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## Commercial Verses Cooperative Microfinance Program

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# Commercial Verses Cooperative Microfinance Program: An Investigation of Efficiency, Performance and Sustainability

Zahoor Khan\*, AsmatUllah\*\*, Khyber\*\*\*

## Abstract

*The present study has been carried out to compare the performance, efficiency and sustainability of Islamic and conventional micro finance programs. Islamic and a conventional microfinance organizations namely AKHUWAT (Islamic Microfinance organization) & Sarhad Rural Support Program "SRSP" (Conventional Microfinance organization) were selected. Secondary, time series data ranging from 2005 to 2009 about the operating income, total assets, total income from investments, operating cost, total amount of disbursed loans and number of beneficiaries were selected. Profitability, number of beneficiaries from each program and amount of disbursed loan, have been used as a proxy of successful performance of Microfinance programs. The efficiency and performance of these two microfinance programs have been measured by using four different ratios i.e. Return On Assets (ROA), Net Interest Margin(NIM), Operating Cost as a Percentage of Loan (OCL), and Beneficiaries to Employees Ratio(BER). AKHUWAT is non-profitable mosque based NGO, working purely on the basis of mutual cooperation. The performance of AKHUWAT organization has been compared viz a viz SRSP for the time period under consideration. The performance indicators show a relative good picture for AKHUWAT as compared to SRSP. The outcome of the study shows that Islamic microfinance programs can perform better and serve the poor with religious compatibility. Therefore, Islamic microfinance programs can be a better candle of hope for the poor and marginalized segments of the society. Conventional microfinance organizations are charging very high rates of interest i.e. charging an interest rate of 22% or more which is not affordable for a person who is already in a disastrous condition of poverty. Under such circumstances the government under its own supervision should initiate a fully fledged Islamic micro finance program, so as to eradicate the*

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*poverty and to improve the standard of living of the poor and marginalized of the society.*

**Keywords:** *Microfinance, Efficiency, Performance, Sustainability*

### **Introduction**

Poverty or economic disparity is the leading ethical dispute of this century. About seven thousand million Creatures called humans live in this world but more than three thousand million human beings in this world live in a condition called poverty<sup>1</sup> i.e. an earning point below some minimum point obligatory to achieve basic wants. This lowest level is generally called the “poverty line” (World Bank). While United Nations has explained poverty as a rejection of choice and opportunities, a breach of one’s self respect. It can be lack of essential requirements to play part successfully in society. It means lack of sufficient food and clothing for a relatives, having no place to study or a health center to cure, it is not having a portion of property on which to grow crops or an occupation to make living for one’s self and his relatives. It means insecurity, no role in power and decision making and removal of individuals, families and entire communities from an economy’s power structure. It means easily influenced to violence, and in addition to all these poverty means living on weak conditions, with no reach to fresh water and hygiene.

Particularly if we focus on Muslim population of the world which is about 1.2 billion the condition is more disastrous than other communities of the world. Muslims are present in all parts of the world either in majority or in minority but except few countries of Middle East and South East Asia where Muslims enjoy luxurious and fancy life style, the poverty levels in rest of the Muslim communities and countries is increasing at a high pace.<sup>2</sup>

The country which has the largest Muslim population of the world is Indonesia over half of its population i.e. about 129 million are poor or faced with poverty having a daily income of about US\$2. In Bangladesh about 122 million Muslims live below poverty line and in India it is estimated that 100 million Muslims live a miserable life of poverty. Also in Pakistan about 122 million Muslims live a miserable life below poverty line. Unfortunately in the list of countries which constitute the poorest nations of the world, ten at the bottom are Muslim countries and those ten constitute more than six hundred million of the world’s poor.<sup>3</sup>

What can be the solution to this impasse of poverty? There is a strong belief among researchers, academicians and think tanks that micro

financing is a way out for poverty alleviation. To get rid of this curse of poverty in most of the poor countries of the world providing financial support to the poor and small businesses is considered as the order of the day.<sup>4</sup> Micro finance can be defined as the delivery of economic services to poor and low-income families who do not have access to proper financial organizations.<sup>5</sup> Micro financing can also be described as the banking for the poor.<sup>6</sup> The micro finance programs facilitate the poor and marginalized of the society in a number of ways i.e. by providing, small loans, small scale savings, micro insurance, training to its clients that how they can effectively and efficiently utilize the limited amount of money they borrowed and other economic services to the people who do not have the standard amount of income and are the marginalized of the society for use in small level businesses.

But being a Muslim there is a problem in conventional Microfinance programs for us because the conventional Microfinance system provides financial services on the basis of interest and in Islam Interest is prohibited under any circumstances to any Muslim as described in Holy Quran;  
“And GOD has permitted trade and forbidden interest.”<sup>7</sup>

So that’s why religious scholars have proposed a micro financing system which is free of any type of interest and in complete accordance with the Islamic Sharia’h, we call this as Islamic microfinance system.

In conventional microfinance system the organization lends money to its client and then charges interest on that money i.e. the money is used here as a commodity, where as it is just a means of exchange.<sup>8</sup>

Where as in Islamic micro finance system the organization provides the required commodities to its clients and then the client returns back the amount after some time to the organization i.e. here exchange of real commodities has taken place. No interest involved here. Islamic microfinance system provides micro financing services on partnership basis (Musharakah & Mudarabah), on trade basis (Murabaha, Salam etc) and on rental basis (Ijarah).<sup>9</sup>

So this paper investigated the efficiency and sustainability of these two systems i.e. interest based Conventional microfinance system and non-interest based Islamic microfinance system in Pakistan, so to check which system was more efficiently and effectively serving its cause of providing financial services to the deprived and destitute of the Pakistan.

## Methodology

### *Population*

The population of this research is all the conventional and Islamic microfinance programs providing their services in Khyber Pukhtoon Khwa (KPK).

- SRSP
- NRSP
- AKHUWAT
- ISLAMIC RELIEF

### *Sample Size*

The sample size for this research consisted of two organizations i.e. AKHUWAT “an Islamic Microfinance institution”, and Sarhad Rural Support Program (SRSP) “a Conventional microfinance institution”.

### *Sampling Technique*

In the above mentioned population there were two conventional (i.e. SRSP, NRSP) and two Islamic (i.e. AKHUWAT and Islamic Relief) microfinance organizations. First two strata’s were made i.e. Islamic and conventional and then through purposeful sampling the sample was selected.

### *Data Collection*

Secondary, time series and yearly data ranging from 2005 till 2009 was used and collected through annual reports, progress reports of AKHUWAT and SRSP microfinance programs and for further understanding academic journals and digital library were also utilized.

### *Data Analysis*

In order to measure the efficiency and performance of AKHUWAT and SRSP the following financial ratios were used to analyze the performance of both the programs. The financial ratios are as follows.

- a) Return on Assets (ROA) =  $(\text{Net Income} / \text{Assets}) * 100$
- b) Net Interest (Return) Margin (NIM) =  $[\text{Total income from investment and interest} - \text{Total borrowing Cost (interest payments)}] / \text{Total Assets} * 100$
- c) Operating Costs as a Percentage of Loan Disbursed (OCL) =  $(\text{Operating Costs} / \text{Loan Disbursed}) * 100$
- d) Beneficiaries to Employee Ratio (BER) =  $\text{Total Beneficiaries} / \text{Full-time Employees}$ .

Return on Assets measures the efficiency of an institution that how better that institution has utilized its assets so as to generate income.

Net Interest Margin elaborates the efficiency of those funds which are generated from different sources and then disbursed to clients/users.

Operating Cost as percentage of Loan disbursed is also used to measure the operating efficiency of microfinance program.

Beneficiaries to Employees ratio are used to check that how efficiently employees have covered the beneficiaries of loans and in how much number, only one figure for total beneficiaries were given also total number of employees are given as aggregate and not for each individual period, so only one value was calculated for this ratio and not separate values for five years. However there is a tradeoff between increases in income per employee due to increase in number of beneficiaries and lack of supervision by employees which leads to increase in default rate. Graphs and Bar Charts were also used for further elaboration.

### Data Analysis

Return On Assets (ROA) shows us that what a firm can do with what it owns i.e. what amount of value they got from each dollar of assets the firm has. It is a useful number if one is comparing competitors in identical industry. From above table I, we can see that the five years analysis of ROA for both the microfinance organizations clearly indicates that SRSP is outperforming AKHUWAT on numbers. Also when the average ROA was calculated it was 1.89 for SRSP and .093 for AKHUWAT, so SRSP's number is quite high than that of AKHUWAT. But one should not forget that the role of microfinance organizations is not to earn profit particularly when their objective is to improve the living standard of the poor and marginalized of the society, on these grounds a microfinance organization with a low ROA would be considered as the one performing well. So AKHUWAT on the basis of low ROA is performing well than SRSP by not exploiting the needs of the needy of the society by earning profits from them.

Table: 1. Return on Assets

	SRSP	AKHUWAT
Years	ROA	ROA
2005	1.73289214	0.082666622
2006	2.053146661	0.080189888

2007	5.279165235	0.084017651
2008	0.200378865	0.123189865
2009	0.160744863	0.094974314
Average ROA	1.885265553	0.093007668

Source: Annual Reports of SRSP & Akhuwat from 2005 till 2009

Net Interest Margin (NIM) it is defined as the dollar difference between incomes earned from interest and the expenses of interest occurred. Table II shows that after analyzing five years of both the organizations the income earned by SRSP from interest is far more better than AKHUWAT, even considering the five years average NIM its evident that SRSP with 2.68 is far ahead than AKHUWAT with -1.184. Such a big difference in figures was eminent because being an Islamic microfinance organization AKHUWAT cannot participate in any sort of transaction which involves interest. Interest in Islam is strictly prohibited under any circumstances. So AKHUWAT can neither pay interest to any other donor organization nor can it charge any interest from their clients. AKHUWAT only recovers its principle loan given to its clients without any additional charges.

Table: 2. Net Return/Interest Margin

	SRSP	AKHUWAT
Years	NIM	NIM
2005	2.449582012	0.114712356
2006	0.711383161	-1.022659821
2007	1.870573454	-2.439767016
2008	3.79169424	0.132028208
2009	4.58271181	-2.70406113
Average NIM	2.681188936	-1.183949481

Source: Annual Reports of SRSP & Akhuwat from 2005 till 2009

Operating Cost as a Percentage of Loan Disbursed is the amount of operating cost an organization had incurred while distributing each individual loan to its customer or client. By analyzing Table III of the study we can reach to the conclusion that for the period of five years from 2005 till 2009 AKHUWAT organization is far more efficiently

managing the loans disbursement process than SRSP. If one analyzes the average OCL obtained for the five years period the Average OCL of AKHUWAT is almost four times lower than the Average OCL of SRSP.

Table: 3. Operating Cost as %age of Loan Disbursed

	SRSP	AKHUWAT
Years	OCL	OCL
2005	67.4170192	9.592825458
2006	29.14501769	11.64486612
2007	32.32006263	13.71795169
2008	45.49640549	14.81096229
2009	56.07342853	14.90688158
AVERAGE OCL	46.09038671	12.93469743

Source: Annual Reports of SRSP & Akhuwat from 2005 till 2009

Table: 4. Aggregate Averages of the ratios'.

	Aggregate Averages of the Ratios	
	SRSP	AKHUWAT
Average ROA	1.885265553	0.093007668
Average NIM	2.681188936	-1.183949481
Average OCL	46.09038671	12.93469743

Beneficiaries to Employees Ratio (BER) is a ratio in which an organization tends to know that how much efficiently its employees were able to reach the beneficiaries of microfinance program. Till 2009 SRSP had about 550 employees and the number of beneficiaries both male and female till 2009 were 10537 which make its BER 19.16 i.e. one employee of SRSP was able to reach 19.16 beneficiaries of loan efficiently. Whereas till 2009 AKHUWAT had 400 employees and about 50,000 beneficiaries, which makes its BER 125 i.e. one employee of AKHUWAT was able to reach 125 beneficiaries of loan efficiently. These figures of the study clearly indicate that the employees of AKHUWAT are better trained and efficient in providing their services to the needy and marginalized of the society.

Figure: I. Operating income SRSP 2005 till 2009

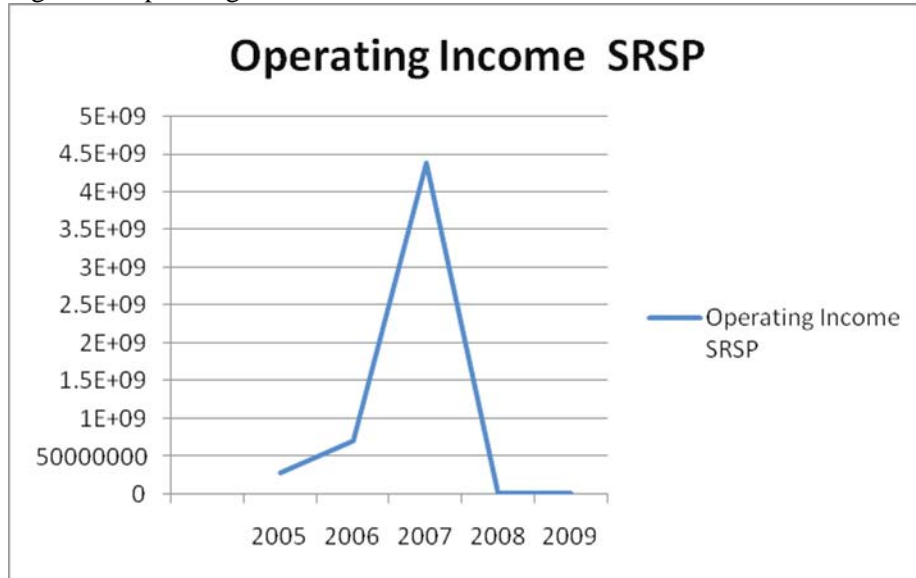


Figure: II. Operating income AKHUWAT 2005 till 2009

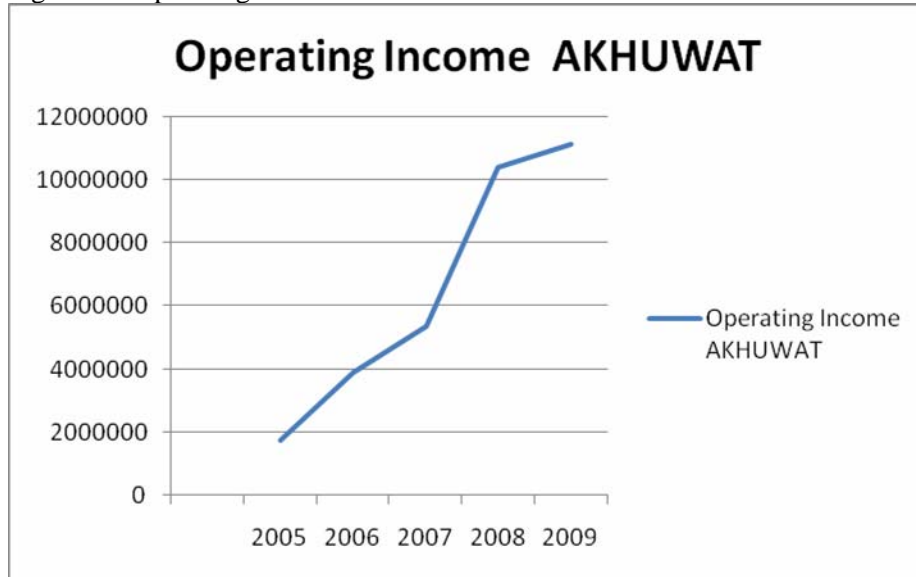


Figure: III. Total income from Investment SRSP 2005 till 2009

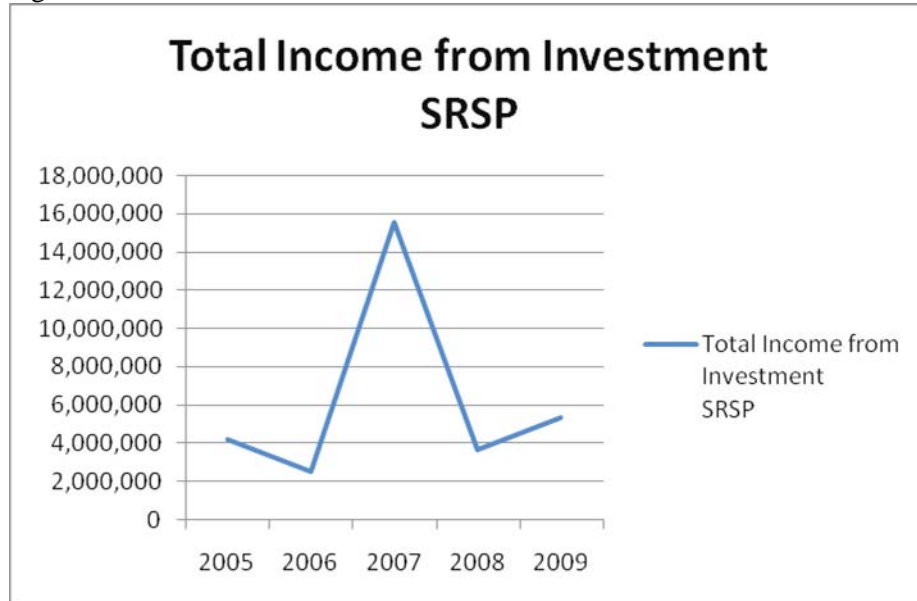


Figure: IV. Total income from investment AKHUWAT 2005 till 2009

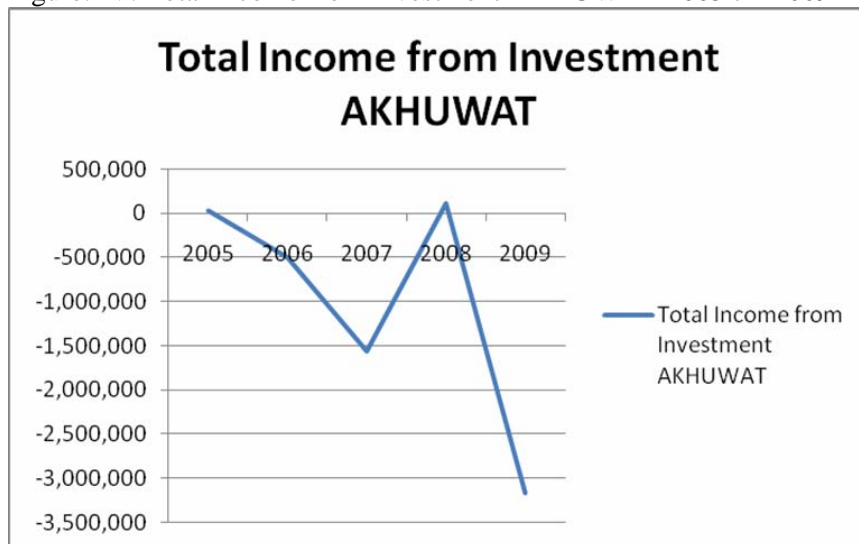


Figure: V. Operating cost SRSP 2005 till 2009

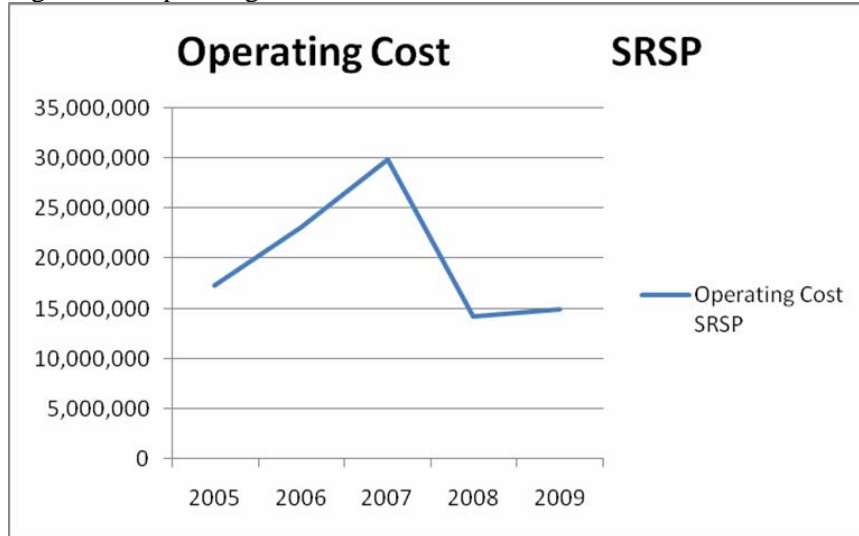


Figure: VI. Operating Cost Akhuwat 2005 till 2009

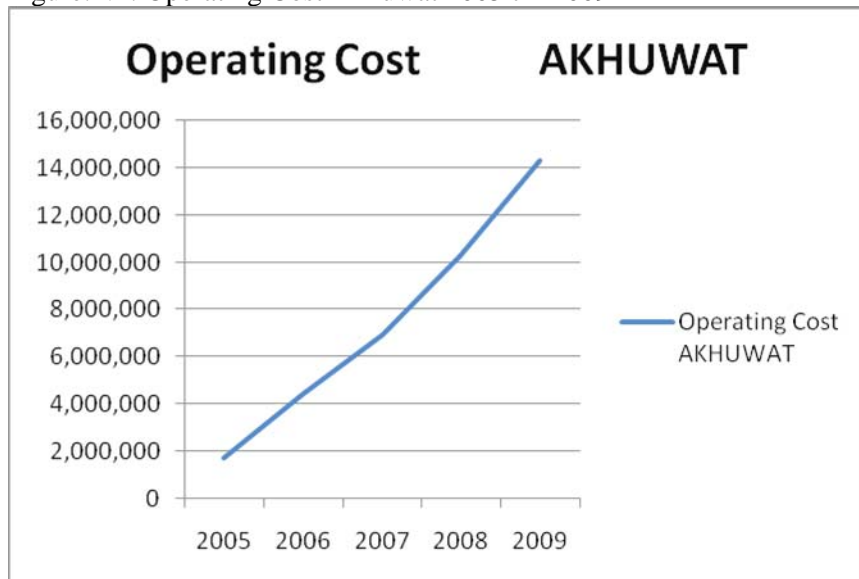


Figure: VII. Total loans Disbursed SRSP 2005 till 2009

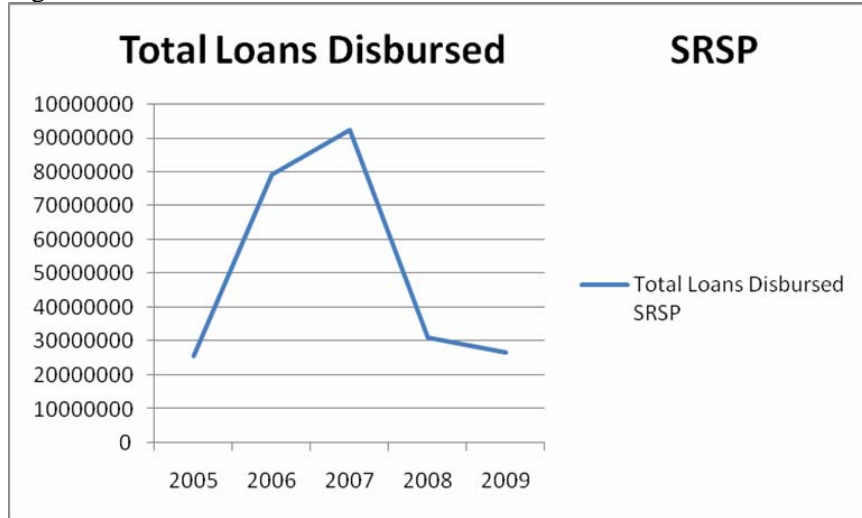


Figure: VIII. Total loans Disbursed Akhuwat 2005 till 2009

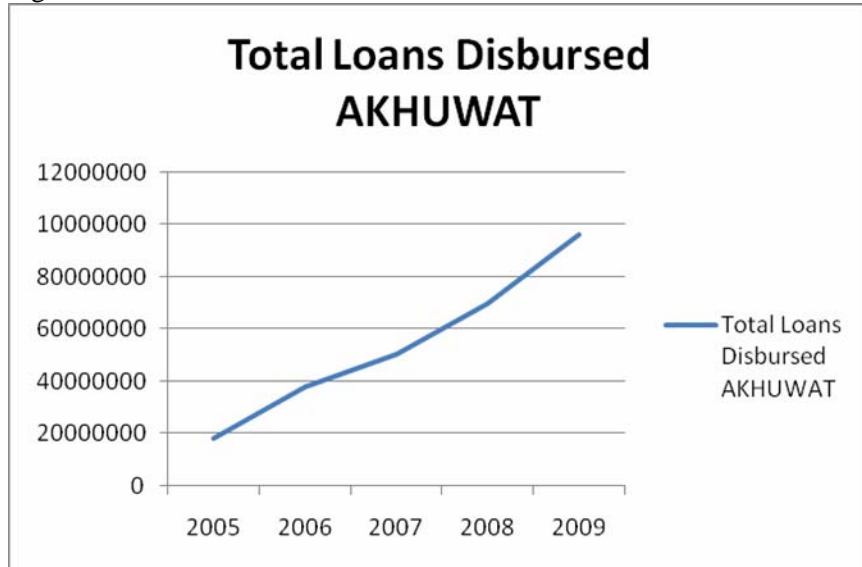
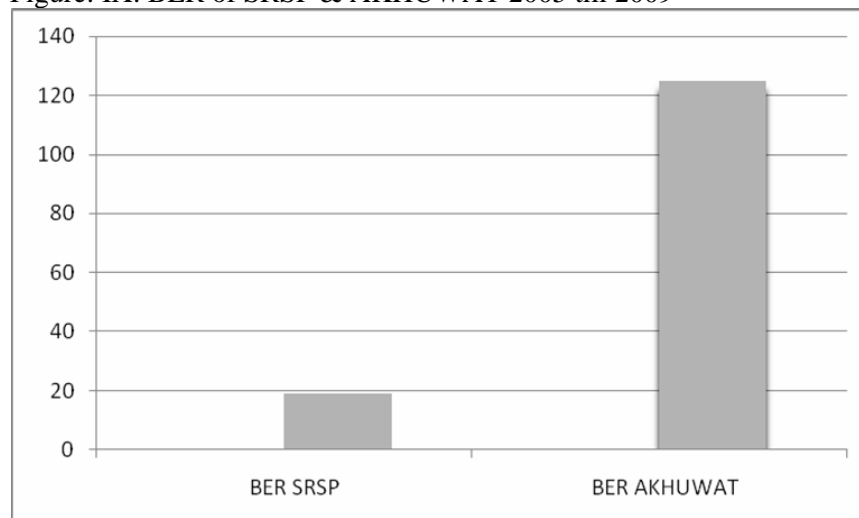


Figure: IX. BER of SRSP & AKHUWAT 2005 till 2009



By analyzing the data for both the organizations graphically it is again prominent that AKHUWAT is doing well than SRSP. By analyzing Figure. I. for SRSP we can see that there are very big fluctuations in the operating income of SRSP in the period under study one of the reason for such behavior is the high interest rates charged by the said organization due to which their clients were unable to pay their dues on time and they defaulted due to which the operating income of SRSP suffered. Whereas in case of AKHUWAT there is a steady increase in operating income level from 2005 till 2009 period under study i.e. Figure II, which shows that the said organization was able to win the trusts of its cliental by charging no interest what so ever due to which its clients were able to pay the loans on time and also the number of clients taking micro loans kept on increasing for AKHUWAT.

If we observe Figure. III. For income from investment activities and interest earned for SRSP though it shows fluctuations but is on a positive end of the graph showing that SRSP is earning income from interest which also means that the sole aim of SRSP is not just eradicating poverty but to bring some personal benefits to those who are in charge of this organization. Where as in case of AKHUWAT the graph of Figure. IV shows a total negative income from such activities which involves interest, not for a single time in period under study i.e. 2005 till 2009 the income was found on positive side of the graph, which shows that AKHUWAT is in real essence serving the cause of poverty elevation by not exploiting the poor and needy of the society through charging them with high unbearable interest rates while returning the

principle amount of loan taken from the organization by its clients and thus AKHUWAT is in accordance with the Islamic Sharia'h of not being indulging in any sort of transactions which carries the element of interest.

If we analyze the graph for operating cost for SRSP i.e. Figure. V we could see that at the beginning of the period under study the operating cost of SRSP was on a higher side but later on the organization was able to reduce operating costs this could be attributed to economies of scale achieved in its services by SRSP because the organization is providing its services from 1989 so it has gained expertise in how to minimize its costs while providing its services. Where as in case of AKHUWAT we can see in graph i.e. Figure. VI, there is a continuous incline in operating cost for the organization, one of the reason could be that the organization is quite young as compared to SRSP i.e. established in 2001, so it will take some time for the organization to achieve operational efficiencies and the other reason is that the client base for AKHUWAT is increasing due to which the operating cost would also rise thus the graph shows a continuous incline in cost for the period under consideration.

By analyzing the total amount of loan disbursed by SRSP for the period in Figure. VII. We could see reduction in the amount of loans disbursed by SRSP the reason could be high interest rates for micro finance schemes due which the marginalized of the society are not opting for SRSP's loan scheme over whelmingly. On the other hand the graph of AKHUWAT i.e. Figure. VIII. Shows a continuous increase in the level of loans disbursed by the organization, which could be attributed to no interest charges what so ever by the organization on any sort of loans provided and following the guidelines of Islamic Sharia'h.

The bar graph in figure. IX. Shows that what number of beneficiaries one employee each of the both organizations has served and it could be seen from the graph that one employee of SRSP has served about 20 beneficiaries, whereas one employee of AKHUWAT has served 125 beneficiaries, which shows the professionalism and dedication of the employees of AKHUWAT so to achieve their objective of eradicating the poverty from Pakistan.

### **Conclusion and Recommendations**

There is enormous growth opportunities for the Islamic microfinance organizations and programs in Pakistan because the conventional microfinance programs are charging very high interest rates which are not affordable for the poor and needy of the society and also people are now getting more aware of the injunctions of Islamic Sharia'h which prohibits interest under any circumstances. The facts and figures reveals

that AKHUWAT the Islamic microfinance organization, is performing well by reaching the needy of society and making them self sustainable, dignified citizens without charging them any sort of interest. But there is always space for improvement and this study finds out that the operating cost of AKHUWAT is rising for the period under study which needs to be controlled and efficient management of the resources for microfinance program needs to be done. Furthermore, AKHUWAT has focused more intensely on the rural areas of Punjab province only but intensity of poverty in the rest of provinces is comparatively high therefore, AKHUWAT needs more deep concentration because the poor in the rest of provinces are far behind the socio economic development of the country. The study suggests that in Muslim communities, the Islamic microfinance practices are welcomed as they are in accordance with the Islamic Jurisprudence. At the same time these practices are not in contradiction with the Non Muslim community's religious practices and they can also avail micro financing facilities without any hurdles and extra burdens in the shape of higher rate of interest. The Government should form a policy in which formation of conventional micro financing institutes should be discouraged and Islamic micro finance programs and organizations should not only be encouraged but also facilitated so that poor and needy of the society could play a positive role in the economic development of the society.

## Notes

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<sup>1</sup> M. Obaidullah, *Introduction to Islamic Microfinance*. (New Delhi: IBF Net (P) Limited, 2008)

<sup>2</sup> Ibid.

<sup>3</sup> Ibid.

<sup>4</sup> Zahoor Khan, Alam Khan & Asmat Ullah, "Cooperative Microfinance: A New Option for Government & Development Organizations", *Journal of Managerial Sciences*, III (1I), pp.180-191.

<sup>5</sup> John D Conroy, "The Challenges of Microfinancing in Southeast Asia", *Financing Southeast Asia's Economic Development*, (Singapore: Institute of Southeast Asian Studies, 2003), p. 1-44.

<sup>6</sup> Zahoor Khan, op.cit.

<sup>7</sup> Al-Quran, Sura Al-Baqara, 2:275

<sup>8</sup> <http://www.slideshare.net/alhudacibe/asasah-islamic-microfinance>, 2011, retrieved on 23<sup>rd</sup> April, 2010

<sup>9</sup> Ibid.