

A PROPOSAL FOR ESTABLISHING A MICROENTERPRISE ISLAMIC BANK

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I RATIONALE

Islamic financing is growing at the rate of 15 percent per annum in Pakistan and the Gulf region. There is evidence that the demand for Islamic financial instruments is large.

Islamic banks have concentrated at the top of the market and like conventional banks, they have been a channel for transmitting savings to large investors. Their development impact has been low and their development experience has been confined to government projects and both IDB and DMI are experiencing difficulties in disbursement and recovery of loans to government projects.

The economic condition of ordinary Islamic workers is deteriorating. This is specially true of our brothers working in mosques and madrassahs.

The community based bazaar is a thoroughly Islamic institution but it is being secularized due to the need for borrowing from the riba based money and capital markets.

Increasing Islamic financing can be an effective means for developing Islamic community work and re-establishing the mosque as the institutional focus of mohalla life. It can provide a basis for Islamic self and community governance.

II CONCEPT

Microenterprise Islamic Bank (MIB)

MIB should be a project sponsored by the Ulema and the religious groups.

MIB should be a link between those who wish to deposit money in an Islamic institution and small traders, manufacturers, service sector owners (specially madaris) and shopkeepers who seek Islamic finance for investment.

MIB should be a profit oriented business venture.

MIB should be a focus for community organization – specially in the area of deposit mobilization.

MIB should function strictly in accordance with Shariah and should have no links with non Islamic financial institutions, in the money market or the capital market.

III OWNERSHIP AND CAPITAL STRUCTURE

MIB should have a paid up equity of Rs 500 million.

Rs 180 million should be provided by a consortium of religious groups, organizations, madaris and ulema. This consortium will be the “strategic investor” with management control of MIB.

Rs 175 million to be raised from the non financial corporate sector.

Equity financing of Rs 125 million to be obtained from foreign individuals and Islamic groups.

Rs 20 million to be raised from the Muslim community by sale of MIB ownership certificates in areas where MIB branches are to be established. Mosques, madrassahs, Islamic groups must raise this money through campaigns which must begin three to six months prior to the establishment of the branch. Fund raising groups must be under the direct control of the strategic investor consortium.

IV AREAS OF BUSINESS

Deposit mobilization, chequing and account maintaining facilities.

Investment financing for small business of both short and long term nature by use of “tamveel” instruments.

Provision of finance to support regional clustering strategy of large enterprises.

V OPERATIONS

Headquarters will be in Quetta and Peshawar.

Each branch will include,

- i. Administrative and Support Staff

- ii. Three Credit Officers
- iii. Two Deposit Mobilization Officers
- iv. One Training Liaison Officer
- v. One Community Liaison Officer (maintaining continuous contact with masajid, madaris, religious groups and Islamic community organizations).

Each branch will be a profit centre and will be expected to become capable of fully financing its operations within an 18 months period.

Head Office will consist of the following Divisions,

- i. Administrative and Finance
- ii. Business Strategy and Research
- iii. Monitoring and Co-ordination
- iv. Marketing and Liaison
- v. Investment Operations
- vi. Export Promotion

An autonomous Central Training Institute will be established. Its cost will be covered by the financial charges levied by the Bank. Its functions will be,

- i. Provision of on the job technical training for financed enterprises.
- ii. Research for technological upgrading and adoption in specific industrial branches.
- iii. Provision of managerial and accounting training to small and micro-enterprise entrepreneurs.
- iv. Conception and support of integrationist clustering strategies for large enterprises.

VI Pre-Feasibility Data of a Branch Office of the Proposed Bank

CASE-I

Location	The branch will be located in a nearby commercial area where there is a cluster of 1500 to 2000 micro-enterprise units operating.
Area of premises	2000 Sq. ft.
Annual value of production by micro-enterprise units in the area of operation.	Rs 300(m) to Rs 400(m).

Business

Investment opportunities upto Rs 60(m) to Rs 80(m).

Cost of funds (for 18 months):

Administrative & Overheads (fixed cost) Rs 2.250(m)
Which include salaries, rents, electricity,
gas, taxes, stationery, depreciation etc.

Financial cost investments must be made to ensure that on average a 20 percent return on investment is realized annually. The profit share of Head Office may be 60 percent on this return on average.

The profit share of branch depositors may be 50 percent on this return on average.

Hence on total funds of branch = Rs 30 million borrowed for 18 months, return to Head Office and depositors = Rs 3.635 million.

Total cost = Rs 5.885 million.

Month-wise projected budget estimates for 18 months are given at Table 1.
Assumptions are:

- i. Equity of the micro-enterprise bank will be Rs 500(m).
- ii. The maximum financing by each branch will be Rs. 30(m) averaging Rs 50,000 per case for 600 cases.
- iii. The financing will yield @ 20% p.a.
- iv. 80% of the financing needs will be met from H.O. and 20% from local deposit mobilization during the first eighteen months.
- v. The total projected average cost of 18 months includes salaries, rent, electricity, gas, taxes, depreciation etc.
- vi. The maximum staff strength is estimated to increase to total 10 in number consisting of following categories:

a. Administrative and Support staff	3
b. Credit Officers	3
c. Deposit Mobilization Officers	2
d. Training Liaison Officer	1
e. NGO Liaison Officer	1

BREAK EVEN POINT

- The branch will be at break-even point after 7 months when the financing will be Rs 17.5(m) @ 20% return i.e. Rs 0.294(m) and total cost will be Rs. 0.295(m).
- The branch will be a profit unit after 14 months also making good the accumulated losses of the first 7 months from the profit generated in between 8 to 14 months.

Table 1
Budgeted Data of a Branch. Case-I

(Rupees in Million)

Month	Financing	Source of Funds			Financial Cost	Fixed Cost	Total Cost	Profit & Loss
		Income	H.O	Deposit				
1	2.500	0.042	2.500	—	0.025	0.125	0.15	0.108
2	5.000	0.084	1.500	0.500	0.049	0.125	0.17	0.090
3	7.500	0.126	6.500	1.000	0.074	0.125	0.19	0.073
4	10.000	0.168	8.500	1.500	0.098	0.125	0.22	0.055
5	12.500	0.210	10.500	2.000	0.122	0.125	0.24	0.037
6	15.000	0.252	12.500	2.500	0.146	0.125	0.27	0.019
7	17.500	0.294	14.500	3.000	0.170	0.125	0.29	0.001
8	20.000	0.335	16.500	3.500	0.194	0.125	0.31	0.016
9	22.500	0.377	18.500	4.000	0.218	0.125	0.34	0.034
10	25.000	0.419	20.500	4.500	0.242	0.125	0.36	0.052
11	27.500	0.461	22.500	5.000	0.267	0.125	0.39	0.069
12	30.000	0.500	24.500	6.000	0.290	0.125	0.41	0.085
13	30.000	0.500	24.500	6.000	0.290	0.125	0.41	0.085
14	30.000	0.500	24.500	6.000	0.290	0.125	0.41	0.085
15	30.000	0.500	24.500	6.000	0.290	0.125	0.41	0.085
16	30.000	0.500	24.500	6.000	0.290	0.125	0.41	0.085
17	30.000	0.500	24.500	6.000	0.290	0.125	0.41	0.085
18	30.000	0.500	24.500	6.000	0.290	0.125	0.41	0.085
	375.000	6.268	305.500	69.500	3.635	2.250	5.88	0.383

Break-even Point in revenue = Rs 0.268(m)
(each branch)

Return on Investment on = 1.84%
average funds employed
(each branch)

**Global Profit and Loss
Position – A**

Profit of branches (16) = Rs 6.128(m)
6.128(m)

**Global Profit and
Loss Position – B**

Profit of branches (16) = Rs

Return on investment @15% = Rs 51.400 (m)
68.660(m)
on portion of equity invested
by H.O.

Return on investment = Rs
@20% on portion of
equity invested by H.O

Return on investment @ 48.880(m) 12% on Equity invested at	= Rs 48.880(m)	Return on investment @12% on Equity	=Rs
Total 123.668(m)	= Rs 106.408(m)	Total	=Rs
Less H.O. Expenses @ Rs 3(m) P.M.	= Rs 54.000(m)	Less H.O. Expenses @Rs 3(m) P.M.	=Rs 54.000(m)
Profit before tax	= Rs 52.408(m)	Profit before tax	= Rs69.668(m)
R.O.E.	10.48%	R.O.E.	13.9%

CASE-II

Location	The branch will be located in a nearby commercial area where there is a cluster of 1500 to 2000 micro-enterprise units operating.
Area of premises	2000 Sq. ft.
Annual value of production by micro-enterprise units in the area of operation.	Rs 300(m) to Rs 400(m).
Business	Investment opportunities upto Rs 60(m) to Rs 80(m).
Source of funds	Funds from Head Office 20% of the financing and deposit mobilization 80% of the financing.
Cost of funds (for 18 months):	
Administrative & Overheads (fixed cost) Which include salaries, rents, electricity, gas, taxes, stationery, depreciation etc.	Rs 2.250(m)
Financial Cost (variable costs) @12% p.a. to be paid to Head Office for the funds borrowed upto maximum of Rs 24 (m) @ 10% p.a. to be paid to Customers on deposits.	Rs 2.276 (m)
	Rs 4.526 (m)

Month-wise projected budget estimates for 18 months are given at Table II. Assumptions are:

- i. Equity of the micro-enterprise bank will be Rs 500(m).
- ii. The maximum financing by each branch will be Rs. 45(m) averaging Rs 50,000 per case for 900 cases.
- iii. The financing will yield @ 20% p.a.
- iv. 20% of the financing needs will be met from H.O. and @ 12% p.a. and 80% local deposit mobilization @ 10% p.a.
- v. The maximum staff strength is estimated to increase to total 10 in number consisting of following categories:
 - a. Administrative and Support staff 3
 - b. Credit Officers 3
 - c. Deposit Mobilization Officers 2
 - d. Training Liaison Officer 1
 - e. NGO Liaison Officer 1

BREAK EVEN POINT

- The branch will be at break-even point after 5 months when the financing will be Rs 15.0 (m) @ 20% return i.e. Rs 0.250 (m) and total cost will be Rs. 0.235(m).
- The branch will be a profit unit after 11 months also making good the accumulated losses of the first 5 months from the profit generated in between 6 to 11 months.

Table II
Budgeted Data of a Branch. Case-II

(Rupees in Million)								
Month	Financing	Source of Funds			Financial	Fixed	Total	Profit
		Income	H.O	Deposit	Cost	Cost	Cost	& Loss
1	2.500	0.042	0.500	2.000	0.013	0.125	0.14	0.101
2	5.000	0.084	1.000	4.000	0.027	0.125	0.16	0.078
3	7.500	0.125	1.500	6.000	0.040	0.125	0.18	0.055
4	10.000	0.167	2.000	8.000	0.053	0.125	0.19	0.031
5	12.500	0.208	2.500	10.000	0.067	0.125	0.21	0.009
6	15.000	0.250	3.000	12.000	0.080	0.125	0.23	0.015
7	17.500	0.292	3.500	14.000	0.093	0.125	0.25	0.039
8	20.000	0.333	4.000	16.000	0.106	0.125	0.27	0.062
9	22.500	0.375	4.500	18.000	0.120	0.125	0.29	0.085
10	25.000	0.417	5.000	20.000	0.130	0.125	0.30	0.112
11	27.500	0.458	5.500	22.000	0.147	0.125	0.32	0.131
12	30.000	0.500	6.000	24.000	0.160	0.125	0.34	0.155
13	32.500	0.542	6.500	26.000	0.173	0.125	0.36	0.179
14	35.000	0.583	7.000	28.000	0.187	0.125	0.38	0.201
15	37.500	0.625	7.500	30.000	0.200	0.125	0.40	0.225

16	40.000	0.667	8.000	32.000	0.213	0.125	0.41	0.249
17	42.500	0.708	8.500	34.000	0.227	0.125	0.43	0.271
18	45.000	0.750	9.000	36.000	0.240	0.125	0.43	0.295
	427.500	7.126	85.500	342.000	2.276	2.250	5.36	1.745

Break-even Point in revenue =Rs 0.233(m)
(each branch)

Return on Investment on average funds employed (each branch) 7.34%

Global Profit and Loss Position – A

Global Profit and Loss Position-B

Profit of branches (16) =Rs 27.920(m) Profit of branches (16) = Rs 27.920(m)

Return on investment @ 15% =Rs 95.400(m) Return on investment = Rs 127.200(m)
on portion of equity invested by H.O. @ 20% on portion of equity invested by H.O.

Return on investment @ 12% = Rs 13.690(m) Return on investment = Rs 13.690(m)
on Equity invested at branches @12% on Equity invested at branches

Total = Rs 137.010(m) Total = Rs 168.810(m)
Less H.O. Expenses = Rs 54.000(m) Less H.O. Expenses = Rs 54.000(m)
@ Rs 3(m) P.M. @ Rs 3 (m) P.M.

Profit before tax = Rs 83.010 Profit before tax =Rs 114.810(m)

R.O.E. 16.6%

R.O.E. 13.0%

VI STRATEGIC CONSIDERATIONS

The viability of MIB depends above all on the ability to invest money so that a 20 to 25 percent rate of return on financing can on average be realized on an annual basis. This is not unrealistic. Rates of return on Islamic instruments in the formal sector are usually in this range. Rates of return in the informal sector can be higher – a hundred percent rate of return on new investment is not un-common. In general, investments must be made in businesses where new investment will realize at least a fifty percent average

annual rate of return. A forty to fifty percent profit share will then make investment viable.

This requires that for a considerable time period (say five years) loans will be limited to a relatively small number of sectors and a relatively small number of on going businesses. MIB can in the early stage afford to finance only the expansion of small units in profitable sectors. The most important asset of the bank is the credit officer. His selection of investment projects will determine the viability of MIB. He must ensure that those projects are selected which can realize at least a 50 percent rate of return on new investment. He must also ensure that a hundred percent recovery rate is maintained. The credit officer must participate in the preparation of monthly income and expenditure accounts by the projects financed. Repayments must be on a monthly or quarterly basis. (All this was achieved by Allied Bank's USF scheme).

Initially the role of the H.O is important since it will be the principal source of investment funds. But this role must be reduced. H.O will not have access to any lines of credit nor will it have a mandate to raise funds in the money market. In all probability, rate of return on funds deployed by it directly will be less remunerative than funds lent by the branches. Therefore the share of H.O. in branch financing must decrease over time. MIB must assume the form of a holding company where the H.O is eventually restricted to a coordinating, planning, marketing and research role.

Hence deposit mobilization at the branch level becomes very important. The growth of the financing net work – officially the ability to finance higher risk, lower return projects – depends crucially on the mobilization of deposits (specially current account type deposits and deposits which can be used for qard-e-hasna purposes). Deposit mobilization is a means for increasing the mass character of MIB. Individuals, religious groups and community organizations must also be encouraged to purchase equity of MIB. It has been suggested that Rs 20 million (4 percent of MIB's total equity) ought to be raised by sale of ownership participation certificates. This implies that if there are to be a total of 16 branches, a branch should be opened in an area where the community purchase of ownership certificates equals Rs 1.25 million.

The viability of the MIB also depends crucially upon increasing the technical capability of financed enterprises. Hence the creation of a Central Training Institute is proposed as well as programmes for integrating the production and distribution systems of large and small units through the development of a regional clustering enterprises. Grants from IDB and other Islamic institutions may be utilized for the provision of these services but the need for cost effectiveness should not be ignored. Small and large enterprise integration can be mutually beneficial, large enterprises gain due to a significant reduction in import need and small enterprises benefit from the access to efficient production and marketing technology. There is therefore a strong case for MIB's H.O. developing commercially prices management consultancy service for facilitating enterprise integration.

Finally it may be stressed that a primary purpose of MIB is to strengthen Islamic community organization. MIB can contribute to this end by encouraging the enterprises it finances to:

- a) develop vertical integration and enterprise networking to realize economies of scope and scale in both production and marketing.
- b) pool zakat, khairat and sadqa funds and utilize them for promoting Islamic education and Islamic social work.
- c) MIB can also organize community groups for pooling individual savings – the Islamisation of the mohalla based B.C/committee system is a relatively easy task.