life. The second *al-Hajjiyyat* refers to the interest that supplement the vital interest, and *al-Tehsinyyat* represent the interest which leads to the improvement and perfection of the customers (Alam et al., 2015).

Figure 4
Levels of Maqāṣid



If we categories Islamic microfinance institutions according to above three stage. Charity and *qard* Hasan based institutions would belong to *al-Daruriyyat*. The institutions which do financing to business development on the basis of profit-oriented modes may fall under the category of *Al-hajiyyat* in individual capacity. MSME financing may fall in the category of Al-*tahsiniyyat* but if we consider *al-tahsiniyat* for overall community then they may fall in the category of *Al- hajiyyat*.

There are three levels of poverty namely extremely poor, ultra-poor, and poor (Government of Pakistan, 2007). Extremely poor need food before financing for business growth (Aslam, 2016) because food is their necessity and financing for business development is their need. In case they are financed for business development before being provided with food, this will not be beneficial for them and the objective of such financing will not be met. Therefore, it is necessary to priorities microfinance facilities as per the clients' financial status.

According to the contemporary approach of *Maqāṣid al Shari'ah*, the first three *Maqāṣid* directly and the fourth one indirectly are related to the microfinance sector, its vision and mission.

Conventional and secular economic theories are based on the fundamental principle that there are limited resources and unlimited wants. The Holy Quran and *Hadith* of the Holy Prophet (PBUH) guide us in detail about all protective and promotional aspects of *Hifz-ul-maal*. According to the Quran, "He placed therein firm hills rising above it, and blessed it and measured therein its sustenance in four days alike for (all) who ask" (Al-Quran, 41:10).

As per the Islamic economic model, there are adequate resources to meet the needs of the whole community. However, as per Islamic economic law, there should be protective and promotional measures for the protection of wealth.

Shari'ah Concept of Governance for Poverty Eradication

Islam never promotes begging behavior in the society. However, it promotes charitable activities for the needy and the poor in every stage of life. The under mentioned *Hadith* demonstrates the process of poverty alleviation through wise governance and economic empowerment. Moreover, it also shows the real spirit of governance for poverty eradication.

Hadrat Anas bin-Malik narrated that, "A man of Ansar community came to Prophet (peace be upon him) and begged. He (Prophet) asked: Have you anything in your house? The person replied: Yes, a piece of cloth that we used to wear, or which we spread (on the ground), and a wooden bowl, which we used to drink water. He (the Prophet) said: Bring them to me for you. The (human) subjects brought him in and He (the Prophet) took them in his hands and asked the Assembly: Who will buy? A man said: I shall buy them for one Dirham. He (Peace be upon him) asked two or three times: Who will offer more than one dirham's? Another man said: I shall buy them for two dirham's. Hadrat Muhammad (Peace be upon him) took that two dirham's and handed over to the man of Ansar and said: buy food one of them for your family and buy the axe from the other and bring him to that. He then brought it to him. Muhammad (peace be upon him) appointed to handle with his own hand. He (Peace be upon him) said, Go, cut the wood, store them and sell them. Do not let come here to see me for fore night. The man went away and gathers the fire wooden and sold it. When he earned ten dirham's and came back to Hadrat Muhammad (PBUH) and bought some garment from it and the food other of them. Prophet (peace be upon him) said: This is better for you to show sow the spots of begging on the Day of Judgment. Begging is valid for only three people, one who is in grinding poverty, one who is seriously in debt, or who is responsible for compensation and find it difficult to pay[7] (Sunan Abu Dawood).

This *Hadith* shows the following main parameters for good governance in poverty alleviation programs.

a. Program outreach to the extreme poor.

b. Careful financial valuation of the poor.

c. Transformation of infertile assets into fruitful income generating assets via proper assessment.

d. Fulfilling the basic needs on urgent basis and then investing for the productive purpose.

e. Upper management's assurance to directly contribute for the beneficiary for capacity building and technical support.

f. Technical support in the shape of providing obligatory training to the beneficiary to carry out the income-generating project/ business plan, observe through a time-bound program, and impact valuation through a feed-back mechanism.

g. Operational results of accounting need to be transparently addressed and the permission to use a portion of income to meet advanced needs, proper documentation, and transparent accounting is a necessary and a vital obligation in Islamic contracts.

h. Discouraging dependence on charity because financial empowerment is the elementary rule of Islamic financing. Charity is tolerable for extremely poor and for those overburdened with debt or other obligations, with no payback opportunities in sight.

[7] Sunan Abi Dawood, Kitab al-Zakah, Book 3, Number 1398

Regulations for Microfinance Industry in Pakistan

Microfinance industry of Pakistan consists of the following three peer groups of players.

- Rural support programs
- Microfinance institutions
- Microfinance Banks

Rural support programs and microfinance institutions are categorized as non-profit organizations and listed under four different legislative frameworks, namely Societies Registration Act 1860, the Trust Act 1882, the Voluntary Social Welfare Agencies Ordinance 1961, and the Companies' Act 2017. Microfinance banks are licensed by the State Bank of Pakistan as banks on the basis of Microfinance Institutions Ordinance 2001 (State Bank of Pakistan, 2014).

Microfinance is considered as an essential performer by the Government of Pakistan which receives priority to improve access to finance. The State Bank of Pakistan (SBP) established a dedicated Microfinance Division (MFD) in 2001, to supervise, monitor, and smoothen its development. The Microfinance Consultative Group (MFCG) was also established in 2001. It is chaired by a regulator and comprises open market players, national apex[8], national networks, and donors. Both MFD and MFCG play a vital role in defining strategic direction in order to enhance outreach, performance, and overall market development. Figure 1.6 below shows the share of the above mentioned microfinance programs (PMN, 2019).

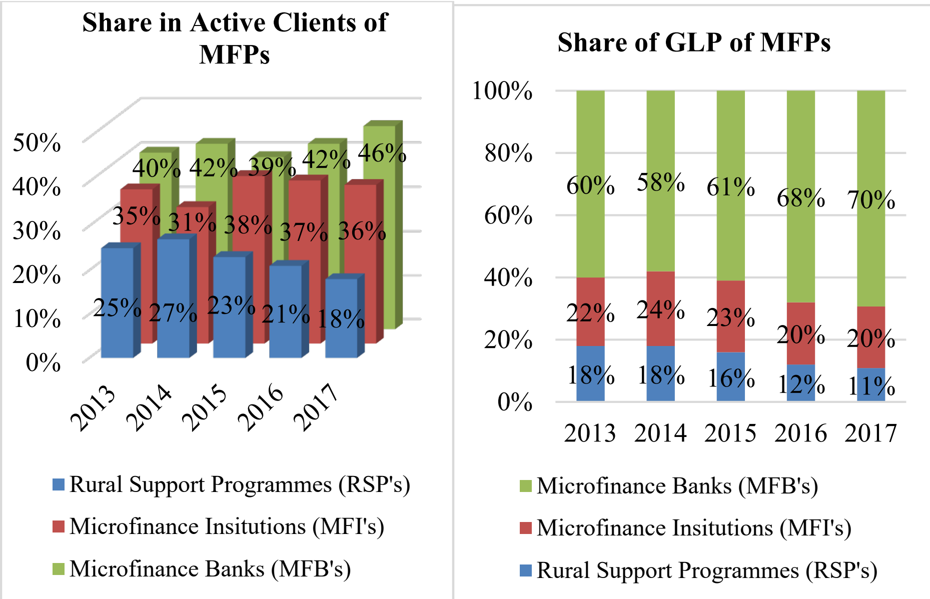
Regulators and Governance of Microfinance Industry

A sizeable group of microfinance institutions, with an opinion of financially sustainable and going concern attitude, central to financial organizations, has come into being since the introduction of MFI ordinance, which are owned privately or managed by institutions. Resultantly, the sector has substantial funds with proper governance; moreover, well-defined ownership and managerial structure also exist in these institutions to manage their investments.

[8] Pakistan poverty alleviation fund (PPAF) is the apex funding body for the microfinance industry in Pakistan.

Figure 6

Market Share of Microfinance Programs (MFPs)



Currently, SBP has the prime responsibility of determining the industry policy. This is evident in the delegation of authority to SBP of crafting the expanding microfinance outreach strategy by the Ministry of Finance (Akhtar, 2007). Therefore, SBP issued a strategic framework for a sustainable microfinance in 2011 (State Bank of Pakistan, 2011). However, there are two main regulators of this industry.

- State Bank of Pakistan (SBP)
- Securities and Exchange Commission of Pakistan (SECP)

In 2001, the Government of Pakistan approved Microfinance Institutions Ordinance. This ordinance was complemented by a set of Prudential Regulations (PRs). These regulations contained a set of principles to establish a microfinance bank and to carry on its operations. Several new PRs were incorporated over the period to retain pace with sector evolutions. The SBP issued its latest version in 2011. Moreover, SBP also established a dedicated microfinance division to oversee, monitor, and facilitate the development of the microfinance industry. However, it controls only one third of the entire microfinance industry.

The second regulator for the microfinance sector is the Securities and Exchange Commission of Pakistan, which registers Microfinance Programs (MFPs) under the Companies' Act, 2017 as largely charity, welfare driven concerns, or non-profit making organization working in a variety of development sectors including education, health, and environment. Although, all rural support programs and MFIs are certified by SECP, yet there lacks a supervision framework. Only limited protection was provided against multiple risks. One of the most substantial gaps is that no approach was given to accommodate the banking court of the country. Moreover, there is no supervision of bad performance and bad practices going with negative implications and no client protection mechanism is there as well.

Empirical Evidence

A research was conducted Kassim (2018) in Malaysia to critically analyze the good governance and sustainability of IMFIs. It found that to safeguard the variability and sustainability of IMFIs, good governance is highly critical and much needed to protect the interest of stakeholders. Since the microfinance industry is scaling up globally, its operational activities and decision-making is also becoming complex. Hence, there is a need of stronger governance.

A conceptual paper was published in Malaysia by Tijani (2020) in which the author diverted the attention of microfinance practitioners toward developing SGF for IMFIs. The author stated that governance and regulations are major concerns for both conventional and Islamic microfinance. IFSB should also include the Islamic microfinance industry in broad perspective which would strengthen the definition of *Shari'ah* governance as well as the structural process in the context of Islamic microfinance. Sometimes this process is very costly and IMFIs are financially burdened by it. Therefore, for the Islamic microfinance industry, this process should be under the purview of the regulator. The regulator can appoint an independent or government linked company for the *Shari'ah* review/audit of IMFIs. To ensure the independence of the board, such cost can be incurred by the regulator or the government.

Khalid (2019) sought to conceptualize a framework of social performance management appropriate for IMFIs. Their study urged that spiritual elements and dimensions should be integrated into the social performance management system of IMFIs, especially in governance, mission statement, and internal system and activities. Furthermore, the study added that effective governance is considered as an act of worship *(Ibadat)*. Good governance is an essential element for the promotion of transparency, fairness, and accountability required by them.

Fithria (2021) tried to analyze the relationship between the ownership of management and the respective IMFIs' performance in Indonesia. The researcher found that BOC and BOD have no significant relationship with efficiency and profitability, while BOD has an inverse relationship with financing risk and this relationship is vice versa for BOC. Furthermore, it was found that SSB ownership plays a significant and positive role to increase profitability and efficiency, while they have no significant effect on financing risk. This study also provides insight into the practices of corporate governance and performance of IMFIs.

In fact, SSB is expected to look after the spirit of the *Shari'ah* for poverty alleviation in addition to monitoring and ensuring the conformance of the activities of Islamic microfinance with *Shari'ah* (Mansori, 2015). However, none of the Islamic microfinance institutions have established an SSB due to cost effectiveness. This is a challenge for the microfinance industry to seek an alternative approach (Khan, 2008).

A continuous supervision by both management and board is mandatory to attain the *Shari'ah* approach for poverty alleviation from the deprived community. Also financing stages should be defined for every stage of poverty (Aslam, 2016). Sheikh (2013) used a qualitative approach with an extensive literature review regarding the challenges and models of Islamic microfinance and advised the formation of a well reputed *Shari'ah* board having expertise in Islamic financial institutions and *Fiqh ul Muamlat* (فقه المعاملات), in addition to the *Shari'ah* requirement for poverty alleviation and its monitoring.

According to Wediawati (2018), social and spiritual intermediation has a significant constructive impact on the sustainability of IMFIs in Indonesia and this issue can be resolved through a holistic approach. Moreover, the purpose of IMFIs should be consistent with *Maqāṣid* al *Sharia'ah* as IMFIs are missionary bodies that convey a spiritual mission.

The study of Okoye (2017) found that regulator supervision was ineffective and consultation with stakeholders was inadequate. Moreover, it was determined that regulation has a negative outcome for board composition and ownership requirements. Due to the ineffectiveness of regulator supervision, the effectiveness of microfinance institutions cannot be ensured.

The study of Mersland (2014) found female leaders to be significantly associated with microfinance management and leadership due to its association with the development sector as per their vision and mission. Furthermore, women in top management and as BOD members were positively linked with microfinance institution and their performance, although this outcome was not driven by an enriched governance. Another study by Mersland (2007) found that the split roles of CEO and chairman are important. The average loan/finance size decreases with an increase in board size. On the contrary, individual guarantee loan/finance increases it. No difference in shareholding firms and non-profit organizations was found in determining the financial peformance and outreach of microfinance institutions.

Methodology

Sample and Data

For this research, data was collected from IMFIs through a self-administered questionnaire. There are 17 microfinance institutions offering *Shari'ah* compliant services in Pakistan so far. Of the total 17, some institutions limit their operations due to higher risks, rising NPLs, funding issues, and market challenges (Aslam, 2021). These IMFIs include an Islamic microfinance window operated by commercial banks, Islamic microfinance division operated by conventional microfinance banks, NBMFCs, Islamic microfinance NGOs, and Islamic microfinance services provided by conventional microfinance programs. The population of the study contains all the 17 Islamic microfinance institutions of Pakistan. However the sample of the study consists of only 14 IMFIs of Pakistan.

Close ended interview questionnaire was distributed among the top mangement (one from each institution) of IMFIs who were well aware of the governance structure of IMFIs and their responsibilities in it as well as among those who participate in defining policy for IMFIs. The qeustionaire was uploaded on google form. Interviews were conducted through personal visits, while emails and social media were also used for discussions. Discriptive statastics and frequency analysis were used to explain the resutls (Aslam, 2021; Akmal, 2014).

Construction of Questionnaire

Keeping in view the industry nature and data provision capability, a questionnaire was constructed after a detailed discussion with practitioners, academia, and researchers. A self-administered questionnaire was used to collect the data (Tafese, 2014; Aslam et al., 2021; Aslam & Usman, 2022). The said questionnaire consists of two parts. The first part aims to collect demographic information, while the second part contains the main survey questionnaire. Demographic portion contains 12 questions and survey part has 24 questions. The survey questionnaire was prepared after collecting information from regulator requirements, instructions, guidelines, circulars, *Shari'ah* requirement for poverty alleviation in light of *Maqāṣid al Shari'ah,* as well as industry information and industry requirements.

Results and Discussion

We received responses from fourteen institutions. Most of the respondents were top level individuals including CEO/ Head of the Islamic Division, while only three respondents belonged to middle management. All the respondents were male and most of them were mature in age, with at least Master-level education and above, except two with professional degrees. However, framing effect was observed in some of the responses. Questions were repeated for robustness and contradictory responses were received from the respondents, especially to the questions relevant to impact assessment, *Shari'ah* compliance, and reporting to BOD.

Out of the 14 institutions, six IMFIs operate in urban, semi-urban, and rural areas, the other six in urban and rural areas, while the remaining two operate in semi-urban areas only. Most of the IMFIs have portfolios in trade, agriculture, production, livestock, and services, which means that IMFIs focus on all areas of development. An IMFI has an average of 63,488 active customers with the average finance size of Rs. 76,250. *Akhuwat* has more customers in the market, while the Islamic division of NRSP bank has the largest finance size. All IMFIs offer microfinance facility against personal guarantee, except a particular bank which offers financing both on personal guarantee and as well as collaterals. Eleven organizations operate at the national level, one at the provincial level, while two at the international level.

Table 1
Demographics

D-1	Organization	A	B	C	D	E	F	G	H	I	J	K	L	M	N	Ave
D-2	Designations[a]	2	1	2	1	1	1	1	1	1	1	2	1	1	1	1.2
D-3	Age[b]	2	1	1	2	3	1	1	2	2	3	2	1	3	1	1.8
D-4	Gender[c]	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1.0
D-5	Education[d]	2	1	1	3	2	1	1	1	2	2	3	1	1	1	1.6
D-6	Area of operation of Islamic Microfinance Institutions (IMFIs)[e]	1	2	3	3	3	3	3	2	2	1	2	3	2	2	2.3
D-7	Business Sector currently covered by Islamic Microfinance Institutions (IMFIs)[f]	4	5	5	5	5	5	5	2	3	4	4	5	5	5	4.4
D-8	Islamic Microfinance Institutions (IMFIs) status[g]	1	2	2	1	1	1	1	1	1	1	1	1	2	1	1.2
D-9	No. of clients of Islamic microfinance Operations (Current/ Active)	4,000	1500	22000	10000	800000	1000	3900	1125	3500	13500	20000	2300	100	9895	63488
D-10	Average Finance size in PKR	50000	124000	235000	50000	50000	25000	65000	100000	23500	40000	55000	40000	175000	35000	76250
D-11	Portfolio Type in guarantee[h]	1	1	2	1	1	1	1	1	1	1	1	1	1	1	1.1
D-12	Types of IMFIs[i]	2	2	2	1	2	2	3	3	2	2	2	2	2	2	2.1

The names of the institutions providing Islamic microfinance services are mentioned in A, B, C, D… and N. Actual names of the organizations are not disclosed due to privacy issues.

The demographic details are as follows:

[a]CEO/ Head of department $\geq$ 1 and Middle Management $\geq$ 2

[b]Age 30-40 ≥ 1, 40- 50 ≥ 2 and 50- 60 ≥ 3

[c]Male = 1 and Female = 2

[d]Master = 1, Above Master = 2 and Professional = 3

[e]Total 3 area Urban, semi urban and Rural

[f]There are five sectors where IMFIs are working like Agriculture, Trade, Production, livestock and services

[g]IMF NGO/ NPO/ NBMFC =1 and IMF bank/ Banking Division =2

[h]Personal Guarantee = 1 and additional guarantee with personal guarantee =2

[i]Provincial = 1, National =2 and international = 3

Table 2
Governance of IMFIs

Sr No.	Organization Name	[a]TY	[b]TN	[c]TNR
1	Do you think regulator (SBP/ SECP) guidelines are sufficient and there is no need for further improvement for IMFIs?	4	10	0
2	Do you think institutions required more support from regulators (SBP/ SECP)??	14	0	0
3	Do you think regulators have made arrangements for IMFIs to meet the capital and liquidity requirements?	4	10	0
4	Does your institution acquired services of Shari'ah Scholar/Mufti as per fit and proper criteria defined by the regulators (SBP/ SECP)?	11	3	0
5	Does your institution has a separate Shari'ah compliance department?	6	8	0

Sr No.	Organization Name	[a]TY	[b]TN	[c]TNR
6	Has your intuition a separate Shari'ah internal audit department or unit?	5	9	0
7	Does your institution acquired services of at least one mufti/ Shari'ah scholar for Shari'ah compliance and Shari'ah audit department?	11	3	0
8	Did your institution build a separate module for staff training regarding Shari'ah?	10	4	0
9	Has your institution a separate Shari'ah board or committee in the board to ensure Shari'ah compliance or Shari'ah audit?	5	9	0
10	Is your institution in practice to issue Shari'ah Board/ Shari'ah advisor report in annual report?	7	7	0
11	Has your institution separate management committee of impact assessment of financial facility on the client's poverty situation?	5	9	0
12	Has the management committee of impact assessment any representative in the management to look after the operational matters in impact assessment sense?	7	7	0
13	Is the Shari'ah advisor/ RSBM of IMFI, also the member of the management committee of impact assessment?	1	13	0
14	Has your institution developed any MIS and have systematic reporting to evaluate the impact of financial facility on clients?	5	9	0
15	Is your institutions in practice to see/ assess the impact of previous financing before further finance?	10	2	2
16	Are you reporting annually/periodically to BOD about working and task performed by management committee of impact assessment?	7	3	4
17	Is your institutions in practice to publish impact assessment report of all client's collectivity in annual report of the IMFIs?	8	4	2

Sr No.	Organization Name	^{a}TY	^{b}TN	^{c}TNR
18	Does your institution define period/ cycles of finance for a specific stage? After that period / cycle no more finance will be awarded to the client for that defined stage?	9	5	0
19	Is your institution in practice to compensate or defer any amount of payment during disaster days?	13	1	0

Note. ^{a}TY, ^{b}TN and ^{c}TNR are total number of "Yes", "No" and Don't Response**.**

Most of the respondents (71%) were of the view that regulatory instructions regarding IMF are not sufficient, they need to be improved further. Further, regulatory guidelines and arrangements are required to meet the capital and liquidity requirements. Regulatory instructions always help to control the organization's internal and external environment and the risk involved in it, especially *Shari'ah* non-compliance risk in Islamic microfinance. Furthermore, IMFIs operate under the special objective of poverty alleviation, development, and social responsibility. Regulatory support for capital and liquidity is mandatory to achieve the said objectives. All the respondents also replied that IMFIs require more support from the regulators. Puteri (2020) concluded that regulatory factors strengthen the social responsibility mission of the *Shari'ah* compliant microfinance institutions and affect their social performance. Akmal et al. (2022) also argued that good governance affects the performance of financial institutions.

Shari'ah compliance remains the fundamental requirement in Islamic financial institutions. Without an independent *Shari'ah* scholar/*Shari'ah* board, there is no authority who can vet the *Shari'ah* compliance principles adopted by IMFIs. *Shari'ah* compliance and *Shari'ah* audit departments keep the organization's environment as per the *Shari'ah* principles. It was found that eight IMFIs have no independent *Shari'ah* compliant department and nine have no separate *Shari'ah* audit department.

Table 3
Governance of IMFIs

Sr No.	Organization Name	A	B	C	D	E	F	G	G	I	J	K	L	M	N
20	What is the frequency of conducting training of BOD and higher management regarding Shari'ah[d].	3	2	2	2	2	1	3	4	1	4	1	3	2	4
21	Do you think due importance is given by microfinance institutions to any of the following three elements of Maqāṣid al Shari'ah[e]?	1	1	1	1	1	1	1	2	2	1	1	2	1	2
22	If your answer is "yes" in question # 11 then what is the frequency of that management committee meeting[f]?	2	N/R	1	N/R	2	1	N/R	N/R	N/R	5	N/R	N/R	N/R	N/R
23	Does your institution define any of the following stages of poverty in your SOPs/ Manual or in products[g]?	3	2	2	3	3	3	4	1	3	3	4	3	2	3

Note. [d]Nil = 0, Quarterly = 1, yearly = 2, Rarely = 3, Never = 4 (Q-20). [f]Three Maqāṣid as Elimination of poverty; Equitable distribution of wealth; Social welfare = 1 & Two Maqāṣid only as Elimination of poverty; Social welfare = 2 (Q- 21). [g]Nil = 0, Quarterly = 1, Semi- Annually = 2, Annually = 3, Rarely = 4, Never = 5 & Don't Respond = N/R (Q-20). [h]Very Ultra Poor, Ultra-poor, Poor, Micro-business, Micro enterprise, Micro Small medium enterprise
One stage =1, Two Stages =2, Three stages = 3 and so on

There are three Islamic banking divisions in the respondent institutions which were found to have separate *Shari'ah* compliance and audit departments, respectively, as per SBP regulations. The remaining IMFIs are NBMFCs. Eleven IMFIs have acquired the services of qualified *Shari'ah* scholar/*mufti* and the remaining three still have not acquired the services of *Shari'ah* scholars. Only five IMFIs have a *Shari'ah* board or a committee in the board (including three Islamic banking divisions) to ensure *Shari'ah* compliance and *Shari'ah* audit. Therefore, *Shari'ah* advisor, *Shari'ah* compliance, and *Shari'ah* audit should be arranged within the limited budget of IMFIs.

Trainings always promote a professional and risk-averse environment in financial institutions. Ten IMFIs have a separate training module regarding the *Shari'ah* and the remaining four have not. Three respondents replied that they conduct their BOD's or higher management's training regarding Islamic finance quarterly, five conduct them yearly, three conduct them rarely, and the remaining three have never conducted the said training. Ali et al. (2017) also discussed the impact of *Shari'ah* trainings on the *Shari'ah* related sensitivity of employees. More than half of IMFIs are in the practice to publish *Shari'ah* advisor's/*Shari'ah* board's report in their annual reports. This report would help to enhance their reliability and credibility.

Impact assessment is the core performance indicator of any microfinance institution. Without impact assessment, the effectiveness of IMFIs cannot be measured. Nine institutions were found to have no impact assessment management committee, nor do they have any MIS of impact identification. The remaining five institutions have impact assessment committees and MIS reporting presented to such committees during different intervals of the year. Almost all the respondents except one replied that *Shari'ah* advisor/member of *Shari'ah* board was not the member of the impact assessment committee. Ten respondents said that they assessed the impact of previous financing before further extension of the facility. Two performed no such practice and the remaining two did not respond. As per the responses received, seven IMFIs presented their impact assessment report to their BOD annually or with intervals, three never presented, and the remaining four were not interested to respond. Eight institutions were found to be in the practice to publish impact assessment report in annual reports, four were found to have no such practice, and two were not interested to respond. Chattopadhyay and Mitra (2017) also discussed the effectiveness of microfinance measures with reference to its special objective of poverty alleviation and social responsibility.

Nine respondents replied that their institution defined finance period/cycle at a specific stage. After that stage, finance was no more available for that defined stage. The remaining five respondents did not define any such stages of poverty. Microfinance literature shows a total of six stages of poverty namely very ultra-poor, ultra- poor, poor, micro business, micro enterprise, and micro small medium enterprises. As per responses, two IMFIs defined four stages of poverty in their SOPs/manuals, eight defined three stages, three defined two stages, and the remaining defined only one stage of poverty. Almost all the respondents were found to be in the practice to compensate their clients or defer the amount of repayment in disaster days, especially during COVID-19, except one. This is regarded as an institution's positive attitude toward poverty reduction. Poverty alleviation is one of the objectives of *Maqāṣid al Shari'ah* as discussed by Mansoori (2004). Ten respondents were well aware of *Maqāṣid al Shari'ah* regarding poverty; however, the remaining four were less aware about the *Maqāṣid* and poverty alleviation.

Conclusion and Recommendations

The current study evaluated the governance framework of IMFIs in Pakistan. The study concluded that the governance framework of IMFIs in Pakistan is not up to the mark as per the market demand and *Shari'ah* requirement, and needs to improve not only at institutional level but also at the regulatory level. Regulatory instructions and guidelines are not sufficient for IMFIs and more support and arrangements are required for capital and liquidity. Some IMFIs do not acquire the services of *Shari'ah* scholars. Most of them have no *Shari'ah* compliance and *Shari'ah* audit departments. Therefore, their claim of selling *Shari'ah* compliant products cannot be verified. Most of the IMFIs focus on *Shari'ah* trainings and have separate modules for such trainings. However, some IMFIs are lacking in this regard. Only half of the organizations are in the practice to publish their *Shari'ah* advisor/board report in their annual reports.

The performance of any microfinance institution can be evaluated through impact assessment. However, most of the organizations have no impact assessment mechanism. Hence, impact assessment reports are not presented to their management and BOD. *Shari'ah* scholars are well aware of *Maqāṣid al Sharia'ah* and should be a part of the impact assessment committee as experts of *Shari'ah*. However, in most of the institutions, *Shari'ah* advisors/board are also not a part of the impact assessment committee.

The most suitable and recommended model for poverty alleviation is defined by the *Hadith* mentioned above. Poverty stages should be identified and microfinance facility should be offered as per the assigned stage. Moreover, as IMFIs, they should incorporate *Maqāṣid Al Shari'ah* in their SOPs/manual as their ultimate outcome remains very relevant to the *Maqāṣid*.

The study contributes in the existing literature of governance for IMFIs by evaluating the governance framework. It was found that different approaches towards governance are implemented in microfinance institutions all over Pakistan. Furthermore, this study recommends to the practitioners to adopt the best practices of governance in the light of *Maqāṣid al Shari'ah*, by highlighting important controls and identifying the gaps in the Islamic microfinance industry.

On the basis of results and findings, it is recommended that the regulators should introduce a separate governance framework or should add to the existing governance of microfinance institutions. They may also give financial and technical assistance for the promotion of IMFIs. Commercial Islamic banks and Islamic divisions of conventional banks may support IMFIs technically and financially through their current account, charity declared, and *Mudarbah* or *Musharakah* contracts. All IMFIs are obliged to acquire the services of *Shari'ah* scholars. Although a separate department may increase the overall cost of the institution, still there is a dire need to establish such departments across IMFIs. However, the cost of such a department may be managed by a supporting mechanism or through third party services. The regulators may ask *Shari'ah* experts of commercial banks to support IMFIs in establishing their *Shari'ah* BODs, *Shari'ah* compliance, and audit. Impact assessment is the core indicator of the performance of IMFIs and it is a *Shari'ah* requirement as well. Therefore, there should be a committee in the management to evaluate impact assessment through MIS. Furthermore, the proceedings of such a committee should be submitted to the BOD on a quarterly or half-yearly basis and a collective report on impact assessment may be published in the annual report of the institution. Poverty stages and their identification may be a part of the SOP/manual of the IMFIs. Poverty score card can be introduced for every stage. Each customer may be evaluated as per their poverty stage score card and microfinance facility should be offered, accordingly. Each stage of poverty should keep its own financial cycles and no more finance should be awarded after respective cycles. Last but not least, good governance not only improves the performance and sustainability of IMFIs but is also helpful to reduce poverty in a real sense. Moreover, effective governance would help the government to comply with the FSC order dated April 28, -2022 in letter and spirit. Otherwise, the dream of a *riba* free economy within the prescribed time may not be achieved.

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