ISLAMIC FINANCE FOR MICRO AND MEDIUM ENTERPRISES

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In the name of Allah, the Most Merciful, Most Beneficent

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FOREWORD

Micro and medium scale enterprises (MMEs) are generators of quality employment and sustainable creators of wealth and therefore, are a powerful tool of poverty alleviation. MMEs provide income and employment for significant proportions of workers in rural and urban areas by producing basic goods and services for rapidly growing populations. MME development is therefore, increasingly being seen as an essential ingredient of broad based economic growth and significant contributor to well being of the poor. Of the many constraints to the development of MMEs, the most formidable is a lack of access to credit. Inadequate collateral, insufficient legal status, high transaction costs, and the sensitivity of entrepreneurs in the Islamic world to interest-based financing products are among the reasons why such enterprises experience exclusion from the formal financial system.

Reflecting the concern for enhancement of financial inclusion through introduction of Shariah-compliant finance for MMEs, the First International Conference on "Inclusive Islamic Financial Sector Development: Enhancing Islamic Financial Services for Micro and Medium Sized Enterprises" was organized during April 17-19, 2007 at Negara Brunei Darussalam. The event was an outcome of collaborative efforts by Islamic Research and Training Institute of the Islamic Development Bank and the Centre for Islamic Banking, Finance and Management of Universiti Brunei Darussalam. Co-operation between the two institutions has also resulted in publication of the present volume of proceedings of this conference. It contains selected papers presented at the conference that seek to deal with major issues of theoretical and practical significance and provide useful insights from experiences of real-life experiments in Shariah-compliant MME finance. We hope the present volume would stimulate further research and sharing of information in this very important area.

We would like to congratulate the members of the Organizing Committees of both institutions for the efforts taken in making the conference a success. It is hoped that this event may motivate and aspire further collaboration between Islamic Research and Training Institute of the Islamic Development Bank and the Centre for Islamic Banking, Finance and Management of Universiti Brunei Darussalam.

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INTRODUCTION

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Exclusion of the poor from the financial system is a major factor contributing to their inability to participate in the development process. Building inclusive financial systems therefore, is a central goal of policy makers and planners across the globe. These concerns are reflected in the Millennium Development Goals (MDGs) set by the United Nations in the year 2000 and the international initiatives that have followed. There is a global consensus on the view that microfinance leads to poverty alleviation through financial inclusion. The labelling of year 2005 of as the Year of Micro-credit by the United Nations and the award of Nobel Peace Prize for the year 2006 to Dr Muhammad Yunus, the father of microfinance, are indicators of the growing importance accorded to microfinance as a tool of poverty alleviation.

Current thinking on microfinance has broadened its definition from micro-credit to provision of an array of financial services, such as, savings, insurance and remittance. It emphasizes that access to microfinance and not cost of microfinance should be under focus in designing and implementing a poverty alleviation strategy. The strategy should aim at sustainability through a shift from a charity-based donor-dependent approach to a market-based for-profits approach emphasizing systemic efficiency and transparency and restricting use of donor funds to capacity building. It also underscores inclusiveness and integration of microfinance with the formal financial system. While there is a consensus among thinkers and practitioners on the above, the same does not imply or advocate a single and uniform approach to microfinance. Arguably, diverse channels are needed to get diverse financial services into the hands of a diverse range of people who are currently excluded. In the context of Muslim societies, building inclusive financial systems would most certainly require integration of microfinance with Islamic finance.

Microfinance and Islamic finance have much in common. Islam emphasizes ethical, moral, social, and religious factors to promote equality and fairness for the good of society as a whole. Many elements of microfinance are consistent with the broader goals of Islamic finance. Both advocate entrepreneurship and risk sharing and believe that the poor should take part in such activities. Both focus on developmental and social goals. Both advocate financial inclusion, entrepreneurship and risk-sharing through partnership finance. Both involve participation by the poor. There should, therefore, hardly be much doubt about the possibility of a successful marriage between the two. This may involve experimenting with the best practices and models of conventional microfinance while modifying the products and services to make them *Sharīʿah*-compliant. The new concept born out of this marriage - Islamic microfinance would therefore, not only retain the accumulated wisdom of the microfinance best practices, but would also give due consideration to religious and cultural sensitivities of the Muslim clients. The result, needless to say, would be enhanced financial inclusion.

Various issues relating to Islamic microfinance were under sharp focus at the First International Conference on "Inclusive Islamic Financial Sector Development: Enhancing Islamic Financial Services for Micro and Medium Sized Enterprises". The event was organized jointly by IRTI and the Centre for Islamic Banking Finance and Management of Universiti Brunei Darussalam during April 17-19, 2007 at Negara Brunei Darussalam. The theme of the conference was carefully chosen to reflect the growing importance of building inclusive financial systems in a *Sharīʿah*-compliant manner as a strategy of poverty alleviation in Muslim societies. It was felt that the event would bring to the fore state-of-the-art research being undertaken across the globe by doctoral and post-doctoral scholars and additionally, would highlight useful lessons from experiences of professionals working in this field. A total of thirty-seven papers were selected for presentation at the event by researchers and practitioners from countries like Australia, New Zealand, Malaysia, Indonesia, Iran, US and UK. The presented papers were further subjected to careful evaluation and eighteen papers were selected to form part of the present volume.

Microfinance institutions have distinct characteristics that make them specialized components of the formal financial system. The main point of departure of microfinance from mainstream finance systems is its alternative approach to collateral that comes from the concept of joint liability. In this concept individuals come together to form small groups and apply for financing. Members of these small groups are trained regarding the basic elements of the financing and the requirements they will have to fulfil in order to have continued access to funding. Funds are disbursed to individuals within the group after they are approved by other members in the group. Repayment of the financing is a shared responsibility of all of the group's members. In other words they share the risk. If one defaults, the entire group's members face a setback that may mean a provisional suspension from the program and therefore no access to financing for the group or other penalties. In most cases, microfinance programs are structured to give financing in small amounts and require payment at weekly intervals and within a short time period– usually a month or a few months. The beneficiary looks forward to repetitive financing in a graduated manner and this also helps mitigate risk of default and delinquency.

There is nothing questionable about this basic methodology of microfinance from the *Sharīʿah* point of view. Indeed Dr Asyraf Wajdi Dusuki in his paper "Lifting Barriers in Financing the Small and Poor Entrepreneurs: Lesson from Group-Based Lending Scheme and Ibn Khaldun's Social Solidarity" finds support for this model in the concept of *Asabiyah* or social solidarity that is the core of Ibn Kaldun's thought concerning the rise and decline of a civilization. In the *Muqaddimah*, Ibn Khaldun emphasizes the importance of having a sense of solidarity or 'espirit de corp' – the state of mind that makes individuals identify with a group and subordinate their own personal interests to that of group interest. Drawing a parallel between the group-based financing methodology and the concept of solidarity, the paper argues that Islamic banks would do well to operationalize this concept in providing financial products and services to the poor.

It is observed however, that mainstream Islamic financial institutions (IFIs) in the recent past have not demonstrated much interest in including microfinance in their portfolio of activities. The issue has taken the shape of a raging debate on whether IFIs have a social purpose beyond their role as a financial institution. It has been argued that IFIs are like any other conventional financial institution, which acts as an intermediary between providers and users of funds, the only difference being that the transactions and contracts of an IFI must comply with Islamic law. Others argue that implicit in the laws of Islamic finance (i.e. the spirit of the laws) is an ethical guideline to ensure that some or all of the funds provided by investors are used to redistribute wealth within society. Microfinance is one such mechanism. This view is presented quite forcefully by Dr Syed Farook in his paper "A Standard of Corporate Social Responsibility for Islamic Financial Institutions: A Preliminary Study". The paper proposes a structured definition of the social purpose of IFIs derived from, among other things, Islamic principles of social equity and redistributive justice. It proposes that the guidelines for Islamic corporate social responsibilities should follow a framework similar to that of personal responsibility - based on the continuum of classifying actions – mandatory, recommended and permissible actions on the one hand and not-recommended and impermissible actions on the other. While payment of *zakāh* is mandatory, the acts of charity under *ṣadaqah*, *awqāf* and microfinance are recommended forms of Islamic corporate social responsibility for IFIs.

In addition to the above, the issues addressed in the present volume fall into five broad areas: (i) Islamic contracts and products for microfinance; (ii) models of microfinance; (iii) integrating *zakāh* and *awqāf* with microfinance; (iv) education and training for microfinance; and (v) role of government in enhancing financial inclusion through microfinance.

Islamic Contracts and Products for Microfinance

A mandatory requirement for mainstream IFIs as well as Islamic microfinance institutions (IsMFIs) is that all their transactions must conform to the *Sharīʿah* and be free from *ribā*, excessive *gharar* and other prohibitions. Over the last couple of mainstream IFIs have expended considerable effort in developing products and services that meet the needs of their clients relating to savings, financing, investment, remittance, risk management etc. in a *Sharīʿah*-compliant manner. While most of these products could be used for IsMFIs as well, there are some micro-finance-specific issues that deserve special mention. These micro-level issues are discussed next.

The first paper dealing with such issues relate to a contemporary innovation in financing modes – the decreasing partnership financing facility that is widely believed to have great potential for financing first-generation entrepreneurs. The paper "Financing Micro and Medium Sized Enterprises through Decreasing Partnership (*Mushārakah Mutanāqisah*): Refining *Sharīʿah* and Banking Aspects for Enhanced Applicability" by M A Sadique essentially stipulates conditions for ensuring "purity" of the decreasing partnership contract so that it may be used as an effective tool of Islamic microfinance, for procurement of assets as well as for financing ventures. Highlighting loopholes in the contemporary use of decreasing-partnership-based products, the author asserts that equity-participation as its basis must be emphasized and the ancillary contracts of *ijārah* and *bayʿ* must function independently. The reality of these contracts should be effectively highlighted through pricing the units and *ijārah* rentals realistically, rather than as an apportionment of the profit element calculated on the capital outlay. Rentals should be reflective of the gradual decrease of the bank's share, and correlate to the nature of the asset rather than the capital. Purchase of units should be dissociated from payment of *ijārah* rentals. Instead of adherence to a specific schedule, the client should be allowed to complete purchasing the bank's share within a defined period. The bank should honor responsibilities devolving on it as co-owner and lessor. In each micro-project financed, means of strengthening the bank's function in these capacities should be explored and adopted. Preferably, the promise to purchase extended by the client should not be held legally enforceable, providing additional flexibility for the micro-projects. The client should be allowed to extend the *ijārah* when necessary.

In financing ventures on decreasing partnership basis, similar checks and balances are proposed. Islamic banks should acquire expertise necessary for rendering an effective role in the operations of the micro-project and mobilizing funds should be undertaken jointly by the bank and the micro-entrepreneur. Expenses of the venture should be shared proportionately. In projects based on *shirkah al-milk*, profit share of the bank should decline corresponding to the bank's stake. Unit price of the bank's share should be fixed based on a price negotiated at the time or professional valuation. Possibility of prior fixing of the sale price should be curtailed, and the promise to purchase not be held legally binding. Instead, where the partner-entrepreneur refuses to purchase the bank's share, the latter could resort to liquidating the venture as provided in *Sharīʿah*, dividing the assets. While many such suggestions in the paper undoubtedly ensure "purity" of the arrangement, their "practicality" needs to be further tested and explored in real-life projects.

In a related study, "Islamic Micro-Finance Practice with a Particular Reference to Financing Entrepreneurs through Equity Participation Contracts in Sudanese Banks" Gaffar Abdalla Ahmed evaluates the performance of projects financed through equity participation by the banking system in Sudan. The study recommends the use of group-lending concept in *mushārakah* financing to small and micro businesses in order to reduce the administrative burden on the bank staff and at the same time provide alternative security against possible default. In addition, it argues for a fair and proper estimation of the management contribution to generation of profits that should be reflected in the management's share of profit. The study further suggests inclusion of a condition against possible interference of the bank in the management affairs or disclosure of information about the business a third party.

The next paper takes a look at another important equity-based contract – *muḍārabah*. In his paper "Agency Problems in *Muḍārabah* Financing: The Case of *Sharīᶜah* Rural Banks in Indonesia" Adnan and Muhamad seek to address a fundamental dilemma. According to most contemporary Islamic economists, profit-and-loss-sharing partnership-based contracts form the basic building blocks of an Islamic financial system that is morally, ethically superior to and more equitable than the conventional system. Yet, these are the least preferred modes of financing for IFIs. A reason for this preference is found in what is documented as agency problems in financial literature. This paper by Adnan and Muhamad examines the use of *muḍārabah* contract in a new setting – in the context of the small Indonesian rural Islamic banks. It provides some interesting statistics based on primary data collected from a sample of sixty-four rural Islamic banks called BPRS. It finds that *muḍārabah* financing forms no more than 15-20 percent of total financing for around two-third of the BPRS; for the remaining one-third, the percentage is less than five. Over eighty percent of all *muḍārabah* financings are for a relatively short period – between one to two years. The maturity never exceeds three years. Over 50% of all financing is in the trading sector, with animal husbandry, manufacturing and agriculture accounting for approximately 25%, 15% and 10% respectively.

The study then undertakes an empirical survey of the Islamic rural banks and seeks to identify the project-related and client (*muḍārib*)-related attributes that financiers value most while opting for *muḍārabah*-based financing. The study finds six project-related attributes to be significant - the prospect of project, availability of collateral, healthiness of project, project's financial statements, clarity of contract conditions, and time period. Five *muḍārib*-related attributes - business capacity, (personal) collateral, reputation and family background, and business commitment are also observed to be significant. Further quantitative analysis of these attributes filters all attributes into five most influential factors - business skill, business reputation, business commitment (of the *muḍārib*), financial report and length of contract (of the project).

Indeed, a rational response to the agency problem with profit-loss-sharing financing would be to reduce uncertainty around profits by generating information. Given that microfinance projects deal with local products and markets, often dealing with a few known types of commodities and assets (such as, poultry, bee-keeping, fisheries, dairy), it is possible on the part of the financier to generate reliable business forecasts and develop products with realistic sharing ratios and expected returns. While cases of negligence of *muḍārib* leading to losses are taken care of in *muḍārabah*, proper systems should evolve to establish such negligence and ascribe the losses to the *muḍārib*. Further, accounting skills could be imparted to the *muḍārib* and made a pre-condition to financing

The importance of micro finance to small and marginal farmers can be hardly overemphasized. The next paper "Application of Islamic Banking Instrument (*Bayʿ Salam*) for Agriculture Financing in Pakistan" by Ahmad Kaleem deals with the issue in a Pakistani setting where agriculture sector represents about a quarter of the total GDP and employs about half of total labour. Access to formal credit is generally restricted to big landlords, since land is the main acceptable collateral. Restricted access to formal credit provides space to informal credit which presently accounts for 72% of total agriculture credit in Pakistan. However, informal credit may not be as conducive to development as it is expensive, short-term and largely used for consumption. This paper explores the potential viability of agriculture financing under Islamic banking principles using the *bayʿ salam* contract. According to survey results reported in the study, middlemen are currently the major financers and buyers of crops in the rural economy and only 10% transactions are conducted on cash basis. At the same time, farmers think that they can save up to 25% of costs if they purchase the crops inputs on cash. Introduction of *bayʿ salam* that provides cash in advance to farmers against supply of agricultural produce at a later date, can thus, bring in major benefits for the farmer community.

One of the rather "neglected" *Sharīʿah*-nominate contracts in mainstream Islamic finance is *qarḍ ḥasan*. It has not found much favour with mainstream Islamic FIs as a mode of financing primarily because of its “zero” stipulated nominal rate of return. However, ordained by the holy *Qur’ān*, *qarḍ ḥasan* is perceived to be a "pure" form of Islamic finance. Among other countries, Iran provides us with a history of *qarḍ ḥasan* being used extensively as a tool of financial intermediation. The paper "*Gharzul Ḥasaneh* Financing and Institutions" by Kazem Sadr takes stock of this mechanism in Iran and observes that *Gharzul-Ḥasaneh* Funds (GHF) are the oldest Islamic financial institutions in Iran which were established long before the victory of Islamic revolution. They have grown over time in numbers, offer a wider spectrum of financial services, and now figure as a prominent segment of formal Iranian financial market. A feature that makes the mode quite attractive is that anyone who borrows from another has to return full amount of the loan whenever the lender calls for it. Although no surplus or additional service charges can be demanded by the supplier, he is entitled to have his funds paid back anytime he so desires; except for a condition which may specifically state and clarify the maturity date or the redemption period of the loan right at the outset when the *qarḍ ḥasan* contract is made. Further, if the borrower delays repayment, he can be subjected to a penalty. These legislative characteristics make *qarḍ ḥasan* loans very secure. They also make the asset owner indifferent between holding a part of his assets as cash or a *qarḍ ḥasan* loan.

It is now an empirically established fact that *murābaḥah* tops the list of available modes of Islamic finance in terms of popularity. A variety of reasons are cited to explain this phenomenon. *Murābaḥah* comes quite close to conventional lending and therefore, is easy to adopt by conventional bankers venturing into Islamic finance. It is also simple and easy to implement. Its proximity to conventional lending also leads to a possibility that the points of distinction between *murābaḥah* and conventional lending may actually get quite blurred in practice. The paper "Evaluation of the Practice of *Murābaḥah* Mode of Financing as an Islamic Instrument and Contract for Micro and Medium Sized Enterprises in the Operations of Baitul Mal Wattamwil (BMT), Yogyakarta, Indonesia" by Nur Kholis examines the degree of conformity of *murābaḥah* in practice to *Sharīʿah*-prescribed norms for a sample of BMTs in Indonesia. The study notes that BMT practices with a few exceptions do conform to *Sharīʿah* prescriptions. It highlights some major discrepancies between conventional lending and *murābaḥah* financing as practiced by Indonesian BMTs. The first and foremost point of difference is the absence of any "compounding" possibility with *murābaḥah* profit rates (unlike interest rates). The nature and manner of charging penalities in cases of defaults and delinquencies is another issue on which there is a clear-cut difference between conventional lending and *murābaḥah* financing.

Rahn is another *Sharīʿah*-nominate financial mechanism that can form the basis of a financial product or an institution. It essentially implies financing backed by a physical collateral and institutions traditionally practicing such financing are called pawn shops. The paper "A Comparative Study of Conventional and Islamic Pawnshops in Malaysia" by Ismail and Cokro argues that as a financial institution, a pawnshop has been playing an important role in providing funds especially for those experiencing difficulties in obtaining funds from formal financial institutions. The study examines the relative efficiency of conventional and Islamic pawnshops as they have been operating in Malaysia. It seeks to measure and evaluate the productive efficiency of both types of pawnshops related to their ability in providing and distributing funds in the society (maketability efficiency). The results of various statistical tests show that the efficiency of Islamic pawnshops was not different from the efficiency of their conventional counterparts.

Physical collateral-backed financing is however, not quite the solution to financing needs of the poor. The poor often do not simply have any physical collateral of value to offer. Indeed modern microfinance is collateral-free finance where a form of group guarantee replaces physical collateral.

Models of Microfinance

The model that has popularized collateral-free micro finance and has been replicated in many countries in a wide variety of settings is the Grameen Bank model. The model requires careful targeting of the poor through means tests comprising mostly women groups. The model requires intensive fieldwork by staff to motivate and supervise the borrower groups. Groups normally consist of five members, who guarantee each other's loans. A number of variants of the model exist; but the key feature of the model is group-based and graduated financing that substitutes collateral as a tool to mitigate default and delinquency risk. This also constitutes the central feature of most Islamic microfinance projects. While the models used are similar, there are significant points of difference between Islamic and conventional microfinance. In addition to ensuring Shariah compliance in their products and services offering, Islamic microfinance projects charge a relatively lower financing rate as compared to Grameen and its conventional replicators. The latter are known to charge very high rates of interest – much higher than the rates of mainstream banks. The higher rate is sought to be justified on grounds of high cost of monitoring a large portfolio of micro-loans. The fallacy inherent in this line of argument is brought to the fore by some Islamic microfinance institutions who charge a low to moderate profit rate in their financing and yet, are profitable and viable. The paper by Dr Mahmood Ahmed, "The Role of PDS in the Development of Women Entrepreneurship under Islamic Micro Finance: A Case Study of Bangladesh" provides a brilliant case study of such practices by the Islami Bank Bangladesh Limited.

A second model that has been widely replicated mainly in Latin America and Africa, but with substantially less total outreach than the many Grameen Bank replications is the Village Bank model. The model involves an implementing agency that establishes individual village banks with about thirty to fifty members and provides "external" capital for onward financing to individual members. Individual loans are repaid at weekly intervals over four months, at which time the village bank returns the principal with interest/ profits to the implementing agency. A bank repaying in full is eligible for subsequent loans, with loan sizes linked to the performance of village bank members in accumulating savings. Peer pressure operates to maintain full repayment, thus assuring further injections of capital, and also encourages savings. Savings accumulated in a village bank is also be used for financing. As a village bank accumulates sufficient capital internally, it graduates to become an autonomous and self-sustaining institution (typically over a three-year time period). This model has been very successfully implemented in a *Sharīʿah*-compliant manner in Jabal al-Hoss, Syria as highlighted in a paper

"Village Funds: A Financial Technology for Reaching Marginal Areas and the Very Poor in Syria" by Mahmoud Al Asaad. A new experiment by FINCA in Afghanistan also seeks to implement this model.

The third type of MF model is a Credit Union (CU). A CU is based on the concept of mutuality. It is in the nature of non-profit financial cooperative owned and controlled by its members. CUs, mobilize savings, provide loans for productive and provident purposes and have memberships which are generally based on some common bond. CUs generally relate to an apex body that promotes primary credit unions and provides training while monitoring their financial performance. CUs are quite popular in Asia, notably in Sri Lanka. A couple of Islamic cooperative models are at work in Australia that are the subject of investigation in the next paper, "Islamic Micro and Medium Sized Enterprises Finance: The Case Study of Australia" by Ahmad and Ahmad. The first Islamic financial institution in Australia - Muslim Community Cooperative (Australia) Ltd (MCCA) is a financial cooperative dealing primarily with home finance. The study finds that the main constraint facing MCCA is attracting more capital, which is now provided entirely by its shareholders. Given that it cannot pay interest to depositors, MCCA instead sells shares to investors and pays a dividend. Because better returns are available elsewhere, these investors tend to be driven at least partly by altruistic reasons. An important consideration is that, unlike deposits, the shares are not protected by the Australian Prudential Regulation Authority. In addition to providing home finance, MCCA has created a *Qarḍ Ḥasan* Fund out of donations to help those in need within the community. The second IFI to commence operations in Australia has also used the cooperative model. This IFI known as the Islamic Co-operative Finance Australia Limited (ICFA), provides a range of services – both for-profit (*murābaḥah* and *ijārah* etc.) and non-profit (*zakāh* and *qarḍ ḥasan*) to its members.

The list of models would be incomplete without mentioning the Self-Help Groups (SHGs) model. Originating in India, under this model each SHG is formed with about ten-fifteen members who are relatively homogeneous in terms of income. An SHG essentially pools together its members' savings and uses it for lending. SHGs also seek external funding to supplement internal resources. The terms and conditions of loans differ among SHGs, depending on the democratic decisions of members. Typical SHGs are promoted and supported by NGOs, but the objective (as with village banks) is for them to become self-sustaining institutions. Some NGOs act as financial intermediaries for SHGs, while others act solely as 'social' intermediaries seeking to facilitate linkages of SHGs with either licensed financial institutions or other funding agencies. The SHG model is a good platform for combining microfinance with other developmental activities. It would be interesting to see how the model works in an Islamic society.

Conventional microfinance over the years has witnessed a paradigm shift - from the traditional donor-based approach to a for-profits approach in building inclusive financial systems. The underlying assumption is that the demand for these services is simply too great to be filled by government and donor funds on a sustained basis. The excess demand will, need to be met by commercial capital available at a "fair" market price. The focus therefore, has sharply shifted from charity to profits. Of all the models above, the Grameen model and the village bank model that are the more structured than the rest have been able to enhance their outreach. Indeed the Grameen model has now become the text-book model of microfinance.

Integrating *Zakāh* and *Awqāf* with Microfinance

Conventional microfinance is not for the poorest of the poor. There is a sizeable substratum within the rural poor whose lives are unlikely to be touched, let alone improved by financial services. They are not "bankable" in their own or their neighbour's eyes, even when the bank is exclusively for poor people. Yet they desperately need some sort of assistance. An Islamic microfinance system, on the other hand, identifies being the poorest of the poor as the primary criterion of eligibility for receiving *zakāh*. It is geared towards eliminating abject poverty through its institutions based on *zakāh* and *ṣadaqah*.

Zakāh and *ṣadaqah* as instruments of charity occupy a central position in the Islamic scheme of poverty alleviation. *Zakāh* is the third among five pillars of Islam and payment of *zakāh* is an obligation on the wealth of every Muslim based on clear-cut criteria. *Zakāh* has been variously described by scholars as a tool of redistribution of income, a tool of public finance, and of course, as a mechanism of development and poverty alleviation. Rules of *Sharīʿah* are fairly clear and elaborate in defining the nature of who are liable to pay *zakāh* and who can benefit from *zakāh*. The first and foremost category of potential beneficiaries is the poor and the destitute. A greater degree of flexibility exists with respect to beneficiaries of *ṣadaqah*. The primary issue with *zakāh* and *ṣadaqah*-dependent institutions is the issue of sustainability as they are essentially rooted in voluntarism. Funds mobilized through charity could fluctuate from time to time and may not lend themselves to careful planning and implementation.

The issue of sustainability is addressed in the institution of *awqāf* through creation of permanent and income-generating physical assets. *Awqāf* has historically been the major vehicle for creating community assets. On the flip side, the restrictions on development and use of assets under *waqf* for pre-specified purposes introduce rigidity into the system. Undoubtedly, it is important to preserve and develop assets under *waqf* to add to productive capacity and create capabilities for wealth creation. *Awqāf* may also be created specifically to impart knowledge and skills in entrepreneurship development among the poor as microfinance alone cannot create wealth unless combined with entrepreneurial skills. Indeed all technical assistance programs can be organized as *awqāf*.

While *zakāh* funds must be distributed to the destitute and poorest of poor, this institution could be integrated with microfinance. This may be attempted by seeking to push such individuals through *zakāh* distribution out of dire poverty to levels, where they are no longer regarded as “unbankable” by MFIs. A linkage if established between the MFIs and *zakāh* funds would enhance the effectiveness of microfinance towards achieving poverty alleviation. There are however, many practical challenges to integrating *zakāh* and *awqāf* to microfinance. In the context of South Africa, it is argued that post 9-11 legislations have made it difficult to achieve the above in the informal sector. The paper "A Tax Engineering Pertaining to *Zakāh* and *Waqf* for Poverty Alleviation and Micro-Financing in South Africa" by Faizal Ahmad Manjoo makes a case for a proper application of the Income Tax Act in South Africa so that *zakāh* can be converted into an economic stimulus for poverty alleviation. The paper attempts to develop an estimate of *zakāh* collection and proposes the creation of a National *Zakāh* Fund by using the existing tax system to optimize poverty alleviation. It proposes that the National *Zakāh* Fund can be created as a Public Benefit Organization (PBO) and this will create room for tax engineering in generating more funds for poverty alleviation.

In another related paper "The Role of *Zakāt* Organization in Empowering the Peasantry: A Case Study of the Rumah *Zakāt* Yogyakarta Indonesia" Dani Muhtada reports an exploratory and descriptive study on a *zakāh* organization in Indonesia that has an empowerment program for peasants. The study analyzes the nature of the *zakāh* organization, its efforts in promoting peasant empowerment, and its contribution to the solution for the peasantry’s problems. The organization has the following major areas of activities: scholarships for poor students, free health service for the poor, economic empowerment, and free ambulance service. The study finds that the organization has been efficiently managing its resources. However, its scorecard in economic empowerment has been less than satisfactory. The organization has been seeking to improve the incomes of peasants by financing additional non-farm activities, but has not addressed the root cause of economic exploitation so far. Its microfinance activities are also adversely impacted by the fact that a large part of financial assistance is used for consumption purposes.

Need for Education and Training

Lack of adequate education and training among clients and organization personnel constitutes a major challenge for the Islamic microfinance sector. Lack of trained manpower is a major constraint for its growth, expansion and consolidation. There is an urgent need to develop resource centers and training material on Islamic finance in general and in Islamic microfinance in particular in multiple languages. This fact is clearly highlighted in the next paper, "The Need to Educate Muslims on Islamic Financial Principles and Practices: A Step Towards Fertilizing MMEs in the Islamic World" by Agung Waspodo. Further, the author suggests that education of Islamic financial principles and practices should be measured in terms of its effectiveness in increasing Muslims' adherence to Islamic principles and tenets.

A similar point is highlighted in the next paper "Building Capacity of MME: Do Muslim MMEs Need Spirituality Training?" by Mardhatillah and Rulindo. The authors suggest spirituality training as an essential ingredient of success of Islamic microfinance. It should be viewed as an essential component of technical assistance along with managerial assistance for capacity building. The suggestions are based on the findings of the study that there is a direct relationship between spirituality and success and performance of the entrepreneurs. The study also develops and tests an instrument for measuring spirituality based on the beautiful names of Allah SWT (*Asma'ul Husna*).

Role of Government

The government has a positive role to play in building inclusive financial systems. There is a growing consensus that the government's best role is to offer a policy environment that allows competitive and diverse financial service providers to flourish. A good policy environment allows a range of financial service providers to coexist and compete to offer higher-quality and lower-cost services to large numbers of poor clients. Government also creates the suitable regulatory framework for ensuring transparency and sound risk management practices on the part of the financial institutions.

Grassroot Islamic microfinance institutions (IsMFIs) in Indonesia called *Baitul Maal wat Tamweel* (BMT) largely fall outside the financial regulatory mechanism since they operate as member-based cooperative organizations without governmental assistance or intervention. The BMT structure has been found to be less vulnerable to systemic risks that arise due to interdependence, as each BMT is an independently operating entity. However, the absence of any element of coercion in the form of regulatory requirement may also mean lesser transparency. In the next paper "The Accountability of Islamic Microfinance Institutions: Evidence from Indonesia", Ersa Tri Wahyuni examines this issue. The study finds that lack of supervisory boards and low demand for audited financial statements provide little incentive for BMT managers to make their financial statement audited by independent auditors with less than one-fifth of BMTs being audited by independent auditors. BMT managers cite lack of any "need for" and the high "cost of" the audit exercise as the primary contributing factor to their decision.

In another paper "The Role of Indonesian Government in Enhancing Islamic Financing for Small and Medium Enterprises (SMEs)", Dodik Siswantoro provides a historical sketch of the contribution of the Indonesian government and its agencies in promoting microfinance in the country. This has been achieved through enactment of various enabling regulations and empowerment by institutions, such as, the Ministry of Cooperation and Small and Medium Enterprises, Bank Indonesia and the Permodalan Nasional Madani (PNM).

To sum up, the present volume provides an interesting cross-section of research studies that examine the principles and practices of micro finance in Islamic societies and in the process, highlight key issues relating to development of Islamic micro finance. Undoubtedly they should be of great interest not only to future researchers in the field of Islamic microfinance, but also to regulators and policy makers keen on poverty alleviation through enhanced financial inclusion.

LIFTING BARRIERS IN FINANCING THE SMALL AND POOR ENTREPRENEURS: LESSON FROM GROUP-BASED LENDING SCHEME AND IBN KHALDUN'S SOCIAL SOLIDARITY

ASYRAF WAJDI DUSUKI

ABSTRACT

`Asabiyah or social solidarity is the core of Ibn Kaldun's thought concerning the rise and decline of a civilisation. In the Muqaddimah, Ibn Khaldun emphasises the importance of having a sense of solidarity or 'espirit de corp' – the state of mind that makes individuals identify with a group and subordinate their own personal interests to that of group interest. The implication of Ibn Khaldun's social solidarity concept to the present world is imperative. The concept of social solidarity can be enforced through formation of group-based lending among small entrepreneurs and rural poor communities who are normally denied access to credit by mainstream financial institution and market. This paper argues that group-based lending approach is not a subject alien to Islam, as it is deeply inscribed in Ibn Khaldun's concept of 'Asabiyah or social solidarity. By adopting group-based lending approach, bank may offer various financial products and services without compromising on the issue of institutional viability and sustainability.

1. INTRODUCTION

The last three decades witnessed a revolution in providing finance for alleviating poverty across the globe. The success in providing finance to the small and poor entrepreneurs widely attributed to the mechanism used particularly the group-based lending scheme that has also captured the attention of development practitioners around the world. Group-based lending is a mechanism that allows the poor to access to financial services that they have historically been denied[1]. The formation of group among the rural poor is an essential part of the financing

[1] The most quoted example is the experience of Grameen Bank in Bangladesh, which lends only to the poor. The bank enjoyed considerably higher repayment rates than similar credit programmes using traditional lending practices. Hosseun (1998) reports that the Grameen Bank has a repayment rate in excess of 95%.

process directed to the poor. The group generates social capital that compensates for their lack of material assets. In turn, this investment in social capital creates creditworthy borrowers where none existed before and simultaneously attracting financing from financial institution to support their economic activities.

The key feature of group-based lending is social capital which is broadly defined as social networks, norms and trust that facilitates coordination and cooperation for mutual benefits (Putnam 1993). In other words, social capital refers to the internal social and cultural coherence of society, imbuing qualities like sense of belonging, group loyalty, good will, sympathy, respect for others and teamwork among people and the institutions in which they are embedded. These salient features of social capital can be utilized by the poor both as a creation of human capital (Coleman 1988) and a substitute for physical capital (Collier 1998). Trust and willingness to cooperate allows the poor to form groups and associations, which facilitate the realization of shared goals.

The emergence of microfinance industry coupled with the propagated group-based lending mechanism and social capital concept today requires an instructive examination from an Islamic perspective. The discussion of social capital as an effective instrument in the present day group-based lending is directly related to Islamic concept of *`Asabiyah* or social solidarity concept expounded by Ibn Khaldun in his famous book, *al-Muqaddimah*. Indeed, the social solidarity concept is deeply inscribed in social capital framework of group-based lending. Therefore, the concept of social capital and group-based lending approach can be benefited by Islamic banks who are currently looking for the most viable, effective and efficient ways to provide finance to the poor.

The purpose of this paper is primarily to review the group-based lending model in the light of Ibn Khaldun's social solidarity concept. Drawing on general works of group-based lending methodology and experiences, the paper will outline what is currently known about the characteristics of and approaches to social capital in which social solidarity concept is paramount. It is believed that by having a good understanding of this concept, Islamic banks may leverage on its potentials in providing financial products and services to the poor.

The remaining of this paper is organised as follows. Next section highlights the concept of social solidarity as expounded by Ibn Khaldun. The relevance and its implication to the current development of social capital is further elaborated in section 3. While section 4 reviews some theoretical issues on the existing numerous barriers to finance the poor, section 5 discusses the potential of social capital in enforcing group-based lending mechanism to overcome such barriers. Fittingly, the conclusion is in the final section.

2. IBN KHALDUN'S SOCIAL SOLIDARITY CONCEPT

Ibn Khaldun in his *al-Muqaddimah* postulates the necessity to have *`asabiyah* in constructing a strong civilisation. *`Asabiyah* or social solidarity or *'espirit de corp'* can be broadly defined as the state of mind that makes individuals to identify with a group and subordinate their own personal interests to the group interests (Ibn-Khaldun 1995).

According to Ibn Khaldun, human being by nature are social being who prefer to live together, cooperate and helping each other. However, due to numerous worldly temptations and motivations, individuals sometime acting to serve their own self-interest, thereby undermining the interest of the society at large. In his writings, Ibn Khaldun asserts that *`asabiyah* or social solidarity was more evidenced and much stronger in nomadic tribes. This is due to the fact that nomads lead a very simple life and do not know anything of luxury.

In contrast, sense of solidarity was less evidenced in urbanite society where luxuries were highly demanded. Due to shortages of such resources, individuals tend to compete with each other in negative ways. Extravagant lifestyles and preference for luxury goods also have deleterious effects of the morality of the people. In his words:

> "*Immorality, wrongdoings, insincerity and trickery, for the purpose of making a living in a proper or an improper manner, increase among them. The soul comes to think about (making a living), to study it, and to, use all possible trickery for the purpose. People are now devoted to lying, gambling, cheating, fraud, theft, perjury and usury"*. (Ibn Khadun, p.293)

Therefore, it is necessary to instil *`asabiyah* in people to keep them together, to promote altruism and sense of cooperation which ultimately generates social harmony. It may also serve as a decisive and unifying force in the rise and development of a civilization (he uses the word *'umran* to imply this) (Ibn Khaldun, p.102-103). Indeed, *`asabiyah* binds groups together through a common language, norms, trust, culture and code of behaviour. Therefore, a society imbued with a sense of social solidarity fulfils its primary purpose to function with integrity and cooperate for mutual benefits and common goals (Ibn Khaldun, p.105).

In Islam, the term *`asabiyah* is used to connote two different and sometimes opposite meaning. The first meaning identifies *`asabiyah* as a social solidarity which is in harmony with the concept of brotherhood and mutual cooperation (*ta`awun*) in Islam. This type of *`asabiyah* is praiseworthy since it encourages people to cooperate with each other for common objectives, restraint their self-interest, and fulfil their obligations towards each other. The following *Qur'ānic* verse attests to this:

"And cooperate in righteousness and piety, but do not cooperate in sin and aggression: (*Al-Qur'ān* 5:2)

The second meaning of *`asabiyah* is *'asabiyah jahiliyah* referring to the blind and prejudiced loyalty to one's own group. This leads to the favouring of one's own group, irrespective of whether it is right or wrong. This type of *`asabiyah* is blameworthy, having tendency to promote injustices, inequities, mutual hatred and conflict. The Prophet (p.b.u.h) made a clear distinction between these two types of *`asabiyah* in a *ḥadīth*:

> It was reported by Ibn Majah from the father of Fusaylah, that the Prophet, peace be upon him, was asked whether the love for one's own qawm (group, tribe or nation) constituted under the meaning of *`asabiyah*. He replied: "No! *`asabiyah* is rather the helping of one's qawm in zulm (injustice)."

Undoubtedly, Ibn Khaldun uses the word *`asabiyah* in the Muqaddimah to imply the positive *`asabiyah* or social solidarity strongly premised in Sharīʿah. He asserts, social solidarity becomes an irresistible power if it is grounded on the religious paradigm. Hence a sense of solidarity of any group or tribes can only make a real impact if supported by religion and not otherwise.

Justice: A hallmark of the Islamic `Asabiyah

The core value in the Islamic system and worldview is justice coupled with beneficence. Ibn Khaldun asserts that justice as the defining characteristic of Islamic life and society, and as an indispensable part of the legal, social and economic progress (Ahmad 2003). Moreover, Islam stresses that justice should not only be rooted in the system of society but should also resonate through all levels of social life, in all relationships and dealings, from the family to the state.

The concept of justice is integral in the understanding of the concept of social solidarity expounded by Ibn Khaldun. It establishes equilibrium by way of fulfilling rights and obligations and by eliminating excess and disparity in all spheres of life. For instance, the benefits and costs of any scheme of social cooperation must be shared in proportion to the contribution made by each participant. Furthermore, individuals must be guaranteed equal rights and opportunities for their basic needs of food, housing, education, health, transport and employment (Parvez 2000). Society must also make provisions for those who, because of their physical disability cannot reciprocate in equal measure the benefits accruing to them from social cooperation nor bear the costs (Naqvi 2003)[2]. The intense commitment of Islam to justice and brotherhood demands the Muslim society to take care of the basic needs of the poor and those who are less-privileged in society (Rice 1999). The Islamic institution of *zakāh* is an example of compulsory charitable-giving specially designated to facilitate the care of all members of society.[3]

Thus, Ibn Khaldun's concept of social solidarity has a great implication on how human beings conduct their affairs. They can choose either to be selfish or socially entrenched individuals. The latter will definitely have a positive impact on the well-being and prosperity of an entire community. The sense of social solidarity implies that human interactions should be based on trust, equity and justice. They should not attempt to dominate or wrong each other; instead cooperate and support each other towards fulfilling their role of God's vicegerency on earth. Therefore, the right attitude towards human beings is not 'might is right' struggle to serve only one's own 'self-interest', or 'survival of the fittest'[4] but the mutual sacrifice and cooperation to fulfil the basic needs of all, to develop the entire human potential and to enrich human life.

3. *`ASABIYAH* AND SOCIAL CAPITAL CONCEPT

The preceding section has discussed the idea of *`asabiyah* or social solidarity as proposed by Ibn Khaldun. In a sense, social solidarity, as a unifying force, is analogous to the modern concept of social capital. Indeed, the idea of social capital has captured much attention and has been applied to a variety of issues in recent times.

Coleman (1988) and Putnam (1993) were among the first to popularise the term 'social capital' in the sociological literature. Coleman (1988) introduces the concept of social capital in attempt to reconcile the two contradicting intellectual streams in the description and explanation of social action. On one stream (represented by the work of most sociologists) perceives the economic actor as

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[2] Naqvi (2003) asserts that meritocracy and feudalism denote injustice which blindly emphasise on 'equality of opportunity' without recognising the natural differential in intellectual endowments and abilities of different individuals in society. This, he argues, would essentially result in extreme inequalities of social, political and economic conditions. See Naqvi (2003).

[3] The Islamic jurists have unanimously held the view that it is the collective duty (*farḍ kifāyah*) of the Muslim society to take care of the basic needs of the poor. In fact according to Shatibi, this is the raison d'être of society itself. See Chapra (1992).

[4] Hassan (1996) also asserts that the philosophical foundation of a society based on secular self-interest or selfish point of view will do more harm as those in the position to manipulate will do so in order to achieve success in life at the expense of others. See detail discussion in Hassan (1996).

socialized and action as governed by social norms, rules and obligation. Another stream (represented by the work of most economists) perceives the economic actor as having a wholly self-interest goal of maximizing utility[5]. On the other hand, Coleman's definition of social capital mainly focuses on its function, which constitutes a particular kind of resources, inherent in the structure of relations between actors and among actors. These resources include trust, information channels, norms and effective sanctions.

As an extension to the Coleman's concept of social capital, Putnam (1993) defines social capital as "*those features of social organisation such as networks, norms, and trust that facilitate coordination and cooperation for mutual benefits*". In other words social capital refers to the internal social and cultural coherence of society, the trust, norms and values that govern interactions among people and the institutions in which they are embedded.

Intuitively, social capital stands for the ability of an individual to secure benefits by virtues of membership in social networks, groups or social structures. The social capital recognises a sense of identity and common purpose within a group. Like Ibn Khaldun's *`asabiyah* framework, social capital concept is not a sense of identity alone. Instead, aspiration, loyalty, trust, norms and devotion are also prerequisites for the preservation of the group.

In the light of the preceding discussion on the concept of social solidarity, the notion of social capital assumes a broader and more holistic significance especially to the Muslim community, since it is based on religious doctrine. Islamic guidance enshrined by its principle of justice brings about a balance between the rights of individuals and their duties and responsibilities towards others (Parvez 2000), and between self-interest and altruistic values (Naqvi 2003).

Islam recognises self-interest as a natural motivating force in all human life. But self-interest has to be linked to the overall concept of goodness and justice. Therefore, individuals, imbued with a sense of justice, are not expected to abandon their individual interests altogether. In other words, altruism will not push individuals beyond justice. However, Islam attempts to create a culture that binds individuals and families into a community so that a natural infrastructure for providing support and help to those in need is developed.

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[5] Both streams have their own serious defects. By overemphasizing the conception of action as wholly a product of the environment, the sociologists tend to undermine the actor's own action that give him a purpose or direction. In contrast, the economist's principle of rational action tends to ignore the social context; norms, interpersonal trust, social networks and social organization which may partly shape the actor's action. For details analysis refer Coleman (1988)

Islam, in fact, lays down a moral framework for effort, spelling out values and disvalues, what is desirable and what is reprehensible from a moral, spiritual and social perspective (Chapra 2000a; Ahmad 2003). The concept of reward is also broadened by incorporating within it, reward in this world and reward in the Hereafter. This provides a strong and self-propelling motivation for good and just behaviour, without denying the natural instincts for personal gain (Ahmad 2003). Hence, moderation and concern for the needs of others, along with ones own, become an integral part of the Islamic perspective of social capital.

The forthcoming sections shall review the important implication of social capital to the development of group-based lending mechanism which aims at providing finance to the poor who are normally denied access to credits and other conventional financial services.

4. BARRIERS IN FINANCING THE POOR

Pichke (1991) highlights that finance is primarily social based on the Latin root word of credit, *credere* which denotes the meaning of to believe or entrust. Indeed, the essence of every financial transaction is the invocation of an element of trust. The contacts between a borrower and a lender will only be honoured if the element of trust exists in such transactions. According to Arrow (1972), *"Virtually every commercial transaction has within itself an element of trust, certainly any transaction conducted over a period of time. It can be plausibly argued that much of the economic backwardness in the world can be explained by the lack of mutual confidence."* The basis of the trust depends on two critical elements; first is the applicant's reputation as a person of honour (Diamond 1991) and; second is the availability of enough capital or collateral against which claims can be made in case of default (Holmstrom and Tirole 1993).

The essence of conventional profit-maximization banks as financial intermediaries that provide financial services to the people hinge upon these two elements. As the formal lenders, risk-averse banks will only be willing to lend if these two elements that serve as a basis of trust in their reciprocal relationship with their clients (as borrowers) exist.[6]

However these two elements poised important impediments to the poor especially in the rural areas to access into credit market. The poor are usually perceived by the 'profit-orientated' conventional banks as high-risk borrowers due

[6] For instance, the bank is able to assess the reputation of the borrowers based on the bank's intimate knowledge embedded in the clients personal accounts as well as other documented history of past borrower behaviour. At the same time the clients have material value such as properties or any valuable assets as collateral to pledge against risk.

to the inherent difficulties in assessing their creditworthiness at the same time their inability to provide collateral to pledge against any potential risk.

These traditional formal lenders faced with borrowers whom they do not personally know, who do not keep written accounts or 'business plans' and who want to borrow small and uneconomic sums (Jacklen 1988); thus exposing them to very high risks due to the inherent screening problems faced by the lenders at the same time make the project appraisal become too expensive(Rhyne and Otero 1992).

Most formal intermediaries like commercial banks also regard low-income households as 'too poor to save', thus further accentuates the risk of supplying credits to them (Adams and Vogel 1986; Sinclair 1998)[7]. Furthermore, no insurer is willing to insure against possibility of non-repayment due to natural and commonest hazards which afflict small producers in developing countries; for example, drought, livestock disease and breakdown of equipment (Hulme and Mosley 1996) [8]. The risk exposure in supplying credits to the poor clients further exacerbate due to the inherent difficulty for the commercial financial institution to diversify their portfolio. For example, most of the rural clients who derive their incomes from agriculture need to borrow in the pre harvest season, making it difficult for banks to diversify their portfolio (Zeller and Sharma 1998).

Financial institutions inevitably suffer high transaction costs due to asymmetric information problems which naturally appear in the financial transactions. These costs related to the searching costs, monitoring costs and enforcement cost which are directly related to the information problems incur in the rural financial markets.

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[7] In the case of Britain, the poor devotes only 1.5% of their incomes to life insurance, savings and investment. The inference made by Sinclair (1998) from the figures is that savings are regarded to be a luxury for the poor to save almost nothing of their income. One of the reasons is that the poor perceive little point in saving on their own when they expect to avail themselves of this benefit if they have saved nothing. Moreover the poor is lacking the incentive and resources to make the investment that strengthen their demand for consumption in old age. For detail discussion refer Sinclair (1998)

[8] In their analysis, Hulme and Mosley hypothesize that the credit market fails if poor people –whether farmers or micro-entrepreneurs are unable to borrow for socially beneficial projects due to any of four reasons: Firstly, no lender is willing (or legally permitted) to pass on the extra costs associated with lending to unknown customers in small quantities; secondly no insurer is willing to compensate for borrowers' and lenders' risk aversion (and for the presumed absence of collateral) by offering insurance against non-repayment due to natural hazards; thirdly, even if the first two reasons are untrue, potential borrowers are unwilling to borrow because of their risk-aversion attitude; and finally, social and private values of cost and benefit diverge because of externalities or otherwise, so that some projects which are socially profitable do not survive on the basis of private costs and returns. For details see Hulme and Mosley (1996)

The uncertainty regarding the ability of borrowers to meet future loan obligations, inability to monitor the use of funds and demand for small sum of loans by the rural households further reinforces the higher units of transaction costs, which is characterised by fixed costs[9] (Braverman and Guasch 1986; Zeller and Meyer 2002).

5. BUILDING SOCIAL CAPITAL IN GROUP-BASED LENDING

Many writers, including Bennett and Cuevas (1996), Fukuyama (1995), Coleman (1988) and Collier (1998), believe that overcoming the many barriers that have prevented large potentially productive segments of the population from access to formal financial institutions may require more than conventional financial intermediation. Integrating under-served groups into the formal financial markets may entail some measure of up-front investment to develop the human resources (confidence, knowledge, skills and information) among the clients at the same time to build local structures that help them to link with financial institutions.

These two measures are naturally embedded in social capital structure. The salient features of social capital can be utilized by the rural poor both as a creation of human capital (Coleman 1988) as well as a substitute for physical capital (Collier 1998). Trust and willingness to cooperate allows the poor to form groups and associations, which facilitate the realization of shared goals particularly to be linked with financial institutions. Fukuyama (1995) further elaborates the significance of social capital building in the institutional setting especially when addressing the issue of eradicating poverty by emphasising the concept of 'trust' within the society and organizations. In his perspectives trust is hailed as the paramount social virtue, the creator of prosperity, by which opportunism can be reduced and transaction costs can be minimized.

The following summarises the many advantages of social capital that have been discussed in the economic development and sociology literature. These advantages have internal and external dimensions. The former reflects the advantages and benefits of social capital building to the organization, while the latter directly relates to the empowerment of the target groups under consideration. Some of the benefits and advantages are briefly discussed as follows:

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[9] Transaction costs have a large fixed-cost component, so unit costs for smaller savings deposits or smaller loans are high compared with those for larger transactions. The conventional banks are structured to handle much larger individual transactions or loans than those required by the poor. Lending to the poor who normally demand small amount of loans is regarded expensive because of high overhead costs. See Jacklen (1988), Zeller and Meyer (2002)

Enforcing group-based lending

Bridging social capital (by enforcing shared norms, trust and values of behaviour) through formation of group-based lending among rural poor communities will improve access to physical capital, particularly in the absence of collateral. Peer Guarantee Mechanism, which is the essence of the group-based lending, has proven empirically as an effective way of designing an incentive-monitoring system in the presence of costly information[10]. It introduces shared liability and pressure from social groups as a replacement for security (i.e. collateral) and business appraisals.

This mechanism proves to be an effective and efficient way to reduce the transaction costs in credit delivery and disbursements (searching, monitoring and enforcement) of the lender by shifting onto the groups as well as securing loan repayments. Besley and Coate (1995) suggests that group lending may also harness 'social collateral' which constitute a powerful incentive device to yield higher repayment rates than individual lending. The self-selected group members share a common interest in gaining access to credit and savings services, and possess enough low-cost information to adequately screen each other and apply sanctions to those who do not comply with the rule[11].

Hence it lowers transaction costs, reduces financial risk and facilitates a greater range of market transactions in outputs, credit, land and labour which can in turn lead to better incomes. For example strong social link among borrowers may increase their ability to participate in credit transactions that characterized by

[10] Grameen Bank (Bangladesh) which started operation in 1976 has now a daily loan volume of $1.5 million and has 98 percent repayment rate, appears to be a model of success in applying this mechanism. One of the distinctive characteristics to the Grameen Bank is that loans are made to self-formed groups of approximately five farmers, who are mutually responsible for repaying the loans. Additional amounts of loans will be further granted if all members of the group have settled all the outstanding amounts. In such arrangement, Stiglitz (1990) argued that the Grameen Bank devised an incentive structure called 'peer monitoring' whereby the others within the village do the monitoring on their behalf by exploiting the local knowledge of the members of the group. However Besley and Coate (1995) and Hulme and Mosley (1996) assert that even though the group-lending may prove to have a positive effect on enhancing the incentive of loan repayment, it may have perverse effect when the whole group defaults, even when some members would have repaid individually.

[11] In their model, Besley and Coate (1995) postulate a social penalty function that describes the punishments available within a group rather than the bank. This social penalty implies that members in the community who do not comply with the norms, trust and values of the communities can be ridiculed or ousted from the family. This may constitute a powerful incentive device, since the costs of upsetting other members in the community may be high.

uncertainty about compliance[12]. In particular, social capital could lead to a better flow of information between lenders and borrowers and hence less adverse selection and moral hazard in the credit market. Social capital also potentially expands the range of enforcement mechanisms for default on obligations in environments in which recourse to the legal system is costly or impossible. Again, trust (social capital) plays a paramount role in the formation of group lending success, particularly in the absence of collateral. (Stiglitz 1990; Otero and Rhyne 1994; Besley and Coate 1995; Krishna, Uphoff et al. 1997; Bhatt and Tang 1998; Collier 1998; Zeller and Sharma 1998; Narayan and Pritchett 1999).

Informal safety nets

Social Capital may act as informal safety nets or informal insurance that mitigates the consequences of any hazards and adverse outcomes. These safety nets are especially important due to several reasons including severe income fluctuations, erratic natural disasters, like crop and human diseases, and weather-dependant availability of food.

The informal safety nets are exhibited through strong social ties and networks within the communities and the willingness to share risk among villagers. In fact the essence of social solidarity in Islam obligates Muslims to help their fellow afflicted human being especially at times of distress. A beautiful *ḥadīth* of the Prophet p.b.u.h. delineates this responsibility:

> *"Whoever relieves a believer of some of the distress of this world, Allah will relieve him of some of the distress of the Day of Resurrection. Whoever eases an insolvent's loan, Allah will make things easier for him in this world and in the Hereafter. Whoever conceals a Muslim's faults, Allah will conceal his faults in this world and in the Hereafter. Allah will help a person so long as he helps his brother." (Ibn-Baz 2005)*

Therefore, the availability of social capital in the communities induces risk averse borrowers amongst the poor households to pursue higher return and adopt profitable production technology and techniques (Townsend 1994; Morduch 1999; Narayan and Pritchett 1999).

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[12] In Tanzania, social capital at the community level impacted poverty by making government services more effective, facilitating the spread of information on agriculture, enabling groups to pool their resources and manage property as a cooperative, and giving people access to credit who have been traditionally locked out of formal financial institutions. For details data analysis and empirical studies refer Narayan and Pritchett (1999)

Mobilising infrastructure

Social Capital by means of norms of civic cooperation amongst the rural and poor people can mobilize better services from the state; improve infrastructure; and provide access to wider markets and formal credit systems. In Putnam's analysis, he finds that the greater citizen's civic cooperation and trust (exemplified through joining football clubs and choral societies) the faster the regional government is in reimbursing healthcare claims. In other words social capital may improve economic outcomes indirectly since it appeals to the political interest of the government. (Putnam 1993; Knack and Keefer 1997)

Promote efficiency

Organizations may also reap the benefits from social capital by reducing transaction costs internally especially those that are associated with lack of trust due to numerous potential inherent uncertainties in the social-economic organizations, such as co-ordination and motivation costs among stakeholders. Although external parties may perceive the non-profit status of a social enterprise itself as a sign of trust (Hansmann 1980; Easley and O'Hara 1983; Hansmann 1996), it is becoming increasingly clear that this status alone is insufficient in building relationships of trust[13]. Therefore, the mobilization of social capital by establishing trust through group formation (teamwork) may promote cooperation and coordination amongst the various stakeholders within the organization, thereby lessening the incentive of opportunistic behaviour. Workers and shareholders in a firm are likely to feel an increased sense of pride in their work if they are part of an entity which strives to make a positive contribution to its surrounding communities which are often considered as home to firm staff. This will inadvertently improve the efficiency of an economic organization.(Fukuyama 1995; Laville and Nyssens 2001).

In sum, social capital (e.g. through group-based lending initiatives) can play an important role in social banking institution that aims at alleviating poverty. In general, the building-up of social capital by an institution is to ensure that it economises transaction costs for both lenders and borrowers.

From the economic point of view, social capital economises the transaction costs in credit delivery associated with searching for loanable funds, designing credit contracts, engaging in community outreach, screening borrowers, assessing project feasibility, evaluating loan applications, providing credit training to staff

[13] The absence of profit motive does not prevent managers of organizations from pursuing objectives other than explicit profit and behaving in the manner that do not necessarily coincides with the interests of the beneficiaries. For example they may divert excessive remuneration to staffs or themselves or simply stray from its original objectives.

and borrowers, and monitoring and enforcing loan contracts. This is achieved mainly through shifting the transaction burden to group members.

From borrower's perspective, transaction costs which include negotiating with the lender, filling out necessary paperwork, transportation to and from the lending agency, time spent on project appraisal and meetings, monitoring group activities and enforcing group rules can be minimized by the social capital elements imbued in their group formation in which joint responsibilities and liabilities are prerequisite.

The discussion on group-based lending mechanism which exploits social capital as an essential innovative programme for building a viable mechanism in financing the poor has been extensively discussed in the microfinance literature. The three most quoted and prominent types of group lending arrangements are; First, loan granted to the group (who then responsible to distribute to all of the members) at the same time jointly liable for repayment; Second, loan granted to individuals in a group and group is jointly liable for repayment and; Third, loans given to individuals in a group, and it is the individuals not the other group members, who are liable for the loan. For convenience we label the three arrangements as Type 1, Type 2 and Type 3 group lending respectively. Table 1 summarizes their most distinctive features.

Table 1. Comparative Features of Group-based Lending Arrangements

	Type 1: Group Loan-Joint Liability	**Type 2**: Individual Loan-Joint Liability	**Type 3**: Individual Loan-Individual Liability
1. Basic Procedures	A group of 3-10 individuals is self-formed. Loans are given to the group who collectively guarantee loan repayment, and access to subsequent loans depends on successful repayment by all group members.	A larger group from 50 to 200 or more. May be regulated (if credit union) or unregulated (if self-help groups). Most of the time the lender will have to outreach to prospective borrowers. Loans are made directly to individuals within the group who collectively guarantee loan repayment.	Resemble the traditional lending methods in which funds are loaned to individuals based on credit and collateral checks. Individuals and not the group are responsible for loan repayment. Nevertheless borrowers are required to form groups of typically 3 members in order to receive credit.
2. Group's Duty	Select group members and leaders, assess, decide and approves the amount of loans needed by each member, disburse the granted loan to each member, collectively guarantee loan repayment and collect payments. Groups also sanction those who do not pay.	Organize weekly meeting at agency's centre. Fewer loan disbursement responsibilities (i.e. group project appraisal, group-needs assessments). Group responsible in monitoring, sanctioning and repayment by all group members.	Provide the lender information regarding group members' creditworthiness or project-risk and to provide each other with assistance in business contacts.
3. Lender's Role	Low involvement. Providing basic business training; interacting with group representative for record keeping and collection.	Moderate involvement Outreach prospective borrowers, take a lead role in screening and evaluating individual loan request and project appraisal. Keeping track of individual loans and providing basic business training.	High involvement. Lenders must assume most of the credit delivery responsibilities from screening, monitoring to enforcing loan disbursements and repayments. Extensive business training also needed to ensure borrowers' capability for repayment.

	Type 1: Group Loan-Joint Liability	**Type 2**: Individual Loan-Joint Liability	**Type 3**: Individual Loan-Individual Liability
4. Guarantee Mechanism	Peer guarantee Progressive lending: Expand credit limits based on previous repayment record. Compulsory savings.	Peer guarantee: Strong social pressure and sanctions. Progressive lending Voluntary and compulsory savings also emphasized.	Physical guarantee (land, vehicle, savings). Progressive lending Prompt repayment discount (or late payment penalties)
5. Element of social capital	Very high due to the mutual trust and respect as members know each other well and share same set of social norms and conventions. E.g. neighbours, workmates etc.	Moderate due to geographical factors such as remoteness and scattered settlements.	Low because group members are usually unfamiliar with each other owing to a lack of spatial proximity
6. Models available	Solidarity groups, village banks, microfinance institutions. e.g. Grameen Bank, BRAC Bangladesh, ACCION International, BancoSol Bolivia	Credit unions, cooperatives e.g. SANASA Sri Langka Credit Solidaire Burkina Faso, Cameroon Credit Union Movement, Smallholder Agricultural Credit Administration, Malawi, Banques Populaires du Rwanda, Cooperatives d'Epargne et de Credit du Togo.	e.g. Bank Rakyat Indonesia Unit Desa (BRI-UD), Kredit Usaha Rakyat Kecil (KURK) Indonesia, Badan Kredit Kecamatan (BKK) Indonesia.

Source: (Gurgad, Pederson et al. 1994), (Holt 1994), (Magill 1994), (Reed and Befus 1994), (Berenbach and Guzman 1994), (Bennett, Goldberg et al. 1996), (Hulme and Mosley 1996), (Edgcomb and Barton 1998), (Bhatt and Tang 1998)

As shown in the table, the transaction costs imposed by the three types of group-based lending may vary according to the degree of social capital accessibility in the region. When social capital is very high, Type 1 group-based lending is more preferable, since shifting responsibilities and transaction burdens onto groups are more plausible. This is because groups characterised with high level of trust and information availability will help bank to internalize transaction costs associated with the credit delivery responsibilities (such as searching, screening, monitoring and enforcing loans).

On the other hand when social capital is not as high due to lack of familiarity and information, bank should therefore choose Type 2 arrangement so that lenders assume more of the responsibilities of loan disbursement and give less responsibilities to the group. This may reduce moral hazard on part of the borrowers who do not belong to strong social-ties groups. Finally when social capital is low, Type 3 group-based lending is more reasonable since lenders maximize their involvement and minimize the group's participation in the crucial stages of loan disbursements.

It is therefore argued that only those types of group-lending programmes that economize transaction costs for both the lenders and the borrowers have a chance at being viable. This implies the need to consider the social context including cultural variation and economic conditions of a region as a key to design viable group lending arrangements (Bhatt and Tang 1998). Any attempt to transfer or replicate a successful group-based lending model of one institution of a country to another must be taken with caution (Mutua, Nataradol et al. 1996). The difference between the experiences of the Kenyans and Bolivians with group lending approach could be a good example in this respect. K-REP's experience indicates that the group-based approach of lending to individuals, which Bolivia's BancoSol has found effective is of limited use in Kenya[14].

It is also not necessary for choosing one type of programme while abandoning others. Bank may adopt hybrid approach using the combination of two or more approaches based upon the characteristics of the target market. Bank Shinta Daya of Indonesia is an example of hybrid programmes. This private rural bank adopts hybrid approach by employing both Type 1 and Type 3 group-lending programmes, which is working quite well[15] (Seibel and Parhusip 1998).

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[14] When the group-based lending method was introduced in Kenya, K-REP's staff expected that group savings guarantees and peer pressure would be effective to minimize defaults. Nevertheless, the results turn otherwise as compulsory savings and the use of savings as security directly impacted repayments. Moreover borrowers who are otherwise creditworthy become defaulters when they forfeit savings on behalf of their group members. Some consider the use of peer pressure to enforce payments an unfair shifting of the responsibilities of a lender onto their clients. K-REP also faced problems with the practice of delegating credit assessment to the groups, because group members are not objective when assessing applications from their peers. Finally, it is difficult to screen out deceivers from honest borrowers under this scheme. See Mutua, Nataradol, et al. (1996) for details evidence.

[15] Bank Shinta Daya was established with private capital of US$40,000 in 1970 and financed its expansion from its profits. Its net worth in December 1995 was Rp. 495.8 million (US$215,000), comprising Rp 179.5 million in capital and Rp 316.3 million in retained earnings. Group members comprises the poor in the rural area represents 49 percent of the bank's direct and indirect borrowers and 24 percent of the bank's depositor.

Apart from various lending technologies that bank should consider in preserving its viability while addressing the poor clients, another important aspect is to provide demand-oriented financial services. The scope of lending services offered to the poor and rural households must address not only production and income-generating activities but also consumption needs such as health, education, nutritional food and other social obligations (Diagne and Zeller 2001).

Flexible and innovative refinancing and repayment procedures must also be offered to accommodate unanticipated events typically affecting poor households especially in rural area. This may require unbureaucratic access to emergency loans or the build-up of emergency funds by group-based lending members, which possibly be pooled through a regional or national second-tier institution (Zeller and Sharma 1998). Only by addressing the needs and the real demand of the vulnerable groups in providing the financial services, a social banking institution can achieve better impact and outreach while preserving its viability[16].

6. IMPLICATIONS AND CONCLUSION

This paper discusses the salient characteristics of group-based lending, which is one of the most important features of successful microfinance initiatives. The main characteristic discussed in the concept of social capital and how this concept directly related to Ibn Khaldun's social solidarity or *`asabiyah*. In the paper, we have argued that both *`asabiyah* and social capital promote positive values like sense of belonging, teamwork, cooperation and more importantly trust. Such values which are grounded on the religious paradigm may strongly function as sources for successful operation of group-based lending mechanism.

As reviewed in this paper social capital is critical for the successful design of group-based lending programmes to increase the access of poor or low-income earners to credits. The social capital as reflected in strong association activity is

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For the bank both types of group-lending are profitable. But the individual technology is more profitable than the group technology as 94 percent of the bank's profits are derived from its individual lending and only 6 percent from group lending. Nevertheless, according to the bank's management, by providing financial services to group members with microenterprise activities, it contributes to their growth. As the members' microenterprises grow, so will their business with bank. See Seibel and Parhusip (1998).

[16] In the microfinance impact studies conducted by Diagne and Zeller (2001) on several rural financial institutions in Malawi, it was found that no significant impact of access to credit on the per capita incomes, food security and nutritional status of credit programme members. This is because the rural financial institutions in Malawi covered in their study do not offer financial products, such as consumption credit and precautionary savings options, which could eventually have a direct effect on consumption or on nutritional status. See Diagne and Zeller (2001)

believed to be an effective tool to reduce transaction costs and lower exposure to numerous financial risks in relation to providing credit to the rural poor.

Social capital is deemed to be an effective tool to foster a better flow of information between lenders and borrowers and hence less adverse selection and moral hazard in the credit market. It also potentially expands the range of enforcement mechanism for default on obligations in environments in which recourse to the legal system is costly or impossible. Therefore, social capital may increase the ability of borrowers to participate in credit transactions that involve uncertainty about compliance and numerous financial barriers.

The discussion of group-based lending scheme in the light of social capital concept is imperative for a successful design and implementation of Islamic microfinance initiative. Indeed, Islamic banks may emulate the various approaches of group-based lending scheme in designing their Islamic microfinance or any efforts to provide Islamic banking products and services to the poor. It is strongly believed that, unless Islamic banks expand their financial frontier to include the poor, their noble socio- economic objectives to promote social justice, equitable wealth distribution and poverty alleviation can never be materialised.

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A STANDARD OF CORPORATE SOCIAL RESPONSIBILITY FOR ISLAMIC FINANCIAL INSTITUTIONS: A PRELIMINARY STUDY

SAYD FAROOK

ABSTRACT

It is evident, in both practitioner and academic circles, that there is a debate raging on whether Islamic Financial Institutions (IFIs) have a social purpose beyond their role as a financial institution and what the ambit of this social purpose is, if any. This study proposes a structured definition of the social purpose of IFIs derived from, among other things, Islamic principles of social equity and redistributive justice. It is posited that IFIs are meant to be socially responsible for two interrelated reasons: their status as a financial institution fulfilling a collective religious obligation and their exemplary position as a financial intermediary. This study subsequently attempts to provide an efficient pragmatic framework by which Islamic Financial Institutions can address their social responsibilities. It is proposed that the guidelines for Islamic corporate social responsibilities should analogously follow a framework similar to that of personal responsibility, based on the dichotomy of permissible and recommended actions on the one hand and impermissible and not recommended actions on the other. Specific responsibilities within this dichotomy are also framed allowing for a clear structured logic for IFIs to implement policies.

1. INTRODUCTION

The primary objective of this study is to ascertain, through a review of Islamic principles, a structured definition of Islamic corporate social responsibility (ICSR) and the basis of this responsibility. The secondary objective of this study is to provide a pragmatic framework through which IFIs can implement ICSR policies.

It is evident that there is now, more than ever a debate raging within the academic community (as witnessed in the 6th International Conference on Islamic Economics and Finance, Jakarta, Indonesia) and in the practitioner community (as witnessed in the World Islamic Banking Conference, Manama, Bahrain 2005) as to whether IFIs have achieved or are even close to achieving the objective promised 30 years ago to implement a just and equitable distribution of wealth. Further, the debate questions whether it is justified in allocating the role of a charity organisation to an Islamic Financial Institution (IFI). It has been argued that IFIs are like any other conventional financial institution, which acts as an intermediary between providers of funds and fund users, the only difference being that the transactions and contracts of an IFI must comply with Islamic law.

On the other hand, others argue that implicit in the laws of Islamic finance (i.e. the spirit of the laws) is an ethical guideline to ensure that some or all of the funds provided from investors are used to redistribute wealth within society profitably. This can be done in a number of ways and have proved to be profitable areas of investment for a number of Islamic and conventional banks alike (for e.g. through micro-financing). Moreover, there are those traditional means by which to redistribute wealth through methods such as *zakāt, qarḍ, and waqf.*

Indeed, the founding fathers of modern day Islamic finance have concurred to the view that IFIs do have a heightened sense of social responsibility, as do any other 'Islamic' institution. However, this does not entail IFIs to become uncompetitive and unprofitable charitable organisations used to only further social development objectives. This entails a change in the mindset of Islamic bankers to incorporate social development objectives into their portfolio of investments profitably.

As more investment account holders, shareholders and general stakeholders understand fully the objectives that underlie the Islamic economic system, there shall be more demand to know to what extent their local IFI fulfils those social objectives. Therefore, the IFI that extensively involves itself in CSR and demonstrates by disclosure that it is extensively involved in CSR will more easily earn the legitimacy of certain stakeholders (particularly those interested in the IFIs CSR activities), and ultimately earn their loyalty. This represents in itself a value proposition for IFIs who seek to retain clients on the basis of non-price competition.

However, this is not to say that IFIs should implement corporate social responsibility because of its long term economic benefits. While viable economic institutions have to be driven by profit incentives, in the case of IFIs, it is not their only priority and certainly not the only reason for them to implement corporate social responsibility.

Indeed, any notion that IFIs or any other institution that claims to be Islamic, for that matter, should be socially responsible must derive its justification from Islamic law and principles, as contained within the *Qur'ān* and the *Sunnah* of the Prophet of Islam, Muhammad (P.B.U.H). Without this ultimate source of legitimacy, there is no reason for any action.

This study provides the foundation of social responsibilities that are applicable to IFIs derived particularly from those divine sources. It is proposed that Islamic banks should be socially responsible for two interconnected reasons: first, they fulfil a collective religious obligation *(farḍ kifāyah)* for Muslims and hence they are in a position to fulfil an enlarged scope of responsibilities that Muslims cannot fulfil individually; second, they are in an exemplary position in society. These reasons provide the basis for the development of a structure for corporate social responsibility standards based on a dichotomy of mandatory and recommended conduct.

The study is structured as follows. Section 2 provides the basis of individual social responsibility in Islam while section 3 to discusses the extension of individual social responsibility to organisations that carry out a collective religious duty for the community of Muslims and/or are in an exemplary position. Section 5 further refines the meaning of Islamic social responsibility for IFIs and contrasts it from the social responsibility due of individuals. Section 6 develops the justification for mandatory and recommended forms of social responsibility, while section 7 develops the basis of mandatory forms of disclosure.

2. THE BASIS FOR ISLAMIC SOCIAL RESPONSIBILITY

ICSR derives itself from core principles in the holy *Qur'ān*. The three major foundational principles for ICSR are the vicegerency of mankind on earth, divine accountability and the duty on mankind to enjoin good and forbid evil.

2.1. Vicegerency

The principle of vicegerency denotes that mankind is the representative of Allah on earth and as such Allah has entrusted mankind with stewardship of Allah's possession. Allah states this principle in the holy *Qur'ān*: 'I will create a vicegerent on earth'[1]; and Allah further states: 'It is he who hath made you the inheritors of the earth',[2]

2.2. Divine Accountability

The principle of divine accountability flows from the vicegerency principle and denotes that individuals will be accountable to Allah for all of their actions on the Day of Judgment. This principle is expounded in several verses of the holy *Qur'ān*, two of which are: 'Allah takes careful account of everything',[3] and 'Then shall anyone who has done an atom's weight of good shall see it and anyone who has

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[1] Surat Al Baqarah (The Heifer) verse 30.
[2] Surat Al Ana'm (Cattle) verse 165.
[3] Surat Al Nisa (Women) verse 86.

done an atom's weight of evil, shall see it'.[4] This divine accountability is the basis for all actions of a Muslim[5], and in turn the representative organizations of Muslims.

2.3. Enjoining Good and Forbidding Evil

The principle of enjoining good and forbidding evil encapsulates the responsibilities that Allah places on Muslims as trustees and vicegerents. Allah says: 'The Believers, men and women, are protectors one of another; they enjoin what is just (accepted), and forbid what is unjust (rejected)…' [6] and in another verse, Allah states: 'You are the best of peoples, evolved for mankind, enjoining what is just (accepted), forbidding what is unjust (rejected), and believing in Allah'[7]. This responsibility is overwhelming and encompasses all aspects of a Muslim's life. It comprises a prescription towards positive (permissible and recommended) actions and a prescription against negative (impermissible and not recommended) actions. IFIs have generally ensured their operational status by avoiding negative actions. However, their approach to positive actions has been varied due to a lack of standards in the area.

The combination of these principles denotes a divine accountability for each Muslim to enjoin good and justice and forbid evil and injustice. These core principles therefore constitute the basis of individual social responsibility.

3. COLLECTIVE RELIGIOUS DUTY AND ISLAMIC FINANCIAL INSTITUTIONS

IFIs came into existence as a collective religious obligation (*farḍ kifāyah)*[8] on the larger community (*Ummah*). This obligation is to operate a financial intermediary for individuals[9] in the community wishing to comply with Islamic law

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[4] Surat Al Zalzala (The Earthquake) verse 7-8)
[5] One who submits to the will of Allah.
[6] Surat Tawba (The Repentance), verse 71.
[7] Surat Al-e-Imran (The Family of Imran) verse 110.
[8] *Farḍ Kifāyah* refers to a collective religious duty which, if performed by some, would exempt others from performing it. However, if it is not performed by any, the entire community is sinful.
[9] The IFIs are representatives for individuals who:

i. invest their money as shareholders or investment account holders,
ii. have co-operative, partnership or borrowing relations with the IFI,
iii. are employed by the IFI,
iv. have other explicit contractual relations with the IFI,
v. in addition to the above, have a implicit social contract with the IFI as part of the larger community *(Ummah).*

(Sharīʿah). To that extent, IFIs are representative organisations of individuals. The IFIs are representatives for individuals who:

i. invest their money as shareholders or investment account holders,
ii. have co-operative, partnership or borrowing relations with the IFI,
iii. are employed by the IFI,
iv. have other explicit contractual relations with the IFI,
v. in addition to the above, have a implicit social contract with the IFI as part of the larger community *(Ummah).*

In this special position, IFIs are able to perform the obligations and recommended actions that Muslims cannot perform individually. They have the ability to influence allocative justice through their transactions, something beyond the reach of an individual Muslim, but recommended in the strictures of Islamic principles.

Second, IFIs fall in the category of highly visible institutions in society as financial intermediaries which source and allocate funds. The example set by IFIs has an impact on other individuals, institutions and organizations, who are influenced by the actions of the IFI. Indeed, IFIs have the potential to 'teach' individuals and communities to apply justice in all facets of their life based on the IFIs example.

It is for these two reasons that IFIs and any other representative 'Islamic' institution that is performing a *farḍ kifāyah,* for that matter, have a special duty of social responsibility. This social responsibility is an extension of the social responsibility of every Muslim, but it is a responsibility that Muslims do not have the capacity to perform individually.

4. THE NOTION OF ISLAMIC SOCIAL RESPONSIBILITY FOR ISLAMIC FINANCIAL INSTITUTIONS

In its core form, the responsibilities due of a representative organisation such as IFIs are the same as the individual social responsibility of each Muslim: to enjoin right and to forbid wrong. The definition of right and wrong in Islam can be defined in various dichotomies which are overlapping. In their legal form, right refers to everything that is permissible or recommended (*ḥalāl* and *mustahab* respectively*),* while wrong refers to everything that is impermissible or not recommended *(ḥarām* and *makruh* respectively*).* From the perspective of Islamic jurisprudence, right refers to what is just while wrong refers to what is unjust.

However, because IFIs are a collective religious obligation (*farḍ kifāyah),* the definition of right and wrong are sometimes of a different nature than those that apply to individuals. This is because IFIs have a special religious and financial position in society.

Religiously, IFIs have a responsibility to comply with the form and substance of Islamic law in all aspects of their operations. This is because they are in a representative and exemplary religious position, whereby they represent the interests of their stakeholders and at the same time are exemplars to their stakeholders. This implies that all aspects of their operations should be conducted in a permissible or recommended manner while no aspect of their operations should ideally be conducted in an impermissible or not recommended manner. If it is conducted in an impermissible or not recommended manner, it is an obligation to disclose to its stakeholders the reasons for that particular conduct.

Financially, IFIs are intermediaries which mobilize funds from investors and allocate funds to projects and other investments. In this context, it is the responsibility of IFIs to mobilize funds from permissible and recommended sources and invest funds in permissible and recommended projects. Further, IFIs are also in an exemplary position as financial intermediaries and hence can significantly impact the conduct of the IFIs stakeholders in terms of the ideal Islamic investment and allocation process.

It is for these two reasons that IFIs have a contrasted social responsibility to that of individuals. For instance, individuals have limited capacity to avoid *ribā* in financial systems that are overwhelmingly based on *ribā.* Hence, IFIs were created to avoid this form of impermissible activity. This can be extended to recommended types of activities such as the allocation of funds for the purposes of the benefit of society or to alleviate poverty. These activities can only be performed in a limited extent by individuals due to minimal scale economies, but are recommended of individuals through charity and helping those who are destitute. The overall theme encouraged by Islam is one of assisting those who are in a relatively disadvantaged position in society because of circumstances. In this context, IFIs can perform these functions profitably and efficiently because of the sheer scale of their operations compared to individuals.

The nature of responsibility of IFIs can further be distinguished from charitable organisations which exist in Islamic societies, which are also a function of individual social responsibility. Charitable organisations only redistribute wealth, while IFIs have the dual ability to redistribute wealth and allocate wealth to selective investments that contribute to the betterment of society. It is this allocation power that differentiates IFIs from other institutions and indeed bestows upon it special responsibilities.

However, it is widely cited that IFIs generally only perform a part of their social responsibility. As stated above, social responsibility is comprised of a prescription towards positive (permissible and recommended) actions and a prescription against negative (impermissible and not recommended) actions. IFIs are widely accused to have generally ensured their operational status by avoiding negative actions or impermissible activities, while minimally and variedly conducting recommended activities.

This may be a function of two overlapping issues. The first issue is that IFIs are unsure of what is expected of them based on Islam other than to avoid *ribā* and *gharar*. In this confusion their approach to social responsibility widely varies based on individual IFI preferences. The second issue is that, even if it is assumed that IFIs are conducting their social responsibility activities, they may not be informing the rest of society through disclosure, leading to an expectations gap. This may be despite the fact that IFIs are complying to the fullest extent of their abilities with Islamic notions of social responsibility.

It is in this context that it is recommended that regulatory authorities standardise the notions of social responsibility that are mandatory and recommended for IFIs if they are to remain as Islamic organisations. Mandatory forms of social responsibility refer to conduct that must be carried out or conduct that must be avoided. Recommended forms of social responsibility are one step further, in that it defines the kinds of conduct that the IFI should engage in if it has the ability/capacity. This is based on the intuition of the *Qur'ān* where Allah states: 'On no soul doth Allah Place a burden greater than it can bear'.[10] Allah does not impose a burden on individuals greater than they can bear. It is for this reason there are duties that Allah commands us to do (*ṣalāh*, *zakāḥ, hajj* etc), while there are duties that Allah recommends for us to do for additional rewards and our betterment.

It is proposed that any notion of social responsibility for IFIs should be designed to meet this divine theory of regulation. Hence, it is suggested that IFIs must comply with some mandatory guidelines that are fundamental to their existence as IFIs (mandatory), while it is recommended that they undertake voluntary activities if it is within their capacity.

[10] Surat Al Baqarah (The Heifer) verse 286.

5. THE JUSTIFICATION FOR MANDATORY AND RECOMMENDED FORMS OF ICSR

5.1. Mandatory Forms

Mandatory forms of social responsibility refer to conduct that the IFI has to avoid, in its capacity as a representative institution that serves a collective Islamic religious obligation. These responsibilities, if not carried out will mean that the IFIs are not complying with fundamental edicts of the *Qur'ān.* This form of social responsibility does not need a significant expenditure of resources and is within the reach of all IFIs regardless of their country of origin, legal form or size. This is because such mandatory forms of social responsibility are mostly prescriptions to avoid (for e.g. such as *ribā*) rather than prescriptions to act. However, that does not necessarily mean that the IFI does not have to implement policy and therefore expend some resources to avoid these actions.

Screening of investments

Muslims cannot invest their money in enterprises that engage in impermissible activities, for instance, pig farm, alcohol producing factory, tobacco industry etc. Furthermore, they cannot invest in activities that are financed by debt or interest based activities. These requirements are directly applicable to IFIs as representative organisations. Hence, in this context, it is imperative that IFIs screen their investments for compliance with Islamic laws and principles. IFIs should have a clear policy outlining their method of screening investments and the depth of their screening. IFIs should also gain approval of this screening process from their Sharīʿah Supervisory Board.

Earnings prohibited by Sharīʿah

Since Muslims cannot also engage in impermissible activities, earnings from impermissible activities are impermissible to be utilised for the operations of the firm and must be dealt with according to the Sharīʿah Supervisory Board's opinion. To that extent, Islamic stakeholders need to be assured that the representative IFI is acting in accordance with Islam by ensuring that no part of the stakeholder's wealth or income or activity is impermissible, and where it is impermissible, how it is dealt with.

Responsible dealings with clients

As representatives of Islamic stakeholders, IFIs need to ensure that they substantively follow Islamic prescriptions on how to deal with debtors as stipulated in the holy *Qur'ān:* 'If the debtor is in difficulty, grant him time till it is easy for him to repay. But if you remit it by the way of charity, that is best for you if you only knew.'[11] The *Qur'ānic* prescription contains a mandatory and a recommended action. The mandatory action in this circumstance is allowing the debtor time to pay it off if he/she is in difficulty. Indeed, the substance behind the prohibitions against *ribā* (usury) was to ensure that clients do not fall into excessive debt.[12] To fulfil this prescription in its true substance, IFIs should implement both *ex ante* (prior to giving fund to a client) and *ex post* (when the client is in financial difficulty) measures. *Ex ante* measures should include provisions of the policy ensuring that the *Sharīʿah* Supervisory Board or its agent review every contract form to avoid onerous terms being imposed on clients, who may be in a weaker bargaining position relative to the IFI. Other *ex ante* measures should include due process provisions whereby the bank must assess the disposable income capacity of the client, so as to take into consideration the client's ability to repay and the subsequent effect on the client's financial and overall well-being. In the event that *ex ante* measures are not effective to prevent insolvency of clients perhaps caused by external economic or personal circumstances, *ex post* measures should clearly stipulate the rights and obligations of both parties to the contract, particularly with regards to the conditions under which late penalties will be charged and under which conditions IFIs will defer collection of debt. For the purposes of transparency and fairness to clients, IFIs should also stipulate these conditions to the client prior to the settlement of any contract.

Employees

Justice forms the core of *Qur'ānic* prescriptions and therefore IFIs must be just in all its dealings with employees, customers, and all other members of society. Employees are a vital facet of IFI operations and they are sometimes in an unequal bargaining position with IFI management. As a result, onerous conditions on the employees and paltry wages may be characteristic of these situations. The *Qur'ānic* principle of brotherhood[13] is particularly pertinent in the discussion of the treatment of employees as Muslims treat one another as brothers. This relationship extends to the working relationships established in IFIs as IFIs are regulated primarily by Islamic principles. The relationship between employer and employee should therefore be based on Islamic moral and ethical principles of justice and divine accountability as applied between Islamic brethren. This places a responsibility on IFI management to ensure that the employees are treated with justice and that they are valued regardless of their position in the bank. IFIs therefore should have a policy on the fair treatment of employees. This policy should encompass providing an environment free of exploitation and discrimination, free from class or race

[11] Surat Al Baqarah (The Heifer) verse 280.
[12] For an in-depth analysis of the substantive intuition behind Islamic laws and their place in the development of Islamic pre-modern laws, please see El-Gamal (2006).
[13] Surat Al Hujraat (The Apartments) verse 10

barriers and equal opportunity for all based on merit regardless of gender, race, religion, disability or socio-economic background.

Zakāh

Paying *zakāh* is a mandatory obligation on the part of all Muslims to purify their wealth, regardless of mental health or youth. AAOIFI has already mandated standards for the accounting treatment of *zakāh* (FAS 9). However, these standards do not recommend the creation of a policy on *zakāh* as is part of the obligatory social responsibility of Muslims. To complement this existing standard, the ICSR standard would mandate that there is a policy for *zakāh* in every Islamic institution that is unambiguous about the obligations of the IFI with regards to collection and payment of *zakāh*. It is nevertheless acknowledged that there is controversy in the Islamic literature as to whether Islamic businesses are obligated to pay this tax, or whether it is only obligatory for only individuals (Shihaddeh, 1987, p.32; Gambling and Karim 1991, p. 103). To that extent, some IFIs do not necessarily need to establish a policy on *zakāh,* unless it is voluntary and they feel it is in the capacity of the IFI. Hence, the direction taken by AAOIFI in this regard should be either to supplement the existing standard on *zakāh* to mandate a policy for those IFIs that have to pay *zakāh* to their government and for those IFIs that voluntary pay *zakāh*. Alternatively, there should be an ICSR provision which mandates the establishment of a *zakāh* policy as a mandatory form of ICSR for those IFIs that have to pay *zakāh* and as a recommended form of ICSR for those IFIs that do not have to pay *zakāh*.

5.2. Recommended Forms

Recommended forms of social responsibility refer to those actions that go beyond the mandatory requirements and are done purely on a voluntary basis based on the capacity of the IFI to undertake such activities. As representative organisations, IFIs should feel the need to engage in whatever recommended activity that it can in its capacity. This is in line with the Islamic vision of spreading Islamic justice through all facets of an individual's life and consequently all aspects of the IFIs operation. Some of the recommended actions derive from the position of the IFI in society as a financial intermediary, while others are purely operational aspects that affect any Islamic business. The categories are self-explanatory and are founded on *Qur'ānic* principles of justice/equity.

Qarḍ Ḥasan

Qarḍ ḥasan is the only type of loan recognised in Islam. Allah refers to it in the *Qur'ān:* 'Who is it that will give Allah a gratuitous loan (*qarḍ ḥasan*), which Allah will double into his credit and multiple many times?'[14] It is a gratuitous loan given to needy people for a fixed period without requiring the payment of interest or profit. The recipient is only required to repay the principal. As a financial intermediary, IFIs are in a special position in society to encourage *qarḍ ḥasan* activities both within itself and with its clients and customers. This is because IFIs are able to direct funds from depositors and customers and also allocate them to the neediest purposes. No other social organisation has the opportunity to offer the specialisation in intermediation that IFIs can. For instance, IFIs can open special *qarḍ ḥasan* accounts through which deposits can be received, which would then be transferred to needy clients such as those unable to pay their dues to banks or newly married couples unable to purchase household items or students unable to get an education as a result of financial strife. IFIs can run special fund raising campaigns to increase their *qarḍ ḥasan* funding with minimal marginal expenditure through the existing infrastructure of the IFI.

Reduction of impact on the environment

As vicegerents of Allah in earth, Muslims are accountable to Him to protect and preserve what He has entrusted them with (*amānah)*. Destruction of or damage to the physical environment, if it is considered harmful to the interests of the individual or the society at large, is prohibited in Islam. Indeed, it is necessary for every individual to ensure that their actions have minimal environmental consequences. While financial intermediation itself does not have direct environmental consequences, projects funded by the IFI may have a harmful environmental impact. As a trustee of several contracting parties including individuals and organisations who deposit or invest their money with the IFI, the IFI has a recommended responsibility to ensure that such harmful investments are avoided and that the IFI actively promotes, through investment quotas, projects that have a beneficial impact on the environment. Of course, this would only be encouraged for those banks that have the capacity, financial or otherwise, to sustain such policies.

Screening clients and contractors (additional criteria)

Depending on their bargaining power with clients and contractors and infrastructure capacity, IFIs can both screen and negotiate terms with clients and contractors to ensure their activities comply with Islamic principles as contained in the mandatory section of the proposed standard. For instance, they can ensure that clients and contractors businesses do not associate with other contractors that support or engage in activities such as usury (*ribā),* alcohol gambling (*maysir),* extreme uncertainty (*gharar*)*,* tobacco or arms production. Further, IFIs can also ensure that contractors also treat their employees to the standard applied in the IFI

[14] Surat Al Baqarah (The Heifer) verse 245.

itself. This is consistent with Islamic accountability and allows for IFIs to enjoin good and forbid evil to the fullest extent of their capacity. In addition, the implementation of such screening can complement the usual screening process run by IFIs for the purposes of assessing credit worthiness and character etc. To that extent, minimal financial outlay will be required if the existing infrastructure is sufficient.

Industry wise investment quotas

In line with its responsibility to enjoin good and forbid evil in a macro-financial scale, IFIs are able to implement policies to ensure that investments are directed towards those industries that are most beneficial to economic development and are also aligned to Islamic principles of social equity and redistributive justice. IFIs have a special financial position whereby they are entrusted with funds from individuals and other organisations. The sheer size of the funds implies that IFIs are able to utilise economies of scale in investing. To that extent, they are also able to utilise these economies to invest in ventures that lead to socio-economic development, in contrast to individuals who are unable to diversify and invest in such ventures due to lack of economies of scale and other factors. This does not preclude the fact that IFIs will invest in such industries based on the underlying economic rationality of the particular venture/project, not on altruism. Individual research undertaken by the banks could lead to an appreciation of the particular industries that drive greater economic development, while at the same time reducing income parity between the wealthy and the poor.

Social impact based investment quotas

Since IFIs have a special financial position (because of their diversification capabilities and economies of scale), they are able to invest in industries that produce social, cultural or religious development in line with Islamic ideals. IFIs can set aside a portion of their investment quota as a target for increasing investments in social impact based projects. Again, individual research undertaken by the banks could lead to an appreciation of the particular projects that have the greatest social impact. For instance, positive NPV investments in projects such as welfare centres or religious centres can be classified as social impact based investments. Alternatively, investments in projects that lobby for human rights or reducing child labour or greater female participation in the economic or political process, could be classified as social impact based investments. Again, this does not preclude the fact that IFIs will invest in such projects based on the underlying economic rationality of the particular venture/project, not on altruism.

Environmental impact based investment quotas

In line with the principle of vicegerency and accountability (see section on *Reduction of impact on environment)*, IFIs are able to direct funds, through establishing quotas, to investments that have a positive environmental impact. The parameters of such a policy would of course have to be discussed in the individual IFIs and it would only be encouraged for those banks that have the capacity to sustain such policies.

Par excellence customer service

Islamic ideals of brotherhood imply a treatment of all human beings with dignity and respect as is evidenced in numerous verses of the *Qur'ān*[15]. Allah prescribes Muslims are to greet others with a greeting better than the greeting they receive: 'When a (courteous) greeting is offered you, meet it with a greeting still more courteous, or (at least) of equal courtesy. Allah takes careful account of all things.'[16] Indeed manners are emphasised as the most important attribute of an individual's Islamic character as emphasised by the Prophet Muhammad (PBUH): 'The best amongst you are those who have the best manners and character' [17]. To that extent, IFIs as representative Islamic organisations should require its agents (employees and contractors) to provide the best service possible to its clients and customers, regardless of their status, financial or otherwise. Besides teaching staff about Islamic manners, IFIs should utilise performance measures and incentives to encourage employees to behave with the best of manners between each other and with clients and customers.

Micro and small sized business and social savings and investments

A key principle of Islam in achieving its ideal of redistributive justice is the support and empowerment of the weak. Indeed, numerous verses of the *Qur'ān* point to the assistance of the weak (in education, economic, family affairs).[18] This can be achieved most significantly through the financial empowerment of family units in the lowest echelons of society. Micro and medium sized business can usually be run by such families if given the appropriate seed capital to initiate business. IFIs can also make profitable divisions serving this class of clients,

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[15] Surat Al Mumenoon (The Believer) Verse 52, Surat Al Anbiya (The Prophets) Verse 52, Surat Al Hujraat (The Apartments) verse 10
[16] Surat An Nisa (The Women) Verse 86
[17] Translation of Sahih Bukhari, Virtues and Merits of the Prophet (pbuh) and his Companions, Volume 4, Book 56, Number 759
[18] For instance, Surat Al Baqarah (The Heifer) Verse 273 or Surat An-Nisa (Women) Verse 436

particularly because existing examples of conventional micro-credit banks are very successful (for instance, Grameen Bank).

Employee welfare (extension)

As previously stated in the mandatory section, employees should be treated on the basis of the principle of brotherhood in Islam. This requires some mandatory acts to be definitely carried out to ensure that their rights are protected even though they are likely to be in an unequal bargaining position. Examples of these include pay/salary guarantees, equal opportunity and no discrimination. Beyond this, it is encouraged to create provisions for employee treatment that achieve the Islamic ideals of social equity. Social equity in practice requires Muslims to provide opportunities for those classes/segments of society that require it the most; not by giving them charity, but employing them in productive activities. Examples of such practices include establishing pro-active quotas in employing staff that are disabled, from disadvantaged backgrounds, from minority groups and/or from under-represented groups.

Charitable activities

Numerous verses of the *Qur'ān* encourage Muslims to give charity[19]. As a representative Islamic organisation, it is recommended that IFIs also give charity to the fullest extent of their capacity. As a financial intermediary, IFIs are in a special position to source charitable funds, both from within and without the IFI, for deserving causes. With minimal financial outlay, IFIs are able to create charity accounts and fund raising drives for charity from customers and clients to complement their banking operations. This will allow IFIs to utilise their existing capacity for the benefit of society's most deserving individuals.

Waqf management

Awqāf (religious endowment) are a vital part of Islamic infrastructure due to the crucial Islamic services their revenues provide. Because IFIs already have the technologies to provide efficient financial intermediation, they can play an important role in securing revenues from *awqāf* and distributing it to the specified charitable causes, with minimal marginal outlay.

6. DISCLOSURE AS A MEANS OF ACCOUNTABILITY

Disclosure is a crucial aspect of the accountability function of an IFI to its stakeholders. The other such accountability function is the *Sharīʿah* Supervisory Board. However, the *Sharīʿah* Supervisory Board cannot often disclose all or any

[19] For instance, Surat Al Baqarah (The Heifer) Verses 43, 110, 177, 273, 283.

social responsibility duties. Hence, it is required that IFIs disclose as much information in a succinct, truthful and understandable manner to its stakeholders.

From an Islamic perspective, the main objective of corporate reporting that overrides other objectives is to allow Islamic enterprises to show their compliance with *Sharīʿah* (Baydoun and Willett 1997). The implication of this objective is that IFIs have a duty to disclose all information necessary to its stakeholders about their operations, even if such information is adverse to the IFIs interest (Maali, Casson and Napier 2006). This is derived from the divine duty of accountability that each Muslim bears. However, this is not to say that Allah needs to know through disclosure the activities of the IFI. Indeed, Allah knows and hears everything and is Omniscient: 'I know what you reveal and I know what you hide' [20] and also: 'He knows what is manifest and He knows what is hidden'[21]. As representative organisations, IFIs have a duty to disclose their compliance with the principles and laws of Islam to stakeholders. This is because the stakeholders (Muslim or otherwise) have a relationship or are represented in some form or manner by IFIs even if the IFI has no direct contractual relationship with the individuals. As Maali *et al.* (2006) explains, 'the requirement for Muslims to uncover the truth is intended to help the community to know the effect of a person or a business on its wellbeing' (p.273). It is this social dynamic that makes it essential that IFIs disclose all relevant information truthfully to its Islamic stakeholders.

Maali *et al.* (2006) categorises three broad objectives that are used as the basis for social responsibility disclosures by Islamic businesses:

1. To show compliance with Islamic principles and laws, in particular dealing justly with different parties.
2. To show how the operations of the business have affected the well-being of the Islamic community.
3. To help Muslims to perform their religious duties.

As of now with the current AAOIFI standards, there is an expectations gap in all but one of the three broad objectives. IFIs are only mandated by existing AAOIFI standards to help Muslims perform their religious duties through the standard on *zakāh.* However, IFIs are not mandated by AAOIFI to show full compliance with Islamic principles and laws, nor are they mandated by AAOIFI to show how the operations of the business have affected the well-being of the Islamic community. To that extent, it is important that AAOIFI promulgate ICSR disclosure standards that mandate the disclosure of such important information to the stakeholders of an IFI.

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[20] Surah An-Nisa (Women) verse 33.

[21] Surah Al-Ala (The Most High) verse 7

7. CONCLUSION

This study provides the basis for ICSR for IFIs and the justification for developing a flexible ICSR standard that encompasses both mandatory and recommended forms of ICSR. It further provides the accountability foundation for mandating disclosure of ICSR conduct. Standard setting bodies such as the AAOIFI have the ability to influence the activities of IFIs by giving them flexible ICSR provisions that they can adopt depending on their underlying economic capacity. It is hoped that these standards will provide the impetus, long desired in the Islamic community, for IFIs to incorporate Islamic social responsibility principles in all aspects of their activities. To that extent, it is acknowledged that many IFIs do perform ICSR activities and already have ICSR provisions that are not recorded or disclosed. It is anticipated that the recommended ICSR standard will provide a uniform and consolidated basis for IFIs to carry out their ICSR conduct. Further, it is hoped that the disclosure as recommended here of the ICSR provisions and ICSR performance of the IFI will fill a long held expectations gap about what IFI are 'supposed' to be doing as Islamic institutions.

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FINANCING MICRO AND MEDIUM SIZED ENTERPRISES THROUGH DECREASING PARTNERSHIP (*MUSHĀRAKAH MUTANĀQISAH*): REFINING SHARĪʿAH AND BANKING ASPECTS FOR ENHANCED APPLICABILITY

MUHAMMAD ABDURRAHMAN SADIQUE

ABSTRACT

Decreasing partnership as proposed by contemporary scholars could be effectively employed in financing MMEs, for procurement of assets as well as financing complete ventures. Its significance in financing MMEs could be enhanced through giving further prominence to the basis of equity participation, allowing the ancillary contracts of ijārah and sale to function independently. The paper argues that the reality of the underlying contracts should be effectively highlighted through pricing the units and ijārah rentals realistically, rather than as an apportionment of the profit element calculated on the capital outlay. In financing ventures on decreasing partnership, expenses of the venture should be shared proportionately; profit share of the bank should decline corresponding to the bank's stake, and unit price of the bank's share could be fixed based on a price negotiated at the time or professional valuation. The paper seeks to highlight many other conditions that are often violated in practice but that must be fulfilled in order to ensure full Sharīʿah compliance.

1. INTRODUCTION

Financing micro and medium sized enterprises (MMEs) is a vital area that could be modelled based on equity participation, which could facilitate a more equitable sharing of returns as well as sustaining losses. Due to their inability to provide acceptable collateral and various other reasons, MMEs generally fail in meeting the stringent credit criteria of conventional banks, and rarely qualify for credit lines. Conventional banks consider the viability of the venture mainly for assessing the credit risk, which would determine the nature of collateral and other security to be sought. Conversely, in adopting equity participation as a medium for financing projects, the recovery of the capital along with realising a return is intrinsically related to the success of the venture. Demand for collateral would be practically relevant only in situations where the entrepreneur is liable for losses, due to reasons such as negligence and fraud. As such, where the viability of the enterprise could be reasonably ascertained, lack of collateral alone need not deter Islamic banks from financing on the basis of equity participation, especially due to the fact that the bank gains ownership to a portion of the business assets, and the possible higher returns realisable as an equity partner.

Despite of an apparent reluctance on the part of Islamic banks to employ equity modes, especially so in the case of MMEs due to the perceived vulnerability and augmented risk, equity arrangements appear best suited for the purpose. In financing MMEs, unilateral funding modes such as *muḍārabah* as well as common equity participation based on *mushārakah* could be adopted. However, in ventures of medium and long-term duration, termination of equity partnership cannot be done abruptly, and a gradual withdrawal may become necessary. Decreasing equity partnership (*mushārakah mutanāqisah*), a combination mode widely adopted by Islamic banks presently for financing ventures and purchase of high-value assets such as houses, could be an ideal tool for financing MMEs. The possibility of equity participation while ensuring an exit mechanism offered by this structure provides an appropriate platform for the bank's involvement. Financing here could include both founding an enterprise jointly as well as joint purchase of an existing venture, until it gains sufficient financial strength to acquire total ownership. Decreasing partnership could also be employed in procuring assets needed by the enterprise. Thus, factories, buildings, machinery, equipment, tractors, boats, vehicles etc necessary for MMEs could be financed using the structure. However, decreasing partnership structures that are presently adopted could require further refinement and enhancement for achieving optimum performance in MMEs. They could be further upgraded in order to make the procedure more reflective of the basis of equity participation, thus ensuring bilateral justice and boosting the success and growth of MMEs, leading to a win-win situation.

This paper analyses the application of the decreasing partnership format in facilitating procurement of assets and financing complete ventures, and examines the currently adopted structure from an operational and Sharīʿah angle with a view to suggesting possible measures for enhancement in order to realise optimum suitability in a MME environment.

1.1. Essentials of Decreasing Partnership

Prior to analysing aspects particularly relevant to financing MMEs, it is pertinent to examine the nature of decreasing partnership. Diminishing or decreasing partnership is a structure fundamentally based on equity participation that has been proposed for bank financing by a number of contemporary jurists. While some have restricted its use to financing assets such as real estate, others uphold its use in venture capital financing. The primary concept of decreasing partnership involves the joint purchase of an asset or a venture by two parties, on the assurance given by one of them that the share of the other in the asset or the venture would be purchased by the former in stages. Due to the fact that the share of one party, usually that of the financial institution, declines gradually as a result of the consecutive purchases by the other, this structure has been referred to as *mushārakah mutanāqisah* or decreasing partnership. Based on the common ownership of the parties, any revenue through the asset or the venture would be shared between them. When this structure is adopted for procurement and development of assets, the additional feature of *ijārah* is usually seen to be incorporated, however, as an independent contract. The share of one partner, usually that of the Islamic bank, is leased to the other at a fixed rental. With the progressive purchases of the client that result in the decline of the bank's share, the rental too is reduced, based on an undertaking given by the bank to this effect. With the client's purchase of the bank's share completely, the *ijārah* terminates and the relationship comes to an end. The structure differs from other asset financing modes such as *murābaḥah* due to features such as the co-ownership of the bank in the asset / venture with the resultant right of the bank to claim a proportionate share of any revenue through the asset / venture, and the possible incorporation of the rental element. Several variations to the above process have been suggested, all of which, while agreeing on the initial joint ownership, mainly differ on the process adopted for the gradual secession of one of the parties.[1]

Thus, decreasing partnership, while having an equity relationship as its base, also involves the concurrent application of other relationships such as agency, *ijārah*, sale etc, which, although not forming a condition to the validity of the basic partnership, are crucial ingredients for the viability of this mode, and necessarily adhered to as such. The component contracts, the synchronized application of which gives rise to the multifaceted relationship referred to as decreasing partnership, are recognised in Sharīʿah, on the basis of which advocates argue for the validity of the overall structure.

1.2. Basis of Decreasing Partnership

Some proponents of decreasing partnership have identified the basic contract that forms its core as *shirkah al-'aqd*, on which basis they propose its application in a large variety of projects, extending from financing the purchase of assets such as machinery, factories, and houses to financing large-scale enterprises. Since the

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[1] See AAOIFI, Sharīʿa Standards May 2002, p. 214; First Islamic Banking Conference Dubai, 22-24 May 1979, held at Dubai Islamic Bank, *Fatāwā Shar'iyyah fī al-A'māl al-Masrafiyyah*, p. 22; Muhsin Ahmad al-Khudayri, *al-Bunūk al-Islāmiyyah*, Al-Qāhirah, Iytrak li al-Nashr, 1995, p. 133; Abd al-Sattār Abū Ghuddah, "al-Mushārakāt al-Mutanāqisah wa Dawābituhā al-Sharʿiyyah", in *al-Iqtisād al-Islāmi*, No. 277, Rabīʿ al-Akhir 1425H, vol. 24, p. 217.

partnership is founded from the inception as a contractual partnership, they see no bar to utilising this structure for all sorts of financing that give rise to revenue.[2] AAOIFI Sharīʿah Standards seems to adopt this position. However, it does not bear any clear reference to utilising decreasing partnership structure in asset purchase.[3] Others have preferred to regard it as a structure based on shirkah al-milk when used for the purpose of acquiring assets such as real estate, however, allow its application in financing ventures that are based on assets, with some necessary guidelines to be observed due the structure taking the form of *shirkah al-ʿaqd* in this instance.[4] Where the relationship is categorised as shirkah al-milk, the partners could gain certain additional privileges that allow them to guarantee each other where necessary, and based on it, to pledge to purchase the other's share at a fixed price. Similarly, the partners' liability as well as right to any gain through the jointly held property would necessarily be proportionate to their ownership. However, when the relationship is identified as *shirkah al-ʿaqd* formed through investment with a view to sharing profits, purchase of the other's share at a fixed price may not be assured, as this would tantamount to guaranteeing a similar amount of the other's capital. The latter is not allowed in *shirkah al-'aqd*, as such an assurance would interfere with the mandatory requirement that liability should be shared strictly on the basis of capital participation.

2. DECREASING PARTNERSHIP FOR ASSET PURCHASE

An important area where decreasing partnership could be used in financing MMEs is facilitating the acquirement of assets. Various assets required by MMEs, where Islamic banks would be reluctant in providing debt-based modes such as *murābaḥah*, could be financed using this structure with a greater level of comfort for both the bank as well as the client partner. This is due to the usual incorporation of the *ijārah* contract that could accommodate delays in meeting periodical payments without loss of revenue for the bank, which would not be possible in fixed price mechanisms such as *murābaḥah*. This aspect also provides a greater level of ease to the MME partner, as he is granted more freedom in managing liquidity. However, the prevalent decreasing partnership mechanism requires several important adjustments in order to provide such benefits optimally.

2.1. Mechanism

Decreasing partnership, when applied in projects that involve the procurement or development of assets, consists of the joint purchase of an asset by the Islamic bank and the client initially. After the joint purchase of the asset, the client is

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[2] Abd al-Sattār Abū Ghuddah above.
[3] AAOIFI, Sharīʿah Standards May 2002, p. 214.
[4] Muhammad Taqi Usmāni, An Introduction to Islamic Finance, Karachi, Idaratul Ma'arif, 2000, p. 91.

required to purchase the share of the bank on a staggered basis based on a preceding promise made by the client to the effect, through purchasing a portion at equal intervals until the whole asset is owned by the client. The price of each unit of the bank's share is usually fixed beforehand. If the asset purchased is proposed for utility such as buildings and machinery, the client is allowed to commence using it soon after the joint purchase, where the share of the bank would be leased to him for the purpose, under a separate *ijārah* agreement, at a fixed rental. The share of the bank would successively decrease due to the periodic purchases by the client, as a result of which adjustment to the initial rental becomes necessary. This is achieved by a separate undertaking proffered by the bank that in the event the client purchase the share of the bank in units, the rental would be reduced accordingly, to reflect the reduced ownership of the bank. A rental schedule for the purpose usually accompanies the undertaking. With the purchase of the last unit by the client, the asset becomes wholly owned by him, terminating the *ijārah* contract simultaneously.

2.2. Major Sharīʿah Issues

As far as creating common ownership over an asset through joint purchase is concerned, this is evidently recognised as valid in all schools of Islamic law.[5] When a partner appoints the other as his agent for the joint purchase of a specific asset, the latter becomes jointly owned by the partners upon purchase. In a jointly owned asset, a co-owner may sell his share or a part of it to the other without any objection.[6] Similarly, a co-owner of an undivided asset could lease his share to the other party under an *ijārah* agreement.[7] These being the basic constituent contracts found in decreasing partnership, when regarded independently, they are not understood to involve any aspect objected to in Sharīʿah. Despite of this, various other aspects of Sharīʿah relevance are found in the decreasing partnership mechanism as enumerated hereunder, some of which are also common to structures for financing ventures. All of these are pertinent to financing MMEs.

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[5] Shams al-Dīn al-Ramli, *Nihāyah al-Muhtāj*, Bayrūt, Dar al-Kutub al-Ilmiyyah, n.d., vol. 5, p. 8, Muwaffaq al-Dīn Ibn Qudāmah, *al-Mughni*, Bayrūt, Dar al-Fikr, 1992, vol. 5, p. 122, ʿAlā al-Dīn al-Kāsāni, *al-Badā'i' al-Sanā'i'*, Bayrūt, Dar al-Maʿrifah, 2000, vol. 6, p. 90.

[6] Muhammad Amīn Ibn ʿĀbidīn, *Radd al-Muhtār*, Bayrūt, Dar al-Fikr, 1979, vol. 4, pp. 300 – 304; Abd al-Rahmān al-Jazīri, *Kitab al-Fiqh 'ala al-Madhāhib al-Arba'ah*, Bayrūt, Dar al-Kutub al-Ilmiyyah, 1986, vol. 3, pp. 65, 69. al-Kāsāni, *al-Badā'i' al-Sanā'iʿ*, vol. 5, p. 168, Sulaymān ibn ʿUmar al-Bujayrami, *Hāshiyah al-Bujayrami*, Diyār Bakr Turkiya, al-Makatabah al-Islāmiyyah, vol. 3, p. 107, Muhyī al-Dīn ibn Sharaf al-Nawawi, *al-Majmūʿ*, Bayrūt, Dar al-Fikr, 1996, vol. 9, p. 273.

[7] *Al-Majallah*, article 429, vol. 1, p. 83, Abū Ishāq ibn Muflih, *al-Mubdiʿ*, Bayrūt, al-Maktab al-Isāmi, 1400H, vol. 5, p. 79, ʿAli ibn Sulaymān al-Mardāwi, *al-Insāf*, Bayrūt, Dar Ihya al-Turāth al-ʿArabi, n.d., vol. 6, p. 33, Mansūr ibn Yūnus al-Bahūti, *Kashshāf al-Qināʿ*, Bayrūt, Dar al-Fikr, 1402H, vol. 3, p. 563.

A major Sharīʿah concern that is not confined to decreasing partnership alone is the level of Sharīʿah acceptability of amalgamating various contracts together in a single process with the connivance of the contracting parties. Whether contractual promises could be held enforceable, and whether an individual binding promise, offered by the client at the time of finalising the shirkah agreement or the joint purchase that the bank's share would be purchased by him subsequently, is substantially different from an instance where two transactions are made conditional to each other, too are important Sharīʿah aspects. Contemporary scholars recognise enforceability of contractual promises in certain situations, and regard that an individual promise that is not related to the text of a contract may not be compared to a condition for the validity of the latter. Therefore, it is necessary that the client's agreement to purchase the bank's share in units take the form of a unilateral promise made separately.[8]

In assets such as real estate and vehicles where registration with the relevant authority is mandatory in many jurisdictions, the legal title to the asset is usually transferred from the original owner, i.e. the housing development firm or the vehicle dealer, to the client directly. Thus, from a conventional legal standpoint, the bank's involvement in the asset is limited to its financial interest, while the legal ownership rests on the client solely. To smoothen the issue from a Sharīʿah angle, the client is appointed as the bank's agent to carry out the purchase of the asset and to hold its legal title. Therefore, in spite of having the legal title to the asset, the client is considered the owner of only a part of it initially, i.e. to the extent of his participation in the cost of purchase, and would gain complete ownership only at the end of the tenure.

In order to secure the bank's interest legally in this instance, a legal mortgage over the whole asset is usually drawn in favour of the bank. This document is not reflective of the true state pertaining to ownership of the asset, as it reflects the position of the bank as that of a mortgagee who is entitled to monetary dues from the mortgagor. Although not appearing on the deed of mortgage, its applicability is considered limited to the share owned by the client, mortgaged in favour of the bank for securing *ijarāh* rentals and actual damages to the bank due to possible non-adherence to the promise to purchase.

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[8] Islamic Fiqh Academy, 5th Session held in Kuwait, December 1988, Resolutions Nos. 40-41 (2/5 & 3/5); Muhammad Taqi Usmani, "al-Turuq al-Mashrūʿah li al-Tamwīl al-ʿIqārī", in *Buhūth fī Qadāyah Fiqhiyyah Muʿāsirah*, Karachi, Maktabah Darul Ulūm, 1996, and *An Introduction to Islamic Finance*, pp. 120-126, 87-89; Wahbah al-Zuhayli, *al-Fiqh al-Islāmi wa Adillatuh*, Bayrūt, Dar al-Fikr, 2000, vol. 4, pp. 2928-2930. Enforceability of promises in the context of murābahah has also been upheld by other bodies such as the Second Conference of Islamic banks held in Kuwait, March 1983.

In the course of the decreasing partnership process, the client is expected to purchase the undivided share of the bank in units, usually at pre-agreed intervals. The purchase of each unit would form a separate transaction that should necessarily fulfil the requirements pertaining to sales. Thus, it is emphasised that the sale here take place through a proper offer and acceptance, accurately describing the nature of the unit purchase and the price, through which the ownership of the unit would transfer to the client.[9] This would allow the reality of the transaction to be manifested duly, in addition to rectifying the approach of the client as well as the bank towards the transaction.

In the event of any reluctance on the part of the client to purchase the units as promised, contemporary scholars regard the bank justified in demanding his performance. In the event of non-compliance, the bank may recover the actual damages suffered due to the client's failure to fulfil his promise. This could provide the bank with the necessary validation for commencing legal procedures for liquidation of the mortgage. However, it is clear that if the mortgage is liquidated, the bank would be justified only in recovering the actual damages suffered due the client's non-purchasing, together with the *ijārah* rentals for the bank's portion of the asset for the period. Any balance remaining of the sale price of the client's share should necessarily be given to him.

It could be seen from the above that obtaining legal title to the property in the name of the client solely, followed by a legal mortgage over the same, amounts to a misrepresentation of the underlying transaction of co-purchase. Registering both the bank and the client as co-owners is not generally favoured due to the involvement of multiple legal costs in transferring the bank's share to the client at the end. The long-term alternative would be to attempt to obtain legal recognition of the promises and other transactional documents executed in Islamic banking operations at least to a limited extent, with exemption from duties and other taxes normally involved.[10] Such a step could facilitate financing MMEs greatly. This could also result in an increased sense of responsibility in both the bank and the clients in carrying out such transactions. It should not be forgotten that irrespective of whether legal recognition is awarded, all transactions carried out by the bank, when found to fulfil the necessary criteria, are valid and enforceable in Sharīʿah, and give rise to legal consequences such as transfer of ownership, liability for expenses and right to revenue.

[9] Muhammad Taqi Usmāni, An Introduction to Islamic Finance, p. 90.

[10] The issue of double stamp duty had been solved in the context of Islamic mortgages in UK, which could set a precedent for other countries. However, the legal status of Islamic banking transactional documents is yet to be asserted.

Implications of the bank's co-ownership in the asset

As a result of the joint purchase, responsibilities pertaining to ownership would necessarily be attached to the bank, proportionate to its ownership. Similarly, a proportionate share of any increase or revenue generated by the asset could be claimed by the bank. The latter aspect is discussed below under decreasing partnership in ventures. Consequently, liabilities pertaining to ownership such as major repairs, risk of loss or destruction etc should be shared by the bank proportionately. These liabilities may not be transferred to the client even though the bank's share is leased to him, because they fall on the lessor even in *ijārah*. Minor repairs and upkeep necessary for usage could be assigned to the client as a lessee is required to bear them. Therefore, in spite of any reference to the bank in the legal documents as a mortgagee, liabilities inherent to ownership would necessarily fall on the bank proportionately. Such sharing of liability, if genuinely undertaken, could be a major boost to MMEs, and could serve as a key differentiator between *mushārakah mutanāqisah* and interest based facilities.

On the other hand, due to the fact that decreasing partnership involves co-owning the asset for a relatively long duration, the bank exercising due care in the co-purchase of the asset becomes necessary. Although the client could be made responsible for the selection of the asset, if the latter is unable to provide the usufruct expected there would be no justification for charging *ijārah* rentals. If the client refuses to purchase the bank's share as a result and the asset has to be liquidated, recovery of the bank's capital outlay may prove difficult unless if additional security is available. Even when the asset fetches a higher price, recovery of rentals may not be justified if the asset had been unusable. Thus, co-purchase dictates that these aspects that are necessary features of ownership and *ijārah* be kept in view at the time.

Lease of bank's share to the client

Decreasing partnership in asset purchases usually involves lease of the bank's share of the asset to the client through an *ijārah* agreement. A separate undertaking to reduce the rental in the event of the client purchasing units of the bank's share is made concurrently by the bank. This undertaking, made unilaterally by the bank without forming part of the *ijārah* agreement or the joint purchase, mentions the reductions in rental that would take place periodically according to the decline in the bank's share, subject to the client's purchase of units. Being separate unrelated transactions carried out individually that are not conditional to each other, these are not understood to impair the validity of the procedure.

If this procedure is held valid, it is necessary to observe Sharīʿah rulings pertaining to the lessor / lessee relationship. Thus, although expenses related to minor wear and tear could be assigned to the client, major repairs and overhauls would necessarily have to be borne by the bank proportionate to its ownership. This is also necessary for stressing the bank's role as a co-owner and *ijārah* lessor, instead of that of a lender or financial lessor whose interest in the asset is limited to his financial dues. In addition, the danger of *ijārah* rentals being misunderstood as interest on the bank's remaining capital exposure should not be underestimated. To mitigate this possibility, suggestions offered below regarding the pricing of units and rentals as well as the obligation on the client to purchase could be considered.

Fixing unit prices and ijārah rentals

Subsequent to the bank's becoming a co-owner of the asset in a Sharīʿah perspective through joint purchase, while the bank's share is leased out to the client based on an *ijārah* agreement, at periodic intervals, the bank's share is sold to the client in units. The recovery of the capital involved in the facility along with a profit is realised in the form of sale prices of units and *ijārah* rentals. While the *ijārah* rental for the whole of the bank's share is fixed at the outset to be reduced gradually based on the undertaking to do so, whether the sale price of units could be thus fixed at the inception is a matter of difference among contemporary scholars. Contemporary scholars who regard decreasing partnership to consist of shirkah al-milk when utilised for asset purchases, while encouraging the price of units be fixed based on market value, have also allowed prior agreement between the bank and client regarding it.[11] Thus, the promise to purchase offered by the client could indicate the prices to be paid for the units. This is justified based on the fact that the partners here are mere joint owners in an asset, who have not entered into a joint venture for investing their capitals or to realise a gain through the sale of the asset to a third party. As such, the question of a partner guaranteeing the other's capital, which would occur had the partnership been based on *shirkah al-ʹaqd*, is not relevant here. Others who uphold *shirkah al-ʹaqd* as the universal basis of the procedure, consider such prior agreement impermissible.[12] This ruling also aims at safeguarding decreasing partnership from becoming a mere interest-based financing transaction in which a client undertakes to pay another party for his finance, in addition to a share in the partnership income.[13]

Issues on fixing unit price and rental

If the *mushārakah mutanāqisah* structure is to be employed for financing MMEs with any measure of success, an aspect of paramount importance would be the pricing mechanism adopted for fixing unit prices and *ijārah* rental. A

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[11] Muhammad Taqi Usmani, An Introduction to Islamic Finance, p. 83.
[12] See section above on basis of decreasing partnership.
[13] AAOIFI, Sharīʿah Standards May 2002, p. 225.

drawback that is found in the practical application of the current structure for asset purchases is that the purchase prices of the units and the *ijārah* rentals are not found to have any relationship with the market value of the asset or its utility. The bank's intent is seen limited to recovering its capital together with an amount of return relative to the period of exposure, calculated based on the rate of return applicable to such facilities. Thus, considering the fact that the bank's share is divided into equal units, while the nature of the equity relationship could call for the unit prices to be similar and the rentals to decrease according to consecutive purchases effected by the client reflective of the portion remaining in the ownership of the bank after each purchase, the usual practice of banks is found to be different. The periodical purchase and payment of rental by the client are taken as a single payment, which is usually fixed as a uniform figure throughout the tenure of the facility. The components of unit price and rental comprising each payment are fixed with the aid of discounted cash flow technique, where the unit price is seen to increase while the rental amount diminishes progressively, without much relation to the number of units owned by the bank at each stage. While a perceived benefit here is that the client is required to pay a fixed total sum throughout, this method defeats a proper appreciation of the nature of decreasing partnership to a great extent, in that the client is made to understand from the process that a simple repayment of the bank's capital outlay is effected monthly with a margin of profit. This lack of appreciation is seen to manifest in the reluctance to carry out the offer and acceptance procedure for each unit purchase, as mere payment of the total 'instalment' is considered enough.

Treating the unit price and rental as a single payment could lead to another aspect that downplays the equity relationship. When units are not purchased at intervals as agreed, the terms of the *ijārah* agreement and the undertaking would require that no change take place in the rental. This is because the rental would be subject to adjustment only when the ownership of the bank is reduced due to the purchase of units. At any point of the tenure, if a unit is not purchased at the appointed interval, the share owned by the bank would remain unchanged. Thus, until another unit purchase is effected, the same amount of rental as was due earlier would remain payable periodically. However, if the unit price and the rental are taken as a lump sum payment regardless of its composition, the client could be understood only to have defaulted in meeting an instalment. Due to treating the amount thus as any instalment outstanding through other modes such as *murābaḥah*, its payment within the tenure could be considered sufficient. Thus, the *ijārah* rental would be taken to reduce automatically irrespective of whether a unit purchase was done at the right time or not. While this could be advantageous to the client, the reality and the significance of the underlying contracts of sale and *ijārah* are brought into question here through their apparent inefficacy.

Illustration

The following example could illustrate this point. Let us imagine the joint purchase of a property on decreasing partnership where the client's purchase of the bank's share is planned to take place in ten months in ten equal units. The unit price is fixed as P while the monthly rental for each unit is R. The rental due for the whole share of the bank being 10R, at the end of the first month, the total sum payable by the client, for purchase of one unit together with the rental, is (P + 10R). (As explained above, mere payment here would not be sufficient. The purchase should be concluded properly through the exchange of an offer and acceptance. If this is not done, the unit price paid would remain as an advance paid on account for a future purchase.) If a unit was purchased at the end of the first month, the rental is payable at the end of the second month only for nine units. Thus, the sum payable at the end of the second month would be (P + 9R). Let us imagine that the client did not purchase a unit at the end of the second month, i.e. the rental too was not paid, as both are usually paid together. In this instance, the rental would not decrease at the end of the second month, due to the share of the bank remaining the same. Thus, at the end of the third month, if the client were to pay both 'instalments' together through the purchase of two units at once, the sums payable would be (P + 9R) + (P + 9R). Thereafter, at the end of the fourth month, the total sum payable would be (P + 7R). A table illustrating an asset divided into ten units with deferment of purchase in the 2nd, 7th and 8th months is given below.

Table 1. Unit Price and Rental in Decreasing Partnership in the Event of Irregular Payments

	1st month	2nd month	3rd month	4th month	5th month	6th month	7th month	8th month	9th month	10th month
Units owned by client during month	-	1	1	3	4	5	6	6	6	9
Units owned by bank during month	10	9	9	7	6	5	4	4	4	1
Total rental due at end of month	10R	9R	2(9R)	7R	6R	5R	4R	2(4R)	3(4R)	R
New units purchased at end of month	1	-	2	1	1	1	-	-	3	1
Total Amount paid at end of month	P + 10R	-	2P + 2(9R)	P + 7R	P + 6R	P + 5R	-	-	3P + 3(4R)	P + R

Nevertheless, in the current scenario, when the unit prices and rentals are fixed with the aid of discounted cash flow method where a major part of the initial 'instalments' are treated to consist of the profit element, i.e. rental, while the capital element, i.e. unit price, therein is negligible, it is not seen practicable to alter the rentals only based on unit purchases even when these are delayed, as dictated by the reality of the transaction. This is because, in the case of a non-purchase occurring during the initial months, an unrealistically large amount would be payable as additional rental, as the rental component is substantial during the early period. However, when the rental component is not regarded in its proper perspective and is made payable thus with little consideration for purchase of units or the remaining share of the bank, the function of the basic contracts comprising decreasing partnership could become neglected.

2.3. Suggestions for Enhancement

The decreasing partnership mechanism as endorsed by a number of contemporary scholars could be a highly viable tool in facilitating MMEs to procure necessary assets. Its potential in enhancing the revenue of Islamic banks and their depositors through the operation of the *ijārah* is a noteworthy feature that differentiates it from fixed price mechanisms such as *murābaḥah*. By means of the *ijārah* contract, a great amount of flexibility could be created in the operation, which, in addition to bringing in additional revenue for the bank in an acceptable manner thus compensating for the delay, could provide MMEs with an additional measure of ease in meeting payments. This would facilitate MMEs more freedom in deciding the duration of the bank's involvement in the asset. However, in order to avoid issues such as outlined above and improve efficiency of the mechanism, some suggestions are offered hereunder.

A primary measure needed in this respect is to effectively highlight the reality of the underlying contracts, through pricing the units as well as the rentals more realistically. Unit prices and rentals could be fixed in a manner that is more reflective of the gradual decrease of the bank's share. Adopting the discounted cash flow technique in a direct fashion for this purpose could result in misrepresenting the essence of the structure seriously, while making its application unrealistic in instances of delay in unit purchase. Therefore, it is necessary that the core contracts comprising decreasing partnership be given a higher level of visibility by allowing their smooth operation independently. This is all the more important for avoiding treatment of the structure as an interest-based scheme.

For this purpose, it appears that the purchase of units should be dissociated from payment of *ijārah* rentals, thus thwarting the possibility of misunderstanding the simultaneous payment of both as an 'instalment'. The bank's share could preferably be divided into equal units, priced evenly.[14] The client may be allowed

[14] As mentioned above, the basis of decreasing partnership in assets, i.e. whether it forms shirkah al-milk or *shirkah al-'aqd* would determine pricing of the units largely. See section above on basis of decreasing partnership.

the facility of depositing a portion of the purchase price when convenient, the sale of the unit only taking place when the complete price for a unit is paid. This could be especially welcome in the case of MMEs, where management of cash flow could be a serious issue. The sale, formally finalised through proper offer and acceptance, would result in the transfer of the unit's ownership to the client, while resulting in the reduction of the rental based on the undertaking provided by the bank.

Instead of making the unit purchase mandatory at defined intervals, the procedure could provide more choice to the client on the issue, by allowing him to complete purchase of the bank's share within a defined period. For instance, if the bank's share was divided into thirty-six units, instead of scheduling the purchase to take place in three years, a duration of five years could be allowed for the purpose. The client would be permitted to purchase units during the period whenever his cash position allows him to do so, singly or several units together. The delay in purchase of the units would not create a loss for the bank as rentals would keep accruing for the unpurchased units.

Payment of *ijārah* rentals could be carried out as a process that is separate from that of unit purchases. *Ijārah* rentals should be fixed in a manner that defines the rental for each unit of the bank's share, where an equal amount of rental is fixed for every unit. Thus, the amount of rental to be paid would depend directly on the number of units owned by the bank at the time. If the client puts off purchase of units for several months, the previous rental would remain applicable during period, as the bank's share would remain unreduced. As mentioned before, this would call for the rentals to be fixed in a more realistic and uniform manner than by a direct application of the discounted cash flow method. Thus, the amount of rental on the remaining units throughout the tenure should be priced in such a way that the client could afford to pay additional rentals when postponing the purchase of an instalment becomes necessary, while discouraging undue delay in this regard resulting in the unnecessary prolongation of the *ijārah*. Although a strict application of market rates may not be necessary as this could defeat the purpose of the client in opting for the facility, the rentals should be fixed in a reasonable manner that is reflective of the bank's co-ownership. When the client needs to extend the *ijārah* beyond the stipulated period, this could be accommodated based on the previous rental structure or a new one, as agreed beforehand.

It is clear that when the units are equal and the rental is directly proportionate to the number of units, a higher rental would be payable initially, that would gradually decrease according to the unit purchases effected by the client. Despite of the fact that here the total amount payable by the client differs from month to month, thus resulting in the variation of the total amount payable by the client every month, it may be preferable to adopt this method as it serves the purpose of differentiating decreasing partnership from instalment payments. However, if the client desires to pay an equal amount monthly, this could be done through fixing the total payable as an equal amount every month, where a part would consist of the complete purchase price of a unit while the balance goes towards settling the rental. It is evident that here the amount paid for rental would not be sufficient for covering the total rental in the initial months, which would be matched by the amount exceeding the rentals towards the end of the tenure. Allowing the client to pay part of the rental in the initial months is preferable to recovering the rental in full from the fixed amount while leaving the unit price incomplete, as the balance in this instance not being sufficient for the purchase of a unit, the client would be obliged to pay additional rental until its purchase through the subsequent payment. It may not be practicable to allow purchase of units on credit.

A necessary practical measure for removing the inherent danger of rentals on units being perceived as interest on capital is to emphasise the co-ownership of the bank in the asset. The contracts of sale, lease as well as the equity relationship could only be held real when the obligations attached to these capacities are effectively discharged. Thus, in each venture financed, ways of strengthening the bank's function in these capacities should be ascertained. It should be noted that as the legal mortgage over the asset could weaken this image through projecting the bank as a lender, an alternative method for asserting the bank's ownership should be explored. As stated earlier, obtaining legal recognition for transactional documents could rectify the situation greatly. Educating clients as well as staff on the concept of decreasing partnership would be essential in the initial stages.

Allowing client the option to purchase units or continue the lease

Finally, if the provision that the promise to purchase extended by the client be legally enforceable could be dispensed with, it could result in some additional flexibility in the procedure for MMEs. Instead of the mandatory purchase of the share of the bank, the client could be given the choice to continue the *ijārah* through extending it with the bank's agreement. The objection of making diverse contracts conditional to each other may be substantially eliminated through this measure, thereby making the structure further acceptable from a Sharīʿah perspective. It should be noted that when the promise to purchase is made legally binding, the materialisation of the contract as planned is assured for all intents and purposes. Thus, there remains little more than a dialectical justification for not considering the promise to be a full-fledged contract mutually concluded, as any possibility of a refusal on the bank's part to conclude the contract is only a remote theoretical possibility. This is because the insistence on the legal enforcement of the promise comes from the bank itself. Therefore, although such measures could be adopted with the sanction of Sharīʿah experts where necessary, the delicate reasoning employed in the process should not be lost sight of. Some of the critical observations made in this regard by analysts seem not to be devoid of merit.[15] Another option that could be availed of is that instead of the client, the bank should provide a promise to the effect that it would sell its share to the client, as has been proposed by some contemporary scholars.[16] It is noteworthy in this regard that the first ruling issued by a body of contemporary scholars on the decreasing partnership structure envisaged that both the client as well as the bank be given the freedom to sell their shares to each other or to outside parties.[17]

If the client were to be given a choice between purchasing the bank's share and continuing the *ijārah*, this could call for several important adjustments. A possibly beneficial measure is that the bank would be required to scrutinise the nature of the asset more thoroughly, in order to verify its worth and suitability for *ijārah*. Although this aspect was incumbent on the bank due to its gaining co-ownership as explained above, the possibility of a long-term *ijārah* would require the bank to be even more earnest in this respect. Another vital requirement in this event is that the *ijārah* rentals be fixed in a realistic manner, rather than as an apportionment of the profit element expected on the capital outlay. In addition, as stated above, such a rental arrangement that is more correlated to the nature of the asset rather than merely to the capital, would enhance the equity aspect of the relationship greatly.

3. DECREASING PARTNERSHIP FOR FINANCING VENTURES

Some contemporary scholars hold decreasing partnership the best suited structure for all types of project financing in the modern context.[18] The structure as validated by contemporary scholars could be effectively utilised in financing MMEs, with distinct advantages for both the financier and the entrepreneur. In addition to the prospect of sharing in unlimited profits due to all profits being divided proportionately, if the venture becomes successful, the bank could expect to earn a sizable profit through the sale of its share to the client, as the price for such sales would be based on market value. Being a co-partner who is able to contribute towards the venture, the bank may also consider specialised services it may carry out towards the project, and where worthwhile, hire staff and expertise necessary for the purpose. Thus, major advantages to the bank lie in the possibility

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[15] See Frank E Vogel and Samuel L Hayes III, Islamic Law and Finance, p. 126-128. Discussing some examples, the authors maintain that acknowledging future promises as binding risks subverting a basic principle of the Islamic contractual scheme as it has been known upto now, and that this risk persists even if the promise is seen as merely unilateral or is enforced only by damages awards.

[16] Abd al-Sattār Abū Ghuddah, p. 26.

[17] First Conference of Islamic banking held in Dubai, May 1979, Resolution on decreasing partnership structure, in Dubai Islamic Bank, *Fatāwā Shar'iyyah fī al-A'māl al-Masrafiyyah*, p. 21.

[18] Abd al-Sattār Abū Ghuddah, p. 24.

of contributing effectively in the management of the venture and monitoring its progress as enabled by the joint equity participation, as well as the ability to carry out a smooth withdrawal while making a gain through both dividends and the sale of its share to the client partner. The MME could benefit through the profit / loss sharing structure that facilitates enhancing the capital base and the cash position without placing an undue burden on the enterprise in the form of interest payments, the expertise and supervision extended by the bank, and the possibility of gradually redeeming total ownership by purchasing the bank's share through profits realised.

3.1. Mechanism

The basic ingredients of the decreasing partnership structures advocated by contemporary scholars for financing ventures, for the most part, are found to be similar to those for asset financing. The mechanism here involves joint investment by the bank and the client towards a venture, the share of the bank in which would be later purchased by the client in stages, until the client becomes the sole owner of the project. Although similar in these fundamental ingredients, decreasing partnership for ventures embodies several major differences. Among these is the identity of the partnership, which, as explained before, is based on *shirkah al-'aqd*. As a result, rules pertaining to *shirkah al-'aqd* would become applicable in such ventures. Division of profits realised through the venture could be agreed to take place on a proportion other than that of ownership, based on the position of the Hanafi and Hanbali schools.[19] However, loss would necessarily be divided on the ratio of ownership. In addition, the share of the bank could be sold to the client at a price negotiated by them at the point of sale, if necessary based on a valuation of the business done by a party chosen mutually. Prior agreement regarding the price of the bank's share or indicating the price payable in a promise to purchase / sell provided by either of them is not admissible, in order to avoid guaranteeing the capital of the other party to that extent. Within this broad framework, diverse formats have been proposed by contemporary scholars.[20] Through these structures, financing for a large variety of MMEs of different types and durations could be facilitated.

3.2. Major Sharīʿah Issues

While, some of the Sharīʿah issues outlined above under asset financing are also applicable to structures for financing ventures, certain additional issues more pertinent to the latter are delineated hereunder. It could be seen the all of these issues are greatly relevant to financing MMEs, and being aspects that are reflective of equity participation, could play an important role in boosting their success.

[19] Al-Kāsānī, *Badā'i' al-Sanā'i'*, vol. 6, p. 94, Ibn Qudāmah, *al-Mughni*, vol. 5, p. 140.
[20] See note under asset financing for references.

Although decreasing partnership for ventures involves inception of a partnership for generating income, some scholars have pointed out certain instances where such partnership could be established based on shirkah al-milk. These pertain to joint purchase of assets that provide an income such as purchase of buildings, machinery or vehicles for lease or hire. In such instances, decreasing partnership could be based on shirkah al-milk.[21] As such, the division of revenue should be on the proportion of ownership. Therefore, when the proportion of ownership becomes altered upon the MME partner purchasing a part of the bank's share, the ratio or profit division too would change accordingly. With the gradual decline of the bank's stake in the MME, its profit share too would be subject to reduction.

The profit sharing ratio for division of final profits would be agreed at the inception. Some contemporary scholars allow the partners to agree on a ratio different from that of capital participation, which could remain static throughout the tenure of partnership or be pre-agreed to vary at stipulated intervals, based on the client's purchase of the bank share or otherwise. Along with such agreement, they could arrive at an understanding on the amount of profit that should be set aside from the client's share of profits for purchasing the bank's share in the enterprise. Either the whole of the client's share of profits or a specific portion at every profit division would be agreed to be set aside. AAOIFI Shari'a Standards suggests that the client could promise to set aside a portion of the profit of the return he may earn from the partnership for this purpose.[22]

Mobilising the funds and investment will be undertaken jointly by the bank and the MME client. Where the bank does not have the expertise or capability of undertaking its share of management and other duties, the client may be entrusted with representing the bank in operating the project. However, the bank would be entitled to monitor the progress of the enterprise as well as taking an active role in auditing financial and other aspects. It may reserve for itself such tasks as receipt of income through the venture and managing finances. All income through the venture would be credited to the common funds of the venture, and a partner would not be given exclusive rights to any income. Expenses would be undertaken from the joint capital, i.e. common funds of the enterprise, so that a partner is not obliged with bearing them to the exclusion of the other.

After the commencement of the enterprise, the client could start to purchase the share of the bank in units, based on a price negotiated at that time or professional valuation, as agreed. The price for the bank's share would depend to a great extent on the performance of the enterprise at the points of time its units are purchased by the client. Purchase of shares could be agreed to commence when the project

[21] Muhammad Taqi Usmani, An Introduction to Islamic Finance, p. 90.
[22] AAOIFI, Sharīʿah Standards May 2002, p. 215.

becomes functional and starts generating revenue. When all the units of the bank's share have been completely purchased by the MME partner, he becomes the sole owner of the venture, and would be entitled to all revenue generated. All functions carried out by the bank for the venture will be transferred to the client, and any existent mortgage in favour of the bank will be cancelled at the exit of the bank from the partnership.

3.3. Observations on Decreasing Participation for Ventures

Observations made earlier on the decreasing partnership structure for asset purchases would, in a number of instances, be applicable to structures for financing ventures as well.[23] Some additional aspects are explored hereunder.

Issues pertaining to promise to purchase / sell

Similar to asset financing, an important aspect relevant to MMEs in structures for venture financing is the promise extended by the bank or the client regarding the sale of the bank's share in units. AAOIFI Sharīʿah Standards rules that a binding promise could be given by one partner, which entitles the other partner to acquire his equity share gradually.[24] This implies that the promise is made by the bank. In a number of formats adopted, the client's portion of the profits is retained, either partly or in full, in order to facilitate the purchase of units. With regard to MMEs, it appears that such purchase could largely depend on the profitability of the enterprise. If the enterprise has not been able to generate sufficient profits, the client may not be able to purchase as agreed. In this event, if the promise to purchase had been extended by him, it is important to resolve whether the client could be required to purchase using his personal funds. It appears that if the legally binding promise had stipulated the intervals at which the client is bound to purchase, he may be required to adhere to the schedule in spite of the performance of the venture. However, as pointed out earlier[25], since the legal enforceability of the promise could usually materialise only in the form of liquidating the mortgage, it is improbable that this measure would be resorted to except at the end of the tenure. Similarly, the bank's commitment to sell also could be important. This is because, in a situation where the client offer to purchase a unit when the enterprise is generating low profits and is valued low, if it is expected to give higher levels of income in the near future, in spite of the client's offer, the bank could be induced to put off the sale until the value of the business rises. On the other hand, if the bank had provided a promise to sell, the client could offer to purchase when the value of

[23] See 'major Sharīʿah issues relevant to decreasing partnership' and 'suggestions for enhancement' above.
[24] AAOIFI, Sharīʿah Standards May 2002, p. 214.
[25] See 'major Sharīʿah issues relevant to decreasing partnership' above.

the business is at its lowest or when the business is undergoing a spell of losses, which the bank would still be bound to honour.

Possibly as a response to such issues, some contemporary scholars have put forth the novel suggestion that the sale of the bank's share may take place based on mutually binding promises made by both the bank and the client. [26] This is based on the argument that a binding mutual promise to sell and purchase in the future, although similar to a future sale as far as the outcome is concerned, is essentially different from the latter. Thus, a mutual promise for the purpose may not be ruled prohibited per se. Consequently, this suggestion considers that although mutual promise is objectionable in the context of *murābaḥah*, it may be allowed in decreasing partnership.[27] Accordingly, the bank and the client could execute mutual promises regarding the sale of the bank's share, and depending on the terms of the promises, when an offer is made by one party, the other would be bound to accept it. Therefore, although the price of the units are left to be determined based on valuation or mutual agreement at the point of sale, the ownership change according to the agreed schedule and terms would be certain for all intents and purposes, thus providing some assurance of the nature and extent of the bank's involvement prior to embarking on the project.

In a different approach to the above issues, some scholars appear to have indicated that, although prior determination of the price of units is unacceptable in decreasing partnership for ventures, this would be the case only where the sale is envisaged to take place between the bank and the client only. If the bank had reserved the right to sell its share either to the client or to another party at its discretion, thus leaving the possibility of transaction open ended, in this event, a price could be fixed at the outset for its sale to the client without objection.[28] Accordingly, due to the sale not being arranged to take place exclusively between the bank and the client, it seems that the client's promise to purchase could spell out the intended price. This is not construed as a guarantee of the bank's capital.

However, in view of the conventional banking theory dominating the practice of Islamic banking currently, it appears prudent that all possibility of a prior fixing of

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[26] ʿAbd al-Sattār Abū Ghuddah, vol. 24, p. 298.

[27] Imām al-Shāfiʿi has ascribed the necessity for choice in such unilateral or mutual promises to the possibility of the promise becoming a sale of what is not owned by the seller or a contingent sale, such as in a promise to purchase on *murābaḥah*. See Muhammad ibn Idrīs al-Shāfiʿi, *al-Umm*, Bayrūt, Dar al-Maʿrifah, 1393H, vol. 3, p. 39. The Islamic Fiqh Academy, in its resolution on discharging promise and *murābaḥah*, has referred to the first reason. See Islamic Fiqh Academy, resolution No. 40, 41, (2/5 & 3/5), 5th Session held in Kuwait in December 1988.

[28] Muhammad Taqi Usmani, An Introduction to Islamic Finance, p. 92. There remains some ambiguity on this issue, as the promise here is offered by the client.

the sale price be curtailed, and the promise, as mentioned above in the context of decreasing partnership for asset purchases, not be held legally binding.[29] Through this measure, the sale of units taking place with the choice of the parties at a price suitable to both of them could be ensured. Thus, the spirit of equity participation could be retained in the decreasing partnership arrangement, disallowing any compulsion on either party to sell his share to the other or to purchase the other's share except on the basis of free will at the time of such transaction. With regard to MMEs that operate amidst various financial constraints, such freedom in deciding the time of purchase could be crucial in managing the finances of the enterprise. A business enterprise being a prospect naturally subject to various phases and ups and downs, inflexible restrictions pertaining to the price or time of sale could lead to a violation of the rights of either party, as well as being alien to the basic concept of equity partnership based on sharing of gains and losses. Although the parties could have an understanding or even proffer promises that are of a non-binding nature on how unit sales should take place, they would be allowed complete choice on the issue at the time of carrying out the transaction, based on the prevailing state of affairs. While ensuring participation in the venture with an enhanced sense of responsibility and entrepreneurship on the part of both the bank and the client, this method would effectively remove any resemblance to interest based financing.

Regarding the prospect that if the promise not be held binding, in the event the client refuses to purchase the bank's share, the bank would be burdened with prolonged participation in a venture that may not be performing up to expectations thus affecting its liquidity, a closer analysis could reveal this apprehension to be groundless. According to all schools of Islamic law, the partners in *shirkah al-ʿaqd* are entitled to terminate the partnership at any stage.[30] Thus, unless if the parties had altered this default provision through agreeing on any other terms at the inception[31], the right to liquidate the partnership thereby recovering whatever that is possible to be recovered is available to every partner. This has been provided precisely in order to prevent any party being compelled to continue involvement in a venture against his will, and appears especially suitable with regard to MMEs.

[29] It was noted above that an early resolution on the subject called for complete choice to both partners in the sale of their shares. (First Conference of Islamic banking held in Dubai, May 1979, Resolution on decreasing partnership structure, in Dubai Islamic Bank, *Fatāwā Sharʿiyyah fī al-Aʿmāl al-Masrafiyyah*, p. 21.) See section above on allowing client the option to purchase or continue lease.

[30] Abu Zakariyya Al-Nawawi, *Rawdah al-Tālibīn*, Bayrūt, Dar al-Kutub al-Ilmiyyah, n.d., vol. 4, p. 515, Ibn ʿĀbidīn, *Radd al-Muhtār*, vol. 4, p. 328, Abu Bakr al-Sarkhasi, *al-Mabsūt*, Bayrūt, Dar al-Maʿrifah, 1406H, vol. 16, p. 194, Ibn Rushd al-Qurtubi, *Bidāyah al-Mujtahid*, al-Qāhirah, Maktabah al-Kulliyyāt al-Azhariyyah, 1969, vol. 2, p. 277, Ibn Qudāmah, *al-Mughni*, vol. 5, p. 133.

[31] To prevent the secession of a partner resulting in the termination of the *mushārakah*, some agreements stipulate that a partner who wishes to resign should do so through selling his share to the remaining partners.

Therefore, if the MME partner refuses to purchase the bank's share on favourable terms, the latter could resort to the ultimate measure of liquidating the venture, so that the parties could exit from the partnership dividing the assets equitably among them. It could be observed that, if this right is maintained unaltered in decreasing partnership in ventures, the need for a legally binding promise or prior fixing of the price in order to sell one's share on reasonable terms could be dispensed with to a great extent.

Participation of the bank in the enterprise

Contrary to a conventional bank, the Islamic bank need not restrict its involvement in the enterprise to that of a financier, except in *muḍārabah*-financed projects. Even in the latter, the bank may appoint its staff in a monitoring capacity, without executive power.[32] In *mushārakah*, as an equity partner entitled to play an active role in management, decision-making and operations, the bank may fully participate in and contribute towards the successful performance of the enterprise. In larger projects, it may assign staff of its own solely working for the enterprise providing various services. By calling on its market awareness, business connections, management expertise etc, the bank may become vigorously involved, progressively eliminating the inherited identity as a lending institution, to that of a commercial associate indispensable for the successful operation of the project, worthy of a sizable share of profits. With regard to MMEs, such effective participation may lead to twin-fold benefit: it will enable the bank to monitor the performance of the venture in a factual and up-to-date manner, rather than depend on information provided by the client partner; in addition, the bank may take timely action in preventing unhealthy developments and avoiding complications inexperienced MMEs may encounter. An area banks may provide an invaluable service to budding MMEs is that of financial management. It is known that a significant percentage of MMEs fail during the early period itself due to incompetence in managing their finances and lack of adequate planning. An Islamic bank coming as a business partner with reserves of expertise in these fields could reduce such avoidable failures greatly, and help enhance the success rate of its clients, also gaining credence for itself in the process.

[32] Al-Māwardi has narrated two positions regarding appointing such an overseer, one of which indicates permissibility. (Abu al-Hasan al-Māwardi, *al-Hāwi al-Kabīr*, Bayrūt, Dar al-Kutub al-Ilmiyyah, 1999, vol. 7, p. 312) However, when the overseer appointed by the investor is expressly precluded from any executive role, there does not seem to be any reason for impermissibility.

ISLAMIC MICRO-FINANCE PRACTICE WITH A PARTICULAR REFERENCE TO FINANCING ENTREPRENEURS THROUGH EQUITY PARTICIPATION CONTRACTS IN SUDANESE BANKS

GAFFAR ABDALLA AHMED

ABSTRACT

The paper evaluates the performance of Islamic entrepreneurship projects financed through the banking system in Sudan. Also it investigates the SMEs to identify the obstacles and factors influencing decision making. The initial results indicate that the need of long term SMEs finance involves a major dilemma facing Sudanese Islamic banks. A fair geographical distribution of banking facilities is needed to serve socio-economic development, particularly in rural areas. The study recommended the use of group lending concept in financing mushārakah to small and micro businesses in order to reduce the administrative burden on the bank staff and at the same time provide alternative security against possible default. In addition, a fair and proper measure of the management role in the profit generation should be reflected in the management share of profit. Also, a condition may be included in the contract which prohibits the bank either from interference with the management affairs or disclosure of any information about the business to any person without prior permission of the entrepreneur.

1. INTRODUCTION

Most of the difficulties in obtaining finance for small entrepreneurs from banks and financial institutions are related to transaction costs, the cost of administering and delivering of credit and the cost arising from the risk of default. That is why bankers consider small and medium enterprises (SMEs) as risky clients, and do not keep proper records or meet conventional security requirements, and hence they are not bankable. The matter is getting more complicated when financed by an Islamic bank which follows profit and loss (PLS) theory and the profits are not granted. The lack of PLS modes of finance performance, because of managerial efficiency especially in financing SMEs, can be considerable and may threaten the existence of Islamic banking, which is already facing strong competition. To shed light on the Islamic finance techniques and practice in financing SMEs through equity participation formula, this paper makes an empirical study of using equity participation formula in the Sudanese banking industry.

When applying *mushārakah* to wide range of micro enterprises in the informal sector several practical limitations and hazards are expected. When the entrepreneur makes some observation not shared with the bank (and bases his actions on that observation), the bank cannot determine whether the entrepreneur has used his information in the way that best serves the bank's interest, therefore, moral hazard arises. The rest of this paper is organized as follows: section two will provide a brief theoretical framework of the equity participation finance scheme through the banking system. The methodology and data collection process is reviewed briefly in section three. While section four examines SMEs characteristics, section five will discuss the findings and will examine the results of the empirical study. The conclusion will be presented in section six.

2. EQUITY PARTICIPATION FORMULA

2.1. Definition

In the context of business and trade the equity participation formula means a joint enterprise in which all the partners share the profit or loss of the joint venture (Usmani, 2002). *Mushārakah (or Sharāka*) is the equivalent Arabic term for this formula. *Sharāka* in terms of Islamic banking can be defined as a "form of partnership where two or more persons (one of them is a bank) combine their capital and labour together, to share the profits, enjoying similar rights and liabilities" (Usmani, 1999).

2.2. Distribution of Profit and Loss

If a favourable return occurred, the net return will be distributed to both parties according to the contract, this will mean that the proportion of the distributed profit between the partners must be predetermined and agreed upon at the time of signing the contract. It is worth mentioning that it is allowed to agree upon distribution proportion different than the proportion of the capital contribution.

The ratio of profit for each partner must be determined in proportion to the actual profit accrued to the business, and not in proportion to the capital invested by him. It is not allowed to fix an amount in a lump sum for any one of the partners, or any rate of profit tied up with his investment (Ibrahim, 1997).

In addition to that, the contract, if a favourable return occurred, will specify the percentage of distributed profit as an exchange of management and the percentage of distributed profit as a capital price. To illustrate, if we refer to identify the total net profit by *P,* and the capital of both the bank and the entrepreneur partner by *cb* and *ce* respectively which if combined together will give you the total capital of *mushārakah* projects *(L).* Then we will have $P = Pm + Pc$, as Pm represents the profits as exchange of capital management and Pc represents the profits as exchange of capital (Ibrahim, 2004). Every one of these amounts will be distributed according to the agreed share. The contract, as mentioned, will specify the percentages of the distribution denoted to the capital share, supposedly it is *Rbc%* for the bank then the entrepreneur will have to have *(100 - Rbc)%* which represents the entrepreneur 's profit (*Rec%*). Like wise the distribution denoted to the management will be *Rbm%* for the bank and *(100 – Rbm)%* which represents the entrepreneur share of profits denoted for management *(Rcm%).* Accordingly, we recognise these equations (Ibrahim, 2004).

$$Pec = Pc \times (100 - Rbc)\%$$
$$Pem = Pm \times (100 - Rbm)\%$$

In which *pec* represents the share of the entrepreneur on the profit denoted to the capital, and *pem* represents the share of the entrepreneur on the profit denoted to the management. Therefore the total profit distributed for the entrepreneur *(Pe)* will be

$$Pe = \{ Pc \times (1\text{-}Rbc)\} + \{Pm \times (1\text{-}Rbm)\}$$

This distribution can be done in another way when the agreement refers the profit devoted to management for both parties to the total net profit. In such case we will have the total net profit 100% distributed to four collections as a per cent of the 100% as follows

$$P = Pbc + Pec + Pbm + Pem$$
$$Rbc + Rbm + Rec + Rem = 100\%$$

In which Rbc and Rbm represent the percent of the profit distributed to the bank as a share in the capital and management respectively, while Rec and Rem represent the percent of the profit distributed to the entrepreneur as a share in the capital and management respectively. The losses from another hand, however, have to be distributed according to the capital contribution. In other words, losses are distributed according to the investment shares even if it is different that the profit distribution (Ibrahim, 1997). Therefore,

$$Le = (ce/C) \times L$$

Where le represents the entrepreneur's share of loss, *ce* represents the entrepreneur capital, *C* represents the total capital of the entrepreneurship, and *L* represents the total loss.

2.3. Intangible Guarantee Concept

The profits produced in *mushārakah* is not guaranteed, as a result, the entrepreneur does not assure, secure or guarantee profits. Fundamentally, no collateral is needed. Therefore, *mushārakah* does not require strict collateral guarantees and does not leave the partner (entrepreneur) with a heavy burden of debts, post-dated cheques or any other kind of obligations compared with debt finance in the conventional system. For this reason, concentration should be on factors like the feasibility of the project, skills of the customer and his history and lastly the objective situation of the market and its risks. Taking the personal features of the customer as a part of the factors can be considered as an intangible guarantee. No doubts, such thing is increasing risks from a hand and promoting a new service from another hand. To illustrate, by taking intangible assets, such as education, skills, and experience, as collateral as tangible assets, Islamic banking breaks this discriminative barrier and offers an equal opportunity to all potential producers to improve their well-being and that of the society. Simultaneously, these banks will have to share any unfavourable return, if any, with its customers.

2.4. Types of Islamic Equity Participation Finance

The partnership financing can be categorized according to the duration of the project or and the nature of the project partnership financing can be categorized according to the nature of the project. According to the duration of the project it can be classified to short, medium and long term *mushārakah*. According to the nature of the project, it can be classified to impermanent, permanent and diminishing *mushārakah.*

While in the permanent continuous *mushārakah*, the partnership supposes to exist for ever and the shareholder might be looking for both or either the capital gain or the profit, in the impermanent partnership finishes in specific period mentioned in the contract or defined by the purpose of the project or by finishing a single transaction. In the impermanent partnership, the shareholders mainly look for the profitability. A diminishing partnership is one wherein the bank's share in the partnership diminishes gradually through repayment, leaving the venture/Asset/or the project to be wholly owned by the client.

Mushārakah can be for either an indefinite period, as it is in the case of the stock of the joint stock companies, or a definite (short, medium or long) period as it is in the case of participation finance through *mushārakah* when it is for specific period or shares in partnerships when profit is not only the capital gain targeted (EI-Bhasri and Adam, 1997). A short-term financing is usually for financing of working capital for one production period, season, fiscal year, or even a certain operation which involves production period ranging between three and 12 months' duration (Al-Harran, 1997). The long-term financing covers the financing of capital assets extending over a period of more than one year.

Impermanent *mushārakah* agreement is normally for one specific purpose, such as the purchase and sale of a machine or a commodity or for specific period of time (Usmani, 2002). Most of the impermanent normal *mushārakah* is unusually used for commercial purpose. The impermanent can be divided to financing a single transaction, financing and working capital. Impermanent normal *mushārakah* partnership financing can be either for financing of a single transaction, financing of working capital or sharing in the gross profit only**.**

In financing a single transaction, *mushārakah* can be employed as an example for fulfilling the day-to-day needs of small traders and financing imports and exports. To illustrate, the exporter (the entrepreneur) will have a specific order from abroad in which the price of the exported goods will be sold well before hand. Since the exporter doesn’t have the ability to finance the whole transaction alone or does not want to, he might apply for *mushārakah* finance. The bank can easily calculate the expected profit and if decided to take it further, both of them will share the amount of export bill on a pre-agreed percentage as well as sharing the profit according to the predetermined percentages ratios and sharing the loss according to their share of the capital (Usmani, 1999).

In financing of working capital, the entrepreneur would have an asset by which he can make revenue but he does not have the ability to finance the working capital. So he seeks this needed finance from the bank in the base of sharing the production brought out from this project according to their contribution. The assets will be hired for a suitable period. The depreciation of the asset for the whole *mushārakah* period will be calculated, and added to capital share of the partner (Usmani, 2002). The profit can be determined before all the assets of the business are liquidated, in case the working partner has purchased the share of the financier in the assets of his business, and the price of his share can be determined on the basis of valuation, keeping in view the ratio of the profit allocated for him according to the terms of the *mushārakah* (Usmani, 1999).

Decreasing participation or diminishing *mushārakah* is defined as a partnership whereby the bank enables the partner to gain ownership of the project gradually, according to the conditions set out in the *mushārakah* contract. This contract will gradually lead to the entrepreneur’s ownership of the asset which was the subject of *mushārakah* project solely as he will buy the banks shares until he becomes the sole owner of the asset. Clients of this form of *mushārakah* are those who are not interested in the bank's continued co-participation in their projects and who wish to gain ownership of the project in the shortest possible time. The financier (the bank) makes binding promise to sell its ownership shares of the enterprise on installments (Boualem and Khan, 1995).

Mushārakah can also be adopted for continuing businesses. The partners agree on the share of the profits to be allocated to the entrepreneur for his management, and the balance is shared in the same proportion as their respective investments. The entrepreneur also agrees to buy out the banking partner over an agreed period, by paying a certain percentage of the original investment each year, and the banker receives a smaller proportion of the profits each year, as his share decreases (Harper, 1994).

3. METHODOLOGY AND DATA COLLECTION

The main objective of this study is to investigate the implications of using *mushārakah* mode of finance by the Islamic banks in Sudan and to provide an empirical assessment of the *mushārakah* projects performance and its obstacles. The significance of this study stems from the fact that despite the apparent success of Islamic financial institutions in many corners of the world, many governments are reluctant to endorse a wide scale shift towards Islamic entrepreneurship micro-finance. The moral hazard and limited knowledge about the wider economic effects of PLS method of the Islamic finance is one of the reasons behind such reluctance. The study hopes to contribute to a better understanding among researchers and policy-makers as to the likely implications of *equity participation* of Islamic micro-finance.

The data from Sudan, which fully adhere to interest-free principles of finance, will be used to answer our questions. Part of the data source used in this paper is the Sudanese banks balance sheets and annual reports, which provides bank level data for all Sudanese banks for the period 1990-2005. Initially some descriptive analysis is provided. The concentration of *mushārakah* in the Sudanese Islamic banks each year is provided. The second part of the data is a survey data collected from entrepreneurs who have been financed through equity participation formula mainly in Khartoum[1]. The survey questions are of nominal and ordinal data. Therefore non-parametric procedures are best suited to this data. A total of 150 of entrepreneurs were randomly being sampled. The methods of investigation are analytical and descriptive. Although the sample represents the Khartoum province, the results of the survey are generally applicable to the rest of the urban areas and around the country, based on the fact that the Sudanese society is homogeneous, and any segment of the population should be a fairly accurate representation of the population as a whole. Nevertheless this study doesn't claim that the sample is a representation of all equity participation projects outside Sudan.

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[1] A breakdown of the finance banks will be shown.

4. EQUITY PARTICIPATION PROFILE

4.1. Structure of the Sudanese Banking Sector

The Sudanese banks are very small by international standards the paid capital together with the reserves of the Sudanese banking industry in a whole at the end of 2005 was 183862 million Sudanese Dinar SD ($750 million) with an increase of 27% compared with the year before (BOS, 1990-2005). The deposits for the entire banking system was SD 977595 million ($3910 million) in 2005 with an increase of more than half compared with 2004. While the credit capacity used in 2005 was 700018 million SD ($2800 million). The total asset of the Sudanese banks is SD 1530310 million ($ 6121 million). The share of the lending capacity over the total sources in 2004 was 71%, while the share of the capital and reserves and profit are 26% and 3% respectively (BOS, 1990-2005).

Table 1 Structure of the sudanese banking industry 1990-2005

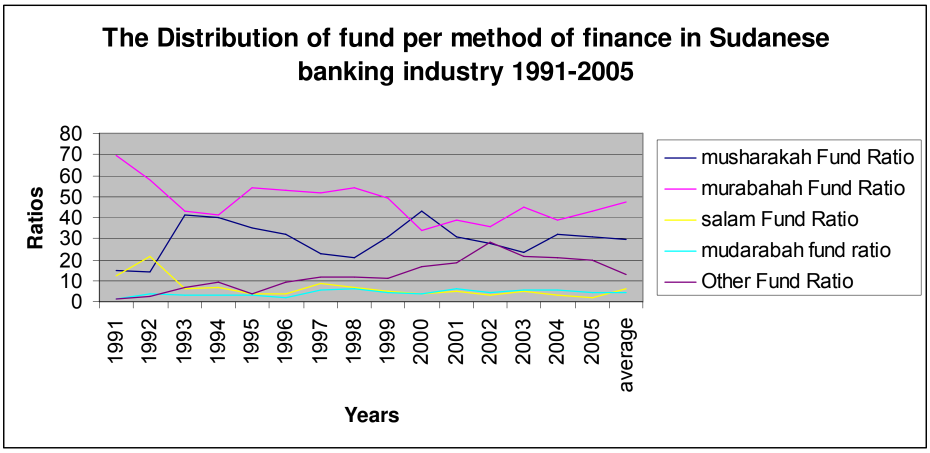
	Total number of banks	State-owned banks	Joint banks Foreign + Local capital	Joint banks Government+ private capital	Foreign banks	Specialized banks	Investment banks
1990	28	5	10	2	6	4	1
1991	28	5	10	2	6	4	1
1992	29	4	10	4	6	4	1
1993	29	4	11	5	4	4	1
1994	28	4	11	5	4	3	1
1995	27	2	11	6	4	3	1
1996	27	2	11	6	4	3	1
1997	27	2	11	6	4	3	1
1998	27	2	11	6	3	3	2
1999	26	2	11	5	3	3	2
2000	25	2	11	5	3	3	1
2001	26	2	8	9	3	3	1
2002	26	2	9	8	3	3	1
2003	26	2	9	9	3	2	1
2004	26	2	9	8	3	3	1
2005	29	2	10	10	4	2	1

The institutional structure of the banking sector was stable in the 1990s. Table No 1 shows that the total number of banks was in the range of 25-29 in this period where two insolvent banks have been liquidated, three (public) banks have been merged into Khartoum Bank to form the largest bank in Sudan, and in 1993 the merger of *El- Neilein* Bank and the Industrial Development Bank created the second largest bank. The *El-Neilein* bank itself has been sold in 2006. In fact the period after 2000 witnessed the sale of those three governmental banks. Currently, the Sudanese banking system consists of one investment banks, one specialized bank, and 27 commercial banks (4 foreign, 2 state-owned, and 21 jointly owned banks). As in several developing countries, the Sudanese financial sector is dominated by a few banks. For instance, the largest two banks (*Omdurman* Bank and Bank of Khartoum) are government-owned banks with a 25 percent market share. Those two banks hold about 40 percent of the total banking deposits (Kireyev, 2001).

4.2. Distribution of Funds per Method of Finance in Sudanese Banks

Figure 1 shows the total funds distribution among Islamic finance methods namely, *mushārakah*, *murābaḥah*, *salam, muḍārabah* and other methods between 1990 and 2005. The figure shows that the Sudanese banks prefer *murābaḥah* over other types of Islamic modes of finance. According to this figure *murābaḥah* had the biggest share of the fund with an average of 47.3% from the overall funds. *Mushārakah* is also a popular form of finance among Sudanese banks with an average share of 29.3 percent of total finance.

Figure 1 Finance by modes of finance



Source Bank of Sudan (Bank of Sudan, 1990-2005)

Due to the increase in non-performing loans in agriculture, banking finance through *salam* contracts declined from 22 percent of total banking finance in 1992 to 2 percent in 2005. Other modes of finance constitute a small fraction of total finance. Remarkably, the *muḍārabah* has never been more than marginal importance (Stiansen, 2004). From the other hand there are many reasons why *muḍārabah* does not play as large part as *mushārakah*. One of them is because *muḍārabah* in Sudan works mainly on trade. *Mudarabah* application is confined only to a small number of well- trusted clients with a good track record, usually well known to the financiers.

Salam, *muḍārabah* and other methods achieved on average 6.5%, 4% and 13% respectively. In general, we can notice that there is a gradual increase for *mushārakah* fund as it started with 15% in 1990 and increased to 32% in 2004 compared with a gradual decrease for *murābaḥah* which started with 70% in 1990 and ended by 38% in 2004. In fact in 2000, *mushārakah* reaches the peak by holding the largest amount of 43% compared 33% for *murābaḥah*.

It must be noted that whilst all of Islamic finance banks and banking operations, all over the world, have been dominated by the non-PLS modes and the share of *mushārakah* and *muḍārabah* is very low. In Sudan, the story is different, as a great increase happened to the PLS share. The share of partnership modes of financing in Sudan, although not satisfactory, are, nevertheless, better than the general trends of Islamic banking over the world in which these formulae constitute less one-fourth of the asset portfolio of the world-wide Islamic banks (Ibrahim, 2006). Yousef (1996) has cited that the mark-up techniques shared around 51-60 per cent for Iranian banks and more than that in Pakistan, which like Sudan applies full Islamization of the banking system. However, because the use of *muḍārabah* in Iran is bigger, the combination of *muḍārabah* and *mushārakah* in both countries Sudan and Iran are almost equal. Yousef added that the share is in the range of 83-90 per cent for banks in the mixed financial sectors in other countries (Yousef, 1996).

The relative proportions of these different types of Islamic assets will, of course, have implications for a bank's medium and longer term liquidity. The asset structure also has implications for income, with higher income associated with *mushārakah* than *murābaḥah*. The asset structure and composition will also have consequences for bank risk. If problems arise with *muḍārabah* these will have to be sorted out in a relatively short period or else the asset will be written off. Non-performing assets based on *mushārakah* may cause problems for years, and there will be much less pressure to make provisions until the date of maturity of the assets approaches. This, however, means that problems may accumulate ultimately threatening the financial viability of the Islamic bank itself unless appropriate action is taken.

Profit and loss (PLS) modes conform to the real Islamic system of finance which stands contrary to the interest-bearing traditional banking system. They are, nevertheless, not free from application complications.

Al-Harran (1993) identified that risk, difficult nature of investment and long-gestation period in receiving returns and problems of management are the major reasons why Sudanese Islamic banks (ISBs) do not undertake equity financing modes. PLS modes require adequate experience in management, additional supervisory and monitoring roles compared with sales-based modes which are relatively less risky and easy to manage. Moreover, PLS modes are subject to erosion of investment in the case of a loss that is why ISBs are hesitant to undertake them at the initial phases of their operations. Instead they use mostly debt-based Salam and *murābaḥah* instruments which shift most of the risk to the client. The bank of Sudan Annual Report of 2001 admitted that the substantial use of *murābaḥah* mode of finance in the Sudanese banking system is due to the simplicity of this mode and the people's preference (Bank of Sudan, 2001). Choudhury (2001) believe that reason that the PLS is not feasible for funding short-term projects is due to the ensuing high degree of risk (i.e., the time diversification effect of equity). This makes Islamic banks and other financial institutions rely on some other debt-like modes, especially mark-up, to ensure a certain degree of liquidity. This is again not the case of Sudan as most of *mushārakah* finance is a short-term finance. Choudhury, further added, the restrictive role of shareholders (investors) in management and, hence, the dichotomous financial structure of PLS contracts make them non-participatory in nature, which allows a sleeping partnership. In this way, they are not sharing contracts in a true sense; the transacting parties share financial resources without participatory decision-making.

Dar and Presley (2000) believes that the reason behind the lack of PLS modes in Islamic banking practice is because of the fact that PLS contracts are inherently vulnerable to agency problems, because entrepreneurs have disincentives to put in effort and have incentives to report less profit compared to the self-financing owner-manager. But if this is the case in Sudan, it should apply to both *mushārakah* and *muḍārabah*. However, in Sudanese banks as we have seen, this is the not case. Sudanese banks rely on the use of *mushārakah* but not *muḍārabah*. Further Dar and Presley added the an imbalance between management and control rights is attributed as a major cause of lack of Profit Loss Sharing (PLS) in the practice of Islamic finance. Given this dichotomy, the agency problem gets accentuated, which may put the PLS at a disadvantage vis-à-vis other modes of financing. The reason of the *murābaḥah* preference is because of a trading technique, as it is an appropriate instrument, given that most of the finance provided by Islamic banks is directed to trade financing.

Ahmed (2005) believes that government pressure has been the major factor behind this shift towards more *mushārakah* finance. Two objectives have guided Government policy in this regard. One objective has been to reduce what de facto was the continuation of interest-based lending through widespread use of synthetic *murābaḥah* contracts. Another aim has been to increase long-term finance. Some bankers have expressed strong reservations about the Government's preference for the *mushārakah* contract, because they see this contract as much more risky than the *murābaḥah* that commonly can be secured against liquid assets (Stiansen, 2004).

To conclude, Islamic banks over the world have shown strong preference for modes of finance, which are less risky, namely the mark up device instead of upholding the fundamental principles of PLS. In Sudan, given that some fifteen years earlier *murābaḥah* contracts may have accounted for 70 pr cent or more of the total, this is an important change In the cumulative investment profile of the financial sector because *murābaḥah* contract are primarily used for short-term deals, while *mushārakah* contracts are better suited for long-term investments. Put differently, a *murābaḥah* contract is particularly well-suited to finance imports and exports, and the *mushārakah* is more a vehicle for equity finance (Stiansen, 2004).

4.3. Respondents' Profile

In this section we will provide information on the background and personal characteristics of the entrepreneurs of the *mushārakah* projects including sex, age, marital status, size of the family, education and history with banks. These characteristics are demonstrated in Table 1. The following could be noticed for these characteristics in table 2**:**

Gender: One can notice that the distribution of the respondents of male and female are uneven, as 97% of the respondents are male. Again and as we mentioned before about the employees of the banking industry, the area of male gender domination needs further study to understand the reasons behind it but this is out of the scope of this research. This may be due the nature of Muslim society where males are expected to carry out dealings with the banks. This may be due the nature of Muslim society where males are expected to carry out the responsibilities of their families and therefore they are expected to work more than the females.

Age: The majority about 83% of the respondents were less than 50 years old while 40% of them were less than 40 years old and only less than 3% were less than 30 years. This may indicate that more encouragement and efforts should be spent to promote finance for young partners which will lead to more development and more experience for the partners on the long run future.

Table 2 Respondents profile

Factor	Category	Frequency	Valid Percent
Sex	Male	146	97.3
	Female	4	2.7
	Total	150	100.0
Age (years)	20-30	4	2.7
	31-40	56	37.3
	41-50	65	43.3
	51 and above	25	16.7
	Total	150	100.0
Marital Status	Single	16	10.7
	Married	132	88.0
	Other	2	1.3
	Total	150	100.0
Size of the family	Less than 2	8	5.3
	2 – 4	47	31.3
	5 - 7	64	42.7
	Above 7	31	20.7
	Total	150	100.0
Education	No formal Education	1	.7
	Less than high secondary Certificate	8	5.3
	High secondary Certificate	33	22.0
	University Graduate	81	54.0
	Postgraduate	27	18.0
	Total	150	100.0
History with banks (years)	0 - 5 years	30	20.0
	6 - 10 years	30	20.0
	11 - 15 years	34	22.7
	16 - 20 years	29	19.3
	21 - 25 years	14	9.3
	26 years and above	13	8.7
	Total	150	100.0

Marital Status: The majority of the respondents approximately 90% were married which reflects the Sudanese culture which has a tendency towards encouraging early marriage.

Size of the family: More than 40% of the respondents were having a family size of 5 to 7 members and 31% having 2 to 4 members. This means a wide range of people were benefit from the finance. General speaking households are consisting of the house hold head, almost always a man, his wife, their children (2 or 3) and 2 or 3 relatives.

Education: In general, the respondents as a whole were well educated seeing that about 54% of them were holding a university degree at the undergraduate level. Moreover, 18% of them have had a postgraduate studies which will mean, when put together, about 3 quarters of the respondent (72%) of them have studied at one of the universities. This high level of education found in this sample shows the high degree to which entrepreneurs (partners) are informed about the different finance resources and methods and can deal easily and possess the skills to deal with banks as well as indicates the relatively high skills of management. This evidence is considered in the light of an overall illiteracy rate of about 60% in Sudan (The World Bank, 2005). From another hand, entrepreneurs with no informal education and with less than high secondary school certificate are less than 1% and 6% respectively while those who hold high secondary school certificate are 22% of the respondents. Therefore, it is possible to conclude that the dominant type of the entrepreneur s is well educated.

History with banks: One can notice that 60% of the respondents have more than 10 years dealing experience with banks and 80% of them have more than 5 years. Furthermore, approximately more than half of the respondents have between 10-25 years dealing with banks. We may add here that the majority have had witnessed the convert of the traditional and conventional banking system in Sudan to Islamic banking system which had commence on 1992. Thus, in a whole, most of the respondents have a good experience dealing with banks which emphasize, support and confirm the same results reached when looked to their educational level.

4.4. Banks Selection Criteria

Many studies have investigated the bank selection criteria or the reasons on the basis of which entrepreneurs choose to bank with specific banks. These studies have identified a number of such factors: convenience (i.e. the location), friends' recommendations, reputation of bank, availability of credit, competitive interest rates, friendliness of bank staff, service charges, adequate banking hours, availability of ATM, special services and the quality of services on checking accounts (Naser and Al-Khatib, 1999). The relative importance of these factors varies from one country to another depending upon the age, gender, income, marital status, occupation and cultural background of entrepreneur. For example, convenient location has been identified as a critical factor influencing the choice of a bank by entrepreneurs. This enables close supervision by the bank representatives, and easier contact on the part of the partner. It also facilitates the regular deposit of sales proceeds. The relative importance of these factors varies from one country to another depending upon the age, gender, income, marital status, occupation and cultural background of entrepreneur s as well as the type of bank. Some researches have proved that reputation, religious reasons and profitability were key factors in their choice of an Islamic bank (Naser and Al-Khatib, 1999).

Table 3 Banks selection criteria

Factor	Category	Frequency	Valid Percent
Name of the bank	Shamal Islamic Bank	30	20.0
	Tadamoun Islamic Bank	15	10.0
	Faisal Islamic Bank	20	13.3
	Sudanese Islamic Bank	18	12.0
	Omderman National Bank	20	13.3
	Saudi Sudanese Bank	13	8.7
	Bank of Khartoum	17	11.3
	Savings Bank	17	11.3
	Total	150	100.0

The respondents sampled, as shown in table No 3, represent all Sudanese banks, both governmental and non governmental (private), large and small scale, old and new, and specialized and non specialized (commercial) banks. The percentages revealed which banks the respondents have their *mushārakah* fund from. It is worth mentioning that the sample includes the same banks which have been collected from the employees' sample. Namely, three of these banks are governmental banks, notably *Omderman* National Banks, Savings Bank and Bank of Khartoum. These three banks are represented by 36% of the sample while the 64% representing the five private banks are *Shamal* Islamic Bank, Sudanese Islamic Bank, *Tadamoun* Islamic Bank, Faisal Islamic Bank and Saudi Sudanese Bank. Additionally, 16% of those respondents are working for a specialized bank, the Savings Bank, in contrast to the other seven banks which are commercial banks. The table, in addition, shows that, *Shamal* Islamic Bank the respondents were about 20%. Whereas for *Omderman* National Bank, Faisal Islamic Bank, Bank of Khartoum, Savings Bank and Sudanese Islamic Bank the respondents range from 11% to 14% have been a *mushārakah* entrepreneur for each bank, the rest of the respondents (less than 20%) are entrepreneur s for *Tadamoun* Islamic Bank (10%)

and Saudi Sudanese Bank (9%). Moreover, the largest two banks in Sudan are included in the sample namely *Omdurman* Bank and Bank of Khartoum with a 25 percent market share. Those two banks hold about 40 percent of the total banking deposits (Kireyev, 2001). The majority of the banks included in the sample are reported to be using an average of 47% of their funds to finance entrepreneur s using *mushārakah* for the period between 1993 and 1999 (Ahmed 2005).

We may conclude here, that the sample represents the entire population of the Sudanese banking industry and its components include governmental and non-governmental (private) banks, specialized and commercial banks, as well as large and small scale banks and older and relatively new banks.

5. FINDINGS

5.1. SME Characteristics

In this section we provide a simple profile of the SMEs financed through equity participation formula by the Sudanese banks, including business age, type of finance and processing of finance application. These characteristics are provided in Table 4.

5.2. Long Versus Short-Term Finance

The result of the chi-square goodness-of-fit test [2] indicates that there are differences between the averages of *mushārakah* projects' age. The dominant type of *mushārakah* is that which lasts for 3 to 6 months as reflected by 74% of the respondents. Actually the results come out from both entrepreneurs and employees almost the same. Additionally, the dominant type (96%) of *mushārakah* is the normal *mushārakah* which does not finish with ownership. Therefore, it is possible to conclude that the substantial number of entrepreneurs who had experience before in *mushārakah* and *murābaḥah* found in this sample indicates the high degree to which owners of small enterprises are well experienced in dealing with the banks as well as managing *mushārakah* and *murābaḥah* projects.

One might stop here to keep in mind that almost all the literature states that the PLS supports long term economic and financial development, especially *mushārakah* by financing long term productive projects. In reality, nearly all Islamic banks offer trade and project finance *murābaḥah*, commissioned manufacturing, or on leasing bases and thus PLS features marginally in the practice of Islamic banking and finance. Whatever the degree of success of individual

[2] The chi-square goodness-of-fit test, also referred to as the chi square test for a single sample, is a non-parametric test employed in a hypothesis testing situation involving a single with nominal and categorical data (Sheskin 1997).

Islamic banks, the majority have so far failed to adopt PLS-based modes of financing in their businesses. However, the Sudanese banking experience is different, having seen that they succeeded in offering PLS modes, namely here *mushārakah*. Yet, these offers are mainly for a short term period of 3 to 6 months.

We argue here that one of the major dilemmas facing the present Sudanese Islamic banks nowadays is the fact that these banks have to involve in long term finance according to its theory where these banks mobilize funds on the basis of short term deposits. Facing all the economical and political barriers confronting the country e.g. high inflation rate as external factors, as well as internal factors e.g. small size of the capital and lack of managerial efficiency, yet Sudanese Islamic bank have to involve in long term finance. The Islamic banks in many Muslim countries have occasionally used this partnership financing scheme for financing of the working capital of the enterprises for more than one year with considerable success.

Table 4 SMEs projects profile

Factor	Category	Frequency	Valid Percent
***Mushārakah* project age (How long do expect your business to last?)** Chi-Square 279.333 Asymp. Sig. .000	Less than 3 months	5	3.3
	3 - 6 months	111	74.0
	7 - 9 months	19	12.7
	10 - 12 months	13	8.7
	1 - 2 years	2	1.3
	Total	150	100.0
Kind of *mushārakah* Chi-Square 126.960 Asymp. Sig. .000	Normal *Mushārakah*	144	96.0
	Decreasing *Mushārakah* (finished with ownership)	6	4.0
	Total	150	100.0
Have you approached more than bank for funding your current project?	Yes	29	19.3
	No	121	80.7
	Total	150	100.0
If yes, why have they rejected you? Chi-Square 51.690 Asymp. Sig. .000	No fund available	24	82.8
	No sufficient guarantee has been provided	2	6.9
	Project involve high risk	2	6.9
	Other	1	3.4
	Total	29	100.0
	Not Applicable	121	
	Total	150	

Yousef (1996), showed some evidence indicating that Sudanese banks financing is rarely extended on a long-term basis: and short-term lending dominates overall ISBs distribution of finance during the period 1984-1992 was 75.4 per cent short term, 5.4 per cent medium term, 2.1 per cent long term and real estate financing shared 15.4 per cent. If ISBs are not able to generate long-term sizable deposits, they will not be able to extend long-term loans that are deemed necessary to achieve developmental goals. In fact most Sudanese Islamic fund go to short-term lending (more than 80 per cent) and to financing foreign trade. Less than one-third of the short-term credit goes to financing the working capital of industries.

5.3. Approaching More than One Bank for Funds

Most of the respondents have not approached any other bank than their current bank to finance their project as less than 20% of them have approached other banks for finance. Most of those who tried more than one bank (82%) have been rejected because of lack of fund or no fund was available in these banks' branches while few of them have been rejected because of the high risk of their projects or no sufficient guarantee has been provided.

5.4. Branch Geographical Distribution

As shown by Table No 5 there has been a dramatic increase in the number of branches in 1990s, by the end of 1997 the number of bank branches increased to 695, from 335 compared with 472 in 1990. By the end of 2005 the number of branches increased to (517). The soundness of the banking system is also broadly improving in the last few years, following the Bank of Sudan comprehensive banking policy, which includes structural and financial soundness reforms and deepening of banking technology and Islamization in the banking system (Ibrahim, 2006). The cost of establishing branches in the nineties was high relatively when compared with the eighties as the inflation rates went up. This made the cost higher for banks which mostly came in the above two decades to venture in branch banking and, therefore, enhance financial intermediation (Boualem and Khan, 1995).

The massive increase of the branches shows that Sudan's banking system had undergone visible changes may be in tune with the incessant changes in polities and economic and social policies. It is vital to know these institutional changes before dwelling on the real achievements of Sudanese banking industry.

Despite the prominent increase of the number of Sudanese banks and branches' in 1990s, SIBs are characterized by the regional inequality in the distribution of branches. It is clear that high concentration of branches is in commercial towns compared with and urban areas, in the middle including Khartoum, the capital, compared with other directions. From table No 5 it may be made clear that Central States in which 35 per cent of the population live and consider the most advanced States in terms of development projects, infrastructure, per capita income, and the standards of living (IMF, 2005), share around 50 per cent of the total banks in the country (Hassan and Hussein, 2003). Moreover, the pattern of distribution has been more or less the same for the last fifteen years or so. Another feature is the declining number of branches from over 700 in 1997 to only 533 branches in 2002. This distorted geographical distribution of banking facilities cannot serve socio-economic development, particularly in rural areas (Ibrahim, 2006).

Table 5 Number of banks and branches in every region

	Khartoum	Middle	East	North	West	South	Total No of branches	Total No of banks
1990	29	22	13	15	17	4	414	28
1991	30	21	13	15	17	4	472	28
1992	27	23	15	14	18	4	576	29
1993	29	22	14	13	20	3	621	29
1994	28	22	15	13	19	4	653	28
1995	30	22	13	13	18	4	648	27
1996	32	23	14	10	17	3	687	27
1997	32	23	14	12	16	3	695	27
1998	32	24	13	11	17	3	686	27
1999	32	23	14	12	15	3	628	26
2000	33	22	14	11	17	3	598	25
2001	33	24	11	11	18	3	572	26
2002	36	20	13	11	17	3	497	26
2003	37	21	11	11	17	4	550	26
2004	34	21	14	11	17	3	526	26
2005	36	21	14	11	16	3	517	28
Average	32	22	13	12	17	3	584	27

5.5. Capital Provided for SMEs Financed Using Equity Participation Formula

Table No 6 provides results of the capital provided to finance small entrepreneurs through equity participation formula. Most of the *mushārakah* projects (65%); their banks have supplied the majority of the capital. This is a combination of bank capital share over 80% of the total capital of the partnership for about 23% of the projects whilst banks have shared between 60-79% of the *mushārakah* projects capital in 42% of the *mushārakah* projects numbers under study. By contrast, these banks have provided between 40-59% of the *mushārakah* projects capital in 21% of these projects.

Table 6 Providing capital for SMEs equity participation projects

Factor	Category	Frequency	Valid Percent
Capital share of the bank over the total capital of the partnership Chi-Square Asymp. Sig. .000	Less than 20%	8	5.3
	20 - 39%	13	8.7
	40 - 59 %	31	20.7
	60 - 79 %	63	42.0
	80% and above	35	23.3
	Total	150	100.0
Capital share of the bank (million Sudanese Pounds) Chi-Square Asymp. Sig. .000	1 - 29	12	8.0
	30 - 59	21	14.0
	60 - 89	36	24.0
	90 - 119	18	12.0
	Above 120	63	42.0
	Total	150	100.0
Ability to finance the project without the bank's share	Yes	17	11.3
	No	117	78.0
	To some extent	16	10.7
	Total	150	100.0

To conclude, these banks provide the majority of the capital in most of the *mushārakah* projects. Ultimately, this will mean Sudanese Islamic banks are taking much more risk compared with their entrepreneurs. Moreover, the majority of these banks (42%) have paid 120 millions of Sudanese pounds or over. *Mushārakah,* therefore, seems to be more viable to a limited number of medium or larger scale investments which can be monitored and profits or losses easily identified. This is manifested in the experience of the Islamic banking system in Sudan, which hardly reaches the poor and the most need entrepreneurs. On the other hand, the table shows that most of the respondents were not able to finance their current *mushārakah* projects without their banks help as 78% were not able to finance these projects compared with 11% who were able and 10% were to some extent able to establish their small enterprise without their banks share.

5.6. SME Profitability

Table No 7 shows the results of the SMEs profitability. It is notable that the P-value (significance or Asymp. Sig.) is equal to 0.00 in all profitability questions. The non-parametric test, therefore, confirm that the profitability is not on the same level on all options according to the respondents views. The following can be observed in these differences:

The majority of the respondents (45%) are taking between 10-19% of the net profit for managing the *mushārakah* projects while 31% of them get 20-29% of the net profit. In combination, most of the respondents (85%) take over 10% of their net profit of their *mushārakah* projects for managing these projects. Profit-sharing ratios are determined on the basis of many factors. One of which is a customer or firm's past and expected performance. Banks do not claim a share in the profits on an equal footing, which otherwise would mean sharing profits in strict proportion to the bank's financing of the capital of a customer. In *mushārakah* practice, the bank's role is limited in the most of the cases to the provision of capital, whereas the customer, besides providing his share of the capital, also uses their labour, skill, enterprise and expertise. Therefore, the contract rules evaluate the contribution of the management, labour and skills by devoting and specifying a portion of profit for it. This portion is called the management fee (*Hamesh Al-Edarah*). The management bonus is payable to the customer under one of two basis whether on the basis of the whole profit regardless its quantity or on the basis of achieving the projected profits. If profits fall below the projection, banks may allow a management fee at a lower rate rather than cancelling it altogether. Consequently the entrepreneur who achieves a higher rate of profits can earn a higher percentage of bonuses, which, as mentioned, shall be specified in the agreement (Akhtar, 1997).

Broadly, *mushārakah* contract determines the management share of the profit for parties, the bank and the customer, through mutual agreement. However getting a fair proportion of the profit is a problem as the customer will try to overvalue his management effort and then accordingly he will ask for a high percent of the profit. By contrast the bank will try to underestimate his effort. Thus, a proper and fair methodology and calculation needed and the estimation of the management share of the profit should not be left entirely to negotiations.

Ibrahim (2004) suggested two approaches for that which are; the residual approach (RA) and the imputed market share approach. The residual approach requires knowledge of the rate of return on each unit of the capital invested in previous similar projects. Subsequently we have to deduct the share profits from the total expected profits and then divide the result by the total expected profit (Ibrahim, 1999).

Table 7 SMEs profitability			
Factor	**Category**	**Frequency**	**Valid Percent**
The profit margin for managing *musharakah* project % Chi-Square 141.680 Asymp. Sig. .000	Less than 10%	22	14.7
	10-19%	67	44.7
	20-29%	47	31.3
	30-39%	10	6.7
	40-49%	3	2.0
	50% and above	1	.7
	Total	150	100.0
Annual profit margin on sales (%) Chi-Square 60.373 Asymp. Sig. .000	1-110%	39	26.0
	11-15%	35	23.3
	16-20%	36	24.0
	21-25%	12	8.0
	26-30%	12	8.0
	31 and above	13	8.7
	No profit	3	2.0
	Total	150	100.0
Profitability of *musharakah* project Chi-Square 104.613 Asymp. Sig. .000	Very high	17	11.3
	High	45	30.0
	Acceptable	85	56.7
	Low or none	3	2.0
	Not sure	0	0
	Total	150	100.0

To have the management profit as a residual requires knowledge of rate of return on each unit of the capital invested in previous similar projects. If we denote management profit by *PM,* the Expected profit by *P*, capital Investment by *C* and lastly rate of return *Rc.* Thus in this approach, according to Ibrahim (2004), an estimation of the share profit can be calculated from the product of the volume of capital invested multiplied by the rate of return on each unit of capital (Ibrahim, 1999).

Thus, the subsequent equation to estimate the management share of the profit can be obtained from the following:

$PM = \{P - (C \times Rc)\}/P$

Where, *PM* is the management profit, *EP* is the expected profit, *C* denotes capital investment and *Rc* denotes the rate of returns on each unit of capital. Additional incentive to the partner can be granted, thereby the bank can determine a maximum rate of return of total capital used in the project, above which the bank will be ready to sacrifice additional profit for the partner. In the current situation the partner sometimes gets this incentive through increased management share, over and above the limit determined by the contract. However, the modification outlined is neither operational nor easier to calculate as it is not easy in many profit and loss cases to calculate neither the expected profit nor the expected rate of return per unit of capital.

In, the second approach, the imputed market share approach (IMSA) the evaluation will be through using the current local market price divided by the total expected profit and, therefore, the profit can be calculated according to the following equation:

$$PM = MVm/EP$$

Where, *PM* is the management profit, *EP* is the expected profit, *MVm* denotes the current local market price. A weighing system can be used for factors such as qualifications, experience, and volume of capital, sensitivity of the project and additional incentives for the management (Ibrahim, 2004). From another prespective the table shows that one quarter of the respondents achieved annual profit margin on sale between 1-11% while approximately the second and the third quarters go to 11-15% and 16-20% annual profit margin on sale. Therefore, the majority of the respondents (71%) achieved more than 10%; in addition, 49% achieved more than15% annual profit. It is worth mentioning that only 2% of them have some loss. The profitability of the equity participation projects is high. As a result, on a whole 30% of the respondents consider the profitability of *mushārakah* projects to be high, alongside 11% of them who believe it is very high, while only 2% believe it is low and 56% consider it to have acceptable profits compared with other projects financed used other methods. Accordingly, we may sum up that the majority of the respondents believe that the projects financed using *mushārakah* have an acceptable profitability compared to their banks standards.

5.7. Guarantee Provided to Bank in *Mushārakah* Projects

Profits produced in *mushārakah* is not guaranteed, as a result, the entrepreneur dose not assure, secure or guarantee profits. Therefore, *mushārakah* does not require strict collateral guarantees and does not leave the partner (entrepreneur) with a heavy burden of debts, post-dated cheques or any other kind of obligations. For this reason, concentration should be on factors, among which are the feasibility of the project, the skills of the customer and his history and lastly the objective situation of the market and its risks (Abdouli, 1991). Taking the personal features of the customer as a part of the factors can be considered as an intangible guarantee. No doubts, such thing is increasing risks from a hand and promoting a new service from another hand. To illustrate, by taking intangible assets, such as education, skills, experience, and honesty, as collateral as tangible assets, Islamic Banking breaks this discriminative barrier and offers an equal opportunity to all potential producers to improve their well-being and that of the society.

It has been observed that the existing banking institutions prefer to grant credit facilities to those clients who apart from enjoying a good business reputation are also able to offer sufficient collateral security mainly valuable assets. This practice seems quite reasonable from the risk point of view, however, the non- tangible collaterals holders are unjustifiably deprived of obtaining the necessary financial accommodation. The existing practice of demanding collaterals for the purpose of granting financial accommodation stems from the fact that Western Banking institutions are primarily concerned with the profitability rather than the social imperatives (Abdouli, 1991). The imposition of tangible collaterals as a necessary condition left small businessmen and farmers trapped in a vicious circle: they cannot get access to finance unless they offer sufficient collaterals, they cannot possess tangible collaterals unless they build a strong productive base, they cannot improve their productive base unless they get access to finance, back to the starting point they cannot get access to finance unless they offer sufficient collaterals, so, no solution for the endless, vicious, and evil circle. Besides this, there is no real consideration for their management skills or the feasibility of the project, since you can get the credit as long as the risks is low and the capital with its interests is well guaranteed (Abdouli, 1991).

This raises the fundamental question of whether intangible assets such as education, experience, and skills can be as equal collateral as less than tangible assets. The answer depends very much on the banking system prevailing in the society as well as the practice carried out. By using *mushārakah* mode of finance in the Islamic banking system the answer might be yes. Islamic Banking balances the priority to the needs of society and the common interest with the individual profit and private interest since the primary concern of the banking institution is both the maximization of profitability and the social imperatives, the tangibility of assets, as a requisite to access to finance loses its importance. Moreover, the granting of credit to an educated, yet financially poor person could be even more beneficial on both social justice and long run growth.

In attempt to identify the role of guarantee in financing SMEs equity participation, the respondents were asked three questions related to the guarantee they provide to the bank, the type this guarantee if any and the Importance of the type of guarantee. The results are shown in table no 8. Notice, the result of the chi-square goodness-of-fit test indicates that the differences appeared between all values are significant. As the table shows, almost all the respondents (96%) have provided a guarantee to their banks to be granted *mushārakah* fund for their projects. This guarantee is for mismanagement and negligence. Notice, that almost half of these guarantee provided are real estate guarantee while about one quarter are movable guarantee and 17% of it are a mixed guarantee of one provided to the respondent which are personal guarantee, real estate guarantee, movable guarantee, a guarantee cheque, investment certificate, and other guarantee.

Table 8 Guarantee provided for finance

The majority of the respondents (64%) consider the type of guarantee is very important and 27% of them consider it as important as a combination 91% of them believe it is important by contrast 9% of them who believe it is not important. This

Factor	Category	Frequency	Valid Percent
Guarantee provided to the bank Chi-Square 126.960 Asymp. Sig. .000	Yes	144	96.0
	No	6	4.0
	Total	150	100.0
kind of guarantee Chi-Square 190.542 Asymp. Sig. .000	Personal guarantee	4	2.8
	Real estate guarantee	68	47.2
	Movable Guarantee.	40	27.8
	A guarantee cheque	2	1.4
	Investment certificate	3	2.1
	Other.	2	1.4
	More than one	25	17.4
	Total	144	100.0
	Not applicable	6	
	Total	150	
The Importance of the type of guarantee Chi-Square 71.320 Asymp. Sig. .000	Very important	96	64.0
	Important	41	27.3
	Not important	13	8.7
	Total	150	100.0

raises the fundamental question of whether intangible assets such as education, experience, and skills can be as equal collateral as less than tangible assets in reality. Would it be possible to consider the intangible assets? Can Islamic Banks balance the priority to the needs of society and the common interest with the individual profit and private interest?

Having had more than ten years using *mushārakah* we should have had that balance. At least they have had to start concentrating in granting credit to educated talented customers with no collateral. The price, might be paid when adopting the wide range of no collateral finance through *mushārakah*, is high cost and high risks, as financing on the (un-granted) profit and loss sharing base will increase the risks and following up many financed projects will increase the costs. Unless a developed risk management, efficient managerial staff trained and a proper follow up has taken place.

Some success practices of lending without collateral for small business might proof the possibility for such theory. One well-known success story is that of *Grameen* Bank in Bangladesh, which charges a market rate of interest to finance medium and small enterprise SMEs, without the need for collateral. It is argued that the crucial factor in the success of the *Grameen* model is a cheap system of assessing creditworthiness, through local knowledge and group pressure (Ibrahim and Vijaykumar, 2003). Some suggestions advised (Abdalla, 1999) to use the group lending idea in financing *mushārakah* to small and micro business to in order to reduce the administrative burden on the bank staff and at the same time provide alternative security against possible default. *Mushārakah* agreement could be concluded individually or with members of a group of five clients for example, who mutually select each other before applying to the bank. Group collateral would be the form of security required by the bank against "fraud or misuse of funds". Monitoring of *mushārakah* could be undertaken by the group leader in collaboration with the bank staff. Each group which fully honours its commitments could be rewarded by a larger future "finance" to each member of the group. This would constitute an additional incentive for honouring commitments. This idea is borrowed from experiences with the Grameen Bank (Abdalla, 1999). Consequently this will be serving the overall banks favour. However, this proposal doesn't give a solution for financing medium and big enterprises. In addition, the price might be paid here is high cost and high risks, as following up many financed projects on the profit and loss sharing scheme will increase both the risk and cost. Alternative types of security against possible misuse of funds could be introduced, e.g., pawning of valuable possessions (such as jewellery) when lending to women entrepreneurs. In all cases, being a partner of the customer, the bank will be liable to bear any loss which may be caused due to any reason other than the negligence or misconduct of the customer (Usmani, 1999).

5.8. The Obstacles of Having a Partner

In an attempt to identify the bad side of being a partner for the Islamic bank in a entrepreneurship project, the respondents were asked to rank the following bad factors losing control of the enterprise, difficulty in cooperating with others, Do not want to revealing business profit, sharing business profit and other factors as an open end option. The results are shown in table No 9.

Table 9 Obstacles of having a partner

		Rankings						Mean Rank	Weighted significance points [72]
Factors		R1	R2	R3	R4	R5	Total		
Losing control of the enterprise	F	54	41	30	24	1	150	2.32	723
	P	36.0	27.3	20.0	16.0	.7	100		
difficulty to cooperate with others	F	22	48	48	28	4	150	2.79	656
	P	14.7	32.0	32.0	18.7	2.7	100		
revealing business profit	F	32	52	35	30	1	150	2.61	684
	P	21.3	34.7	23.3	20.0	.7	100		
sharing the profit with others	F	31	40	25	43	11	150	2.91	637
	P	20.7	26.7	16.7	28.7	7.3	100		
Other	F	18	9	2	7	114	150	4.37	410
	P	12.0	6.0	1.3	4.7	76.0	100		

F frequency P percent
Test Statistics Friedman Test N 150 Chi-Square 161.089 df 4 Asymp. Sig. .000

Descriptively, the respondents believe that that the losing control of the business is the worst factor when finance using equity participation formulas giving that the (36%) of them believe ranked it first and almost 27% of them believe it ranked it second. From another perspective, the table shows that the revealing the business profit is the second bad factor on having a partner giving that almost 21% of the respondents ranked it first and 35% ranked it second. In addition to that the respondents believe that the difficulty in co-operating with a partner is also a third bad factor of having a partner. Almost 15% of the

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[72] Numbers weighted significance (points) column in the table are the number of votes that each factor received, ranked from 1 to 5. To estimate each factors' significance, we have weighted each vote by points from 5 to 1, 1st rank has 5 points, 2nd rank has 4 points 3rd rank has 3 points 4th rank has 2 points 5th rank has 1 points e.g. 54* 5 + 41 *4 + 30*3 + 24*2 + 1*1 = 723. The greater of the weighted significance points the more important is.

respondents ranked it third whilst 32% and another 32% of them ranked it second and third. The table in addition presents weighting of the results, the weighted significance points column based on five points for the most important factor, four points for the second most important, and so on. The result of the Friedman test chi-square test [73] indicates that there is reasonable very low like-hood that the differences in the between the mean rank in the sample data can be attributed to chance. The mean rank confirm the results derived from weighted significance points which from another hand confirm the same ranking mentioned on the descriptive above. It is argued that, by making the bank a partner in the business of the client, it may disclose the secrets of the business to other traders through the bank. This obstacle in many cases is almost theoretical as the banks usually do not interfere deeply with the management affairs which cause another problem to *mushārakah* projects. However, a suggestion can be made to include a condition in the contract which prohibits the bank either from interference with the management affairs or disclosure of any information about the business to any person without prior permission of the entrepreneur (Usmani, 1999).

It is argued that some entrepreneurs are not willing to share with the banks the actual profits of their business. The reluctance is based on two reasons. First, they think that the bank has no right to share in the actual profit, which may be substantial, because the bank has nothing to do with the management or running of the business as well as the creativity might involve in the business and why should they (the entrepreneur) share the fruit of their labour with the Bank who merely provides funds. To overcome this concern, a fair and proper measurement should be taken to estimate the management role on the profit and this should be reflected on the management share of profit denoted to the entrepreneur.

It is argued that information about their real profit might be passed through their banks to the tax authorities and entrepreneurs' tax liability increases accordingly (Usmani, 1999). In fact, many countries charge unreasonable tax regardless the kind of the finance the entrepreneur succeeded to secure. In this regard a recommendation of change tax policies and laws should be passed down to the parliaments in these countries for fair tax system. As far as *mushārakah* concern Islamic banks together with entrepreneurs should lobby with the governments and struggle to change the laws which hamper the progress towards Islamic banking (Usmani, 2002). In addition, before entering into a partnership agreement, the banks are required to review the purpose, prospects, and future operations under the proposed partnership agreement, and ensure that the expected profit will be realised and visible to cover estimated tax, and that the partnership capital will be,

[73] The Friedman test is the nonparametric equivalent of a one-sample repeated measures design or a two-way analysis of variance with one observation per cell. Friedman tests the null hypothesis that k related variables come from the same population. For each case, the k variables are ranked from 1 to k. The test statistic is based on these ranks.

in all probability, safe and secure throughout the duration of the agreement, and that the partnership agreement can be terminated at the end of its duration accordingly (Usmani, 2002).

Lastly, certain fundamental considerations, namely, lack of entrepreneurial skills, technical facilities required to undertake investment, finance and infrastructural facilities justify the operation of these institutions. Individual counselling or one-to-one discussion clearly can addresses the need of the improving these skills. It is obviously possible to teach practical financial management skills like book-keeping in a one-to-one situation but it is costly in terms of time.

6. CONCLUSION

Whilst all of Islamic finance banks and banking operations, all over the world, have been dominated by the non-profit and loss sharing modes and the share of *mushārakah* and *muḍārabah* is very low, in Sudan, the story is different, as a great increase happened to the PLS share. The share of partnership modes of financing in Sudan, although not satisfactory, are, nevertheless, better than the general trends of Islamic banking over the world in which these formulae constitute less one-fourth of the asset portfolio of the world-wide Islamic banks. The government pressure has been the major factor behind this shift towards more equity participation finance.

Almost all of the entrepreneurs were men, which means there is more need to encourage women entrepreneurship. The results in addition show that the dominant type of *mushārakah* is that which lasts for 3 to 6 months. We argue here that one of the major dilemmas facing the present Sudanese Islamic banks nowadays is the fact that these banks have to involve in long term finance according to its theory where these banks mobilize funds on the basis of short term deposits. Despite the prominent increase in the number of Sudanese banks and branches' in the 1990s, SIBs are characterized by the regional inequality in the distribution of branches. This distorted geographical distribution of banking facilities cannot serve socio-economic development, particularly in rural areas (Ibrahim, 2006).

Most of the *mushārakah* projects (65%); their banks have supplied the majority of the capital. This is a combination of bank capital share over 80% of the total capital of the partnership for about 23% of the projects whilst banks have shared between 60-79% of the *mushārakah* projects capital in 42% of the *mushārakah* projects numbers under study. *Mushārakah,* therefore, seems to be more viable to a limited number of medium or larger scale investments which can be monitored and profits or losses easily identified. This is manifested in the experience of the Islamic banking system in Sudan, which hardly reaches the poor and the most need entrepreneurs. The profit devoted to management should be left for merely negotiations; a kind of formula to evaluate the role of the entrepreneur must be created for better and fair system. The profitability of the entrepreneurship SMEs needs to be increased as it low compared with its counterpart financed using other mode of finance.

Almost all SMEs have provided a guarantee to their banks to be granted *mushārakah* fund for their projects. Suggestions we made to use the group lending idea in financing *mushārakah* to small and micro business to in order to reduce the administrative burden on the bank staff and at the same time provide alternative security against possible default. The respondents believe that that the losing control of the business and revealing the business profit is the worst factor when finance using equity participation formulas. To overcome this concern, a fair and proper measurement should be taken to estimate the management role on the profit and this should be reflected on the management share of profit denoted to the entrepreneur. In addition, a suggestion can be made to include a condition in the contract which prohibits the bank either from interference with the management affairs or disclosure of any information about the business to any person without prior permission of the entrepreneur.

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AGENCY PROBLEMS IN *MUḌĀRABAH* FINANCING THE CASE OF SHARĪʿAH (RURAL) BANKS, INDONESIA

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ABSTRACT

This study is concerned with agency problems that arise in Muḍārabah financing in Indonesian Rural Sharīʿah Banks. The study is focused first on project attributes, especially those that might be considered in dealing with Muḍārabah financing; and second the Muḍāribs' attributes financed by the banks under consideration. .The study found that there are six attributes that were considered from the Muḍārabah projects point of view. These include: the prospect of project, availability of collateral, healthiness of project, project's financial statements, clarity of contract conditions, and conformity of time period. In regard to Muḍārib attributes, the study concludes that five characteristics were considered important. They include: business capacity, (personal) collateral, Muḍāribs' reputation and family background, and their business commitments. Further quantitative analysis to examine these attributes filters them into five most influential factors. They are: business skill, business reputation, business commitment (all are related to Muḍārib), financial report of project and length of contract of project.

1. INTRODUCTION

The existence of Islamic (or as commonly stated, Sharīʿah) Banks in Indonesia began in 1991. Establishment was initiated by Bank Mualamat Indonesia (BMI) in 1992 after the Indonesian Parliament passed the Banking Act No. 7, 1992 (following the promulgation of Government Regulation No. 72, 1992. Significantly, the growth of the industry became more progressive after the Bank Act No. 7 was amended by Banking Act No.10, 1998).

According to Banking Act No.10, 1998, the Indonesian Banking Industry is classified according to two levels. They are General or Sharīʿah Banks and Rural Sharīʿah Banks. Bank Indonesia (Indonesia's Central Bank) statistics show that in July 2006 there were three fully-pledged Sharīʿah Banks, 10 Sharīʿah Banking

Units[1] and 94 Rural Sharīʿah Banks. These do not include more than 3000 other *Baitul Maal Wat Tamweels* (BMT), or micro-finance industry establishments, which were formerly operated under the Cooperative Act. (BMT's legally function like Sharīʿah Banks; however they cannot be classified in this way.)

Notably, the market share of the industry remains relatively small, nevertheless growth has been remarkable. The following (Table: 1) demonstrates market share development in comparison to aggregate industry (current to July 2006).

Table 1. Islamic Banks' Share to All Banks in Indonesia

(As per July 2006)

	Islamic Banks		
	Nominal	Share	Total Banks
Total Assets	22.86	1.51%	1517.06
Deposit Fund	16.51	1.42%	1161.04
Credit / Financing Extended	18.53	2.58%	716.79
LDR / FDR*)	112.23%		61.74%
NPL	4.71%		8.10%

LDR: Loan (credit) extended to deposit ratio.
FDR: Financing extended to deposit ratio.
Source: Bank Indonesia (August 2006) *Islamic Banking Statistic.*

Notably, predictions have been made about the future prospects of the industry. For example, Karim Business Consulting (KBC) forecasted that Islamic bank market share could potentially reach 6.67 per cent of the industry by 2008, (See the Indonesian newspaper *Republika*, 21 December 2006). Alternately, the Central Bank of The Republic Indonesia predicted the lesser figure of 5.18 per cent by the same year.

Despite good growth and increasing market share, the overall contribution of Islamic banks in Indonesia is still below industry expectations. These expectations are based, *inter alia*, on the fact that Indonesia is numerically the largest Muslim country in the world. Indonesia has a total population of over 238 million, of which over 80 per cent are Muslim. Consequently, the market share of the Islamic banking sector should ideally be greater than what has been achieved to date. The contribution of Islamic banks in Indonesia towards national economic growth remains dependent to large extent on how they are able to operate effectively, either in offering attractive products or services, or else in playing a constructive social-mediation role. As elsewhere, this is a balance between the availability of surplus funds (capital), and the need for investment funds (various capital requirements).

[1] These Unit Sharīʿah Banks belong to conventional or general banks, which are given the rights to operate the Sharīʿah division in the form of branches.

Most Sharīʿah Banks in Indonesia have historically offered the following products: (1) Funding products which include: (a) *Wadīʿah* Current Account, (b) *Muḍārabah* Saving Account and (c) *Muḍārabah* Investment Account. (2) Financing products, including: (a) *Murābaḥah*; *Bayʿ as-salam* and *Bayʿ al-istiṣnāʿ*, (b) *Ijārah*, (c) *Muḍārabah* and *Mushārakah*, and finally: (3) supporting products which cover *Al-wakālah*, *Al-kafālah*, *Al-hiwahal* and *Al-qarḍ ḥasan*.

Islamic economics basically emphasize the implementation of a preference for the 'real sector' rather than the financial sector (Adnan, 2003), or in the words of Khurshid Ahmad (2000), "moving from a debt-based to an equity-based or stake-taking economy" (p 63). Based on this, the Islamic banking industry should have focused operations on products such as *Muḍārabah* and *Mushārakah*, since these two products are closer to the equity-based or stake-taking 'real economy'. However, the world-wide development of Islamic banking does not exactly show this trend. What has been alluded by Karim (2001), and Warde (1999, 199) clearly shows this. Mujiyanto (2004, 15) reported that in Indonesia the *Muḍārabah* contributes only 14.33 per cent, while *Mushārakah* even less: 2.86 per cent.

The following (Table: 2) represents the current development of financing modes in Indonesia. This shows a promising change from results of research conducted during 2003-2004; however the total composition of product portfolio still does not yield the outcomes expected by Khurshid Ahmad (2000) and Adnan (2003) as alluded earlier.

Table 2. Composition of Financing of Islamic Banks (Million IDRs)

Items of Financing		Sep-05	Dec-05	Mar-06	Jun-06	Jul-06	Aug-06
Mushārakah Financing	Amount	1,830,176	1,898,389	2,005,520	2,099,122	2,206,122	2,298,641
	Share	12.41%	12.46%	12.54%	11.55%	11.91%	12.07%
Muḍārabah Financing	Amount	3,004,030	3,123,759	3,208,905	3,560,848	3,636,451	3,697,849
	Share	20.36%	20.51%	20.05%	19.61%	19.63%	19.42%
Murābaḥah Receivable	Amount	9,310,948	9,487,318	9,981,242	11,778,333	11,843,364	12,118,566
	Share	63.11%	62.29%	62.39%	64.85%	63.92%	63.66%
Salam Receivable	Amount	150	-	-	-	-	-
	Share	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Istiṣnāʿ Receivable	Amount	297,086	281,676	289,179	293,359	301,079	303,335
	Share	2.01%	1.85%	1.81%	1.63%	1.63%	1.59%
Others	Amount	310,909	440,800	512,102	430,464	540,250	619,201
	Share	2.11%	2.89%	3.20%	2.37%	2.92%	3.25%
T o t a l		14,753,299	15,231,942	15,996,948	18,162,126	18,527,228	19,037,592

Source: Bank Indonesia (August 2006) *Islamic Banking Statistic.*

The facts presented above indicate the significant differences between theory, expectation and reality. It is undeniable that a number of factors are in play. Two different perspectives can therefore be applied. One is internal Islamic banking factors and the other is external Islamic banking factors.

A full understanding of product offered, like *Muḍārabah*, is one such important internal factor. The readiness to deal with risk is another. Most Islamic Bank Managers are accustomed to a risk-averse than a risk-taker approach. This implies that *Muḍārabah* has been perceived as a risky product. This risk is in fact related to agency issues associated with the external factors, where the honesty, transparency and trustworthiness of the consumer cannot be guaranteed.

The *Muḍārabah* contract is an agreement between two or more parties, where profit and loss are shared between the capital owner or principal, and the agent or bank consumer. It is important therefore to understand that this functions effectively when both parties are ready and willing to be transparent. This includes disclosure of all aspects of the business they have agreed to operate. Such a contract is strongly associated with moral hazard particularly in the context of 'asymmetric information'. This is likely to be unavoidable in the contract of *Muḍārabah*.

2. RESEARCH QUESTIONS

There are basically two levels of research questions that need to be answered. The first is to investigate the attributes of both project and *Muḍārib,* as considered by the Islamic bank. At this level the study aims to answer the following questions:

1. What are the projects attributes considered by *Ṣahibul Māl* (Islamic Banks) in financing *Muḍārabah* projects.
2. What are the *Muḍārib* attributes considered by *Ṣahibul Māl* in financing *Muḍārabah* projects.

In the second level, the study aims at examining the model designed to ensure that those attributes can effectively reduce agency problems. The questions raised are as follows:

1. How far can the screening mechanism of project attributes reduce agency problems in *Muḍārabah* financing?
2. How far can the screening mechanism of *Muḍārabah* attributes reduce agency problems in *Muḍārabah* financing?

3. RESEARCH OBJECTIVES

The research has two objectives. In the first level, it is expected that the research can find:

1. the project attributes considered by *Ṣahibul Māl* in financing *Muḍārabah* projects, and
2. the *Muḍārib* attributes considered by *Ṣahibul Māl* in financing *Muḍārabah* projects.

In the second level, the research is expected to formulate:

1. the project attributes that can reduce agency problems in *muḍārabah* financing.
2. the *Muḍārabah* attributes that can reduce agency problems in *Muḍārabah* financing.

4. PREVIOUS RESEARCH SURVEY

There is a demonstrable need to orientate the Islamic banking industry to be closer to the 'real sector' than the financial sector (Adnan, 2003), or from debt-based to equity-based financing (Khurshid Ahmad, 2000). The best products, or these more closely linked to such a direction are the *Muḍārabah* and *Mushārakah*. However, historical industry data, particularly in Indonesia, and generally at the international level, indicate the contrary. Obstacles remain when faced with offering the *Muḍārabah* product, such as moral hazard, asymmetric information and so forth. Significantly there has been no research conducted to specifically investigate these related attributes.

A survey of the literature reveals that some cursory research associated with the issue of *Muḍārabah* has been conducted. Ibrahim Warde (1999) for example has focused his study on the impediments and problems of implementation of profit-and-loss sharing contracts. By applying the explorative method, Warde found that *Muḍārabah* contract was often associated with adverse selection and moral hazard. Warde's findings are important; however the research has not formulated a measurement of adverse selection.

Abdul Fatih, A. A. Khalil, Colin Rickwood and Victor Muride (2000) conducted research related to the characteristics of agency in *Muḍārabah* contract between Islamic banks and their customers. They basically found that there are: (1) risk problems caused by moral hazard and adverse selection; (2) linear relationships between projects and profit, and; (3) discretionary power.

The authors also identified several aspects which were considered by *Ṣāhibul Māl* in selecting: (1) the *Muḍāribs* or projects; (2) the criteria to accept or reject; (3) the factors which determine the profitability of projects; (4) the variables that can be used to re-structure the *Muḍārabah* contract; (5) agency problems and; (6) monitoring and contractual governance. However, the study did not identify the influence or the contribution of the factors found in agency problems faced in *Muḍārabah*.

Karim (2000) has also studied the suitability of *Muḍārabah* and *Mushārakah* financing. He found that *Muḍārabah* and *Mushārakah* financing is fit for small and medium business enterprises, provided that incentive compatible constraint mechanism is applied. This includes: (1) the setting up of capital proportion or the collateral contributed by *Muḍārib*; (2) a minimum operational business risk; (3) the project should be ready with financial statements and; (4) the project has relatively low uncontrollable expense.

According to Sumiyanto (2004) who conducted research on *Muḍārabah* at BMT, both the projects attributes, *Muḍāribs* compliance and financing pre-requisites, have a significant role in the increasing of *Muḍārabah* contract between the BMTs and their customers. Although the study was more focused, it was done for BMTs, instead of Islamic banks, which are much bigger in terms of size and complexity.

In addition to above research, Darmawangsa (2003) researched the *Gharar* aspects in *Muḍārabah*. By implementing the case study approach, he found that the *Gharar* will emerge in the *Muḍārabah* contract when two conditions exist: (1) the project financed has incomplete information: and (2) the *Ṣahibul Māl* has no sufficient information about the project, so that they have no capacity to control.

Several research projects in a related area (*Muḍārabah*) have been conducted; however this research has maintained a different perspective in terms of research questions, methods, scope and data analysis. This study rather is aimed at a determination of project attributes considered by Islamic banks in order to effectively offer their financing services, as well as *Muḍārib* attributes in selecting the potential *Muḍārib* to be financed.

5. LITERATURE STUDY

This study was primarily conducted because of the low proportion of *Muḍārabah* financing offered by Sharīʿah banks in comparison to other products such as *Murābaḥah* or other 'trading' products. This is why many critics have raised questions about the operations of Sharīʿah banks generally (See for example Kuran, 1986; Weiss, 1999; Ahmad, 2000, Adnan, 2003 just to mention a few).

Ironically, the *Muḍārabah* product has been the most popular product associated with Islamic economics generally and Islamic banking in particular.

Among the concerns on the *Muḍārabah* operation is the possibility of agency problems linked with modern investments. Jensen and Meckling (1976) are among the pioneers who raised the issue of agency problems. The agency concept is related to incentive- based contract, where the rewards are provided by the principal for the party working to improve productivity (Pass, Lowes and Davies, 1985, 285). The reward can be in the form of a bonus, profit-related-pay or profit sharing.

The *Muḍārabah* is defined as a contract between the *Ṣahibul Māl* (in this case the capital provider) and the *Muḍārib* (business operator) in which the profit earned is shared according to an agreed proportion. This includes the case of loss, which two parties will also share – the capital provider being responsible for financial loss and the *Muḍārib* being charged with non-financial loss (see for example Antonio, 2000; IAI 2002).

The modern investment concept is not exactly similar to the *Muḍārabah* concept, however there are similarities. Because of this, associating or analogizing the *Muḍārabah* with the agency problem is plausible.

Jensen and Meckling (1976) offered two methods by which a capital owner can reduce the risk of inappropriate agent conduct. One is by carefully monitoring the agent and the other is by bonding the manager or agent to certain positive outcomes. Consequently, this process limits the opportunity for an agent to mismanage or abuse the project, while at the same time increasing expenses and reduces profit. Any residual losses are categorized as an agency cost.

According to Rechelstein (1992) the agency problem will arise when the principal hires the agent, and the agent does not share what he or she has earned. While Stiglitz (1992) views that the agency problem exists if in the relationship between the principal and the agent there is imperfect or asymmetric information sharing (Jogiyanto, 2000, 369). Jogiyanto also states that asymmetric information may occur where some of investors are given information, while some others have not.

Asymmetric information can be either in action or information. It is related to action if there is a hidden outcome; it is related to information if there is hidden information. Raviv's research (1990, 32-49) examined both asymmetric information and agency model. Raviv found that there was an association between asymmetric information and agency model under default probability. He further stated that the existence of asymmetric information might influence the return on investment.

The 'principal–agent' relationship in the *Muḍārabah* context has been discussed theoretically by Habib Ahmed (2000). Ahmed analyzed the limited information obtained by principal on *Muḍārib*, where he proposed the adverse selection index λ (0 < λ < 1), adverse selection is = 1/ λ. while moral hazard has been symbolized as E (C_f) < E(C_t), in which the actual profit is less than the expected profit. Ahmed also suggested that the difference should be identified through auditing practices. An example of moral hazard might be excessive project cost (window dressing), and retaining some of the profit earned.

In addition to these discussions, related to either adverse selection and/or moral hazards, there is a need to screen both the projects and the *Muḍāribs*. The screening, in turn, may help the *Ṣahibul Māl* to reduce related problems. Some variables were identified and proposed. In terms of project, they are: profitability, return, risk, monitoring cost, accounting aspect, related social and environmental supports, contract period, cash flow and collateral (Khalil, Rickwood and Murinde, 2000, 641). In terms of *Muḍārib*, they are: reputation, experience and qualification of *Muḍārib*, religiosity, and the ability to access information (Khalil, Rickwood and Murinde, 2000, 641). In addition to this, Sumiyanto (2004) added the following: track record, business skill base, ability to adjust to business risk and ownership of the business.

Again, the main issue raised by this study is that all variables need to be checked, rechecked and examined, especially in the Indonesian social context, and particularly in the environment of Rural Islamic Banks (*Bank Perkreditan Rakyat Syariah*) or – BPRS.

6. RESEARCH METHOD

This research applies the 'combined qualitative and quantitative design' (Cresswell, 1994). According to Cresswell, combined research can be considered in one of following research designs: (1) the two-phase design, (2) the dominant-less dominant design, or (3) the mixed-methodology design (1994: 177). Based on Cresswell's classification, this research might be classified as the two-phase design.

In this regard, the qualitative design approach is first conducted in order to investigate the possible attributes associated with both projects and *Muḍāribs*. In the second step, these attributes are examined statistically.

In the qualitative step, the explorative approach is applied. This includes the following procedures (1) Key-informant technique; (2) Focus group interview; (3) Secondary-data analysis, and (4) Case study method (*Mudrajad*, 2003: 73-74). The attributes identified either in regards to projects or *Muḍāribs* are then examined quantitatively.

The research samples are BPRS Managers. Sixteen BPRS[2] – representing the banks which are spread widely in two important islands of Indonesia, namely Sumatra and Java, (which includes West, Central and East Java). These centres were chosen on the basis of purposes cluster sampling method.

The bank samples selected were required to conform to the following conditions: first, the bank had been applying the *Muḍārabah* contract, and second, the *Muḍārabah* had been operated for a period of at least three years before the commencement of research.

There were eighty nine BPRS in Indonesia during the time of research. Eighty four were sent questioners, with only 64 either replying or deemed as eligible for analysis. Finally, 16 of out 64 BPRS Managers were selected to be interviewed.

The primary data was collected by interview and by the observation approach. The qualitative data was then examined by triangulation technique (Moleong, 2000:175). It is important to ensure that the data was valid and reliable. In turn, this guarantees that the knowledge generated is true, re-searchable, verifiable and can be generalized (Strauss and Corbin, 2003:14-15). On the other side, the validity and reliability of examination of the quantitative part is conducted with product moment correlation and alpha technique.

Research variables were decided after exploratory steps were conducted. As alluded earlier, the following items were investigated during the research. First, the possible attributes associated with projects, which include the characteristic projects deemed by the bank to be worthy of finance. Second, possible attributes related to *Muḍāribs*, which comprise the characteristics *Muḍāribs* considered by the bank before contracts were approved and finally, agency problems in the *Muḍārabah* contract. Agency problems deal with the disobedience of *Muḍārib*s *vis a vis* the agreed contract, particularly in terms of profits earned that must be shared with the bank. The agency problem was measured by comparing the percentage of expected and actual return (Towsend, 1979; Gale and Hellwig, 1985; Ahmed, 2000).

7. DATA ANALYSIS TECHNIQUE

Following the research objectives, two tiers of analysis technique were prepared. They are: (1) qualitative analysis and (2) quantitative analysis. The first technique was aimed at investigating the attributes considered by Islamic banks'

[2] The list of sixteen BPRS can be found in the appendix.

management in deciding both projects as well as *Muḍārib* prior the approval of the *Muḍārabah* contract.

The quantitative analysis was designed to examine the investigated attributes identified in the qualitative approach. Two more techniques were also applied at this level. First, the factor analysis which screens attributes of projects and *Muḍārib* statistically. This is then followed by regression analysis. This ensures to what extent the screened attributes are involving in agency problems. This approach strongly suggests then that this research may constitute a new model.

8. DATA ANALYSIS AND RESEARCH FINDINGS

Data analysis and research findings can be described according to the following steps: (a) a description of how the *Muḍārabah* are practiced in the BPRS; (b) exploratory analyses of project and *Muḍāribs'* attributes; (c) analyses of factors attributed to projects as well as *Muḍārib* in financing in *Muḍārabah* contracts, and (d) research model confirmation.

A. The following data figures in the practices of *Muḍārabah*, particularly among the BPRS. Below (Table: 3) describes the portion of *Muḍārabah* included in research samples.

Table 3. The Proportion of *Muḍārabah* Financing at BPR *Syariah* in 2004

The proportion of *Muḍārabah* financing of the total financing products offered.	Frequency	Percentage
a. Less than 5%	24	37,50
b. 5% - 10%	00	00,00
c. 10% - 15%	00	00,00
d. 15% - 20 %	40	62,50
e. More than 20%	00	00,00
T o t a l	64	100,00

Source: Analyzed Primary Data.

The above data is in-line with the data issued by the Central Bank of Indonesia, where *Muḍārabah* contract constituted 15.35% in 2004 (and 19.42% in August 2006) of the total financing products applied (See: Table: 2 above).

The *Muḍārabah* contract can be further classified into two types. They are the *Muḍārabah Mutlaqoh* or Un-restricted Investment Accounts, and *Muḍārabah Muqayyadah* or Restricted Investment Accounts. How the applied preference of BPRS can be seen in the following table.

Tabel 4. The Proportion of *Muḍārabah Mutlaqah* and *Muḍārabah Muqayyadah* at BPR Syari'ah in 2004

Types of *Muḍārabah.*	Frequency	Percentage
a. *Muḍārabah Mutlaqah* (Un-restricted *Muḍārabah*)	36	56,25
b. *Muḍārabah Muqayyadah* (Restricted *Muḍārabah*)	28	43,75
c. Both	00	00,00
Total	64	100,00

Source: Analyzed Primary Data

As shown above, the majority of BPRS prefer the *Muḍārabah Mutlaqoh* or Unrestricted Investment Account (56.25%) compared to the *Muḍārabah Muqayyadah*. Two explainations are suggested to explaion this phenomenon. First, simply because most customers who have invested their money prefer this type of *Muḍārabah*; it is then easier for the banks to manage the investment under the same type of investment. The second reason is that the *Muḍārabah Mutlaqoh* is both more flexible as well as more more profitable than *Muḍārabah Muqayyadah*, since the last is subject to some constraints stipulated by *Ṣahibul Māl* (Karim and also Waris[3], 2004).

In regard to the length of contract, the research found that most contracts were signed for 1 – 2 years (81.25%), and only 18.75% of contracts hstiputaled a period of between 2.1 – and 3 years period. This also confirms that no contract was signed for longer than 3 years, as shown below.

Table 5. Length of *Muḍārabah* Financing Contract in BPR Syari'ah in 2004

Length of *Muḍārabah* Financing Contract	Frequency	Percentage
a. 1 – 2 years	52	81,25
b. 2,1 – 3 years	12	18,75
c. 3,1 – 4 years	00	00,00
d. 4,1 – 5 years	00	00,00
e. 5,1 – 6 years	00	00,00
T o t a l	64	100,00

Source: Primary Data Analyzed

The above trend indicates two things. One is that the BPRS were avoiding longer contracts due to limited funds available for financing, since the BPRS are

[3] This view was expressed during the interview. Karim (was the former manager of one Islamic Banks, and Waris was one managers of the interviewed BPRS). The interviews were done separately in August, 2004.

classified as small to medium size banks. The other is that the banks followed URF or ‘Socio-Cultural Habit’ or business practices in general. Below (Table: 6) shows the types of industries which are financed by banks under *Muḍārabah* contracts.

Table 6. Types of Business / Industry Financed under *Muḍārabah* by BPR Syari’ah in 2004

Types of Business / Industry	Frequency	Percentage
a. Agriculture	07	10,94
b. Animal husbandary	15	23,44
c. Trading	33	51,56
d. Manufacturing	09	14,06
e. Craft	00	00,00
f. Other	00	00,00
T o t a l	64	100,00

Source: Analyzed Primary Data

As indicated in the above (Table: 6), the trading sector is dominating the *Muḍārabah* contract by 51.56%. According to most interviewed Bank Managers trading is the most manageable sector. This is consistant with conditions such as the availability of financial statements and other related documents. In turn, this facilitates the banks undertaking their control function. Moreover, the trading sector is more flexible than for instance agriculture and husbandary which are subject to external factors lsuch as weather, seasons and so forth.

B. In respect to the explatory analysis on attributes of projects and *Muḍāribs*, based on questioners circulated among the respondents and followed-up by in-depth interview, the following projects attributes are noted.

1. Minimum business risk
2. Accounting information system
3. The certainty of return
4. Low monitoring cost
5. Project’s rate of return
6. Project’s soundness
7. Guarantee / collateral
8. Project cash flow
9. Contract period
10. Project horizon
11. Prospect

12. Business's going concern
13. Contract conditions

Based on the same method of exploring projects' attributes, the following factors were also noted with relation to *Muḍārib's* attributes, which are considered important by the management of BPRS.

1. Having skill in the related business or area
2. Market familiarity
3. Ability to correct the business risk
4. Possesing collateral
5. Family business background
6. Business commitment
7. Ability to articulate the particualr business language
8. Having business habit
9. Having own business
10. Historical business lingkage with *Ṣahibul Māl*
11. Ability to grasp business opportunity
12. Social class
13. Ability to anticipate business risk
14. Track record

C. Analyses of factors attributed on projects as well as *Muḍārib* in financing in the *Muḍārabah* contracts.

As described earlier, there are several attributes noted for both projects and *Muḍāribs* from the BPRS management point of view. In this section those attributes are statistically examined. Table 7 shows the ranks of the attributes and their standard deviations.

The table shows the heterogeneity of *Ṣahibul Māl*. The standard deviations indicate to what extent the *Ṣahibul Māl* rank the projects attributes. In this the certainty of return has been considered to be the most important attribute. The examination by the Kaiser-Meyer-Oklin (MKO) and Barlett Measures of Sampling of attributes confirm the result, as shown below.

Table 7. Ranking of All Projects' Attributes

Attributes	Abbreviation	Mean	Std. Deviation	Analysis N
Certainty of return	PSTHASIL	4.30	.68	64
Collateral on project	JAMINAN	4.09	.68	64
Prospects of projects financed	PROSPEK	4.02	.72	64
Projects' rate of return	TKRETURN	3.97	.76	64
Project's period of financing	JGKWAKT	3.94	.79	64
Projects' rate of risk	TKRISIKO	3.88	.85	64
Projects' cash flow	ARUSKAS	3.77	.77	64
Projects' conditions	KLAUSUL	3.77	.81	64
Projects' age financed	USIAPRO	3.69	.75	64
Projects' going concern	BERKMB	3.56	.89	64
Business health rate	TKKSHTAN	3.55	1.05	64
Accounting information system	SIA	3.39	.81	64
Projects' cost of monitoring	BIAPANTU	3.33	1.13	64

Table 8. Summary of Kaiser-Meyer-Olkin (KMO) and Bartlett Examination

Kaiser-Meyer-Olkin Measure of Sampling Adequacy.		.502
Bartlett's Test of Sphericity	Approx. Chi-Square	297.632
	df	78
	Sig.	.000

It was found that the coefficient *Kaiser-Meyer-Olkin Measure of Sampling Adequacy* (MSA) was 0,502. This indicates that the samples used are sufficient, since the mark required by MAS Hair *et. al* (1998) is 0.50. The interrelation of attributes can be seen from the co-eficient of *Bartlett's Test of Sphericity,* which is 297,632 and significancy level at $p<0,01$.

The analysis to determine the projects attributes is iniatited by communalities analyisis which can be seen in Table 9.

This analysis groups attributes which have a significant relationship. They were analysed by the Orthogonal Varimax Method. It was intended to have the rotated orthogonally attributes. The summary of results are provided in Table 10.

Table 9. Communalities of Projects' Atributes

Attributes	Abbreviation	Initial	Extraction
Projects' Cost of Monitoring	BIAPANTU	1.000	.670
Project's Period of Financing	JGKWAKT	1.000	.839
Business Health Rate	TKKSHTAN	1.000	.841
Accounting Information System	SIA	1.000	.854
Certainty of Return	PSTHASIL	1.000	.865
Projects' rate of Return	TKRETURN	1.000	.887
Projects' Conditions	KLAUSUL	1.000	.797
Projects' rate of Risk	TKRISIKO	1.000	.805
Prospects of projects financed	PROSPEK	1.000	.787
Projects' Cash Flow	ARUSKAS	1.000	.745
Collateral on Project	JAMINAN	1.000	.724
Projects' Going Concern	BERKMB	1.000	.748
Projects' Age Financed	USIAPRO	1.000	.806

Extraction Method: Principal Component Analysis.

The results in Table 10 shows how the common factor analysis explains latent root criterion by indicating the total variance explained. There are six factors out of 13 which contributed 79.750% to the total projects attributes, each with the following figures: component 1 = 21.982%, component 2 = 19.238%, component 3 = 11.238%, component 4 = 10.951%, component 5 = 8.627% and component 6 = 7.715%.

The result of Principal Component Analysis with Extraction Method and Varimax Rotated Component explains the content of each component. The first component is named as project soundness which include project monitroing cost with coeeficient 0.559, business health rate with co-efficient 0.902 and business's going concern with co-efficient 0.854.

The second component is named Repayment Guarantee which include payment certainty and project collateral, with coefficients of 0.921 and 0.647 respectively. The third component consists of project's rate of return (0.542), project risk (0.762), and prospect of the project (0.825). This component is identified as project's prospective.

The fourth component is classified as financial aspect which include accounting information system (0.899) and project's cash flow (0.557). The fifth component is identified as contract conditions, which include the conditions required by the contract (0.850) and finally the projects' age financed which has 0.885 co-efficient. All attributes mentioned above have loading factor > 0.05.

Table 10. Projects Attributes Based on Factor Analysis

Projects' Atributtes	SET Variabel					
	1	2	3	4	5	6
Projects' cost of monitoring (BIAPANTA)	0,559					
Business health rate (TKKSHATA)	0,902					
Projects' going concern (BERKMB)	0,854					
Certainty of return (PSTHASIL)		0,921				
Collateral on project (JAMINAN)		0,647				
Projects' rate of return (TKRETURN)			0,542			
Projects' rate of risk (TKRISIKO)			0,762			
Prospects of projects financed (PROSPEK)			0,825			
Accounting information system (SIA)				0,899		
Projects' cash flow (ARUSKAS)				0,557		
Projects' conditions (KLAUSUL)					0,850	
Project's period of financing (JKWAKTU)						0,614
Projects' age financed (USIAPRO)						0,885
Eigen Value	**2.858**	**2.501**	**1.461**	**1.424**	**1.121**	**1.003**
Percentage of Variance	**21,982**	**19,238**	**11,238**	**10,951**	**8,627**	**7,715**

Extraction Method: Principal Component Analysis.
Rotation Method: Varimax with Kaiser Normalisation.
Remarks: 1) Business health rate; 2) Collateral on project; 3) Prospects of projects financed; 4) Financial reports; 5) Conditions of Projects, and 6) Time period of projects .

It can be concluded that what have been considered by Islamic banks in financing the projects are: the project soundness, the repayment guarantee, the prospect of project, financial aspects (financial statements), project conditions and project age.

With regards to *Muḍāribs'* attributes, as stated earlier, there are thirteen attributes, as shown below.

Table 11. Ranking of All Attributes of *Muḍārib*

Attributes of *Muḍārib*	Abbreviation	Mean	Std. Deviation	Analysis N
Having a good track record	TRECKAC	4.09	.68	64
Owning business collateral	JAMINAN	4.05	.70	64
Historical relationship	HUBHIST	4.03	.85	64
Good business habit	KEBIASA	4.02	.72	64
Good relatiosnhip with *Ṣahibul Māl*	HUBKELU	3.97	.76	64
Market accepted	FAMILIAR	3.94	.79	64
Project (self) possesion	MLKSEND	3.88	.85	64
Ability to grab an opportunity	TKPELUA	3.86	.85	64
Ability to articulate the business language	ARTIKUL	3.86	.81	64
Good social class	KELSOSI	3.72	.58	64
Having related business skill	KEAHLIAN	3.70	.71	64
Ability to Control the risk	KORERISK	3.70	.85	64
Coming from business family	KELPEB	3.39	.81	64
Having a good business commitment	KOMITMEN	3.33	1.13	64

The above dislcoses the level of importance of attributes considered by the bank in relation to *Muḍārib*. The business track record has been ranked in the first and then followed by collateral, and so forth.

The Sample Suitability Test was also undertaken for this case, where the Kaiser-Meyer-Olin and Barlett examination was applied. The result is as follows:

Table 12. Summary of Kaiser-Meyer-Olkin (KMO) and Bartlett Test

Kaiser-Meyer-Olkin Measure of Sampling Adequacy.		.573
Bartlett's Test of Sphericity	Approx. Chi-Square	496.605
	df	51
	Sig.	000

The Kaiser-Meyer-Olkin Measure of Sampling Adequacy (MSA) is 0,573. This indicates that the samples used are sufficient, since according to Hair *et. al* (1998) the requirement is 0,50. The intervariable correlation can be referred to coefficient of Bartlett's Test of Sphericity, that is 496,605 at $p<0{,}01$.

Further analysis is required to determine the attributes by communalities analysis. The result is as follows:

Table 13. Communalities Attributes of *Muḍārib*

Attributes	Abbreviation	Initial	Extraction
Having a good business commitment	KOMITMEN	1.000	.797
Market accepted	FAMILIER	1.000	.805
Coming from business family	KELPEB	1.000	.816
Having a good track record	TRECKAC	1.000	.712
Historical relationship	HUBHIST	1.000	.710
Project (self) possesion	MLKSEND	1.000	.631
Ability to Control the risk	KORERISK	1.000	.750
Owning business collateral	JAMINAN	1.000	.848
Good business habit	KEBIASA	1.000	.700
Having related business skill	KEAHLIAN	1.000	.400
Good social class	KELSOSI	1.000	.770
Ability to articulate the business language	ARTIKUL	1.000	.906
Ability to grab an opportunity	TKPELUA	1.000	.951
Good relatiosnhip with *Ṣahibul Māl*	HUBKELU	1.000	.911

Extraction Method: Principal Component Analysis.

The final analyisis is grouping or classifying the attributes which have significant relationship. This is done by orthogonal varimax method. The anlysis is expceted to produce a rotated orthogonal attributes. The summary of result analysis is shown in Table 14.

The common factor analysis, which explains the latent root criterion, is indicated by the total variance explained. The analysis found five components of 14 attributes, which describe 76.478%. Each component contributes 26,469%; 17,031%; 15,176%; 9,421%; and 8,381% respectively.

The attributes that belong to the first component is: Ability to control the risk; ability to articulate the business language; and ability to grasp an opportunity. They are identified as 'business skill or ability'.

The attributes that belong to second component is: collateral. This relates to the following attributes: Owning business collateral; good business habit; and good relatiosnhip with *Ṣahibul Māl*. The third component includes the following attributes: Market accepted; having a good track record; and having related business skill. They are named as 'reputation'.

The fourth component consists of: Coming from business family, project; (self) possesion, and; good social class. They are identified as 'background'. The last component is known as business commitment, it constitutes of the following attributes: Having a good business commitment and historical relationship. All those attributes have a loeading factor more than 0.05.

Table 14. Summary of Variable Names and *Muḍāribs'* Attributes Based on Factor Analysis

Attributes of *Muḍārib*	SET VARIABEL				
	1	2	3	4	5
Ability to control the risk (KOREKRISK)	0,777				
Ability to articulate the business language (ARTIKUL)	0,925				
Ability to grab an opportunity (TKPELUA)	0,968				
Owning business collateral (JAMINAN)		0,877			
Good business habit (KEBIASA)		0,644			
Good relatiosnhip with *Ṣahibul Māl* (HUBKELU)		0,947			
Market accepted (FAMILIAR)			0,859		
Having a good track record (TRECKAC)			0,975		
Having related business skill (KEAHLIAN)			0,514		
Coming from business family (KELPEB)				0,583	
Project (self) possesion (MLKSEND)				0,528	
Good social class (KELSOSI)				0,826	
Having a good business commitment (KOMITMEN)					0,782
Historical relationship (HUBHIST)					0,625
Eigen Value	**3.706**	**2.384**	**2.125**	**1.319**	**1.173**
Percentage of Variance	**26,469**	**17,031**	**15,176**	**9,421**	**8,381**

Extraction Method: Principal Component Analysis.
Rotation Method: Varimax with Kaiser Normalization.
Remarks:1) Business skill; 2) Collateral; 3) Reputation; 4) Background; and 5) Business commitment.

C. In the regression analysis on the screening effectiveness of agency problems the regression analysis is intended to confirm the qualitative analysis and co-efficient quantitative. It is expected that in passing this examination the research findings will have a sufficient platform. Three more analysis are understaken for this purpose. They are as follows:

The previous analysis has found five factrors or variables as the the most important attributes related to projects in the view of banks' mangement in order to reduce agency problems. They are project soundness (KSHTPROY), projects' prospect (PROSPROY), financial reports (LAPKEU), contract conditions (PERSYKLA) and the length of contract (WAKTKONTR). When the variables are examined with the regession analysis, the following result is obtained:

AGPROB	= β_o +	β_1KSHTPROY+	β_2PROSPROY +	β_3LAPKEU +	β_4PERSYKLA +	β_5WKTKONTR
Coef Reg	= 0,434 +	0,0614 +	0,125 +	0,234 +	0,574 +	0,274
Coef. t	= (4,051)	(2,294)	(2,356)	(2,367)	(4,459)	(2,614)
p	= 0,000	0,025	0,022	0,021	0,000	0,011
F	= 10,784					
adjusted R^2	= 0,437					

As shown above, F is 10,784 with p= 0,000. This indicates that those variables significantly affect the agency problem in *Muḍārabah contract*. Furthermore, the *adjusted R^2* is 0,437 which means that the variance of agency problem is explained by the above variables is 43.7 per cent. The rest of 56.3 per cent problems are explained or caused by other variables. The examination resulted in the co-efficient of project soundness variable β_1 2.294 with p = 0.025. This indeed is the lowest, yet it still has a significant effect toward minimizing agency problem among the BPRS. Other coefficeint variables (project's prospect, financial reports, contract condititions and length of contract) have positive results. It can be concluded that all those attributes can be screened to reduce agency problems in *Muḍārabah* contract.

The same regression method is also applied to the attributes of *Muḍārib*, resulting from previous analysis. There are also five main attributes identified: (1) business skill (2) collateral; (3) reputation (4) background; and (5) business commitment. The regression analysis has further resulted in the following coefficients regression:

AGPROB	= β_o +	β_1KEMBIS +	β_2JAMINAN +	β_3REPUTASI +	β_4ASALUSUL +	β_5KOMITMEN
Coef Reg	= 0,526 +	0,103 +	0,144 +	0,165 +	0,148 +	0,220
Coef. t	= (5,781)	(3,721)	(3,054)	(3,728)	(2,444)	(2,017)
p	= 0,000	0,000	0,003	0,000	0,018	0,048
F	= 13,581					
p	= 0,000					
adj. R^2	= 0,500					

It was found that F = 13.581 at p = 0.0000. This indicate that statistically the variables are significantly effective to be used in preventing agency problems in *Muḍārabah* contract at Islamic banks or BPRS.

The *adjusted* R^2 is 0,500. This means that the variaety of agency problems are explained by those indepenendent variables. While the other fifty per cent of problems are explained by other (unidentified) variables. It is then confirmed that all 5 variables identified can be utilised to reduce agency problems in *Muḍārabah* contract.

The final part is the examination of research design. To a large extent this relate to the question of those project and *Muḍārib* attributes (together) which have influences on the agency problem minimally.

As discussed above, the research found six attributes of projects and 5 attributes of *Muḍārib*. A combination of them (11 attributes) are once again tested by regression analysis. The result shows that F = 13.609 at p=0.000, and *adjusted* R^2 is 0,688. What can be concluded from this is that all those variables (together) contributed to explain 68.8% of possible agency problem that arise in the *Muḍārabah* contract, while 32.2% of problems are explained by other variables. However, further assestment on individual variable resulted in only 5 variables which howver have significant influence. They are: (1) Business skill of *Muḍārib*, (2) business reputation of *Muḍārib*, (3) Business commitmnent of *Muḍārib* (4) financial report of project, and (5) the length of contract of project.

Based on the above finding, the research model formulation proposed is:

$$AGPROB = \beta_o + \beta_1 KEMBIS + \beta_2 REPUTASI + \beta_3 KOMITMENT + \beta_4 LAPKEU + \beta_5 WAKTKONT$$

Coef Reg	= 0,409 +	0,150 +	0,142 +	0,349 +	0,540 +	0,343
Coef. t	= (4,099)	(2,083)	(2,753)	(3,219)	(3,207)	(3,398)
p	= 0,000	0,042	0,008	0,002	0,002	0,001

9. CONCLUDING REMARKS

The research has investigated how the *Muḍārabah* product has been practiced by the BPRS. From a descriptive-statistic point of view, the research found the following. First, 62.5 per cent of respondents offer between 15 – 20 per cent of *Muḍārabah* financing to customers, and the rest (32.5 per cent) offer less than 5 per cent. Second, 56.25 per cent of respondents prefer to practice *Muḍārabah Mutlaqoh*, intead of *Muḍārabah Muqayyadah*. Third, 81.25 per cent of banks signed the *Muḍārabah* contract between 1 – 2 years, and 51.56 per cent of bank had *Muḍārabah* with trading industry.

The study then identified qualitatively the attirubutes on both projects and *Muḍāribs* which are perceived by *Ṣahibul Māl*. The research initially found thirteen attributes related to project and 14 attributes related to *Muḍārib*. However, after further screening statistically, it was found that 5 main attributes related to project and 6 attributes related to *Muḍārib*.

Further quantitative analysis has been conducted to examine those attributes. This finally filters all attributes into five most influential factors. They are business skill, business reputation, business commitment (all are related to *Muḍārib*), financial report of project and length of contract of project.

Implications

The five attributes stated above can then be seriously considered by the Islamic banking management to determine both the project and *Muḍārib* before the contract is signed. As proven by analysis, the selected attributes are identified as the factors that might potentially reduce agency problems which is perceived as one of the reasons why the *Muḍārabah* contract is not widely practiced by the Islamic banks.

Limitations and further research suggestions

This research has been conducted carefully, however some limitations cannot be avoided. These include: first, the scope. As presented earlier, the research was focused on BPRS, which represent 'small' Islamic banks in Indonesia. BPRS is a rural bank limited by size, capital and location. The second limitation is: the number of samples. The sample size is statistically accepted, however it is undeniable that a larger sample, as well as broader scope might possible, but not necessarly, produce a more accurate or representative result. The third is related to research methodology. As there are many possible statistical tools that can be applied, this research applys sselected methods. This means that the aplication of other possible research methods might result in different findings. For this reason we humbly encourge other researchers to further examine what have been found by improving on some of these limitations.

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APPLICATION OF ISLAMIC BANKING INSTRUMENT (*BAY*ʿ *SALAM*) FOR AGRICULTURE FINANCING IN PAKISTAN

AHMAD KALEEM

ABSTRACT

*This article explores the possible application of Bay*ʿ *Salam contract in the agriculture sector of Pakistan. Survey is conducted in the four districts in Punjab. A specifically designed questionnaire was used to gather farmers concerns related to crops inputs, output and credit requirements. Empirical findings conclude that agriculture income represents upto 60% of average farm households' income. 70% of the farmers participate in the credit market. They need money to purchase crops inputs, to pay the labour and to hire rental machinery. Farmers think that they can save upto 25% cost if they purchase the crops inputs on cash. Survey also discloses that middlemen are the larger financers and buyers of crops in the rural economy. Only 10% transactions are conducted on cash basis. Farmers usually return money after the sale of crop. This article also suggests two possible models for introducing Islamic banking in agriculture sector. Some policy recommendations are also given at the end of the article.*

1. INTRODUCTION

Agriculture credit has a significant impact on rural economy (Zuberi, 1989; Aleem, 1990; Malik et al., 1991; Hussain and Demaine, 1992 and Khandker and Faruqee, 2003). It capitalizes farmers to undertake new investments or adopt new technologies. Agriculture sector has witness increased demand for credit over the period of time due to increase usage of fertilizers, pesticides, improved seeds and mechanization. Opposite side, income from farmland has traditional produced a low yield by comparison with the return from other form of investment (Marsden et al., 1986, p. 270).

In Pakistan, agriculture sector represents 23% of the total GDP and employed 44.8% of total labour (Economic survey of Pakistan, 2005). Access to formal credit is generally restricted to big landlords, since land is the main acceptable collateral. Restricted access to formal credit provides space to informal credit which presently accounts for 72% of total agriculture credit in Pakistan (World Bank Report 2004).

However, informal credit may not be as conducive to development as it is expensive; short-term and largely used for consumption[1].

This article explores the potential viability of agriculture financing under Islamic banking principle - *Bayʿ Salam*, in Pakistan. Islamic banking does not use interest as income generating source. *Bayʿ Salam* locks input with the output on cash basis. The article may have significant contribution in the existing literature as noe of the financial institution in Pakistan offers agriculture credit under Islamic principles. Presently, agriculture credit through formal channels is only limiting to not more than 0.57 million farmers against the potential clients number 5.44 million (State Bank of Pakistan, 2002).

1.1. Concept of *Bayʿ Salam*

Bayʿ Salam is deferred delivery contract where delivery of the commodity occurs at some future date in exchange of an advanced price fully paid at spot. According to Taqi Usmani (1998, p. 186) the basic purpose of this sale contract was to meet the needs of the small farmers who need money to grow their crops and to feed their family upto the time of harvest.

The contract is beneficial for both the parties as seller receives the money in advance while buyer normally pays the prices at lower rates. In addition, buyer can also ask the seller to furnish a guarantee in the form of mortgage, hypothecation or personal guarantee. Buyer through this contract transfers the price risk towards the seller other side seller transfers their business risk towards buyer through guaranteed quantity and quality supply of output at predefined date and place.

Bayʿ Salam contract is fully acceptable under modern banking. The only concern is bank prefers to deal in money than commodities. The problem can be solved through parallel Salam contracts whereby bank enters into two separate contracts – first with the seller and second with the buyer of the commodity. It acts as an intermediate between the two parties. The only condition is that contracts with both the parties should be entirely independent of each other.

1.2. Objectives

Following are the main objectives of this article.

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[1] Khandker and Faruqee (2003) observed that 95% formal loans in Pakistan supported production. In contrast, 56% of informal loans were used for consumption, while 44% were used to support production. The authors also observed that Agriculture Development Bank of Pakistan (now ZTBP) charged as much as 13% interest rate for smallholders (who own up to 2.5 acres of land) compared with 0% for medium and large farmers but the recovery rate is much better in case of small farmers.

1. To identify the problems faced by the farmers at the time of cultivation.
2. To explore the hurdles faced by the farmers at the time of harvesting.
3. To investigate the contribution of formal and informal lending channels in the agriculture sector.
4. To explore the viability of *Bay*ʿ *Salam* contract as an alternate to existing agriculture credit schemes.
5. To come up with Islamic financing models suitable to Pakistani agriculture sector.

2. SELECTED LITERATURE REVIEW

Agriculture sector is generally considered as cash constraints. Historically, financial institutions are reluctant to lend to the small farmers due to their inability to provide collateral, higher risks and high transaction costs associated to small loans (Adams and Fitchett, 1992). Higher interest rate is also not a recommendable solution as it ends in adverse selection (Coleman, 2006). Binswanger and Khandker (1995) estimated the impacts of formal credit using district level panel data from India. They found that formal credit increases rural income and productivity, and that benefits exceed the cost of the formal system by at least 13%.

Diagne and Zeller (2001) found that rural banks, savings and corporative societies in Malawi prefer to give loan to households with diversified assets portfolios and have more diversified incomes. Households do not consider interest rates an important factor in which financial institution to approach. Non price attribute such as types of loans provided, the restriction on their use as well as the non financial services provided play an important role.

Khandher and Faruqee (2003) examined the performance of Agriculture Development Bank of Pakistan (now ZTBP). They calculated that 10% increase in formal credit increase agriculture production cost and productivity by 1% while consumption increases by 0.04% only. They also observed that hiring labour or purchasing fertilizer and other inputs are the main purposes of the credit.

Informal lenders play a pivotal role in the provision of credit to rural household in developing countries. Amount borrowed from informal markets are primarily for consumption purposes often at very high interest rates (Johan et al., 1995). Aleem (1990) found that nearly one third of the total funds utilized in the informal credit transactions originate from formal credit sources. On average 19% interest rate is charged in informal market which is 5% higher than the formal credit. Average interest rate on inputs is 25%.

Bhalla (1976) in case of Haryana, India found that workers often borrow consumption items from the local shopkeeper and repay the loan through labour service for the landlord at below market wages. The landlord later adjusts their accounts with the local shopkeeper for the grain purchased and sold to the later.

Flora and Yotopoulos (1991) in case of Philippines pointed out that middleman usually have some collateral assets and have developed extensive relationship with the large traders through frequent dealings. They have extensive knowledge of local conditions such as the time of harvest, efficiency, yield and the reputation of the farmer. They noted that these middlemen are usually very effective in distributing loans and handling loan repayment at harvest time.

Farmers operate in a limited geographical area which allows lenders to not only become familiar with the production capacity but also have the ability to physically monitor the performance and condition (Klinefelter et al, 2005). Mansuri (1998) in case of Pakistan noted that it is often the case in informal markets that the person with the supply of credit does not have the ability to monitor and control the person with the greatest need of credit.

In another study on Pakistan, Mansori (2007) found that landless tenants borrow largely from their landlords while farm households with some land borrow almost exclusively from middlemen. In northern Punjab where the land is more equally distributed, landlord share in total debt is 16%. Most of the rest come from middlemen. In contrast in southern Punjab and Sindh where landholdings are more concentrated, landlords accounted for almost two thirds of all informal debt held by farm households.

Political interference at management level, combined with lack of competition, depressed the prices paid to the producers. Other side collective willful default is common among farmers when loan defaulters are rarely punished and local politicians are quick to defend them (Dorward et al, 1998). Brambilla and Guido (2006) noted that farmers in Zambia took loans from one institution while selling crop to another. As a result, credit prices increased, which made cotton production less profitable and led to increasing farmer default.

Khandker et al., (2006) in case of Bangladesh found that road project lowered agriculture input cost, increased transportation demand and hence increased farm productivity. The authors concluded that government policymaking in credit can influence household outcomes directly and indirectly via the input and output markets as well as through improved access to key facilities like health and education. Renos et al. (2003) measured the transaction costs occurring when a farmer sells his crops on the market. They showed that the level of transaction costs will determine which market (farmgate, local or distant market) farmers enter.

Pitt and Khandker (1998) examined the impacts of credit from the Grameen Bank on a variety of individual and household outcomes, including school enrolment, labour supply, asset holding, fertility and contraceptive use. They found significant effects of credit on the well-being of poor households in Bangladesh.

3. METHODOLOGY

The survey was designed and conducted in the four district of Punjab; Lahore, Gujranwala, Sheikhoura, and Qasur. Districts were selected on the basis of per acre productivity. Three agriculture markets from each district were selected as primary sampling unit. In addition three villages from each district were chosen on the basis of their distance from the market they were serving. Respondents were identified on convenient basis and questions were asked about the wide range of issues related to agriculture inputs, outputs and credit.

A specifically designed questionnaire in Urdu was used as a tool and farmers were requested to complete. Questionnaire was designed on an ordinal scale to quantify the responses. Some open ended questions were also included to collect additional information. Questionnaire was divided into three sections. Section one and section two covered the issues related to agriculture inputs and outputs while section three covered questions related to agriculture credit.

Trained students under the supervision of an author visited selected agriculture markets and villages. Personal connections of colleagues and students were also used. Students distributed to and collected back the questionnaires simultaneously. Farmers showed keen interest in the survey and none of them refused to participate. It is noted that good numbers of the farmers were illiterate and required students help to fill the questionnaires. The survey was conducted in the month of December and January. It was peaked season of wheat sowing and majority farmers visited agriculture markets to purchase inputs. Overall 225 complete questionnaires were collected for analysis purposes.

4. RESULTS AND DISCUSSIONS

Table 1 presents the descriptive statistics of the survey conducted. It shows that 47 questionnaires were filled in from Gujranwala district, 50 from Lahore district, 58 from Qasur district and 70 from Sheikupura district respectively. Results also find that 25.3% of the respondents hold cultivated area upto 5 acres, 45.8% upto

Table 1. Survey Statistics

Districts	Frequency	Percentage
Gujranwala	47	20.9
Lahore	50	22.2
Qasur	58	25.8
Sheikupura	70	31.1
Total	225	100.0
	Area under Cultivation	
Upto 5 acre	57	25.3
Upto 12.5 acre	103	45.8
Upto 25 acre	37	16.5
More than 25 acre	28	12.4
	225	100.0

12.5 acres, 16.5% upto 25 acres respectively. Only 12.4% of the respondents hold cultivated area larger than 25 acres. Table 1 concludes that majority of our respondents fall under subsistence and economic holdings categories[2]. They are either considered poor or middle income farmers. The survey also revealed that 95.85% of the total respondents cultivate 2 crops in a year**.**

Table 2. Number of Households Engaged in the Agriculture

Households	Fulltime (%)	Cumulative (%)	Total (%)	Cumulativ e (%)
1	11.8	11.8	3.2	3.2
2	52.7	64.5	34.5	37.7
3	17.7	82.2	25.9	63.6
4	11.4	93.6	23.2	86.8
5	3.2	96.8	6.8	93.6
6	0.5	97.3	2.7	96.3
More than 6	2.8	100.1	3.8	100.1

Table 2 presents the number of households engaged in the agriculture. It shows that 11.8% and 52.7% belong to categories where one and two family members are fulltime engaged in the agriculture. Three and four members engage in the agriculture account for 17.7% and 11.4% of the total sample. Overall upto four family members represent 93.6% of the cumulative percentage.

[2] State Bank of Pakistan in Punjab province has declared area less than 12.5 acres under subsistence holdings category, area upto 25 acres under economic holdings category and area above 25 acres as above economic category. For more details visit, www.sbp.gov.pk

Table 3. Agriculture Income as % of Total Household Income

Income	Frequency	Cumulative Percentage
Upto 20% of total income	2.0	2.0
Upto 40% of total income	14.6	16.6
Upto 60% of total income	53.3	69.8
Upto 80% of total income	20.1	89.9
Upto 100% of total income	10.1	100.0

The survey also asked farmers about the income generate from agriculture as percentage of their total income. Table 3 concludes that 14.6% farmers earn upto 40%, 53.3% farmers earn upto 60% and 20.1% farmers earn upto 80% from agriculture respectively. Only 10.1% of the sample respondents fully depend upon the agriculture income. The results can be verified by earlier study whereby Mailk (2005) found that agriculture income represent up to 55% of total family income in Pakistan.

Table 4. Modes of Purchase/Sale of Agriculture Input/Output

Source	Input purchase (%)	Output sale (%)
Cash	10.7	8.4
Credit	17.3	27.6
Both cash and credit	72.0	64.0
Total	100.0	100.0

Table 4 presents the modes of purchase and sale of agriculture input and output. The results are quite interesting. Cash purchase and sale of crops represents only 10.7% and 8.4% of total transactions. Pure credit related transactions account for 17.3% of purchases and 27.6% of sales. Majority of the farmers are involved in both cash and credit related transactions.

These figures are quite resembled to Pakistan Agricultural Census Commission (1995) which concluded that informal sources account for 78% of the loan volume in rural areas. In another study on rural finance, State Bank of Pakistan (2002) admitted that 70% of the agriculture credit requirements are not met has resulted in charging of extremely high interest rates by the informal credit providers. World Bank report (2004) highlighted that nearly 80% of cultivators' in Pakistan participates in the credit market. Out of this percentage 40% are cash constrained.

Our survey also indicated that 46.5% of the total respondents return their loans after the sale of crop; another 45.5% returns whenever they receive money from other sources. Only 8.2% confirmed that they return their loans as committed. 61.5% of the sample farmers admitted that they 'sometimes' and 29.4% 'always' faced financial problems during the cultivation[3]. When asked about the possible savings made if inputs are purchased on cash. To our surprise, 85.9% of the farmers were confident that they can save up to 25% of cost if they purchase inputs on cash[4].

Table 5. Reasons for Low Agricultural Productivity

Reasons	Percentage	Ranking
Substandard quality of seeds/pesticides/fertilizers	29.28	1
Unavailability of required water	26.38	2
Crops diseases	14.20	3
Unavailability of required machinery	13.48	4
Unavailability of transport	8.99	5
Lack of technical guidance	7.68	6

Reasons of low productivity are represented in table 5. Results indicate that farmers consider substandard quality of seeds/fertilizers/pesticides (29.28%) as the major reason behind low productivity. Our investigations revealed that financial institutions restrict farmers to purchase seeds, fertilizers and pesticides etc. only from the authorized dealers. Farmers' complained that authorize dealers generally sell substandard inputs. Table 5 also highlights unavailability of require water (26.38%), crop diseases (14.20%), unavailability of required machinery (13.48%) followed by unavailability of transport (8.99%) and then lack of technical guidance (7.68%) as major reasons behind low productivity[5].

Farmers also mentioned other hurdles such as lack of godown facilities, high cost of diesel and electricity, expensive agricultural products, late supply of fertilizers and pesticides etc. Table 6 summarizes the problems faced by the farmers at the time of crops sale. 28.48% farmers indicated that they have no option but to sell to the middlemen to adjust their loans. Unavailability of the transport to bring crops to nearby markets (20.00%) is the second major problem.

[3] World Bank Report (2004) indicated that around 17% of all rural households in Pakistan always face credit rationing, resulting a 23% reduction in the value of crop yields.
[4] Aleem (1990) found that average interest rate on inputs was 25%.
[5] World Bank Report (2004) indicated that farm productivity for credit constrained farmers is likely due to lower input as well as fewer long term investments in land or equipment. In addition, limited access to credit also prevent farmer to cultivate more land.

Table 6. Problems Faced at the Time of Crop Selling

Problems	Percentage	Ranking
No option but to sell to middleman at low price to repay the loan	28.48%	1
Unavailability of transport	20.00%	2
Do not get customers who give cash	17.58%	3
Do not receive money on time	13.94%	4
Improper way of auction	10.91%	5
Dishonesty	4.24%	6
Others	4.85%	7

Farmers also complained that they do not find customers who give them cash (13.94%) and they also do not receive money on time (10.91%). Improper way of auction (10.91%) and dishonesty in weight (4.24%) are also some major issues. Farmers' also highlighted agriculture related problems such as;

- Government departments do not care about the farmers
- Lack of agriculture related programs on television
- Crop damage due to flood and bad weather
- No proper arrangement of selling crop on cash
- Majority of the farmers are in debt
- Old traditional way of cultivation
- Tedious procedure of taking loans from the banks
- Bad roads

The survey also inquired farmers about the main buyers of their crop? Combined responses indicate that middlemen (43.13%) and wholesalers (29.15%) are the major buyers followed by mill owners (18.72%) and then government (9.0%). 72.6% of the farmers indicated that buyers of their crops 'sometime' return their money late. 19.25% farmers complained that that they 'always' receive the money late. Further, 33.8% of the total respondents commented that it is difficult to recover money once you sold your crop[6].

Zuberi's study (1989) found that formal credit is an important determinant of fertilizer and seed expenditure. Pakistani farmers typically borrow money at the

[6] State Bank of Pakistan (2002) noted that majority of middlemen running license shops in the fruit and vegetable markets in all the big cities of Pakistan. The most surprising the middlemen are completely disconnected with the commercial banks. Most of the middlemen have considerable assets at their disposal but they perceive obtaining bank loans complex procedures.

beginning of the harvest to purchase the input. Our survey found that 42.48% farmers need money to purchase crop inputs[7], 25.20% to pay the labour, 22.56% to hire rental machinery and 9.76% to pay the lease of their agricultural land. Enhanced credit can thus ensure that key inputs are available in sufficient quantity and in a timely fashion which will ultimately resulted improve agriculture productivity.

Farmers were also asked about how they meet their financial needs? 47.11% farmers meet their financial needs through borrowing from middlemen, 22.80% from friends and neighbours, 11.55% take advance against crops and 10.33% take loans from banks. Small minority (8.21%) of farmers use their own savings[8]. One farmer commented that 'bank loan or loan from middleman costs the same after paying the documentation charges and bribe to bank officials.'

Table 7. Securities Offered Against Loan

	Percentage	Ranking
Personal guarantee	64.82	1
Agricultural land	22.92	2
Any valuable asset	6.32	3
House	3.16	4
Bank guarantee	2.37	5
No guarantee at all	0.40	6

Table 5 indicates the type of securities the farmers can offer against loans. The results show that 64.82% of the respondents can only offer personal guarantee. This outcome can be linked with the respondents profile as mentioned in table 1. 61.1% of our respondents hold area less than 12.5 acres and are poor. They generally do not have extra assets to offer as security. Table 5 also shows that 22.92% and 6.32% farmers can either offer agriculture land or any valuable asset as securities against loan. These results can be verified by World Bank report (2004) which found that all formal loans in Pakistan require collateral and one third are loans are against agriculture land. In contrast, 90% of the informal loan require personal guarantee.

[7] The study of Von Braun et al. (1993) showed that farmers with access to credit have 37% higher input expenditures than those without such access. Formal credit is used to purchase seed and fertilizer.

[8] Khandker and Faruqee (2003) in case of Pakistan calculated that friends and relatives, who do not usually charge any interest, provide 57.2% of the informal loan volume, while interest charging informal lenders (such as *arthi*, input suppliers, shopkeepers, commercial agents and others) provide the remaining 42.8%

Table 8. Advance Against Crops

Responses	Frequency	Percentage
No opinion	8	3.7
Not good	130	60.5
Good	77	35.8
Total	215	100

Farmers were also asked about their opinion towards selling crops in advance. Surprisingly, 60.5% responded are not in favour and 35.8% favoured the idea of advance selling of crops. Further inquiry revealed that middlemen already offer these services in the market. However, middlemen only decide the price once the crop comes in the market. Even sometimes the prices of inputs are not negotiated until harvest when it is based on prevailing market rates[9]. Mansori (1998) found that loans by traders are invariably linked to crop purchase in Pakistan. In fact traders in her surveyed area view cash repayment as a breach of contract terms.

How would they return their loans in case of crop failure was the next question asked? 63.13% replied that they will return when they receive money from other sources. Another 35.03% farmers indicated that they will return on next crop. Our findings also show that 48.9% of the total respondents are aware of Islamic banking in a country. They are normally large farmers.

Table 9. Middlemen as Agents of the Banks

Opinion	Frequency	Percentage
Agreed	66	30.7
Not agreed	45	20.9
Depending upon the person	104	48.4
Total	215	100.0

Farmers' opinions towards the appointment of middlemen as agents of the banks in their respective areas were also explored. Table 9 indicates that majority is either agreed (30.7%) or will decide once the person is appointed (48.4%). Only 20.9% respondents are not in favour of the idea. Farmers also mentioned some possible problems regarding the appointment of the middlemen as agents such as;

[9] Irfan (1999) reported that interest charges of money lenders in Punjab ranging from 48% to 120% per year. State Bank of Pakistan (2002) admitted that informal market charges exploitative interest rates ranging from 50% to 100% per annum. Most informal lenders have limited loan portfolios and operate within narrow area of their influence. In another report on Pakistan, World Bank (2004) reported rural informal sector interest rates ranging from 80% to 150%.

1- Give less profits
2- Consider their own benefits
3- Charge high service charges against the facility provided
4- Give preference to their own relatives
5- Delay in payments
6- Give small amounts as cash
7- Offer less rates for the crop than the market

4.1. Discrepancies in Farmers' Perceptions

State Bank of Pakistan has segregated land holdings in Punjab into three broad categories i.e. (a) subsistence holdings (up to 12.5 acre), (b) economic holdings (up to 50 acres) and above economic holdings (more than 50 acres). This section presents the major discrepancies among farmers of subsistence holdings and economic holdings.

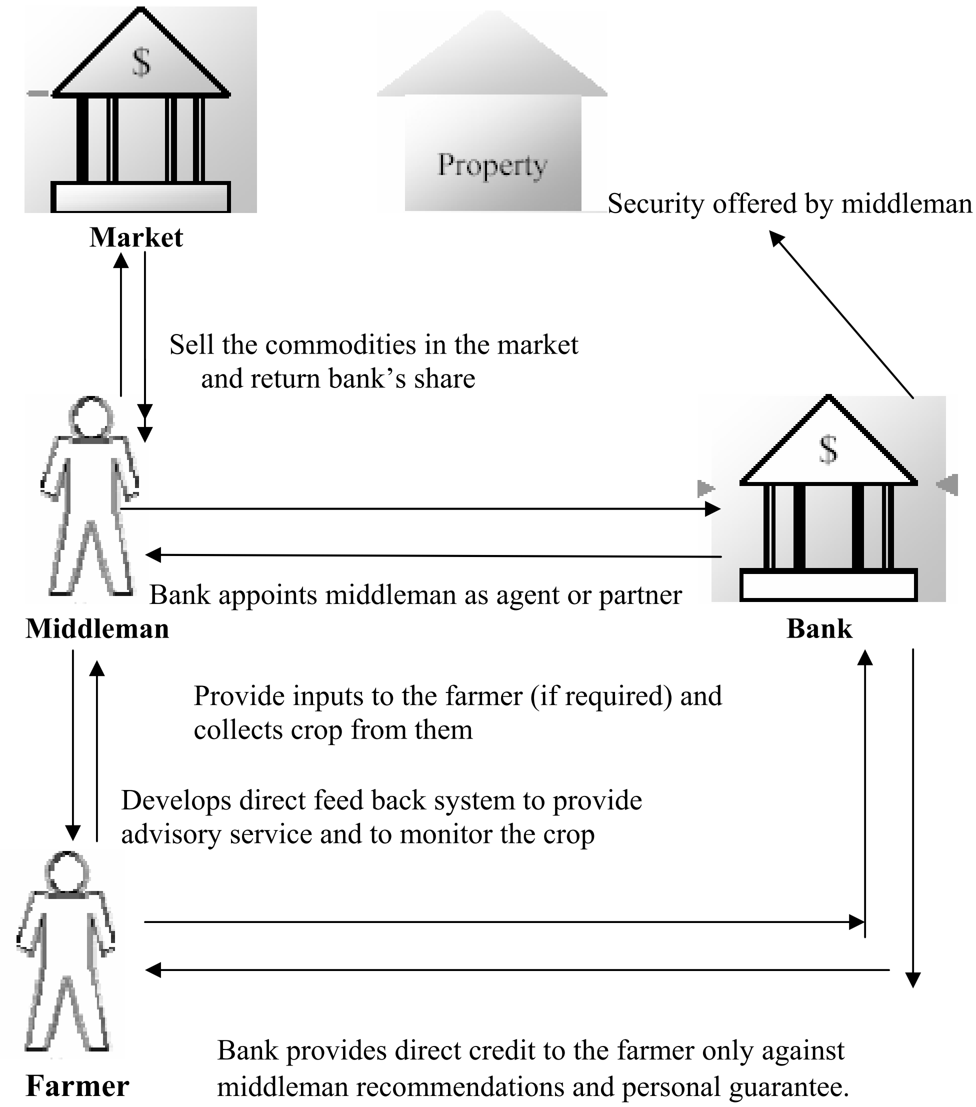
Table 10. Nature of Land Holdings

No	Subsistence Holdings	Economic Holdings.
1	Need money for input and rental machinery	Need money to pay the rental lease of the land
2	always face financial problems	Sometimes face financial problems
3	Majority sell their crop on credit	Majority sell their crop both on cash and credit
4	Always receive their amount late	Sometime receive their amount late
5	Majority depend upon middlemen	Majority depend upon mill owners
6	Can only provide personal guarantee	Can provide both personal guarantee and agriculture land for mortgage.
7	Less aware about Islamic banking	More aware about Islamic banking

5. PROPOSED MODELS FOR AGRICULTURE FINANCING UNDER ISLAMIC BANKING

Model 1: Bank appoints middleman as its agent or enter in a partnership agreement. Middleman identifies the potential farmers from his area. The loans are only provided against his recommendations and personal guarantee. The bank provides credit direct to the farmer and also develops direct feedback system to monitor crop. Bank may also demand personal guarantees from the farmers. At the time of harvesting, middleman is also responsible to collect the crops from the farmers, sells in the market and returns bank's share as per agreement.

Model 1

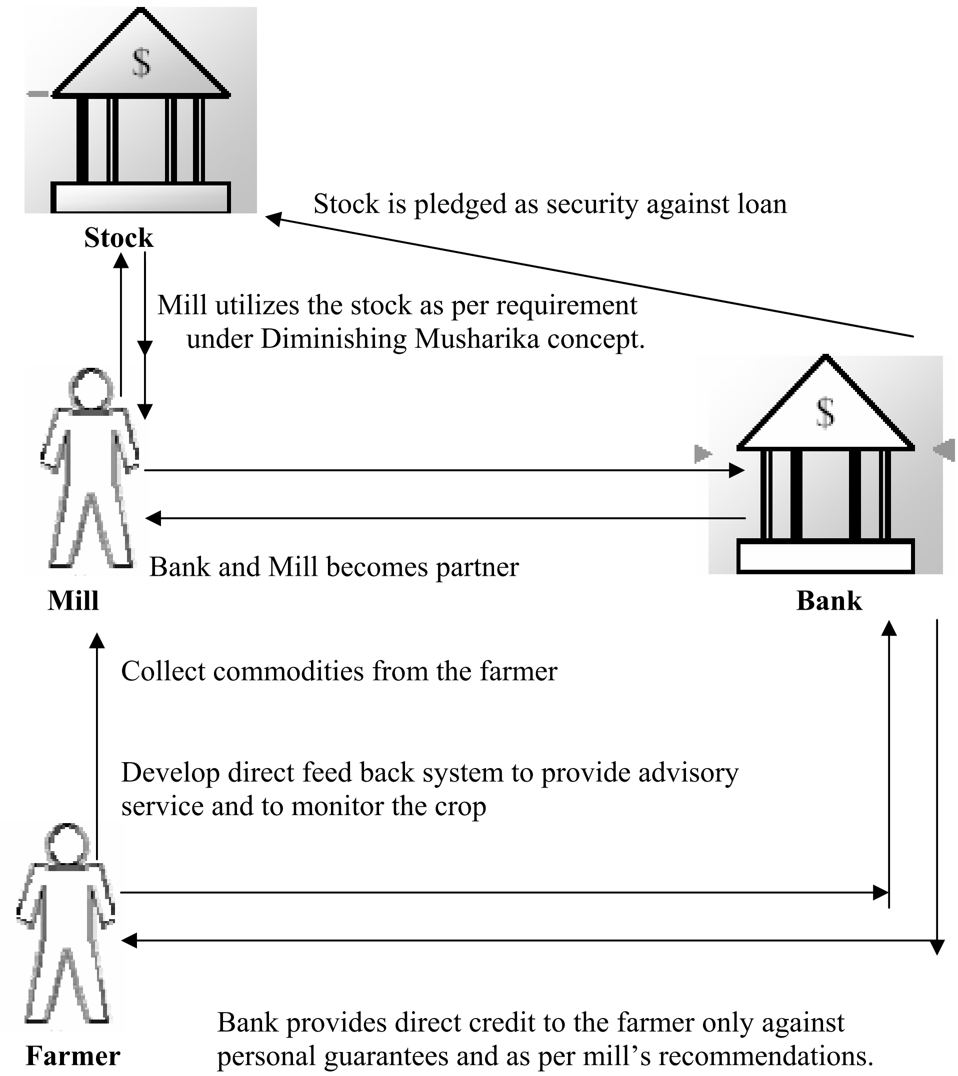


Model 2: Bank and mill becomes partners under diminishing musharika[10] concept. The later identifies the potential farmers and recommends them for loan. The bank provides credit direct to the farmers and also develops direct feedback system to monitor the crop. Bank may also demand personal guarantees from the farmers

[10] Here the share of the bank is divided into number of units. The client purchases all units from the bank periodically till he becomes the sole owner.

who are also responsible to transport crop to the mill. Once the crop reaches the mill bank pledges the crop and later mill purchases bank's share as per agreed terms and conditions.

Model 2



6. POLICY RECOMMENDATIONS

Agriculture is considered as the backbone of Pakistan's economy. Around 65% of the population lives in rural area and directly and indirectly link with agriculture. State Bank of Pakistan (2002) reported that there were 3183 commercial banks branches in rural areas with a total deposits of Rs 159 billions and advances Rs 21.50 billions and lending/deposit ratio of 13.44%. The figures show great scope for Islamic banks to enter in agriculture financing.

The survey concludes that farmers rarely afford to purchase the seasonal inputs on cash basis. They should be offered reasonable returns for their investments otherwise opportunists' middlemen may offer higher prices and lead the whole scheme to failure.

Banks should initially sign selected contracts under *Bayʿ Salam*. The caution is needed in the presence of existing debts of the farmers. The degree of expansion may be achieved after successful initial phase.

Reputation of the farmer should play a vital role in the whole lending decision. Guarantee of future loans should be awarded to the regular payers. Repayment schedule may need to be rescheduled when factors genuinely beyond the control of the farmer.

Banks may appoint middleman as its agent or partner. This arrangement can play twofold important roles (a) to reduce the operational procedure for screening borrowers, monitoring loans, (b) to achieve high loan collection if the farmers announce a bad outcome. It is this enforcement cost which can make a layered arrangement between both the parties attractive.

Quick and efficient decision making will be critical for the success. Bureaucratic procedures, restrictive collateral requirements, petty corruption may fail this financial product.

Continuous monitoring and information sharing with the middlemen in previous defaults can play an important in building trustworthy and cost efficient working relationships.

Sale of substandard seeds, fertilizers and other inputs should be strictly curtailed. Otherwise, once the crop fails banks would hardly even recover the original investments until next harvesting.

The concept of *Bayʿ Salam* may be extended towards non-farm activates. Extensive literature is available about the use of animals as savings and also as insurance against the events of crop and market failure.

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APPENDIX

Supply of agriculture credit by institutions

(Rs in millions)

Year	ZTBL*	Commercial Banks	Taccavi Loans	Cooperative Societies	Total
1987-88	7,598.48	5,171.45	9.14	2,864.42	15,643.49
1990-91	8,218.40	3,629.58	5.58	2,381.96	14,235.52
1995-96	10,260.50	5,031.80	6.48	5,923.16	21,221.94
1999-00	24,170.97	9,188.98	6.26	4,301.61	37,667.82
2000-01	27,293.17	11,936.28	6.33	4,829.24	44,065.02
2001-02	28,848.44	17,373.14	7.30	5,126.24	51,355.12
2002-03	29,107.58	22,596.41	7.30	5,594.70	57,305.99
2003-04	29,693.48	35,721.30	N.A	7,563.54	72,978.32
2004-05	37,216.92	63,721.10	N.A	7,607.46	108,545.48
2005-06*	43,000.00	79,000.00	N.A	9,000.00	131,000.00

* Allocated targets for the financial year 2005-06
ZTBL* Zarai Taraqiati Bank Limited

GHARZUL-ḤASANEH FINANCING AND INSTITUTIONS

KAZEM SADR

ABSTRACT

In this article the characteristics of Gharzul-ḥasaneh loans will be presented. Then the decision of consumers to allocate their income into their consumption and savings will be analyzed initially. Subsequently, their alternative methods of savings in the form of gharzul-hasneh savings, charity donations and long term investments will be analyzed. The third section is devoted to functioning and performance of Garzul-Ḥasaneh Funds (GHF) in the urban and rural sectors of Iran. Lastly we summarize and conclude that Gharzul-hasneh mode of finance and Gharzul-ḥasaneh organizations can play viable and unique role in the Islamic financial markets.

1. INTRODUCTION

Although multitude of financial tools have been introduced and applied in the Islamic financial markets, there are yet many other instruments that have not been applied widely by Islamic financiers. Among these less recognized modes of finance is the *Gharzul-ḥasaneh* contract; which, despite its "zero" stipulated nominal rate of return by Sharīʿah, is a viable tool of finance and can be used by both formal and informal financial intermediaries.

The basic purpose of this article is, to introduce the characteristics of this contract as a financial instrument and the utility it provides for the suppliers of funds. It will be argued that the inherent unique characteristics of this Islamic contract provide many incentives for both the individuals and institutions, to use it as a reliable mode of finance. These features further motivate formal and informal organizations to be formed to intermediate between the borrowers and lenders.

The second objective of this article is to enumerate and analyze the characteristics of the Gharzul- hasaneh institutions and the financial services that they offer. *Gharzul-ḥasaneh* funds (GHF) are the oldest Islamic financial institutions in Iran which were established long before the victory of Islamic revolution. They have grown over time both in number and offer wider spectrum of financial services, and do figure as a prominent segment of Iranian financial market. Their versatile activities compelled the Central Bank of Iran to submit an

Act to the Iranian parliament and get its approval in order to be able to supervise the functioning of GHF's like the banks, credit institutions and other monetary organizations.

2. CHARACTERISTICS OF *GHARZUL-ḤASANEH* MODE OF FINANCE

According to Islamic Sharīʿah principles and legislations, anyone who borrows from another has to return full amount of the loan whenever the lender calls for it. Although no surplus or additional service charges can be demanded by the supplier, he is entitled to have his funds paid back anytime he so desires; except for a condition which may specifically state and clarify the maturity date or the redemption period of the loan right at the outset when the *Gharzul-ḥasaneh* contract is made[2]. Further, if the borrower delays repayment, he can be subjected to a penalty. These legislative characteristics make *Gharzul-ḥasaneh* loans very secured. They also make the asset owner indifferent between holding a part of his assets as cash or a *Gharzul-ḥasaneh* loan. In either form, he can have access to them immediately. As said, this opens an alternative use for the money that is held for precautionary purposes, to be loaned to other consumers or firms.

Second, *Gharzul-ḥasaneh* is very versatile in nature and can be used for financing all sorts of consumption, production, services and debt activities. Financial firms can benefit from this feature to finance the demand of their customers when other tools are not applicable. It is possible in rapidly changing economic conditions that entrepreneurs come up with new plans to be financed and the already available schemes would not suit the purpose. Tentatively, financial firms can use *Gharzul-ḥasaneh* to launch the enterprise and start working on a well designed financial program.

The third characteristics of a *Gharzul-ḥasaneh* contract is that it is complementary to other financial contracts. Often several tools are used to finance a project. For example a poultry project may be financed by musharaka contract to build the buildings, by installment sale to purchase the machinery and equipment, by forward purchase to obtain the granulation. It is possible that in the life of a project, due to some emergencies, an entrepreneur would run into debt and no other tool but *Gharzul-ḥasaneh* would be appropriate to finance it.

3. PREFERENCES OF *GHARZUL-ḤASANEH* DONERS

Gharzul-ḥasaneh loans are offered both by consumers and financial firms. Characteristics of *Gharzul-ḥasaneh* as a tool of finance which were reported above explains why the firms select this tool individually or in combination with other financial instruments to finance various enterprises.

According to standard theory, consumers allocate the flow of their income into a series of consumption over time such that their consumption time preference rate between each two periods would be equal to the market rate of return between the same two periods. If the market rate of return could be assumed to be equal over all periods, then the consumer in each period consumes that much whose time preference rate would be equal to the market rate of return. This implies that the flow of consumer's savings in each period depends both on the market rate of return, the distribution of the flow of their income over time and their total wealth or present value of their income. At times of uncertainty, an individual selects alternative assets, as savings, according to their expected rate of return and risks. Thus each individual selects a portfolio of low , medium, and high expected rate of return and risks, respectively. Not only the attitude of individuals towards risk are different and their choice of assets portfolios would be different, but their perception of risk would also be different; that is, an asset may seem risky to one individual and safe to another; regardless of their attitude towards risk. Therefore two risk neutral individuals may select two separate portfolios, because their perceived risk of identified assets are different.

Many a times, an asset many not have market and therefore an observable rate of return. At such times, the choice of the consumer will depend on the perceived rate of returns of these assets.

The range of such assets are wide open to Muslim consumers. According to the holy Quran, the payment of *Gharzul-ḥasaneh*, charity donations and financial obligations such as zakat, khoms, and Haj spending have definite rewards. Sometimes these rates are specified in Quran; for example the reward of *Gharzul-ḥasaneh*.is tenfold [6/160] and that of charity can be 700 times more [2/261]. But over all the reward is certain, the extent of it depends on the prevailing economic conditions. If a large segment of population is poor, charity may be the most rewarding, but if they can earn their subsistence income level, *Gharzul-ḥasaneh* may have the highest payoff. On the other hand, at late stages of economic growth, donations may have maximum return. At all states of the economy, however, all the stated financial rituals have spiritual rewards, but their priority or perceived rate of return depends on the prevailing conditions. Therefore, Muslim believers will always save part of their savings in the form of *Gharzul-ḥasaneh*

Clearly, applicants always prefer *Gharzul-ḥasaneh* loans to other types of finance for financing their activities. Given such state of demand on one side and preferences of suppliers to offer *Gharzul-ḥasaneh* loans on the other side, there will be room for intermediaries to be formed and lower the contract cost between the two sides. In fact, *Gharzul-ḥasaneh* funds (GHF) and organizations were established in Iran to fulfill this purpose.

4. CHARACTERISTICS OF *GHARZUL-ḤASANEH* FUNDS (GHF)

These funds were innovated and founded prior to the victory of Islamic revolution in Iran. Mostly, they were voluntary and established in Mosques, among families, or employees of an organization. Thus, they did not need a working place and be registered as a charity or non governmental organization. This is why it is difficult to trace the date of their establishment. However, the first fund which was registered in Tehran was formed in 1969 with 140 thousand rials capital (almost $ 2000). It then extended activity by collecting deposits and facilitating zero interest bearing loans. It is a well developed and active fund at present. It took 4 years until the third fund was registered in Tehran with TR 1200 (Thousand Rials) working capital ($ 17143) and 120 share holders. This new fund was registered as a financial (commercial) unit and was eligible to collect deposits and extend non-interest bearing loans. Since prior to the Islamic Revolution all banks were interest based institutions, this new fund served as a model for an Islamic financial institution and few others were established in other cities with the same model.

Therefore, it seems that two types of *Gharzul-ḥasaneh* organizations were developed prior to the revolution; first the voluntary funds to collect *Gharzul-ḥasaneh*. deposits and extend loans, and second as non-interest bearing financial organization. In fact, one of the latter was called "Islamic Bank". The total number of both types reached at least 200 units until 1979.

After the Revolution, the number of funds started growing both in cities and villages According to one source, out of 1200 units which were surveyed, %59 were located in cities, %16 in counties, and %25 in villages. Their total number exceeded 1250 by 1986. The reason for this rapid growth were religious motives of people, ambiguous nature of banking system before the implementation of Interest-Free Banking law in 1984. Prior to this date, all banks were nationalized in Iran (1989) which by itself affected the performance of the banks.

Although GHFs could be registered as non profit organizations by the Interior Ministry, few of them opted to be registered. Therefore, the total number of them is unknown at present.

As said above, the banks were nationalized after the revolution. This decision provided no opportunity for the new private financial institutions to be established. One available avenue was the establishment of GHF's. Therefore, in addition to the two previous models, this new type should also be considered. This necessitated Central Bank of Iran to gain a supervision right over the GHF's as of 1989. The central bank efforts led to proposal of "Unstructured Money Market" act and its approval by the Parliament in 2005. Its code of procedures are being approved by the Government.

One of the financial institutions which was formed in the early years of Revolution (1979) with the intention of becoming an "Islamic Bank" and was forced to reshape its organization into an "Islamic Economic Organization" (IEO) after nationalization of banks started to establish financial relations with other GHF's providing both financial services and training to them. These services include *Gharzul-ḥasaneh* loans, managerial instructions, accounting and deposit-loan management services. In return, the GHF's should open a deposit account and keep a ratio of their statutory reserves in the IEO and abide by its supervision. These relations are established, however, perfectly on the voluntary basis with no connection with either the Central Bank or any other government organization. In fact the majority of GHF's are not a member of IEO.

In some provinces, GHF's have formed a regional unit in which they deposit their excess funds and borrow from it at times of their liquidity shortages. These regional GHF's are also volutary financial units and their membership is optional for the local units. They are mostly, themselves, member of IEO. Other than these too central and regional organization, no other financial body monitors the financial activities of GHF's.

5. THE ORGANIZATION OF *GHARZUL-ḤASANEH* FUNDS (GHF'S)

As stated earlier, the organizational form of GHF's varies very much according to their purposes and locations. Those that are formed among families and employees of an organization have no specific structure and the form of the rest varies according to their size. But, mostly the latter type, i.e. those that are located in a workshop have constituent assembly, board of directors, general manager, inspectors and employees. Each fund has also a board of trustees which, are mostly selected from local well known and trustworthy persons, among whom the board of directors will be chosen. The employees are some paid and some are volunteers.

The general requirements for eligibility of applicants are as follows:

1. The application should be for a legitimate purpose
2. The borrower should be qualified and in real need for the loan.
3. He or she should have a deposit account in the fund or open an account.
4. The applicant should be introduced by one of the directors
5. The applicant should offer adequate guarantee for repayment of the loan according to the terms set by the fund
6. Someone should guarantee the repayment of the loan by the borrower
7. The applicant should be located within the fund's service area.

It should be mentioned that in smaller funds some of above requirements are levied.

The funds provide loan for the following purposes.

1. Marriages
2. Home repairs
3. Residential rents and mortgages
4. Hospital and illness expenses

5. Business working capital
6. Education
7. Agricultural activities; including farming, animal and poultry production
8. Small industries
9. Home appliances
10. Rehabilitation of damages caused by natural disasters
11. Pilgrimage
12. Supporting other GHFs
13. Supporting private and State organizations
14. Repairs of mosques, shrines and library construction
15. Others

6. THE PERFORMANCE OF *GHARZUL-ḤASANEH* FUNDS (GHFS)

As indicated before, the exact number of GHFs is indeterminate. There were at least 2250 units of them in 1986 [3]. But the number has been estimated to grow to 5500 units by the year 2000, according to one source [5]. At this year the IEO had 1200 of them under its supervision. The Statistical Center of Iran published the results of a sample survey of GHFs in 2000 which had been carried out for the purpose of GNP accounts and these funds contribution to the national value added. This Center has reported the performance of 1229 GHFs which are situated in small workshops. Their statistics are reproduced as under:

Table 1. Deposits and Loans (Number & Million Rials)

No. of Deposits	6,480,237
No. of Loans	1,777,583
Total value of Deposits	2,109,914
Total value of Loans	1,572,959
Total outstanding	620,368

The average size of the working places of 1229 surveyed units are 95 square meters. Fifty four percent of them are privately owned, 25 per cent are rented, 14 percent are endowed (waqf) and 6 percent have other types of proprietorship. Almost all of them compensate their expenses by their revenues and only 42 units are dependent on donations and helps for their compensation[3].

It may be noticed in table-1 that the number of deposits in all GHFs in the year 2000 is more than 6.48 million accounts and that of loans is more than 1.7 million offers. Since the amount of each deposit is usually small and that of loans are much greater than that, the number of deposits is a multiple of loans. But the difference between the value of deposits and loans are closer; out of MR 2.1 deposits, MR 1.57 loans have been paid. From this latter total sum of MR.0.95 (%60) have been paid back in the same 2000 year. As noticed, they are very successful in intermediation between borrowers and lenders, collecting many small and trivial deposits, each about R.325,592 and offering many larger loans of about R. 884,889 each , on the average.

Table 2. Value added

	Million Rials
Output Value (revenues)	7o443
Intermediate goods & inputs	8884
Value added	61560

The total value of output or revenues of GHFs are MR.70,443; they use MR 8,884 intermediate products and inputs, to produce MR.61,560 value added in the year 2000. Their labor input productivity in the same year is MR.10 and the ratio of total outputs to input value is 12.6. Therefore GHFs contribute significantly to the value added of the Iranian economy and play an outstanding role in its financial sector .

What are the sources of revenues of GHFs? The answer is provided in table 3. Almost 71 percent of total revenue is restored by sale of loan services; that is charging for their services. This rate differs among various fund units since their cost of operation is different. As will be reported, some have voluntary employees, and others have paid workers. Some pay for the rent of their working place and some have it free. But the overall rate is about one percent of the principal, regardless of period of the loan. It should be added that since each borrower is

Table 3. Revenues in Million Iranian Rials

Total sum	88494
Loans service charges	62587
Commodities sold	10791
Communication	67
Renting Residential buildings	363
Rental income of non- residential buildings	1000
Government grants & subsidies	104
Individuals & non government donations	10382
Others	3201

fully interviewed and evaluated before the service, some of the applicants who are poor will be exempted from the charge.

The next large item is the sale income of commodities. Many funds provide the necessary home appliances, durable consumable goods and also production inputs in rural areas, and secure income for the fund. The rental income of residential and non-residential buildings is the next category. Other sources of income are donations and contributions of individuals, government and non government organizations. Since some of these funds are established and operated by employees of government organizations, they receive some times support from their organizations.

Table 4. Outlays and Expenses (Million Rials)

Sum	94504
Employees compensation	37352
Employees redemption	162
Cost of accounting & legal services	549
Out of town missions	65
Purchase of sold commodities	8301
Rental charge of work place	908
Repair of tools & instruments	346
Repair of cars	130
Repair of buildings	596
Office tools and machines	1110
Cleaning materials	178
Communications	533
Insurance	415
Water	200
Electricity	613
Fuel & energy	457
Depreciation	2697
Taxes	667
Transfer payments	449
Repayment of Loans	35479
Banking services	154
Payment to depositors	312
Others	2831

The expenses of GHFs are listed in table-4. The major items are labor and capital input outlays. Although some of workers are non paid in GHFs, still the total employees compensation, redemption, and missions are MR 37579. If this figure will be added to accounting and legal services, the sum will come out to MR 38128 or 40 percent of total funds expenses. The capital tools and building expenses include rental charge of working place, total instruments and buildings repair, and purchase of office tools. All together they amount to MR 3090 or 3 percent of total expenses. If purchase of goods for sale will be added to this figure, i.e. MR 8301, it will comprise 12 percent of the total sum. Further, if depreciation outlay will be added too, the whole rent, repair, purchase and depreciation of capital items will be MR 14088 or 15 percent of total expenses. Other than the operating cost, i.e. utilities and fuel, the important items are transfer payments 449, which include poor and needy borrowers who will be exempted from repayment of their loans. Next item is MR 32479 for repayment of loans which GHFs will obtain from IEO or other banks. Payment to depositors include the prizes and gifts that will be distributed among depositors.

Table 5. Fixed Capital Formation (Million Rials)

	Purchase order	Construction	Reconstruction & repair
Equipments & instruments	1364	2	23
Office furniture & tools	2357	34	147
Cars	255	-	27
Buildings	2613	345	864
Computer Soft wares	1110	10	1
Others	256		
Total		9407	

Table 5 exhibits the total fixed capital formation of MR 9407 and its various components. As expected, investment in buildings has the highest share and office material and tools have the next higher share. Another interesting item is computer soft wares, indicating that some of GHFs are adopting the new IT technology for an efficient offer of financial services.

The employees information are presented in table 6. Although there are funds operating with one worker, the average number per fund is 5 persons. The proportion of paid, part time paid and unpaid employees are 57, 19 and 24 percent, respectively. It is noticeable that almost one fifth of GHF employees are voluntary individuals. Less than one percent of total workers are illiterate, though non are among women. It was reported before that labor productivity in GHFs is MR 10, on the average.

6. SUMMARY AND CONCLUSION

Gharzul-ḥasaneh contracts entail features which make them very desirable for offering loans, despite their zero rate of return. The fact that lender has the right to have the principal paid back at any time that he asks for it, make it a very secure loan. Therefore, the supplier may treat his Gharzul- hasaneh loans as liquid assets in his portfolio. This feature may lead further to substitution of these loans for money, when they are held for precautionary purposes.

Table 6. Employees Information

Total	6149
Paid full time	3489
Men	(3439)
Women	(50)
Paid part-time	1151
Men	(1136)
Women	(16)
Unpaid	1509
Men	(1490)
Women	(19)
Literate	6106
Male	(6021)
Female	(85)
Illiterate	43
Male	(43)
Female	0
Total	6149

Second, *Gharzul-ḥasaneh* loans can be offered to fulfill all types of demand for financing production, consumption and debt payment activities. This second feature makes *Gharzul-ḥasaneh* contracts a very versatile instrument of finance. Additionally, this contract could be combined with other tools to finance all pieces of a project or an endeavor. Thus it plays a complementary purpose to other equity and debt based sets of Islamic financial instruments. Fourth, at some economic conditions, the perceived rate of return of these loans may exceed that of donations, charities, or endowments. This may lead to its additional supply, in such conditions, making its flow equal to that demanded in the financial market.

These features open room for *Gharzul-ḥasaneh* intermediaries to be formed. In fact long before the Islamic revolution in Iran, *Gharzul-ḥasaneh* funds were formed informally among families, members of organizations, and neighbors in a locality. Other funds were formally established as registered organizations. Their number has grown from 200 prior to the revolution up to an estimate of 5000 at present. As said, many of these funds are still unregistered and therefore no information about their performance is accessible. Even those which are registered, are not monitored by the Central Bank, although according to a new act which was passed last year by the Parliament, they will be soon supervised by this bank.

The statistical center of Iran surveyed 1229 GHFs in the year 2000. This survey shows that they contribute significantly to the value added of financial sector in

Iranian economy by collecting small deposits and disbursing them to borrowers. They provide loan for multitude of production, consumption and service purposes.

Although GHFs vary considerably in size and extent of their activity, they are mostly small units serving a local community on a personal relationship. Thus, their transaction cost is low both for the lenders and borrowers. They make up a significant segment of the financial market and play a complementary relationship with banks and other formal institutions. With the implementation of the newly approved act in the Parliament, Central bank will resume supervision over GHFs. At the same time Central Bank should support the formation and extension of these funds and also provide efforts to facilitate the provision of their services.

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MURĀBAḤAH *MODE OF FINANCING FOR MICRO AND MEDIUM SIZED ENTERPRISES: A CASE STUDY OF* BAITUL MĀL WATTAMWIL (BMT), *YOGYAKARTA, INDONESIA*

NUR KHOLIS

ABSTRACT

This study evaluates the practice of murābaḥah mode of financing as an Islamic instrument and contract for micro and medium sized enterprises in the operations of Baitul Māl Wattamwil (BMT), Yogyakarta, Indonesia. BMT is a unique Islamic micro finance institution. The study examines the practices of murābaḥah financing products, its procedures and its application in the BMTs, Yogyakarta, Indonesia in the light of Sharīʿah rules; evaluates to mark up price method of murābaḥah financing product to show its similarities or differences with interest rate determination in conventional banks and evaluates the policies and actions of BMT's management in case of defaults.

1. INTRODUCTION

1.1. Background

The development of Islamic finance (banking) in Indonesia, though recent has been spectacular. There are four types of Islamic or Sharīʿah banks in Indonesia. They are Islamic commercial banks (BUS), Islamic banking units (UUS), Islamic rural banks (BPRS), and Islamic microfinance institutions (BMT). Bank Muamalat Indonesia (BMI) as the first Islamic commercial bank established in 1991 represents the first kind. Eight years later (1999), the second Sharīʿah commercial bank was established, namely Bank Sharīʿah Mandiri. Until November 2006, there are three Islamic commercial banks.[1] The later Islamic commercial bank is Bank Sharīʿah Mega Indonesia (2004).[2]

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[1] Direktorat Perbankan Sharīʿah Bank Indonesia (Nov 2006), *Islamic Banking Statistic.* Jakarta: Bank Indonesia, p. 2.

[2] Direktorat Perbankan Sharīʿah Bank Indonesia (2005), *Laporan Perkembangan Perbankan Sharīʿah Tahun 2005.* Jakarta: Bank Indonesia, p. 16.

After the New banking Act (No. 10, 1998) was regulated, many conventional banks are interested to operate the special branches which are based on the Sharīʿah law, named by Islamic windows or Islamic banking unit, for example Bank IFI Sharīʿah branch (1999), Bank Jabar Sharīʿah branch (2000), Bank BNI 46 Sharīʿah (2000), Bank Bukopin Sharīʿah branch (2001), BRI Sharīʿah (2001), Bank Danamon Sharīʿah (2002), BII Sharīʿah (2003) etc. They operated dual banking system in their banking system. Until November 2006, there are 19 Islamic banking units.[3]

The third type is Sharīʿah People's Credit Bank as Sharīʿah rural banks. November 2006, there are 105 Sharīʿah rural banks in Indonesia.[4] The fourth type is Islamic microfinance institutions named *Baitul Māl wat-Tamwil (BMT)*. BMT is an Islamic micro-finance institution, established by individual or group initiatives to help micro-entrepreneurs as a strategy for eradicating rural poverty,[5] especially in villages or traditional markets, operationally based on Sharīʿah principles and cooperation.[6] This research is focusing to this type of Islamic finance.

BMT is needed by the society of Indonesia because these rationals, namely: (1) There are more than 34,8 millions micro-entrepreneur in Indonesia.[7] (2) There are just a few banks having good attention and having willingness to connect directly with micro-entrepreneurs. Factually, these banks which have good attention and willingness to connect directly with micro-entrepreneurs emphasize getting high profit so that is precisely inflicted a loss upon the micro-entrepreneurs.

Currently, there are more than three thousands BMTs in the country.[8] About 65 BMT's of them are located in Yogyakarta. There are only 42 BMT which reported their performance to PINBUK Yogyakarta regularly.

Founding of these *Sharīʿah* micro-finance institutions obviously has not been in line with the society's understanding toward Islamic banking concept. Findings of DPNP-BI's research (Direktorat Kajian dan Pengaturan Perbankan Bank Indonesia) in cooperation with three universities in Java (Universiti Indonesia, Institut

[3] Direktorat Perbankan Sharīʿah Bank Indonesia (2005), *op.cit.,* p. 2.
[4] *Ibid.*, p. 2.
[5] It is related with a research done by Saad al-Harran in Malaysia that published in book format, namely Saad al-Harran *et al.* (1994), *Islamic Marketing Strategy Eradicating Rural Poverty in Malaysia.* Selangor: Pelanduk Publication.
[6] PINBUK (t.t.), *Pedoman Cara Pembentukan BMT.* Jakarta: Pusat Inkubasi Bisnis Usaha Kecil (PINBUK), p. 2.
[7] See Robert Rice (2004), "The Contribution of Household and Small Manufacturing Establishment to the Rural Economy", in Thomas R. Leinbach (ed.) (2004), *The Indonesian Rural Economy, Mobility, Work and Enterprise.* Pasir Panjang Singapore: Institute of Southeast Asia Studies, p. 79.
[8] PINBUK dan www.bmtlink.web.id, accessed at 18 November 2006

Pertanian Bogor, Universiti Brawijaya) 2000 show that there is frequent misunderstanding of Sharīʿah banking concept. About 94 % of 4000 respondents acknowledged that profit and loss sharing system is a universal system and can be accepted by all. Society's awareness of Islamic banking existence is relatively high (79%).[9] However their understanding about the characteristics and uniqueness of Islamic banking products is very low. Many in the survey assumed that Islamic banking is same as conventional banking (10.2 % of 1,500 respondent). They also assumed that mark-up price in *murābaḥah* contract was same as interest in conventional banking (16.5 % of 1,500 respondent).[10]

The findings of Magister Studi Islam UII's research showed that the recruited staff of BMT in Yogyakarta did not have any experience and knowledge of how Islamic financial institutions operated.[11] So, it is assumed that there were operations of BMT in Yogyakarta that were not in line with Sharīʿah rules.[12]

Based on these realities, it is very important to purify the BMT's operation so that the same is in line with Sharīʿah rules consistently.[13] *Murābaḥah* product was selected for analysis because its proportion in the portfolio of financing products operated by BMT was more than others.[14] So, it is assumed that *murābaḥah* instrument may contribute heavily towards building negative opinion in the about Islamic banking.

Yogyakarta is selected as the research location based on the following reasons:

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[9] Bank Indonesia (2000), *Potensi, Preferensi dan Perilaku Masyarakat terhadap Bank Sharīʿah di Pulau Jawa.* Jakarta: Direktorat Penelitian dan Pengaturan Perbankan.

[10] According to Jafril Khalil, *murābaḥah* mode of financing offered by Islamic financial institution is rather similar with leasing product offered by conventional bank, even the equivalent rate of *murābaḥah* contract is higher than leasing product offered by conventional bank. So, it can be concluded that the Sharīʿah banks don't want to bearing any risk. All risk are insurable to other party. See http://www.modalonlinecom/ mod.php?mod= publisher &op, accessed at 29 October 2004. It is considered as the main problem of contemporary Islamic banking, so much so that it can be characterized as a crisis of identity for the Islamic financial system.

[11] Researcher Team Magister Studi Islam Universiti Islam Indonesia (MSI UII) (2004), *Profesionalisme Praktisi BMT di Kota Yogyakarta dan Kabupaten Sleman.* Yogyakarta: MSI UII, pp. 50-51.

[12] Amir Muʻallim (2003), "Persepsi Masyarakat terhadap Lembaga Keuangan Sharīʿah", *Jurnal al-Mawarid,* Edisi X, 2003, p. 19; Muhammad (2002), *Manajemen Bank Syari'ah.* Yogyakarta: UPP AMP YKPN, p. 4.

[13] Amir Muʻallim (2003), *op.cit.,* p. 21.

[14] According to Abdullah Saeed, This phenomena is considered as a pragmatic model of Islamic banking and finance that being a weekness of Islamic banking and finance to reach their main objectives. See Abdullah Saeed (2004), "Islamic Banking and Finance, In Search of a Pragmatic Model", dalam Virginia Hooker *et al.* (eds.), *Islamic Perspectives on The New Millennium.* Singapura: Institute of Southeast Asian Studies, pp. 120-123.

a. Yogyakarta is the center of Muhammadiyah mass organization, and Muhammadiyah has been the pioneer of BMT establishment in Indonesia.[15]
b. Muhammadiyah was famous for its purification movement in Islamic teachings.
c. Yogyakarta is located in the central of Java island. This geographic position makes Yogyakarta a strategic town for many aspects like trade, education, culture, etc.

The research problems of this study are the following:
a. How are procedures of *murābaḥah* financing applied in practice in BMT Yogyakarta? Are the procedures and their application in line with Sharīʿah rules?
b. How is *murābaḥah* profit margin determined? What are the similarities and differences of profit margin determination and interest rate determination as compared to conventional banks?
c. What are the BMT management's policies and actions to solve the problem of defaults in payment?

1.2. Objectives

This research is aimed at achieving the following objectives:

a. evaluation of the practice of *murābaḥah* financing products, its procedures and its application in the BMTs, Yogyakarta, Indonesia in terms of compliance to Sharīʿah;
b. evaluation of mark up price method of *murābaḥah* financing to show its similarities or differences with interest rate determination in conventional banks; and
c. evaluation of the policies and actions of BMT's management in terms of compliance to Sharīʿah in case of defaults in payment by clients.

[15] M. Dawam Rahardjo (2004), "Menegakkan Syariat Islam di Bidang Ekonomi", foreward of Adiwarman Karim book, *Bank Islam, Analisis Fiqh dan Keuangan.* Jakarta: PT RajaGrafindo Persada, p. xxii; Soertiana Nitisoemantri (2000), "Muhammadiyah dan Perkembangan Mu'amalah Kontemporer", in Muhammad Azhar *et al.* (eds.), *Pengembangan Pemikiran Keislaman Muhammadiyah: Purifikasi dan Dinamisasi.* Yogyakarta: LPPI UMY dan Majlis Tarjih Muhammadiyah, pp. 77-84.

2. LITERATURE REVIEW

Habib Ahmed[16] wrote an article "Financing Microenterprises: An Analytical Study of Islamic Microfinance Institutions". It is about theoritical basis, operational framework, and empirical support for the establishment of Islamic Microfinance Institutions. Before presenting Islamic Microfinance Institutions as a good alternative of microfinance institution model, he evaluated the conventional microfinance institutions. Some of the problems identified are (1) asymmetric information problems, (2) economic viability of the conventional microfinance institutions, (3) low rate of return on investment, (4) high drop out rate and non graduation from poverty, (5) debt trap, (6) targetting woman as recipient. After critically evaluating the conventional microfinance institutions, he presented Islamic microfinance institutions as a good alternative of microfinance institution model.

Fuad Abdullah Omar and Munawar Iqbal,[17] in their paper "Some Strategic Suggestions for Isalmic Banking in the 21st Century" found that *murābaḥah*, one of the popular financing mode applicated by Islamic banks, is a mode of financing characterized by predetermined return as in the case of interest. It is said to contain some element of risk, but all these risks are insurable and are actually insured against. The uncertainty or risk to which the business being so financed is exposed is fully passed over to the other party. A financial system built solely around this mode of financing can hardly claim superiority over an interest based system on grounds of equity, efficiency, stabililty, and growth. It is considered as the main problem of contemporary Islamic banking, so much so that it can be characterized as a crisis of identity for the Islamic financial system.

The study highlights that the fixed return modes of finance being used by Islamic financial institution are clearly distinguishable from interest based modes. Transactions of the former modes are always done through real commodities, while in the latter they carried out through inter-temporal exchange of money. Further, *murābaḥah* is a permissible mode of financing and it is serving a useful purpose. However, several problems have been noted in the way it is being used. They suggested that serious attempts should be made to cleanse the quasi *murābaḥah* being practiced by some islamic financial institutions at present with undesirable features, to make it genuine *murābaḥah*.

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[16] Habib Ahmed (2002), "Financing Microenterprises: An Analytical Study of Islamic Microfinance Institution", *Islamic Economic Studies,* Vol. 9, No. 2, pp. 27-64.

[17] Fuad Abdullah Omar and Munawar Iqbal (2000), "Some Strategic Suggestions for Islamic Banking in the 21st Century", *Review of Islamic Economics,* No. 9, pp. 37-56.

Joni Tamkin bin Borhan[18] explains bay' al-*murābaḥah* in Islamic Commercial Law. He highlight that the legality of a *murābaḥah* is not questioned by any of the jurists mentioned in the fiqh literature. In this regard this type of financing is unanimously agreed by them without any rejection. However, the use of *murābaḥah* transactions as a credit vehicle by the contemporary islamic financial institutions has been regarded with apprehension by some scholars like Siddiqi considered the financier operated *murābaḥah* mode earns a predeterminated profit without bearing any risk.

PINBUK had also conducted an evaluation study of Pondok Pesantren Cooperative (KOPONTREN) and BMT. The study was conducted based on the survey of 24 BMTs and 30 KOPONTREN in three provinces, west Java, middle Java and east Java. The study concludes that there are three external factors which possibly support the existence of KOPONTREN and BMT. They are (1) the consciences and willingness of muslims to utilize and assist the Islamic financial institutions. (2) KOPONTREN and BMT basically serve the customers well, both in delivering the products or services, and collecting the customers obligation; (3) KOPONTREN and BMT provide the easy procedures to get the projects financed.

Besides the supporting factors, the research also found some external obstacles. They are (1) the lack of knowledge of society towards BMT, as well as (2) misunderstanding among part of the society about the social and religious role of KOPONTREN and or BMT. (3) It is also found that basically there is no leading competitive commodity that can be financed; (4) KOPONTREN and BMT suffer the most from lack of supervision and development assistance; (5) and that there is no single institution which can provide guarantee in the case of liquidity problem.

Amir Mu‘allim[19] explained that the problems faced by BMT are the existence of society prejudice against operations of BMT that are not in line with Sharīʿah rules. It caused trust degradation of saver of BMT and saver candidate. He also stated that the development of islamic banking industry is very rapid but it doesnot accompanied by supported infrastructure like professional human resources available and legality infrastructure. This situation brings Islamic banking in trouble in the future. He concluded that the complexity of problems faced by Islamic financial institutions, especially BMT, bring negative impact to the society trust toward Islamic financial institutions, especially BMT.

[18] Joni Tamkin bin Borhan (1998), "*Bay‘ al-Murābaḥah* in Islamic Commercial Law", *Journal Sharīʿah,* Bil 6, Januari 1998, pp. 53-58.
[19] Amir Mu‘allim (2003), *op.cit.,* pp. 17-31.

While a research conducted by Suhardin[20] researched the issue of societal acceptance of the existence of BMT. A research conducted by Sholihin[21] researched the behaviour of customers toward BMT. Other researchers about BMT are Patimatu Jahra[22] and Elida Putri Nauli.[23] Their findings can be summerized as follows. Although a minority in the society did not accept well the existence of BMT, acceptance of society of BMT including its principles, basic concepts, facilities and services. The findings also show the potential of BMT in developing microenterprises.

A research conducted by Ahmad Dahlan[24] shows how the BMT Mentari Bina Artha Tegal operates *muḍārabah muqayyadah fi al-nisbah bi al-miyyah* system, a system of *nisbah* calculation. Though the mechanism appears similar to interest calculation, the BMT management argued that this mechanism is allowed based on *'urf* consideration and that the *nisbah* calculation operated by BMT did not apply the *ad'afan muda'afah* in case of default payment, and hence, it is different from interest-based financing.

3. RESEARCH METHOD

To achieve its objectives, the study undertakes theoretical as well as empirical method of research.

3.1. Theoretical Method

The theoritical part of the study comprises the theory of *al-murābaḥah* financing in Islamic teaching (elaborated from al-Qur'ān, *al-Sunnah* and *Fiqh* books), the concept *al-murābaḥah* financing implemented in BMT, Yogyakarta, and the history of BMTs in providing financial products and services based on Sharīʿah rules.

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[20] Suhardin (1999), "BMT Sebagai Lembaga Keuangan Alternatif Ummat (Studi tentang Penerimaan Masyarakat atas Keberadaan BMT MUI di Kabupaten Sleman DIY)", *Dissertation of Islamis Studies,* Magister Studi Islam, Universiti Islam Indonesia (MSI-UII), Yogyakarta.

[21] Sholihin (1999), "Perilaku Konsumen Terhadap Produk BMT (Studi Kasus di BMT Kharisma Magelang Jawa Tengah)", *Dissertation of Islamis Studies,* MSI-UII, Yogyakarta.

[22] Patimatu Jahra (2002), "Profil Usaha BMT Ukhuwah di Kota Banjarmasin", *Dissertation of Islamis Studies,* MSI-UII, Yogyakarta.

[23] Elida Putri Nauli (2002), "Peranan Kepuasan dalam Merangsang Minat menjadi Nasabah pada BMT Bina Tijarah, Cilegon Banten", *Dissertation of Islamis Studies,* MSI-UII, Yogyakarta.

[24] Ahmad Dahlan (2002), "Implementasi Pembiayaan Mudharabah di BMT Mentari Bina Artha Tegal (Studi Kasus Tahun 1996-2001)", *Dissertation of Islamis Studies,* MSI-UII, Yogyakarta.

3.2. Empirical Method

The empirical part deals with the operation of *murābaḥah* financing in BMT Yogyakarta. The empirical research and the pactical side of the investigation is based on field work carried out in BMT, Yogyakarta. Three BMTs were chosen for the study, namely BMT Al-Ikhlas (Kotamadya Yogyakarta), BMT Bina *Ummah* and BMT Dana Sharīʿah (Sleman).

4. PROFILE OF SAMPLE

4.1. The History of BMT Al-Ikhlas, Bina *Ummah*, and Dana Sharīʿah Establishment

Those BMTs are classified as Islamic microfinance institutions. All of their operations are based on Sharīʿah principles. The idea to establish BMT Al-Ikhlas and Bina Ummah occured after the third wave of Zakat and Sharīʿah Economic Management Training (MZES) organized by Dompet Dhuafa Republika (DDR) carried out in early November 1994. Ahmad Sumiyanto, directur of BMT Al-Ikhlas at the time, and Afifah Noor Hayati, directur of BMT Bina Ummah, participated in the event as participant.[25] Their understanding about Islamic economic system brings them to think how to start implementing Islamic economic system in Yogyakarta. Lately, they established BMT.[26]

BMT Al-Ikhlas was established at 1 February 1995. BMT Al-Ikhlas got legality from Cooperative Department at 19 April 1997. Since that time, BMT Al-Ikhlas declared itself as the Islamic economic system operated based on cooperative and Sharīʿah principles, with registration number 150/BH/KWK-12/IV/1997.[27] Main BMT Al-Ikhlas office is located at Jl. Prof. Herman Yohanes 103E, Sagan, Kotamadya Yogyakarta, Telp/Fax +62274-580992.

While BMT Bina Ummah was established officially by Prof. Dr. Ing B.J Habibie (The Chief of Ikatan Cendekiawan Muslim Indonesia/ICMI) at 21 April 1995 in Daerah Istimewa Yogyakarta. BMT Bina Ummah started its operation at 5 May 1995.[28] BMT Bina Ummah got legality from Cooperative Department 1997. Since that time, BMT Al-Ikhlas declared itself as the Islamic economic system operated based on cooperative and Sharīʿah principles, with registration number

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[25] BMT Al-Ikhlas Management (t.t.), *Sejarah Penubuhan BMT Al-Ikhlas.* (BMT Al-Ikhlas's Document), p. 1

[26] *Ibid.,* See also, http://www.alikhlas-group.com, accessed at 19 April 2006.

[27] *Ibid.,* pp. 2-3.

[28] BMT Bina *Ummah* Management (t.t.), *Company Profil BMT Bina Ummah.* Yogyakarta: BMT Bina *Ummah* Management, p. 1.

151/BH/KWK.12/IV/1997. Main office of BMT Bina Ummah is located at Jl. Jae Sumantoro 24 Godean, Sleman, Yogyakarta, Telp: +62274-798868.[29]

BMT Al-Ikhlas is supported by real business sectors, namely: Grocir shop of Islamic cassets and VCDs named by "NADA NURANI", electronic shop "ITQAN", and "DEBETA" printing house.[30] While BMT Bina *Ummah* is supported by real business sectors, namely: Bina Ummah printing house and Bina *Ummah* Institute.

The establishment of BMT Dana Sharīʿah was inspired by the result of economic grass root development study organized by Muamalat Center Indonesia (MCI) Yogyakarta, year 2000-an. Several dakwah activists were involved in this study. This study finded conclusion that the traders and microenterprisers in Pakem market did not make use of bank services. They interacted more with informal institution namely *bank plecit*[31] although they payed higher interest rate than formal bank interest. They involved in this situation because there was no an alternative institution giving a good financial service to them.[32]

Based on that finding, BMT Dana Sharīʿah Pakem was established at 17 October 2000 as an alternative of financial institution for the traders and microenterprisers and others in Pakem market operating based on Sharīʿah and cooperativer principles.[33] The operation of BMT Dana Sharīʿah is supervised by Muamalat Center Indonesia (MCI) Yogyakarta and Community Service Institution, Islamic University of Indonesia (LPM-UII) Yogyakarta.[34]

4.2. Products and Services of Sampled BMTs

Products and services of saving mobilization provided by the BMTs are explained below:

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[29] *Ibid.*
[30] BMT Al-Ikhlas Management (t.t.), *Company Profil BMT Al-Ikhlas*. Yogyakarta: BMT Al-Ikhlas Management, pp. 8-9.
[31] Informal or illegal financial institution managed by rich individual or person that renting money to the customer with high interest rate.
[32] BMT Dana Sharīʿah Management (t.t.), *Company Profil BMT Dana Sharīʿah*. Yogyakarta: BMT Dana Sharīʿah Management, p.1.
[33] *Ibid.*
[34] *Ibid.*

Table 1. Products of Saving Mobilization

No.	**Name of Products**	**BMT Al-Ikhlas**	**BMT Bina *Ummah***	**BMT Dana Sharīʿah**
1.	*muḍārabah* Saving Account	✓	✓	✓
2.	Pendidikan Saving Account	✓	✓	✓
3.	Haji Saving Account	✓	✓	✓
4.	Qurban/Aqiqah Saving Account	✓	✓	✓
5.	Time Deposits Account 1, 3, 6, 12 months	✓	✓	✓
6.	Walimah Saving Account	✓	✓	
7.	*Wadīʿah Damanah*	_	✓	✓
8.	Aidil Fitri Saving Account	_	✓	
9.	Amanah Saving Account	_	_	✓
10.	General and institution Saving Account	_	_	✓

Table 2. Certainty of First Saving Minimum, the Latter Saving, and Nisbah of Profit Between BMT and the Customers in BMT Al-Ikhlas

No	**Type of Saving Account**	**First Saving Rp (Minimum)**	**The Latter Saving Rp (Minimum)**	**Nisbah**
1.	*Muḍārabah*	10,000.00	5,000.00	17:83
2.	Pendidikan	20,000.00	10,000.00	18:82
3.	Walimah	25,000.00	10,000.00	20:80
4.	Qurban/*Aqiqah*	20,000.00	10,000.00	17:83
5.	Haji	100,000.00	50,000.00	20:80
6.	Time Deposits Account 1, 3, 6, 12 months	500,000.00	-	1 bln=20:80 3 bln=45:55 6 bln=50:50 12 bln=55:45

Source: Profil Produk BMT Al-Ikhlas; Risalah Am.

Table 3. Certainty of First Saving Minimum, the Latter Saving, and Nisbah of Profit Between BMT and the Customers in BMT Bina *Ummah*

No	Type of Saving Account	First Saving Rp (Minimum)	The Latter Saving Rp (Minimum)	Nisbah
1.	*Muḍārabah*	5,000.00	2,000.00	32:68
2.	Pendidikan	10,000.00	5,000.00	32:68
3.	Walimah	10,000.00	5,000.00	40:60
4.	Aidilfitri	10,000.00	5,000.00	40:60
5.	Qurban/*Aqiqah*	10,000.00	5,000.00	40:60
6.	Haji	100,000.00	5,000.00	40:60
7.	*Wadīʿah Damanah*	5,000.00	2,000.00	Bonus
8.	Time Deposits Account 3, 6, 12 months			3 bln=44:56 6 bln=48:52 12 bln=52:48

Source: Profil Produk BMT Bina *Ummah*; Risalah Am.

Table 4. Certainty of First Saving Minimum, the Latter Saving, and Nisbah of Profit Between BMT and the Customers in BMT Dana Sharīʿah

No	Type of Saving Account	First Saving Rp (Minimum)	The latter Saving Rp (Minimum)	Nisbah
1.	General *muḍārabah*	25,000.00	5,000.00	32:68
2.	Pendidikan	10,000.00	5,000.00	32:68
3.	Qurban/*Aqiqah*	10,000.00	5,000.00	40:60
4.	Haji	10,000.00	5,000.00	40:60
5.	*Wadīʿah Damanah*	5,000.00	2,000.00	Bonus
6.	Time Deposits Account 3, 6, 12 months	1,000,000.00		3 bln=40:60 6 bln=45:55 12 bln=50:50
7.	Amanah Saving Account	-	-	-
8.	General and institution Saving Account	10,000.00	5,000.00	40:60

Sumber: Company Profile BMT Dana Sharīʿah, h. 5; Risalah Am.

The financing products provided by the BMTs are explained below:

Table 5. The Products of Financing Provided by BMT Al-Ikhlas, Bina *Ummah*, and Dana Sharīʿah

No.	Names of Products	BMT Al-Ikhlas	BMT Bina Ummah	BMT Dana Sharīʿah
1.	*muḍārabah* Financing	✓	✓	✓
2.	*Musyārakah* Financing	✓	✓	✓
3.	*Murābaḥah* Financing	✓	✓	✓
4.	*Bayʿ Bi Thaman Ājil* Financing			✓
5.	*Qarḍ al-Ḥasan* Financing	✓	✓	✓
6.	*Ijārah* Financing	✓	✓	✓
7.	*Rahn* Financing			✓
8.	*Wakālah* Financing			✓
9.	*Bayʿ Ta'jiri/Ijārah Muntahiyyah bi al-Tamlik* Financing		✓	

5. PROCEDURES AND APPLICATIONS OF *MURĀBAḤAH* FINANCING IN BMT, YOGYAKARTA

5.1. Procedures of Financing

The procedures of financing in three BMT samples (BMT Al-Ikhlas, Bina Ummah, dan Dana Sharīʿah) have much in common. Process of financing can be divided into three phase, [35] namely the beginning of financing phase, the period of financing phase, and phase of pasca financing.

a. The beginning of financing phase

This phase has the following steps. The customer submits a financing proposal to BMT accompanied by all requirements required by each BMT. The financing proposal is analyzed by a financing committee as prelimanary analysis. If the proposal fulfills all the requirements, it will be subjected to surveying of the customer done by BMT surveyor. All data collected by surveyor from the survey action will be discussed and analyzed again by the financing committee before deciding to refuse or to accept the proposal. Members of the financing committee

[35] BMT Al-Ikhlas Management (t.t.), *Company Profil BMT Al-Ikhlas.* Yogyakarta: BMT Al-Ikhlas Management, p. 20; BMT Bina *Ummah* Management (t.t.), *Company Profil BMT Bina Ummah.* Yogyakarta: BMT Bina *Ummah* Management, p. 5; Interview with Ismiyanto (Directur of BMT Dana Sharīʿah) at 14 May 2006, in BMT Dana Sharīʿah office, Jl. Kaliurang Km 17 No. 13 Pakem Sleman Yogyakarta.

are chief of marketing, surveyor, pengetua pemasaran, penilai*,* finance staff, and marketing staffs. (See the diagram below).

If a financing proposal is passed by the financing committee, the next phase is giving the financing to the customer. Steps of giving the financing to the customer are: (1) Conducting an agreement with the customer (including profit margin negotiation, mode of installment payment, collateral etc.). (2) Stamping *murābaḥah* contract. (3) reading of the contract content attended by the witnesses of two parties.[36]

b. The period of financing phase

This phase is a time for monitoring and supervising to customers. Types of monitoring and supervising to customers are explained below:

1). Visiting the Customers

Visiting the customers is undertaken by BMT marketing division not more than three days after giving a financing to the customers.[37]

2). Supervising to customers[38]

Many aspects are being objects of supervision, namely financial management, setting money aside for adding capital trade, etc.

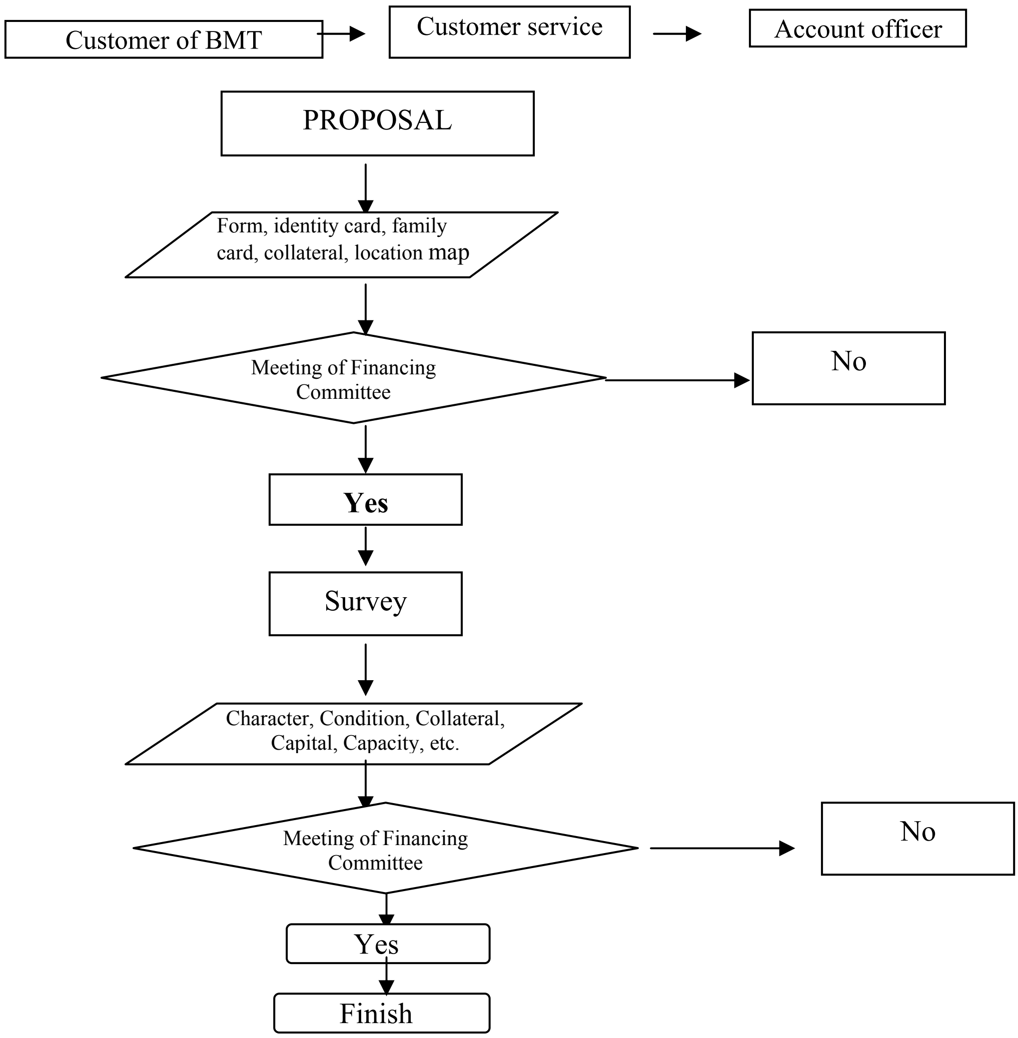
3). Supporting to pay installment payment in the time

4). Giving a tolerance properly in case the installment payment is delayed from the agreed time.[39]

5). Documentation of financing[40]

[36] Interview with Ismiyanto (Directur of BMT Dana Sharīʿah) at 14 May 2006, in BMT Dana Sharīʿah office; *Company Profil BMT Al-Ikhlas*, p. 25; *Company Profil BMT Bina Ummah,* p. 7.
[37] Interview with Muh. Nuruddin Susanto (Marketing chief of BMT Al-Ikhlas) at 13 May 2006, in BMT Al-Ikhlas office.
[38] Interview with Arif Yulianto (Marketing chief of BMT Bina *Ummah*) at 9 May 2006, in BMT Bina *Ummah* office.
[39] Interview with Ahmad Sumiyanto (Directur of BMT Al-Ikhlas) at 12 May 2006, in his home Jl. Ringroad Selatan Godean Yogyakarta; Interview with Ismiyanto (Directur of BMT Dana Sharīʿah) at 14 May 2006, in BMT Dana Sharīʿah office.
[40] Interview with Muh. Nuruddin Susanto (Marketing chief of BMT Al-Ikhlas) on 13 May 2006, at BMT Al-Ikhlas office.

Diagram 1: Process of the beginning of financing phase



Sources: *Company Profile BMT Al-Ikhlas* (t.t: 22); Interview with Ismiyanto (Directur of BMT Dana Sharīʿah) at 14 May 2006, BMT Dana Sharīʿah's office; Interview with Arif Yulianto (BMT Bina Ummah's chief marketing) at 9 May 2006, in BMT Bina Ummah's office

c. Phase of pasca financing

1. Working out a closer or more intense relationship with customer by visiting them regularly (silaturahmi)

2. Offering a new financing to a customer having a good record in financing.

5.2. Financing Requirements

All three BMTs (BMT Al-Ikhlas, Bina Ummah and Dana Sharīʿah) have the following common requirements. The customer must:

a. be a member of the BMT;
b. fill application form provided by BMT management completely and honestly and submit;
c. have a good personality, be responsible and trust-worthy.
d. be of productive age (18-60 years).
e. submit a copy of identity card and or family card (KK).
f. be ready to be surveyed and interviewed.[41]

There are other BMT-specific requirements, such as, submitting a recommendation letter from superior, priority given to who have a collateral,[42] having ownership of a business or enterprise or a permanent job.[43] Submitting guarantee card of good purchased (for electronic good), and authorization letter of taking over a collateral good guaranteed to BMT etc.[44]

5.3. Determination of Profit Margin

The profit margin of *murābaḥah* contract is determined through negotiation between BMT and the client. The agreed profit margin determined by negotiation is stated clearly in the stamped *murābaḥah* contract letter. Although there is room for negotiation in determination of profit margin, in practice, the BMT management determines the minimum profit margin for every *murābaḥah* transaction. The minimum profit margin limit determined by BMT management for every *murābaḥah* transaction is stated below:

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41 *Company Profil BMT Al-Ikhlas,* p. 28; *Profil Produk BMT Bina Ummah*, p. 3; *Company Profil BMT Dana Sharīʿah,* p. 6.
42 *Company Profil BMT Dana Sharīʿah,* p. 6.
43 *Profil Produk BMT Bina Ummah*, p. 3; BMT Bina Ummah management (t.t.), *Risalah Am.*
44 Interview with Muh. Nuruddin Susanto (Marketing chief of BMT Al-Ikhlas) at 13 May 2006, in BMT Al-Ikhlas office.

Table 6. The Minimum Profit Margin Limit Determined by BMT Management for Every *Murābaḥah* Transaction

11.1.1 Name of BMT	The minimum profit margin limit per month
BMT al-Ikhlas	2.55 % per month
BMT Bina Ummah	2 – 2.5 % per month
BMT Dana Sharīʿah	2 % per month

Source: Interview with Ismiyanto (Directur of BMT Dana Sharīʿah) at 14 May 2006,; Interview with Arif Yulianto (BMT Bina Ummah's chief marketing) at 9 May 2006, Interview with Ahmad Sumiyanto at 12 May 2006.

5.4. Application of *Murābaḥah* Contract

Apart from the the procedures and the requirements, the next issue is application of *murabahah* contract. There are many variations of *murabahah* contract application. There are two models of *murabahah* contract application in BMT Dana Sharīʿah. In model one, *murabahah* transaction involves goods that are easy for BMT to provide them like television, air conditioner, motorcycle etc, and is executed at the shop selling the requested goods. After completing the transaction, BMT sends the goods to the customer address.[45]

Model two is relevant in the case of goods that are difficult for BMT to provide them like petroleum, onions, vegetables etc. These goods are generally asked by microenterprises of traditional markets. In this case, the *murābaḥah* contract between BMT Dana Sharīʿah and the client is executed in the BMT Dana Sharīʿah office. BMT usually gives the cash money to the applicant. Buying of the goods is entrusted to the applicant. BMT usually doesnt get directly involved in buying of goods.[46]

The application of *murābaḥah* contract mechanism in BMT Bina Ummah is similar to the first model of BMT Dana Sharīʿah as highlighted above. The differences are about the shop location, place of transaction, and place of transaction binding. It must be highlighted that the BMT Bina Ummah implements musyarakah instrument as a mode of financing for microenterpriser in Godean traditional market.[47]

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[45] Interview with Ismiyanto (Directur of BMT Dana Sharīʿah) at 14 May 2006, in BMT Dana Sharīʿah office.
[46] *Ibid.*
[47] Interview with Arif Yulianto (Marketing chief of BMT Bina Ummah) at 9 May 2006, in BMT Bina Ummah office, Jl. JAE Sumantoro 24 Godean Yogyakarta.

In BMT Al-Ikhlas the purchasing of goods asked by customer is done by itself, except in case of the goods that are difficult for BMT to provide them. The chief of marketing division stated that all of customers that submitted a *murābaḥah* financing proposal are be explained that the *murābaḥah* contract is a transaction that is always done in real commodities. There is a real commodity trade contract in *murābaḥah* transaction. So, it is forbidden if the *murābaḥah* financing proposal submitter only received money from BMT party, except when there is an authorization lettter of purchasing from BMT to the customer on its behalf. The documents of of purchasing must be delivered by the customer to BMT after purchasing.[48] It may be noted that BMT Al-Ikhlas itself owns an electronic shop "ITQON".[49]

All of the BMT management personnel interviewed stated that all rules and regulation, procedures, financing policies are implemented as stated.[50] It is because the supervision of the *murābaḥah* financing application is done everyday.

6. FINDINGS

Major findings of this study are:

a. The *murābaḥah* financing product, its procedures and its applications operated by BMTs are found to be in compliance with Sharīʿah with one exception. In case of BMT Dana Sharīʿah financing goods like petrolium, onions, vegetables etc.the *murābaḥah* contract was executed even while the goods as object of contract were not existing at the time of contracting. Nor were the goods the property of BMT Dana Sharīʿah yet. According to Islamic muamalat law, the existence of the goods as the object of contract is an important requirement.one of the relus an regulations of *murābaḥah* contract. So, in this case, BMT Dana Sharīʿah is involved in *fuduli* transaction that according to Hanabilah, Syafi'iyyah, and Zahiriyyah is prohibited by Sharīʿah.
b. Mark up price method as a method of profit margin determination of *murābaḥah* financing is determined by negotiation between BMTs and

[48] Interview with Muh. Nuruddin Susanto (Marketing chief of BMT Al-Ikhlas) at 13 May 2006, in BMT Al-Ikhlas office.
[49] Interview with Muh. Nuruddin Susanto (Marketing chief of BMT Al-Ikhlas) at 13 May 2006, in BMT Al-Ikhlas office; Interview with Ahmad Sumiyanto (Directur of BMT Al-Ikhlas) at 12 May 2006, in his home Jl. Ringroad Selatan Godean Yogyakarta.
[50] Interview with Muh. Nuruddin Susanto (Marketing chief of BMT Al-Ikhlas) at 13 May 2006, in BMT Al-Ikhlas office; Interview with Ismiyanto (Directur of BMT Dana Sharīʿah) at 14 May 2006, in BMT Dana Sharīʿah office; Interview with Arif Yulianto (Marketing chief of BMT Bina *Ummah*) at 9 May 2006, in BMT Bina *Ummah* office.

client until they agree to conduct contract (*'an taradin minkum*). This method is in compliance with Sharīʿah's rules, and resembles what Rasulullah SAW practiced in trading transactions. However, there are certain controversial aspects to the way it is practiced by BMTs as listed below:

1) Profit rate and installment calculation method by BMTs is similar to flat interest rate model.
2) Profit rates in *murābaḥah* contracts are influenced by maturity of financing. The longer the period of financing, the higher profit margin required by BMT. Majority of ulama (Hanafiyyah, Hanabilah, Syafi'iyyah, and Malikiyyah) and contemporary muslim scholars, such as, Shaikh Yusuf al-Qaradawi, Rafiq Yunus al-Misri, and Muhammad Uthman Syubair state that while the seller is allowed to charge a price higher from the normal price for trade contract with installment payments, it is required that the selling price must be stated clearly in the beginning of contracting.
3) Profit rates in *murābaḥah* contract yield a fixed return to BMT.

The real different aspects between *murābaḥah* financing operation in BMTs and interest-based operations in conventional banks are listed below:

1) Mark up pricing as a method of profit margin determination under *murābaḥah* involves negotiation between BMT and client until they agree to conduct contract (*'an taradin minkum*). It is different from interest rate decisions in credit loans operated by conventional banks that are determined by interest rates prevailing in financial markets.
2) In case of payment defaults, the client of credit loan will be penaltied. On the contrary the client of *murābaḥah* financing cannot be penaltied. The price in the beginning of *murābaḥah* contract is the final price fixed until the end of installment payment finished.
3) There is a real good in *murābaḥah* contract as an object of trade between BMT and the client, so the debt of the client to BMT occured because of the trade contract, in contrast to the debt of the client to conventional bank that occured because of a lending money contract. In other word, the fixed return modes of finance being used by Islamic financial institution are clearly distinguishable from interest based modes. Transactions of the former modes are always done through real commodities, while in the latter they are carried out through inter-temporal exchange of money.

b. Policies and actions of BMT management in case of default payment were mostly in compliance to Sharīʿah's rules. However, there was a specific case of deviation by BMT Dana Sharīʿah management that required the defaulter to pay a penalty of 3 % of agreed profit margin and operation charge of debt collecting. The penalty collected is also a part of BMT Dana Sharīʿah's income. This action is prohibited by Sharīʿah laws. Majority of Ulama and Islamic economic scholars that agreed to the idea of penalty disallowed treating the amount so collecting as part of income of the Islamic financial institution. The penalty payment must be used for social interest (*maṣlaḥah ʿammah*).

7. CONCLUSION

Based on the findings of this research, the minimum profit rate in *murābaḥah* contract at BMTs per year is 24-30% of total financing. Compared with interest rate in conventional banking at 17-20% per year, the profit rates with BMT financing are far higher. It is therefore suggested that such high profit rates are brought down to make the Islamic microfinance institution more competitive in the future. To examine the issue further, one may analyze the factors influencing the selling price. For example how much recovery cost is expensed by BMT for the item? How much profit margin is required by BMT management? How much portfolio return is targeted by BMT management? All of these factors must be analyzed to arrive at the competitive profit margin. The BMT management also have to enrich the quality of human resources so that the operation of BMT become more cost-efficient.

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A COMPARATIVE STUDY OF THE RELATIVE EFFICIENCY OF CONVENTIONAL AND ISLAMIC PAWNSHOP

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WIDIYANTO B MISLAN COKRO
SELAMAH MAAMOR

ABSTRACT

The aim of this study is to measure and evaluate the productive efficiency of pawnshops related to the ability of pawnshops in providing and distributing funds to the society (marketability efficiency). The methodology used to perform efficiency analysis of conventional and Islamic pawnshops is Data Envelopment Analysis (DEA). This study uses CCR model and BCC model. This study also investigates the most productive scale size for pawnshops. Furthermore, by using independent t test we compare the mean of efficiency of conventional and Islamic pawnshops. The CCR and BCC efficiency score analysis results show that 5 and 11 pawnshops are relatively efficient, respectively. In addition, of 39 pawnshops in this study, 30 (76.90%), 5(12.90%), 4(10.20%) show increasing returns-to-scale, constant returns-to-scale, and decreasing returns-to-scale respectively. It indicates that the managers' capability to utilize pawnshops' given resources need to be enhanced to increase their efficiency in providing and distributing funds to society. The result of independent statistical tests show that the efficiency of conventional pawnshops is not different from the efficiency of Islamic pawnshops (ar-rahnu).

1. INTRODUCTION

As a financial institution, pawnshop plays important role in providing funds especially for those who have difficulties in obtaining funds from formal financial institutions. The nation wide establishment of the two types of pawnshop (i.e., conventional and Islamic pawnshop/ar-rahnu) in Malaysia contributes benefits to the society and has great potential for micro-enterprises development. They consititute alternative providers of financing.[1] Nevertheless, the competition among both pawnshops in providing and distributing funds to the society cannot be

[1] According to Abu Hanifah (in Muslehuddin, 2003) pledge (pawn) implies an encumbrance to the extent of loan.

avoided. Thus, it is an important issue for pawnshops to be operated efficiently in order to serve the society.

In this study, we will make a comparative study on the relative efficiency of both pawnshops. The aim of this study is to measure and evaluate the productive efficiency of both pawnshops related to their ability in providing and distributing funds to the society (maketability efficiency). Many studies have measured or evaluated the efficiency of financial institutions, such as banks (Soteriou and Zenios,1999; Leong et al., 2003; Luo,2003; Ataullah et al., 2004; Wang and Huang, 2005) and microfinance institutions (Periera, 2002). So far, no similar studies on relative efficiency of pawnshops have been undertaken, and this study aims to fill that gap. The methodology used to perform efficiency analysis of both pawnshops is Data Envelopment Analysis (DEA). DEA is linear programming-based technique that converts multiple input and output measures into a single comprehensive measure of productive (technical) efficiency. One of its most important features is its ability to handle multidimentional inputs and outputs, unlike traditional performance indicators that generally use one input-one output measures (Wang and Huang, 2005). In addition, DEA is mathematical programming approach developed to measure the relative efficiency of units in an observed group of similar units. Although, DEA was developed by Charnes, Cooper, and Rhodes (1978) to analyze the efficiency of schools, the progress shows that DEA has been applied in many situations (including financial institutions) - for program and managerial efficiency (Charnes et al., 1981), efficiency of hospitals (Hu and Huang, 2004), tourism industry/hotels (Barros and Alves, 2004), forestry (Lee, 2005, and Sowlati, 2005) etc.

In this study, we use Charnes-Cooper-Rhodes Model (CCR model) and the Banker-Charnes-Cooper Model (BCC model). The estimation with these two models allows the technical efficiency (TE) to be decomposed into two collectively exhaustive components, i.e., pure technical efficiency (PTE) and scale efficiency (SE) (see, Coelli,1996). Thus, this study also investigates the most productive scale size for pawnshops. By using independent *t* test we compare the mean of efficiency of both pawnshops and ar-rahnu.

2. REVIEW OF DATA ENVELOPMENT ANALYSIS (DEA)

Many studies have used data envelopment analysis (DEA) to evaluate the efficiency of financial institutions.[2] It is due to several reasons. Among the reasons

[2] For example; Luo (2003), Soteriou and Zenios (1999), Ataullah et al., (2004), Jemric and Vujcic (2002). And Periera (2002) used DEA to evaluate the efficiency (financial and operational) of micro-finance institutions and he concluded that DEA can be powerful instrument to operate in macrofinance industry, whether in operation, deregulatory bodies or the financial institutions.

are: Park and De (2004) reveals that DEA is the most important approaches to measure efficiency. Furthermore, according to Krivonoshko et al., (2002) DEA is a powerful approach to efficiency investigation of production units. Jemric and Vujcic (2002) reveals that the main advantage of DEA is that, unlike the regression analysis, it does not require a prior assumption about the analytical form of production function. Instead, it constructs the best practice production function solely on the basis of observed data and therefore it is not possible to make mistake in specifying the production technology.

The standard estimation of efficiency can be divided into two, i.e., Charnes-Cooper-Rhodes Model (CCR model) and the Banker-Charnes-Cooper Model (BCC model). Both models allow the technical efficiency (TE) to be decomposed into two collectively exhaustive components: pure technical efficiency (PTE) and scale efficiency (SE) (see, Coelli (1996)). The main difference between the two models is the treatment of return-to-scale. BCC allows for variable-return-to-scale (VRS); CCR assumes that each DMU operates with constant-return-to-scale (CRS). PTE refers to managers' capability to utilize firms' given resources, while SE refers to exploiting scale economies by operating at a point where the production frontier exhibits constant returns to scale (Ataullah et al., 2004). According to Luo (2003) SE can be used to determine how close a DMU is to the most productive scale size.

(a) Charnes-Cooper–Rhodes Model

Charnes, Cooper and Rhodes introduced a measure of efficiency for each DMU that is to obtain a maximum of ratio of weighted outputs to weighted inputs. The weight for the ratio is determined by a restriction that similar ratio for every DMU has to be less than or equal to unity, thus reducing multiple inputs and outputs to a single virtual input and single virtual output without requiring pre-assigned weights. The efficiency measure is then a function of weights of the virtual input-output combination. Formally the efficiency measure for DMU_o can be calculated by solving the following mathematical programming problem:

$$\max_{u,v} h_o(u,v) = \left(\sum_{r=1}^{s} u_r y_{ro} : \sum_{i=1}^{m} v_i x_{io}\right) \quad (1)$$

Subject to

$$\left(\sum_{r=1}^{s} u_r y_{rj} : \sum_{i=1}^{m} v_i x_{ij}\right) \leq 1,\ j = 1,2,\ldots, jo,\ldots,n \quad (2)$$

$$u_r \geq 0,\ r = 1,2,\ldots,s \quad (3)$$

$$v_i \geq 0, i = 1,2,\ldots,m \quad (4)$$

where x_{ij} is the observed amount of inputs of i^{th} type of the j^{th} DMU ($x_{ij} > 0$, $i = 1,2,\ldots,m$, $j = 1,2,\ldots,n$) and y_{rj} is observed amount of output of the r^{th} type for the jth DMU ($y_{rj} > 0$, $r = 1,2,\ldots,s$, $j = 1,2,\ldots,n$).

The variable u_r and v_i are the weights to be determine by the above programming problem. However, this problem has an infinite number of solutions. If (u*,v*) is optimal, the for each scalar a, (au*,av*) is also optimal. Following the Charnes-Cooper transformation, one can select a representative solution (u,v) for which

$$\sum_{i=1}^{m} v_i x_{io} = 1 \qquad (5)$$

to obtain a linear programming problem that is equivalent to the linear fractional programming problem (1) – (4). The denominator in the above efficiency measure, h_o, is set to equal one and transformed linear problem for DMU_o and can be written as:

$$\max_{u} Z_o = \sum_{r=1}^{s} u_r y_{ro} \qquad (6)$$

Subject to :

$$\sum_{r=1}^{s} u_r y_{rj} - \sum_{i=1}^{m} v_i x_{ij} \le 0, \; j=1,2,\ldots,n \qquad (7)$$

$$\sum_{i=1}^{m} v_i x_{io} = 1 \qquad (8)$$

$$u_r \ge 0, r=1,2,\ldots,s \qquad (9)$$

$$v_i \ge 0, i=1,2,\ldots,m \qquad (10)$$

For the above linear programming problem, the dual for DMU_o can be written as:

$$\min_{\lambda} z_o = \theta_o \qquad (11)$$

Subject to :

$$\sum_{j=1}^{n} \lambda_j y_{rj} \ge y_{ro}, \; r=1,2,\ldots,s \qquad (12)$$

$$\theta_o x_{io} - \sum_{j=1}^{n} \lambda_j x_{ij} \ge 0, i=1,2,\ldots,m \qquad (13)$$

$$\lambda_j \ge 0, \; j=1,2,\ldots,n \qquad (14)$$

Both linear problems yield the optimal solution θ^*, which is the efficiency score (so- called technical efficiency) for the particular DMU_o. The value of θ is always less than or equal unity, since when tested, each particular DMU_o is constrained by its own virtual input-output combination too. DMUs for which $\theta < 1$ are relatively inefficient and those for which $\theta^* = 1$ are relatively efficient, having their virtual input-output combination points laying on the frontier. The frontier itself consist of linear facets spanned by efficient units of data, and the resulting frontier production function, obtain with implicit constant returns-to-scale assumption, has no unknown parameters.

(b) Banker–Charnes–Cooper Model

Since there are no constrains for the weights λ_j, other than the positivity conditions in the problem (11) – (14), it implies constant returns-to-scale. To allow for variable returns-to-scale, it is necessary to add convexity condition for λ_j, i.e. to include in the model (11) – (14) the constraint:

$$\sum \lambda_j = 1 \qquad (15)$$

The resulting DEA model is called the BCC-model. Solving the model for each DMU, the BCC-efficiency scores are obtained, with a similar interpretation for its values as in the CCR-model. These scores are also called "pure technical efficiency score", since they are obtained from a model that allows variable-returns-to-scale and hence eliminates the "scale part' from the analysis.

(c) Scale efficiency

According to Wang and Huang (2005), the scale efficiency score as defined by the ratio of (CCR/BCC) (or TE/PTE), exhibits large difference between the two groups. Then, a DMU_o found to be efficient with a CCR model will be also be found to be efficient for the corresponding BCC model, and a constant return-to-scale means that DMU_o is the most productive scale size. When a DMU_o exhibits decreasing return-to-scale ($\sum_{j=1}^{n} \lambda_j > 1$), it is likely that the DMU_o can improve its performance by decreasing it size. On the other hand, when a DMU_o exhibits increasing return-to-scale ($\sum_{j=1}^{n} \lambda_j < 1$), it is likely that a DMU_o can improve its performance by increasing its size.

(d) Independent *t* test

We applied independent *t* test to determine the statistical diference in efficiency among the conventional pawnshops and ar-rahnus.

3. DATA AND INPUT-OUTPUT SPECIFICATION

Primary data from the 39 pawnshops were used to determine the relative efficiency of pawnshops in Malaysia. Of 39 pawnshops involved in this study, 14 (35.9%) pawnshops are conventional pawnshop, 25 (64.1%) pawnshops are Islamic pawnshops or ar-rahnu.

The first step in measuring efficiency using DEA is to specify the inputs and outputs of pawnshops. The input-output specification is developed based on the production approach. The inputs of pawnshops consist of: (i) number of employee (x_{1j}), and (ii) operating expenses (x_{2j}) and the outputs are: (i) the average of financing distributed to customers (y_{1j}) and (ii) number of costumer (y_{2j}). The above inputs were adopted from the the model which have been developed by Camanho and Dyson (1999) to analyze the efficiency of bank branches, while the outputs were developed based on the objective of the study that is to analyze the ability of pawnshops in providing and distributing funds to the society (marketability efficiency). Therefore, based on this objective, this study selected the average of financing distributed to customer and the number custumers as outputs.

4. THE RESULTS

Relative Efficiency

Using both the CCR and BCC models, the relative efficiency of conventional and Islamic pawnshops in Malaysia is measured from the survey done in 2005. Production approach is used to estimate relative efficiency of the pawnshops for both DEA models. Furthermore, an input orientation is chosen because there is a tendency that pawnshops had greater control input quantity relative to output quantities. The descriptive statistics of the inputs and outputs in each DEA stage are reported in Table 1.

Table 1. Descriptive Statistics of Inputs and Outputs

	Minimum	Maximum	Mean	Std. Deviation
Inputs:				
Number of employee	1	14	4.69	2.83
Operating expenses (RM)	34.50	3,889,860.00	131,531.33	624,109.33
Outputs:				
Average financing distributed to customers (RM)	26,000	5,200,000.00	529,646.67	851,525.96
Number of customers	52	7,800.00	1,144.00	1,593.62

Source: processed from primary data.

The results show that the mean of the number of employee (of 39 pawnshops) is 4.69 persons. The mean of monthly operating expenses is about RM131,531. Furthermore, the mean of the financing distributed to customers and the number of customer per month are RM529,646.67 and 1,144 persons respectively.

The high standard deviation (column 6) indicates that the variation of the number of employee, operating expenses, the average financing distributed to customers, and the number of customer (from the mean) per pawnshop is high. It can be seen from the high difference of minimum and maximum value of the number of employee, operating expenses, the average financing distributed to customers, and the number of customer (columns 3 and 4).

The summary results of production approach for both CCR and BCC are reported in Table 2. From this table, the average efficiency (stands for the average of all optimal value θ_o^*) was obtained by running separate programs for the CCR and BCC models of each pawnshop.

Table 2. The Summary Result of DEA Score

Efficiency	Number of pawnshop	Number of efficient pawnshops (or in optimal scale)	Average efficiency (or scale efficiency)
TE (CCR model)	39	5	0.532
PTE (BCC model)	39	11	0.708
SE	39	(5)	(0.746)

Under the constant returns to scale assumption (CCR model), as shown in Table 2, the pawnshops were characterized by a large asymmetry in their technical efficiency. Only five (out of 39) BMTs were efficient in that year, and the average efficiency of the pawnsops was only 0.532. It means that if pawnshop produces its output on the efficiency frontier instead of at its current (virtual) location, it would require about 53.2% of the inputs. It indicates that in general the tecnical efficiency of the pawnshops in Malaysia is relatively low. The characteristic of the five efficient pawnshops as follows: (i) four efficienct pawnshops are Islamic pawnshops (*ar-rahnu*); (ii) one efficient pawnshop is conventional pawnshop.

If we allow for variable-returns-to-scale (BCC model), we find much less change during the period being analyzed. Allowing for variable-returns-to-scale always results in higher average efficiency because DMUs that are efficient under the constant-returns-to-scale are accompanied by new efficient DMUs that might be operated under the increasing or decreasing returns-to-scale. The average efficiency of the pawnshops was 0.708 with the number of efficient pawnshops was 11.

Returns to scale

The average scale of efficiency score of pawnshops was 0.746. This condition indicates that pawnshops in Malaysia were operated far below optimal scale. In addition, Table 3 shows that of 39 pawnshops in this study, 30 (76.90%), 5(12.90%), 4(10.20%) showed increasing returns-to-scale, constant returns-to-scale, and decreasing returns-to-scale respectively.

Table 3. Summary Results of Returns-to-Scale

Retuern to scale	Number of pawnshops	Percentage
IRS	30	76.90
CRS	5	12.90
DRS	4	10.20
Total	39	100.00

Note: IRS, CRS, DRS represent increasing return-to-scale, constant return-to-scale and decreasing return-to-scale respectively.

The previous information indicates that the percentage of pawnshops under increasing returns-to-scale is greater than the others. It means that most of pawnshops can improve their performance by increasing their inputs, and small part of them can improve their performance by decreasing their inputs. It indicates that managers' capability to utilize pawnshops' given resources still need to be enhanced to increase their efficiency in providing and distributing fund to society.

Efficiency Comparation

Independent *t* test was used to determine the statistical diference in efficiency (or to compare the efficiency) among the conventional pawnshops (group 1) and ar-rahnu (group 2). Group 1 consisted of 14 conventional pawnshops, and group 2 consisted of 25 *ar-rahnu*. We construct the hypothesis as follows: H_o : group 1 and group 2 have the same of efficiency score and H_a: group 1 and group 2 have the different of efficiency score. The results of the test can be seen in Table 3.

Table 3. Summary Result of Independent *t* Test

Efficiency	Conventional pawnshop (n=14)	Ar-rahnu (n =25)	Difference of mean	T value	Sig. (2-tailed)
Mean TE	.50679	.54616	-.03937	-.382	.705
Mean PTE	.60	.77	-.17	-1.993	.054
Mean SE	.78421	.72420	.06001	.640	.526

Table 3 shows that the difference of mean TE, PTE, and SE of conventional pawnshops and ar-rahnus are not significant at a significant level of 5%. It indicates that the null hypothesis cannot be rejected. The results show that the efficiency of conventional pawnshops is not different from the efficiency of *ar-rahnu*. It means that ar-rahnu can compete with conventional pawnshops in order to provide and distribute funds to the society. Therefore, to win the competition in servicing the society as well as to dispense the society from the *ribā* system, and also as the means of micro-enterprises development, *ar-rahnu* should improve their efficiency.

5. CONCLUSION

The contribution of pawnshop could be seen in term of their benefits to the sociecty and potential for micro-enterprises development. It could also become an alternative provider of financing which could also secure the society from the excessive debt. The competition of the both of conventional pawnshops and ar-rahnu in providing and distributing funds to the society could not be avoided. In this study, we used nonparametric DEA methods to analyze the efficiency pawnshops. The main findings could be summarized as follows. The CCR and BCC efficiency score analysis results showed that 5 and 11 pawnshops were relatively efficient, respectively. In addition, of 39 pawnshops in this study, 30 (76.90%), 5(12.90%), 4(10.20%) showed increasing returns-to-scale, constant returns-to-scale, and decreasing returns-to-scale respectively. It means that most of pawnshops could improve their performance by increasing their inputs, and small part of them could improve their performance by decreasing their inputs. Therefore, the managers' capability to utilize pawnshops' given resources need to be enhanced to increase their marketability efficiency in providing and distributing funds to society. The result of independent *t* test showed that the efficiency of conventional pawnshops was not different from the efficiency of *ar-rahnus*. It means that ar-rahnu could compete with conventional pawnshops in order to provide and distrubute funds to the society. Therefore, to win the competition in servicing the society as well as to dispense the society from the *ribā* system, and also as the means of micro-enterprises development, *ar-rahnu* should improve their marketability efficiency by improving the managers' capability in utilizing *ar-rahnu'* given resources.

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VILLAGE FUNDS: THE EXPERIENCE OF RURAL COMMUNITY DEVELOPMENT AT JABAL AL HOSS, SYRIA

MAHMOUD AL ASAAD

ABSTRACT

This paper is based on a case study of Jabal al-Hoss project in Syria that uses an innovative model of Islamic microfinance based on what are known as Sanadiq or village funds. The model used is based on community partnership, participation and risk sharing. It has been found to be sound and culturally appropriate, given the stated preferences of the community. It is the only membership-based model in the region paying dividends to its shareholders using a profit sharing scheme. Institutional and financial sustainability are explicit objectives of the project with a clear strategy to ensure implementation. Located in one of the most economically depressed regions of the country, the project is reaching the poorest Syrians.

1. INTRODUCTION

Jabal al-Hoss is one of the poorest areas in Syria where UNDP has supported the establishment of self-reliant local financial institutions, *village fund.* The village funds are self-managed and autonomous in their decision-making, which has included the adoption of financial practices consistent with local values. The start-up is self-financed through member share capital, from which small loans are given for up to three months. Whenever initial financial intermediation is satisfactory, UNDP provides an additional capital injection, thereby increasing outreach, loan sizes. Between September 2000 and December 2002, 22 village funds were established, comprising 4,691 members, with shareholder equity of US$ 130,000. UNDP contributed $370,000 in equity. The repayment rate as of 31 December 2002 was 99.7%. Return on average equity was 17%, almost half of which (46%) was paid to shareholders, the balance (54%) retained as capital. Loans permit farmers to bypass trader-moneylenders and sell their produce at a higher price; laborers turn into farmers; and micro entrepreneurs use quick-turnover repeat loans for new investments and rapid business growth. During 2003 growth continued according to a recent UNCDF evaluation: to 30 village funds with 6,468 shareholders and a share capital of SP 10.65 million. Loans outstanding grew to SP 63.8 million; portfolio at risk >30 days was a mere 1.3%.

At annual dividends between 30% and 40% of paid-in-capital, membership was very attractive.

Special attention is given to women who constitute 41 % of the membership, most of them illiterate. They opted for integrated village funds, in which female members participate in management committees. They find access to loans easy, as village funds do not require physical collateral. Loans are used by younger and older women to do business of their own, e.g., fattening sheep, raising cows, opening small shops and renting land to plant cash crops. The additional income is used for business growth and family support. It is not rare that women – many with large families – are the better entrepreneurs, focusing on high yielding activities outside traditional agriculture.

In 2002 first steps were taken towards the establishment of a network which will provide apex services and initiate the dialog on a legal framework; and of a central fund supervised by the Central Auditing Agency.

During phase II, 2003-2007, with support from the Japanese Government and UNDP, the focus is now on the expansion and legal consolidation of the network of village funds. The main objectives of Phase II are to formalize the legal status of the microfinance model piloted; transfer the financial and organizational management of these institutions from project staff to the local communities. There are also plans for extending such networks throughout Syria as a strategy for rural development, poverty alleviation and employment generation.

The "Village Fund" model used – based on community partnership, participation and risk sharing – under the microfinance component was found to be sound and culturally appropriate, given the stated preferences of the community. It is the only membership-based model in the region paying dividends to its shareholders using a profit sharing scheme. Institutional and financial sustainability are explicit objectives of the project with a clear strategy to ensure implementation. Located in one of the most economically depressed regions of the country, the project is reaching the poorest Syrians.

The average Loan Balance Per Borrower is 37,061 SP with an Average Loan Balance Per Borrower/ per capita GDP of 61%. This is high compared to other countries in the region, which is due in part to high concentration in agricultural lending (40% of all loans are for livestock). The project has 6,502 Active Shareholders (45% of whom are women) and 1,721 Active Borrowers (37% women), with 5,637 loans disbursed to date.

The full Micro-Capital grant under the project has been disbursed (1 million over phase I and II) which limits possibilities for further expansion. Without additional funding, the project will not reach the target of 40 Village Funds and 4,000 active borrowers.

The majority of borrowers have taken the maximum loan amount for the maximum period of time, with a balloon repayment option. Repayment rates are still high at 98.7%. By year-end 2003 the project was covering its full adjusted operating costs and reaching 68% FSS. With the current capital base the project can maintain the current level of operations, but cannot extend new loans, which may decrease confidence in the project. The high dividends paid at the beginning of the project to encourage member participation are unsustainable and may create dissatisfaction at the community level when brought in line with the financial reality.

2. THE AREA

Jabal al-Hoss is one of the poorest areas in Syria. The villages are known for the beauty of their houses in the shape of mud domes; but life is harsh, given the rocky surface of the land and the dry climate. Yet there is more of a potential than meets the eye, waiting for an accessible source of finance.

2.1. Basic Information about Jabal Al-Hoss

1- The project aims at a geographic area of 157 thousand hectares named Jabal AL-Hoss , located south – east Aleppo , in two administration districts : Al-Safira and Jabal Sama'an .
2- The area's altitude is 350 – 600 m , distributed on three rain stability areas , which are the second , third and fourth . The average rainfall ranges between 150 – 250 mm .
3- The volcanic rocks cover 55% of the area , hence reclamation is needed , while there are 36 thousand hectares , that can not been reclaimed , forming 23% of the total area .

2.2. Resources and Economic Activity

According to the recent statistics, population of Jabal Al-Hoss is estimated by 250 thousand, consisting 27 thousand households, distributed in 156 villages and farms. 57% of the people work in agriculture and animal raising. Animal wealth in the area is estimated by 160 thousand sheep, 17 thousand goats and 1.7 thousand cows. Crops in the area (wheat, barley, lentil and cumin) are mostly unirrigated, in addition to some fruit trees (olives, pistachios), and some other activities.

2.3. Demographic Status and Livelihood in Jabal Al-Hoss

The general aspects of living levels are negative, and enough to rate Jabal Al-Hoss as the poorest area in Syria. Most important indicators are:

Population

1- The average of population growth in the area is 3.4%.
2- The community is considered youth, age of 51% of the population is less than 15 years, i.e. out of the work force, and average of sustenance is 4 persons.
3- Average size of the household is 9 persons.
4- Average of individual income is 26.5 S.L. per day (under the line of global poverty).

Education

1- Average of illiteracy is 58%, and it is more among women.
2- 23% of the villages has no elementary school. Preparatory schools are restricted in the towns and big villages, while there are only 3 secondary schools in the whole area.

Health

1- Health services in the area are very modest and restricted to (5 dispensaries) with modest equipment and unspecialized medical staff, and there is no ambulance to serve the area.
2- Physically handicapped percentage in the area is 1.3%.

Residence

46.3% of the people live in single or double mud domes, inhabited by 9 persons in average, and used for all the aspects of life.

Services

There is no water net in most of the villages. Water resources are surface wells or it is bought by tanks and stored in semi uncovered ground reservoir, which makes it disposed to pollution.

The area suffers from general weakness in the services, such as; sanitary drains, telephone, electricity and roads.

3. PROJECT DETAILS

3.1. Objectives

Rural Community Development in Jabal Al-Hoss is a joint project of the Ministry of Agriculture and Agrarian Reform of the Syrian Arab Republic and the United Nations Development Program. It was approved in 1998. Implementation started in 2000. The first Village fund was established on September 1, 2000. The project works to instill a national microfinance institutional system suits the prevailed cultural and social morals and comply with the international system, as a way to alleviate poverty to access sustainable human development.

The primary objective is the establishment of sustainable local financial institutions owned and managed by the people themselves. If successful in Jabal al-Hoss, which is one of the most disadvantaged areas of Syria, it will serve as a model for all of Syria and perhaps the wider NENA region.

Its wider objective, or *development goal,* is community development, encompassing income and employment generation through diversified agricultural and non-agricultural income-generating activities (IGA), and the overall improvement in the people’s lives.

3.2. Involved Parties

The involved parties are UNDP, the Japanese Government and the Ministry of Agriculture and the State Planning commission of Syria. The UNDP contributed $50,000, the Japanese government contributed $1.5 million and the Syrian Government contributed sp.40 million to the project.

4. PROJECT COMPONENTS

The project has the following three major components:

- Microfinance program.
- Training & development program.
- Service program.

4.1. Microfinance Program

4.1.1. The strategy

a. Establish credible national financial institutions (Village fund) to offer different financial services to the poorest (saving – loans) and access institutional and financial sustainability.
b. Building human and institutional capacities of the local community on all levels.
c. Financial and service transparency.

4.1.2. Program history

a. Program started on 1st SEP.2000 by establishing 10 village funds, self financed through the local community, where shareholders were 853 and share capital was SL.2.323.500
b. Establish a central fund to manage financial organizational operations of branch village funds net.
c. Elect village funds committees out of the shareholders to manage the village funds.
d. Elect village funds board committee (7 members) out of the village funds committees.
e. put the required guidebooks to manage the mechanism of the village fund:
   - NGO articles of association.
   - Bylaws system.
   - Financial and accounting system according to microfinance best practices.
   - Administrative and employee system.
f. Provide fixed assets for the village funds.
g. Open current accounts for saving and withdrawing to all village funds as well as the central fund in Agriculture Bank.

4.1.3. Characteristics of the village fund model

- Initial feasibility studies showed that a village needs at least 300 inhabitants in order to sustain a village Sanduq
- Initial capitalization through member share capitol;
- Multiple Share Ownership;

- UNDP capital injection only after satisfactory performance of Village Funds as a local financial intermediary;
- Flexible lending: loans may vary in terms of size, loan period, installment periods, and purpose;
- Profit Margin of 0.75-1.25% per month according to *Murābaḥah* principles
- Profits as a source of income to cover the costs of loanable funds, administrative costs, provisioning of bad debts, member dividends and retained earnings;
- Personal guarantees, group guarantees, or physical collateral;
- No deposit mobilization during the initial phase until village fund staff can handle liquidity management completely;
- Integration of women in the village fund with equal rights

Initial feasibility studies showed that a village needs at least 300 inhabitants in order to sustain a village fund (Sanduq).

A village fund needs at least 100 shareholders (members) who contribute SP 1000 each in order to become eligible for a UNDP capital injection. Initially it only required 50 shareholders and there was no matching grant. In phase II it was set at 2:1. At least 50 percent of the shareholders have to be 18 or older. Standardized statutes and by-laws developed by the project management team are used for each village fund.

In the so-called experimental phase before the UN capital injection, the village fund shareholders elect a village fund committee comprising of one accountant and 2 loan officers (one male and one female). The committee receives training in credit analysis and record keeping from the project management team. They receive compensation for their work. A prospective borrower applies to the village committee for a loan. A feasibility study is done for the applicant's project by the loan officer of the Sanduq committee (often assisted by a loan officer of the project management team). In addition, often technical consultants form the projects 'service' programme offer advise. The final credit decision lies with the project management team (i.e., the manager). Cash does not change hands during loan disbursement as the goods are bought on the market for the borrower.

4.1.4. Village fund – A socially appropriate model

A socio-economic survey was undertaken at the beginning of the project, which among other things examined people's preferences for financing options. Overwhelmingly the communities in Jabal Al Hoss expressed their desire to have access to financing that would take into account religious sensitivities against the payment of predetermined interest. In response, the project introduced a lending product based on the Islamic banking concept of *Murābaḥah* or cost plus mark up. Under this arrangement the program buys the goods and resells to the entrepreneur

at cost plus a markup for administrative fees and the borrowers repay in regular equal installments.

4.1.5. Village funds net financial resources

- **Share capital:** they are nominal irrevocable shares, one of the most important self financial resources of village funds net.
- **Retained earnings:** reserves and annual accumulating profits.
- **Grants:** $600.000 to fund village funds net portfolio.
- **Central fund loans:** $ 400.000 has been allocated to the central fund to be reallocated as loans to the branch village funds net.

4.1.6. Financial products

I. Shares:

- Each share value SL.1000, as a shareholder can own maximally 50 share.
- Any member can withdraw his share capital minimally after at least a year of the date of his participation.
- All the inhabitants of the village can buy shares regardless of their age.

At the end of each fiscal year a stock taking conducted at the village fund and after deducting financial and operational costs for sustainability purpose, dividends disbursed among shareholders.

II. Dividends

Table 1. Time Series of Dividends

Year	2001	2002	2003	2004	2005
Dividend % of share value	% 30	% 41	% 36	% 25	25 %

III. Loans

a. Loans type: according to repayment way:

- *Seasonal loans* repaid as a lump sum at the end of the period.

- Loans repaid by *quarterly installments*.(each 3 months).
- Loans repaid by *monthly installments*.

b. *Murābaḥah* Islamic economic principle is adopted at the village fund where loans disbursed in-kind so the item is specified by the client (borrower) then it is bought through the village fund committee after giving an appointment to him to see his item and the committee sells it to the client with an agreed increase in its price.

Table 2. Applied *Murābaḥah* Rates

Loan products	Monthly rate
Loans repaid by equal monthly installments flat rate	% 0.75
Loans repaid by equal quarterly installments flat rate	% 1
seasonal loans flat rate	1.25%

c. Loan term is specified according to the cash flow of the economic activity but it shouldn't exceed a year.

d. **Loan size:** no more than SL.50.000 in the first loan cycle as it is increased gradually through building the client credit worthiness as follows:

Table 3. Loan Size

Loan cycle	1	2	3	4	5
Loan size in SL.1000	5-50	50-75	75-100	100-125	125-150

e. Loan purposes

- Live stock: raising and fattening: (lamb – calves goat- fodder – honey bee)•
- Agriculture: (seeds- fertilizers – production inputs – agriculture equipments – agriculture transportation – gardening – medicinal plants).
- Food industry.
- Trade: (crops trade – fodder- animal products)
- Manufacturing: (brake factory – Sieve for grains and cereals)
- Repairing & Maintenance workshops (fridge – washing machines electric equipments- tractors – cultivators – agriculture equipments)
- Professions (crafts – hand crafts)
- Service (groceries- mobile shop – car washing workshop)
- Transportation (vehicles).

f. Loan procedure

- Two reputable grantors from the village.
- Signing promising vouchers (borrower & grantors).

4.1.7. Sustainability

Here in a general view about sustainability percentages accessed in the program as of 2004 after some amendments according to CGAP measures:

Table 4: Sustainability

Year	**2001**	**2002**	**2003**	**2004**
Operational self-sufficiency	%30	%63	%85	%91
Financial self-sufficiency	%27	%54	%68	%75

4.1.8. Outreach: Depth

The average of annual per capita income in Jabal al Hoss is estimated at $198, less than one sixth of the country's average ($1200). Two thirds of the population own small-size land holding. Adverse climate and difficult access to water significantly limit the financial benefits, which can be derived from agriculture. These conditions have resulted in a problem of food security, which is further complicated by diseases resulting from the shortage of health and sanitation facilities.

All village members are considered to be poor and eligible to participate in the project. Loans are given on a first come first served basis.

The average Loan Balance Per Borrower is 37,077 SP (727 USD) and Average Loan Balance Per Borrower/ per capita GDP is 61%.

This is extremely high given the average annual incomes of Jabal Al Hoss and poses serious questions as to the possibility of "elite" capture as well as repayment capacity.

Table 5. Depth

GDP per Capita	63,750
Average Loan Balance	37,077
Average Loan Balance Per Borrower/ per capita GDP	61%
Regional Average	34% (ranging from 14-54%)

The main rationale given for these large loan sizes is that most of the borrowers are engaged in livestock rearing activities with high upfront capital investments and long term yields.

Another factor clearly has to do with shortage of loan capital, and the perception of borrowers that they should take the maximum available when their turn comes up, as it may be a long time before they have another chance for a loan.

This attitude should slowly change, as the programme is proven sustainable over time. However, in the meantime these big loan sizes, the majority of which have a 1-year balloon payment, constitute substantial liabilities to this poor community.

4.1.9. Outreach: Scale

Since the beginning of Phase I in 2000 the project has disbursed over 8,000 loans through 32 village fund, with 2,200 active borrowers and 7.500 active shareholders. Given the total population of villages with Sanadiq, roughly 15% of all villagers are shareholders (there is no age limitation). Microfinance good practices suggest that no more than one person per household should borrow. In fact this is not always the case. Therefore, in the optimal scenario assuming one borrower per household almost 38 percent of households are reached. A more realistic scenario, which assumes two members per household taking a loan, would put this figure around 20 per cent. The reality no doubt falls somewhere in between, which is still not bad for such a young programme piloting a new approach.

4.2. Non Financial Services

4.2.1. Agriculture services

a. Offer agriculture extension and implement trails on alternative crops.
b. Improve honey bee keeping.
c. Cooperate with FAO, telefood program where many investments conducted at the area such as: mushroom planting – honey bee keeping – lamb raising – egg laying chicken – turkeys – home garden. Beneficiaries were about 100 poor households.
d. Cooperate with Afro Asian organization for development: mushroom planting was introduced to Jabal Al Hoss through the organization in March 2002, where 86 units for producing mushroom were established on household level.

Table 6. Outreach

Outreach As of 12/31/2003	Dec-00	Dec-01	Dec-02	Dec-03
NO. of V.F	9	20	22	30
NO. of Population (in all the villages that have V.F)	11,644	36,444	40,149	43,194
Percentage of Population over 15 years of age	0.50	0.50	0.50	0.50
NO. of Households (in all the villages that have VF)	1,395	3,760	4,210	4,485
Average household size	8	10	10	10
NO. of loans disbursed during the period	104	1,389	1,920	2,261
NO. of active loans (borrowers) at end of period	93	737	1,033	1,724
Percentage of hh borrowing as percentage of all households	7%	20%	25%	38%
Total outstanding loan balance at end of period	1,789,599	24,511,503	31,935,328	63,782,571
Percentage of borrowers who are women	3.22	32.83	32.81	37.12
Average loan balance (7/6)	19,243	33,258.00	30,918	36,996
NO. of members (shareholders) at end of the period	1,110	3,355	4,722	6,468
NO. of shareholders per borrowing household	11.9	4.6	4.6	3.8
Total shares value	1,901,000	4,635,000	6,557,110	10,652,610
Percentage of members (shareholders) who are women	40.45	41.72	41.91	44.66
NO. of loans disbursed since establishment till end of 2003		5,674		
Value of loans disbursed since establishment till end of 2003		182,979,620		

4.2.2. Veterinarian services

a. Offer veterinarian care services as vaccinations and fodder mixture.
b. Establish a unit for lamb and goat raising keepers at the area of Khanaser Valley.

4.2.3. Social services

Establish a village fund for handicapped investments with an amount of SL.1.5 million, offer as Kard Hasan (loan free of interest), loan disbursed number 32 one.

4.2.4. Special services for women

Establish two small workshops at Harbakieh and Hwayer Al Hoss villages for the finishing of the traditional embroidery done by the women in the villages. The workshops equipment offered through German embassy in Damascus to the rural women at Jabal Al Hoss, and market all women products through participation in exhibitions.

4.2.5. Training services

a. 97 training courses were conducted at the area where beneficiaries' number was 1688 (men and women) to prepare target groups and develop their capacities.
b. These courses offered to the local community free of charge. And they included many development fields and specializations for income generating activities as: literacy courses- hand crafts – sewing and tailoring – food industry – livestock keeping – honey bee keeping – mushroom cultivation – electronic devices maintenance – electrical equipment repair – hair dresser – barbers – other vocational training needed.
c. 14 courses were conducted and addressed to the village funds committee members to well prepare them to manage the village funds especially in topics related to microfinance and computer operational system.

5. SUMMARY AND CONCLUSION

The successful operation of the project has the following lessons.

First, the poor can:

- Mobilize their financial resources as shareholders.
- Mobilize their human capacities to manage and operate their own institutions.
- As borrowers invest short term loans in profitable income generating activities.
- Repay loans in time.

Second, women highly contribute in shares, loans and management.

Third, well risk management and follow up procedures can make risky agrarian loans good investments in microfinance institutions.

Major challenges to the sustainability of the project were observed to be:

- Legal frame work (village funds legalization)

- Link village funds with banks (for sufficient fund)
- Independence self management through a qualified village funds board from the local community.
- Access sustainability levels.
- Wide spread nationally and regionally.
- Establish specialized links and unions in production and market income generating activities

THE ROLE OF RDS IN THE DEVELOPMENT OF WOMEN ENTREPRENEURSHIP UNDER ISLAMIC MICRO FINANCE: A CASE STUDY OF BANGLADESH

MAHMOOD AHMED

ABSTRACT

Islami Bank Bangladesh Limited (IBBL) provides micro finance services through Rural Development Scheme (RDS), a Sharīʿah based model of poverty alleviating program, mainly for the poor woman of the rural area of Bangladesh. This paper identifies, through a survey, the basic characteristics of women entrepreneurs in an Islamic perspective and verifies those characteristics of the women entrepreneurs associated with RDS. It also reviews the application of Islamic modes of finance among the women entrepreneurs of RDS. Some grass-root level experiences from the RDS, regarding development of the women entrepreneurship, and policy prescriptions for invigorating the role of the RDS in the development of women entrepreneurship with reference to Bangladesh have been presented here.

1. INTRODUCTION

Entrepreneurship is a deciding factor for economic development of a country. Even abundance of physical and financial resources may go blatantly underutilized or misused if entrepreneurship is not developed adequately. Economic development of a country can be accelerated by encouraging and augmenting entrepreneurial talents. Nafzigar (1971) remarked that entrepreneurship and other high level human skills are key variables which link the socio-cultural milieu with the rate of economic development. To Schumpeter (1961) an entrepreneur is a dynamic agent or a catalyst who transforms increasingly physical, natural and human resources, into corresponding production possibilities. Many define entrepreneurship in many ways. Whatever be the definition, the basic underlying concept seems to have remained the same. It connotes innovativeness and urge to take risk in the face of uncertainties, and intuition, i.e., a capacity of seeing things in a way which afterwards proves to be true (Pareek and Rao, 1978). The definition of entrepreneurship had never been differentiated on the basis of sex and hence could be extended to women entrepreneurs without any restrictions. A women entrepreneur can be defined as a confident, innovative and creative woman capable of achieving self-economic independence individually or in collaboration, generates employment opportunities for others through initiating, establishing and running an enterprise by keeping pace with her personal, family and social life (Singh, 1992). Development of women entrepreneurship needs special attention in the context of developing countries where level playing field does not exist. National Foundation for Women Business Owners, USA (1994) found in a study that male and female entrepreneurs think similarly but their leadership styles differ. Both apply conceptual thinking in acquiring information. But gender differences are exposed in decision making: men strongly emphasize logic or left brain thinking, whereas women balance logic with right brain thinking that is, feelings, intuition, relationship, sensitivity and values. In their orientation of attention women tend to be more reflective and men are more action oriented. So, in the noted study clear differences emerged in their management or leadership styles and distinguishing traits of male development are autonomy, independence and competitions; those of women are relations interdependence and cooperation. Moreover, the structure of male-led organizations resemblance a hierarchy or pyramid and the most frequent management method is "Command and Control". On the contrary women led enterprises essentially reflect feminine values and the characteristic developmental qualities of women such as relationship, interdependence and cooperation. So team approach is very much likely to prevail in those organizations. But surprisingly what is true that globalization forces traditional companies to adopt a new model of management that share some of its features with the leadership traits of women enterprise. Being responsible for both home and work, women manifest the qualities and characteristics such as their great diversity, their interpersonal skill and the transfer of "Mother-hood skills" to the job.

The "Decent Work" report of the ILO Director General Jam Somavia, to the International Labor Conference in 1999, has created a new momentum and renewed emphasis in the women entrepreneurship development. The ILO stresses gender concerns as a cross-cutting theme for the organization. The report also sets the context for the creation of a number of international focus programs, one of which is Women Entrepreneurship Development and Gender in Enterprise, known as WEDGE. There are three major interrelated major elements in the work of the WEDGE unit: expanding knowledge base, promoting advocacy and piloting and developing appropriate services and products to meet the development needs of women entrepreneurs. The ILO is giving continuous effort to promote the interest and development of women entrepreneurs through its member states. The ILOs technical service has included various projects and programs to develop the business knowledge and skills of women entrepreneurs, as well as their access to credit and finance. Because bank credit is highly needed for the development of entrepreneurship.

Islami Bank Bangladesh Limited (IBBL) provides micro finance services, through Rural Development Scheme (RDS), following the ideals and teachings of Islam. The RDS has made an attempt to design a Shari[ah based model of poverty alleviating rural development program following the principle of group lending and participatory management approach. Target group includes destitute women and distressed people, households with 0.50 acres of land either owned or hired for farm activities or the households involved in very small off-farm activities in the rural area. Group formation and related activities are the same as those of *Grameen* Bank (GB). Groups are homogenous and self-selected. The members must bear excellent moral character with commitment to the ideals and teachings of Islam. As in other Micro Finance Institutions (MFIs), the design of RDS requires every member to weekly saving of minimum of Tk. 10 in a savings account at the IBBL branch implementing the scheme. Investments in specified sectors are made in four modes, *Bayʿ-Mu'ajjal, Bayʿ-Murabahah, Bayʿ-Salam* and Hire Purchase under *Sherkatul Melk* (HPSM) or Leasing. As interest is prohibited, IBBL charges a rate of profit of 10% on investment. Timely repayment is encouraged by offering 2.5% rebate. Contribution to Centre Fund by the member is Tk.2.00 per week. Installments are fixed on weekly basis. The Field Officers (FOs) collect installments, personal savings, centre fund etc., in weekly centre meetings. There are 1368 Field Officers who are engaged in supervision of RDS and trained up at Islami Bank Training and Research Academy (IBTRA) and RDS related IBBL branches before posting to the branches working with RDS. The scheme has been implementing since 1995 by the branches of IBBL. The recent data upto December 2006 (Appendix Table-1) shows that under the scheme, an investment of Tk.9300.05 million to 294908 persons, of which 92% woman and 8% man, has been made through 118 branches in 8057 villages of 275 *thanas* (Police Station). Recovery rate is 99 percent. It indicates that within less than a decade of time, RDS has been expanded in 275 *thanas.*

Growth and performance of RDS, therefore, invite the concern of the role of RDS on the development of women entrepreneurship. But there has not been any study on it. It has been assumed that the success of micro finance program depends on development of entrepreneurship of its members and ultimately on improving the living standard of the poor. The main objective of this paper is to invigorate the role of RDS in the development of women entrepreneurship (DWE) with the specific aim of alleviation of poverty.

The specific objectives of the study are as follows:

i. To identify the basic characteristics of the women entrepreneurs in an Islamic perspective and verify those characteristics of the women entrepreneurs associated with RDS;

ii. To review the application of Islamic modes of finance among the women entrepreneurs;
iii. To gather grass-root level experiences from the RDS regarding DWE; and
iv. To suggest policy prescriptions for invigorating the role of the RDS in the DWE with reference to Bangladesh.

1.1. Methodology of the Study

Given the nature of the objectives, the study is based on both literature review and the primary data collected through a sample survey with structured questionnaire. Necessary data for this study are collected from both the primary and secondary sources. For primary data, a short purposive random sample survey has been conducted, among the 200 households financed by IBBL under the RDS in 4 zones namely, Dhaka (North), Chittagong, Comilla and Bogra, considering the time, effort and ability of Researcher. Only Dhaka (South) and Khulna zones were not covered. For investigation, 5 groups from 5 centres have been selected. Two members (Mostly the leader and his/her deputy) have been chosen from each group so that total interviewees become 5cx5gx2m=50[1]. Thus 50 interviewees from each zone have been selected maintaining homogeneity of their socio-economic conditions. Secondary data were collected from Rural Development Division, Investment Wing, IBBL, Head Office, Dhaka.

There are IV sections in the study. Section - I describes the study proposal while section - II discusses identification and verification of the characteristics of the women entrepreneur under study. Section - III delineates practical application of Islamic modes of finance, section – IV delineates grass-root level experiences and section V describes conclusions and suggestions.

1.3. Importance of the Study

In developing countries, vast sections of the population are caught up in the web of poverty. Nobel Laureate Professor Mohammad Younus opines that in the developing countries, economic development can not be said to have taken place unless and until the socio-economic status of these poor people is improved. Perhaps the most important benefit of development of women entrepreneurship among the poor is that it leads to the creation of self-employment as against wage employment. The challenge is, therefore, to develop entrepreneurship and to generate enough productive employment and income opportunities for the poor. Joseph Schumpeter regarded the banking system and entrepreneurship development as being two key agents in the whole process of economic

[1] C for Centre, g for Group and m for Member.

development. The involvement of IBBL in the development of women entrepreneurship through implementation of a poverty alleviation program like RDS is relatively new. It would, therefore, be of immense importance to examine the role of RDS in the development of women entrepreneurship, identify the basic issues and suggest remedial measures.

Alleviation of poverty is now recognized as the prime objective of any development program. Noticeably, the concept of Islamic economic development views poverty as religious as well as social problem. This very often pushes a person to lowliness, sin and crime. As the Qur'ān teaches us, "Kill not your children for fear of want, we shall provide sustenance for them as well as for you. Verily, the killing of them is a great sin" (Bani Israil 17:31*)*. The Prophet (pbuh) also sought refuge of Allah as he says, O Allah, I seek your refuge from poverty, insufficiency and lowliness" (Abu Daud). Women entrepreneurs under study are by definition poor, perhaps half of them are very poor. DWE and poverty alleviation are directly related. If the former is actualized, the latter becomes the output. In a sense the DWE is the only sure method for poverty alleviation in a sustainable manner. Prof. Yunus has given an interesting example in this respect. He said that if engines of the social groups at the tail end are not turned on – not only may they not be pulled by the engines at the front, they may start sliding backwards independently from the rest of the society and to the detriment of everyone involved including those who are better off.

2. IDENTIFICATION AND VERIFICATION OF THE CHARACTERISTICS OF WOMEN ENTREPRENEURS

From an Islamic perspective, an entrepreneur has to perform two types of characteristics namely, necessary characteristics and sufficient characteristics. These are explained below:

2.1. Necessary Characteristics

(i) Education: Basic education is compulsory for all Muslims, men or woman, rich or poor, entrepreneur or non-entrepreneur. To be known as an Islamic entrepreneur, the person concerned must learn the three R's of education (Reading, Writing, and Religion).

(ii) Antipathy towards charity: Under normal circumstances, an Islamic entrepreneur is not allowed to accept any dole or charity. He knows that "Charity is *Ḥalāl* neither for the rich nor for the able-bodied" (*Tirmidhi*). In Islam, work is considered a virtue and idleness a vice.

(iii) Taking initiative: An entrepreneur under the Islamic system always takes the initiative for venturesome activity himself. He knows that if he/she fails to do so, Allah will not help him to improve his living standard. This principle originates from the Qur'ān, which says that Allah does never change the condition of a people until they change in themselves (*Rad 13: 11*)

(iv) Full utilization of resources: From an Islamic perspective, an entrepreneur is under obligation to make full use of all the economic resources under his/her disposal. *(Baqara 2:284, 30 and Lukman 31.20*). He has the legal right to utilize the resources for earning money but has no right or authority to mis-utilize, or even, under-utilize them.

(v) Avoiding prohibited activities: An Islamic entrepreneur does not undertake any activity that involves *Ribā* (or interest), cheating or lying. He knows that it is *Ḥarām* to do business in alcoholic beverages, intoxicants, drugs, swine, idols, statues, or anything of this sort whose consumption and use have been prohibited in Islam.

(vi) Maximization of profits not the sole goal:_An Islamic entrepreneur does not strive to maximize profit under all circumstances. He may remain satisfied with less than maximum profit. Prof. Yunus said that a true entrepreneur maximizes a bundle consisting of two components: profit and social return, subject to the condition that neither the profit nor the social return becomes negative. He coined this type of entrepreneur as "Social-Consciousness-Driven or SCD Entrepreneurs". In this study this concept is accepted but the letter 'S' is given a different meaning i.e. Sharīʿah. That is here SCDE stands for 'Sharīʿah-Consciousness-Driven Entrepreneur'.

2.2. Sufficient Characteristics

An Islamic entrepreneur or a SCDE should have one or more of the following characteristics, called sufficient characteristics.

(i) Wholly new product: An entrepreneur ventures to produce a commodity, which he has never produced: he produces a wholly new product. If a farmer shifts his cultivation from purely food crops (e.g., paddy and wheat) to purely cash crops (e.g., sugarcane, vegetables and banana), or if a weaver shifts his production from *Sari* to *Lungi* or from cotton *Sari* to silk *Sari*, these will be examples of new products.

(ii) New line of business: This is another important characteristic of small entrepreneurs. Examples of new line of business would include: from sale of human labor to any business like grocery shop, poultry raising in large number, goat/sheep/livestock fattening and clothes shop. If a shopkeeper sells his shop and starts buying and selling of bricks that will also be an example of new line of business.

(iii) New process of production: An entrepreneur may produce the same old commodity but under new process. Suppose, a weaver starts producing the same old commodity (cotton Sari) with the help of (say) Fly Loom or *Chittaranjan* Loom in place of Pit Loom, or a farmer tills his land by power tiller/tractor in place of animal driven plough, or a woman husks her paddy with the help of rice mill in place of the traditional *Dheki*, that will be examples of new process of production. In the economic literature, this characteristic is given very high position in the matter of entrepreneurship development.

(iv) Expansion of business: Expansion of business or increase in the volume of production, other things remaining equal, is also considered as an indication of the SCDE. An entrepreneur may have more than one business. He may have grocery shop and rickshaw/van as a side business. His wife may be rearing poultry, goats or livestock. Expansion of business would refer to the increase in the size of any or all of the existing businesses.

(v) New marketing technique: This is another important characteristic of entrepreneur. This feature may manifest itself through several ways. First, he may sell his produce in the wholesale market in place of retail market. Second, he may like to sell commodities at some future date so that improved storage facilities are used. Third, he may now use improved transport facilities (bullock cart in place of head load, van in place of animal-drawn cart, or truck in place of vans, etc.)

(vi) Generation of employment: If financial assistance helps generate employment, this can also be considered as an indication of entrepreneurship development. This generation of employment may be reflected in the volume of work by the client and/or by the members of the family and or by hiring in labor from outside the family. This increase in employment should be sustainable in character.

Now let us verify these characteristics of the selected women entrepreneurs associated with RDS under study.

Educational status: The collected information is exhibited in Table 1. The respondents have been divide into 5 groups namely, illiterate, upto class V, V-X, X-XII, and XII+. The following points can be noted from the table.

Firstly, the over all literacy rate appears to be very high; it is 94% for wives and 75.5% for husbands. All members are required by compulsion to learn how to write their names. It is known that as a rule no finance is given unless and until the members learn to put their signatures. And those who can at least sign their names have been put in the ‘Class V’ category. This explains the very high rate literacy among the women members. Since most of the husbands have not got this opportunity, their rate of literacy has become lower than that of their wives.

Secondly, at higher levels, the husbands are more educated than their wives. This is true for all zones.

Table 1. Educational Status (Both Wife and Husband) in Percentage

Zone	Illiterate	Up to V	V-X	x-xii	Xii+	Total
Z- I: Wife	2.0	50.0	38.0	4.0	6.0	100.0 (50)
Husband	6.4	36.2	42.5	8.5	6.4	100.0 (47)
Z- II: Wife	2.0	52.0	46.0	0.0	0.0	100.0 (50)
Husband	6.1	44.9	44.9	4.1	0.0	100 (47)
Z- III: Wife	0.0	72.0	26.0	2.0	0.0	100.0 (50)
Husband	40.9	52.3	4.5	2.3	0.0	100.0 (44)
Z- IV: Wife	6.0	78.0	16.0	0.0	0.0	100.0 (50)
Husband	30.9	40.5	16.7	7.1	4.8	100.0 (42)

Source: Field survey

Table 2: Life Expectancy of the Respondents

Expectancy	
1. Want to extend our existing business (Rickshaw/ Van renting, grocery shop, medicine shop, cloth shop etc.)	26.0
2. Want to educate our children and arrange marriages for them	23.5
3. Want to build good houses with latrines	10.5
4. Want to lead Islamic way of life	13.0
5. Want to buy cultivable land	9.5
6. Want to lease in land	-
7. Along with agricultural activities, want to rear livestock and poultry	5.5
8. Want to become owners of grocery shop, workshop, sewing machine etc.	4.0
9. Want to stand on our own legs without borrowing	-
10. Want to do pisciculture	-
11. Want to buy agricultural implements, truck, shop, animal cart etc,	-
12. Want to help my husband	-
13. Want to open a monthly deposit account in bank	-
14. Want to perform *Hajj*	-
15. Want to preach Islam	0.5
16. Want to improve our living standard	2.0

N.B: One person was asked to answer one question only.
Source: *ibid*

Charity – mindedness: Table 2 shows that all the respondents have reasonable and meaningful expectations of their lives. Maximum number of clients expressed their willingness to expand their business and thereby improve their living standard.

Self-initiative: It is seen from Table 3 that 23.5% of the respondents stated that they themselves took the initiative in joining the RDS. In no way this represents the poor show of poor people. Next important motivators appear to be Bank Workers/ Field Supervisors and the client's neighbors. They play very important role in motivating the village poor to take advantage of any venturous activities. Most people do what they see their neighbors do.

Table 3. Motivators

Motivators		
Bank workers	66	33.0
Neighbors	62	31.0
Themselves	47	23.5
Friends and Relatives	19	9.5
Imam of Mosques	6	3.0
Total	200	100

Source: *ibid*

Table 4. Number of Earning Members and their Utilization

Total Number of Earning Members	334
Members per family (N=200)	1.67
Utilization	
Full	77.5
Half	22.5
Poor	0.0

Source: *ibid*

Utilization of resources: Regarding human labor, the information as contained in Table 4 shows that on the average there are 1.7 active members per family in the study. In their own opinions, about three-quarter of the labor time are fully utilized and remaining one-quarter is partly utilized because of mainly lack of opportunities or negligence of the persons concerned. This indicates that there is scope for increasing work opportunities.

Next important resource of the rural people is land. Table 5 shows that nearly half of them has some amounts of cultivable land which indicates that RDS are allowing persons having more than the defined area of land to become members or the members have been able to buy new lands with their increased incomes so that they have moved upward in the land ownership scale.

Table 5. Patterns of Land Ownership

Zone -1	Zone-2	Zone-3	Zone-4	Total
Landless household in percentage (N=200 in each case)				
66	20	78	38	50.5
Owned land per household in acres (No. of owners=99)				
1.31	1.02	0.81	1.36	1.15
Homestead and other lands in acres (N=200 in each case)				
0.09	0.18	0.07	0.13	0.14

Source: *ibid*

Table 6 provides data on the extent of utilization of land. Based on their opinions, more than half of the cultivated lands are fully utilized. About one-third remains half utilized. More than half of the land remains partly unutilized. This indicates that provision of finance has positive and definite impact on the nature and extent of utilization of land.

Table 6. Extent of Land Utilization

Nature of Utilization	%
Full	57.6
Half	36.4
Poor	6.0
Total	100.0 (99)

Source: *ibid*

Now look into utilization of physical assets. Table 7 provides the necessary data collected from the field. In this table, 10 types of assets are identified. Out of 200 respondents, 45.5% of them possess these items. Of these, the most valuable asset is irrigation device. Of the total respondent, 32 families of RDS have their own irrigation devices. Data on the utilization of these physical assets shows that most of these assts are fully utilized.

Table 8 shows information about utilization of financial resources. For examining the utilization of funds by the clients, the rural activities have been classified into as per convention, 7 groups. Since all funds are not utilized for productive activities as noted, an unproductive (pure consumption) category has been added. The data collected relate to 3 years. Of the total fund disbursed in 2004, the maximum amount (24.9%) has gone to processing and manufacturing. In order of importance, the other heads are trading (20.5%), agriculture and forestry (17.9%), services (12.1%), and others. About 11.7% of RDS fund is diverted to unproductive uses. The lion share of total micro finance in RDS goes to processing and manufacturing, livestock, trading and services.

Table 7. Physical Assets and their Utilization

Assets	Number	Utilization %		
		Full	Half	Poor
1. Irrigation Devices	32	96.9	3.1	0.0
2. Animal Cart	1	0.0	100.	0.0
3. Rickshaw	14	64.3	35.7	0.0
4. Van	9	77.8	22.2	0.0
5. *Mishuk*	2	100.0	0.0	0.0
6. Tempo	1	100.0	0.0	0.0
7. Rice mill/Oil mill	1	100.0	0.0	0.0
8. Sewing machine	12	58.3	25.0	16.7
9. Thresher Machine	1	100.0	0.0	0.0
10. Bicycle	35	5.7	94.3	0.0

N=91
Source: *ibid*

Table 8. Fund Utilization

In thousand taka

	Agrl.& Forestry	Live& Fisheries	Process& Mfg.	Trading	Services	Shop keeping	Peddling	Unproductive	Total
Z-1									
2004	5(1)	-	-	-	-	5(1)	-	-	10(2)
2005	29.5(7)	15(3)	16(5)	29(6)	23(6)	37(8)	4(1)	4(1)	157.5(37)
2006	32(6)	9.5(3)	72.7(10)	53(5)	39.5(9)	56(9)	4(1)	23(5)	289.7(48)
Z-2									
2004	56(14)	5(1)	9(2)	52.5(10)	15(3)	-	-	3(1)	140.5(31)
2005	86.5(14)	18.5(4)	9(2)	68.5(10)	47(8)	5(1)	-	-	234.5(39)
2006	66(10)	9(2)	61(9)	86.5(11)	74.5(11)	12(2)	-	25(5)	334.0(50)
Z-3									
2004	44.5(11)	5(1)	4(1)	5(1)	-	-	-	3(1)	61.5(15)
2005	51(10)	5(1)	17(3)	20(4)	23(5)	5(1)	-	12(2)	133.0(26)
2006	83(13)	20(4)	27(5)	70(12)	21(3)	17(4)	-	25(5)	263.0(46)
Z-4									
2004	13(4)	8(2)	35(10)	8(2)	24(5)	9(2)	5(1)	18(4)	120.0(30)
2005	31(6)	10(3)	40(7)	26(6)	41(8)	23(3)	8(1)	23(5)	202.0(39)
2006	28(4)	8(1)	128(21)	50(8)	72(12)	18(2)	-	48(2)	322.0(50)
Total (2000)	**209.0 (33)**	**46.5(10)**	**288.7(45)**	**239.5(36)**	**142.0(35)**	**103.0(17)**	**4.0(1)**	**137.0(17)**	**1169.7(194)**
Percentages	**17.9**	**4.0**	**24.7**	**20.5**	**12.1**	**8.8**	**0.3**	**11.7**	**100.0**

Source: *ibid*

Table 9. Just One Reason for Joining RDS

One Reason for Joining	RDS in %
1. To improve our living conditions/ To get loan and invest in productive activities	36.5
2. Speak about the Qur'ān and *Ḥadīth*/ No interest which is *Ḥarām* involves	20.0
3. First to contact us/ Nearer to our house/Neighbors have joined/ Husband likes it	7.5
4. Gives loan at our door step/ Need not to go to office	8.0
5. Flexible/No undue pressure for weekly installment/Waits if we are in real difficulty	17.5
6. Its rate of interest/ profit is lower	3.0
7. To save	2.0
8. They help in our daughters marriage/ Have good behavior	1.5
9. Do not deduct any money from our loan	0.5
10. Gives more than one type of loan simultaneously	-
11. No response / No specific answer	3.5

Source: *ibid*

Avoiding prohibitive activities: Table 9 provides the information on it. One –fifth of the respondent said that they joined the RDS simply because it is "Islamic", because it avoids interest, which is *Ḥarām* in Islam, because it speaks about the Qur'ān and *Ḥadīths.* These are actually the persons who consciously wanted to avoid prohibitive activities. A large number of clients became members with particular aim "To improve the living standard/To get loan and invest in productive activities". This implies that about one-third of the members joined the RDS simply to gain benefit in this material world: There was no consideration for the world Hereafter. Still another interesting point to note is that 17.5 percent of RDS members mentioned flexibility of the Islamic bank regarding the weekly payments. They opined that there was no undue pressure from the bank, it waited when they were in real difficulty.

Regarding sufficiency conditions as many as six major characteristics have been identified for the entrepreneurs. These are: she/ he:

a) produces wholly new product;
b) undertakes new line of business
c) adopts new process of production (in the case of old products)
d) goes to expansion of the existing business;
e) adopts new marketing techniques; and
f) generates new employment opportunities.

Table 10. Nature and Extent of Entrepreneurship Development
(As in the Year 2006)

Nature of Development	RDS Number	RDS %
Wholly new product	23	11.5
New line of business	31	15.5
New process adopted	0	0
Expansion of business	119	59.5
New marketing techniques	1	0.5
Employment generation	6	3.0
Unproductive	14	7.0
Total	195	97.5
No Loan	6	3.0
Grand Total	200	100.0

Source: *ibid*

The collected field information is given in Table 10. It can be said that from the table that expansion of business is the most dominating feature of entrepreneurship development of the clients under study. As many as 60% of the women possessed this feature. In order of importance other features include new line of business (16%) and wholly new product (12%).

From the discussion of these necessary characteristics, it may be concluded that the RDS has contributions towards the development of women entrepreneurship.

3. PRACTICAL APPLICATION OF ISLAMIC MODES OF FINANCING

Following four modes are being applied in the RDS:

1. *Bayʿ-Mu'ajjal,;*
2. *Bayʿ- Murābaḥah Trust Receipt;*
3. *Bayʿ-Salam;* and
4. Hire Purchase under *Sherkatul Melk* (HPSM) or Leasing.

In order to review the practical application of these modes and identify their problems and prospects, several questions were incorporated in the survey schedule meant for the clients of the RDS. Unfortunately the survey results were frustrating, but not at all unexpected. Answer spaces devoted to these questions were blanks just to give the message that none of the selected members of the RDS had any idea about the Islamic modes. All that some members appeared to know was that IBBL was being operated in terms of Islamic principles and that it did not deal with interest, without understanding the difference between 'interest' and 'profit'. The RDS uses very extensively such methods as *Bayʿ-Mu'ajjal* and *Bayʿ- Murābaḥah* without, in most cases, knowing the Sharīʿah implications of these terms. These methods were not applied strictly in accordance with the Islamic Sharīʿah. Although the RDS members do not have any formal knowledge about the Islamic modes of financing, some of them do maintain apathetic attitude towards interest as a mode of financial transaction.

5. GRASS-ROOT LEVEL EXPERIENCES

The members of RDS have given many interesting and important suggestions for increasing the number of clients. These suggestions are given in Table 11 in abridged form.

Table 11. Suggestions for Increasing the Number of Clients of RDS (by the Members of the RDS)

Suggestions	Percentages
1. Increase the volume of investment/ Give more than one loan simultaneously	22.6
2. Preach more about the teachings of Islam/ Say it is a bank for the socio economic development of those who want to avoid *Riba*/Say that it is not a bank for any particular group of people but for all who not to be exploited.	20.7
3. Reduce the rate of profit.	14.3
4. Introduce housing, sanitary latrine, medical and tube well loans	8.8
5 Show good behavior to every body	8.8
6. Increase the number of Bank workers and ask them to give more time with the members	6.9
7. Introduce training program for women	5.5
8. Reduce the number of installment	3.7
9. Give financial assistance during the natural calamities.	3.7
10. Do not know	5.1

N.B.: Number of observations=200, Number of responses=217, some have given more than one answer.

Source: *ibid*

Perhaps very consistently, the members have suggested that the RDS should increase the volume of investment. Through experience they were of the opinion that peoples' demand for money was very high. Whatever money was given by the lending institutions fell short of their demands. Even the amount of finance given by the RDS fell short of the amounts given by the other institutions, particularly GB, ASA and BRAC. Given the opportunities for proper utilization, the bank should also provide more than one type of investments (General investments, housing investments, etc) simultaneously. This is treated as the most appropriate weapon for increasing the number of clients under the present circumstances.

Another very important suggestion given by the members was to preach more about the teachings of the Qur'ān and *Sunnah*. They added that the Supervisors should say that the bank or the RDS was not for any particular category of people but for every one who wanted to improve her /his living standard by avoiding *Ribā* (interest). In order to compete with other leading conventional institutions, the members suggested that the rate of profit (many say 'interest') should be comparatively lower and that should make clear to the members by way of simple examples. Introduction of housing finance and the finance for such things as latrine, education, tube wells and others would definitely attract the general people to come within the umbrella of RDS. Many members have praised the behavior of the RDS Supervisors: some suggested that they should improve their activities with more modern and appropriate tools. Their numbers should be increased. The members have also very consistently insisted introduction of training program for the women on various important issues. Another not negligible suggestion given by the members was that they should be given outright grants in terms of cash or food during the period of natural calamities such as floods, draughts and other catastrophic events.

6. CONCLUSION AND SUGGESTIONS

For invigorating the role of RDS in the development of small entrepreneurs, as many as four areas are identified. Suggestions are given in all these areas as follows:

a. Motivational Tools

Extensive mass contact: The first motivational tool suggested is extensive (and effective) mass contact in the target areas by way of personal discussions, meetings, and distribution of book-lets and pamphlets prepared in well-designed and easy-to-understand language. The importance of savings and scope of investment/credit and income generating activities in their areas, and above all, the need for and benefits of Islamic ways of living and earning Islamic values and faith are to be inculcated among the members.

Investment sanctioning procedure: There should be provision for sanctioning all investments in time and without long drawn procedure.

Volume of investment: Other things being satisfied, the amount of investment should be such that the clients' real demands do not remain unfulfilled. Ultimately, the focus should be shifted from micro-investment to micro-enterprise development.

Multiple investments: For the deserving members there should be provision for more than one loan/investment in a single year.

Amount of installment: The amount of installment should not be 46th portion of the amount due, but should be determined according to the nature of activities financed. This should be decided in consultation with clients. A token amount of money should, however, be collected every week.

Adequate repayment period: The repayment period should not always be one year or 46 weeks. Actual duration may be shortened to 6 months or extended over one year. That again should be decided on the basis of mutual consultation.

b. Ensuring Quality Services

Selection and training of staff: Managers are to be recruited through competition, having good academic background and previous experience. They should be imparted training.

Strategies for meeting investment demands: This study views micro-finance as investment plus mobilization of local resources of the different savings products, it is suggested that more attention should be given to mobilize more savings so that its amount accounts for a substantial portion of the outstanding finance, the members should be given the opportunity to withdraw their savings freely, within some mutually agreed restrictions; savings fund should be utilized so as to beget maximum benefit for the depositors; and the rate of profit should be at least competitive.

c. Art of Applying Islamic Modes of Financing

Choice of a particular mode of finance for the given activity is very important. In this study, all the activities generally done by the small entrepreneurs have been grouped into 8 categories. Choice of modes should be determined by the nature and extent of activities to be carried by the clients with the funds provided.

Field experience suggests that the clients generally come with any one of the following types of demand:

i. To purchase some well specified items in well specified quantities;
ii. To purchase some well specified items in well specified quantities plus some cash to meet some unforeseen needs in the future; and
iii. To have a specified amount of cash (say, Taka 10 thousand) to buy some unspecified items as and when required.

Officials working in the field opine that the demand for investment falling in the first category is not very high, although this is the type of demand, which the RDS would be willing to finance for the development of women entrepreneurship. They also stated that maximum demand comes in the form of the last category, which the RDS finds very difficult to deal with, given the *Sharīʿah* restrictions. The following modes can be applied for various activities.

(i) *Bayʿ-Mu'ajjal / Bayʿ- Murābaḥah*: Among the Islamic modes, *Bayʿ-Mu'ajjal* and *Bayʿ- Murābaḥah* have been found to be very popular both among the officials and clients. These modes can be employed for all activities where buying and selling take place. There are several ways through which these can be applied. Stated in the reduced form of acceptability from the viewpoint of Islamic *Sharīʿah* the ways are:

- The RDS will take dealership of the various items normally demanded by the clients and store them in their own (or hired) godowns and sell the same as and when demanded by the clients. At first sight, this may appear to be an impossible proposition, but from the viewpoint of Islamic Sharīʿah this is the only sure way through the above method can be applied without any doubt.
- The Field Workers will go from shop/Hat/Place to shop/Hat/place along with the clients to buy the necessary items. For bigger items like irrigation devices, power tillers, photo copy machine and other bulky but durable things, there should not be any real difficulty in following this way, but for items or items involving very small amount of money (say, 5 kg. of urea, 5 kg. of onion, etc.) it would be almost impossible to follow this way.
- The RDS will appoint Agents to buy the necessary items from the markets taking the clients with them. The Agents will not be considered as officials and hence will not do any official works. They would work on commission basis. The Centre Chief or any member of the Centre may be given this responsibility for buying the necessary items on behalf of the Scheme.
- The RDS will have a written agreement (specifying the prices) with the wholesalers of the required items located around the locality of the Centre (in the case irrigation water, for instance, with the manager/owner of the irrigation device). It will issue a passbook to the clients for whom investments have been sanctioned. The Book will contain the name of the client and other information including address, family size and composition, physical assets, etc plus the investment transaction. He will use this Book for the purchase of the different items. The wholesaler with whom agreement has been made will supply the necessary inputs specifying the amount and price. The details will be written in the passbook and that wholesaler will keep voucher properly signed by the clients. Upon production of the vouchers, the RDS will pay the money (say, in particular date of every month).
- The clients will apply for investment money giving details of the activities they want to perform. Treating them as, Agent, the RDS will give them cash so that they can buy their things on its behalf. For

following this path, some conditions are to be fulfilled. These include: (a) the clients, or the Centre in which they belong to, will give guarantee in writing that the money would be utilized for the purpose noted in the application, and (b) the Bank workers will also ensure that the clients use the money for the purpose it is given.

If the stated mode were applied by following any of above mentioned ways, this would surely ensure the desired link between the investment/credit and expansion of output of real goods and services. Note that under normal circumstances this is lacking. That is, the loan in cash without condition does not ensure this link, so vital for economic development. After choosing the appropriate way(s), the RDS will add mark-up.

The money would be paid in weekly or biweekly or seasonal installments. In case of weekly or biweekly installments, the RDS will ensure that the clients have supplementary sources of income to pay the weekly installment. In this case, the RDS will not insist on the full money. A token installment may have to be accepted just to keep system moving. This is another mechanism of ensuring the justice (*ʿAdl)* and kindness *(Iḥsān)*. All transactions would be accomplished in the weekly meetings.

(ii) *Hire purchase/Leasing*: The hire-purchase/leasing mode is also used frequently by the RDS. This mode can be applied for all types of durable and reusable items like irrigation devices, power tiller, lathe machine and the like. The RDS will buy the durable and reusable items normally demanded by the clients by following any of the ways as shown in (i) above) and sell them on hire purchase, or on leasing basis.

The clients will be paying the price as per agreed, procedure. After the full payment, the clients become the owners of the thing hired/leased out. The clients can retain the ownership of the things as long as they pay the prefixed rent or until the leasing period is over. The clients can pay the money according to the pre-agreed procedure.

(iii) *Bayʿ-Salam*: This mode can not normally be applied for all types of activities. By definition, the bank pays the price of the commodities that are not produced yet or would be produced in the future in advance. Its application can be shown in the following way.

- The RDS will purchase the agricultural or industrial commodities in advance from the producers to be delivered at some future date and place. The amount and quality of the commodities will be clearly specific.

- If the RDS finds it difficult to handle the bulky commodities, it will find some wholesalers to buy the commodities the clients are willing to produce. The wholesalers will take delivery of the commodities form producers on behalf of the RDS.
- The wholesalers will pay the price to the RDS immediately after receipt of the goods as specified.

To meet the demand for cash: The demand for cash can be met in several ways namely: suppose a particular client wants 2 units of fertilizers and ready cash of Tk.100. Assuming that the price of fertilizer is Tk.100 per unit, he actually demands Tk.300. In this case he may be given 3 units of fertilizer valuing Tk. 300 on the understanding that he will sell out 1 unit to meet his cash demand. But he will have to give mark-up for the 3 units of fertilizers. Alternatively, he gives mark-up for 3 units of fertilizers and gets 2 units instead and 100 taka cash on *Qarḍ-e-ḥasana* basis. These new ideas would of course need approval of the Sharīʿah Council. It can also be given separately as *Zakāt* or *Ṣadaqah* or loan in terms of *Qarḍ-e- Ḥasana.* This of course would require a special fund.

Appendix 1: Monthly Position of RDS
December, 2006

Sl. No.	Particulars	**1.2 June '06**
01	No. of Branches handling the Scheme	118
02.	No. of Villages	8057
03.	No. of Thanas	275
04.	No. of Districts	61
05.	No. of Divisions	6
06.	No. of Centres	15321
7.	No. of Clients (Who availed investment)	294908
8.	Cumulative disbursement	Tk.9300.05 million
9.	No. of Field Officer	1368
10.	Balance of personal savings	Tk.636.05 million
11.	Balance of Centre Fund	Tk. 88.17 million
12.	Percentage of recovery	99%

Source: IBBL, Rural Development Division, HO, Dhaka.

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ISLAMIC MICRO AND MEDIUM SIZED ENTERPRISES (MMEs) FINANCE: THE CASE STUDY OF AUSTRALIA

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ABSTRACT

Microfinance tools can be adapted to every environment, based on the local needs and economic and financial situation. In Australia, Islamic microfinance enterprises that mostly rely on their shareholders' savings proved to be very effective and successful in providing microfinance to their clientele. This study offers an introduction to the emergence and development of Islamic Micro and Medium sized Enterprises (MMEs) finance in Australia, focusing the needs of financing a large and growing Muslim community in line with their Islamic tenets. It also studies the current realities of the Islamic financial system of Australia from the perspective of the theories of modern financial intermediation and Islamic micro finance contracting. This paper explains the key role of Islamic Financial Services Providers in Australia in fulfilling the micro finance needs of Muslim community. It also evaluates the Islamic microfinance techniques used by the Islamic Financial Services Providers of Australia.

1. INTRODUCTION

The contemporary Islamic finance is no longer an uncertain experience, but a reality and is likely to keep growing at a rapid clip. Thus it cannot be dismissed as a passing trend of what is described as a state of Islamic revivalism. Islamic Finance has emerged in recent decades as one of the most important trends in the financial world. There has always been a demand among Muslims for financial products and services that conform to the principles of Islamic Sharīʿah.[1] While the

[1] Sharīʿah is understood as Islamic law or the code of Muslim conduct outlined by the Qur'ān (the direct word of God) and the *Sunnah* of Prophet Muhammad (pbuh). The Sharīʿah of the prophets, from Adam to Muhammad (pbuh) is one in essence. It signifies the way to God, as given *by* God. It is the Way which encompasses the totality of man's life.

global value of total assets managed according to Islamic principles is still relatively small, these are growing at a pace well above 15 per cent annually which, if sustained, will eventually lead to amounts that are a significant proportion of global GDP. Approximate estimates place it at about USD$260 billion according to estimates provided by the General Council for Islamic Banks and Financial Institutions (GCIBFI).[2] A further $200 billion to $300 billion is managed by the Islamic banking branches and subsidiaries of international banks in the world's major financial centres such as New York, London, Paris, Geneva and Tokyo.[3] Although small in terms of the total global assets managed by these financial intermediaries, the growth rate is impressive.[4] The proponents and promoters of Islamic finance and banking are routinely characterising this growth as explosive. See for examples:

> "The market for Islamic Banking is worth more than US $200 billion and is expected to grow at 13 to 16 per cent a year over the next eight to ten years. The target market consists of more than 1.2 billion Muslims and the business is expected to have explosive growth."[5]

> "Mutual funds constitute one of the fastest growing areas of Islamic finance. Opinions vary over the total value of equity funds under Islamic management with estimate ranging from $1,000 million to $3,000 million. However, there is no dispute that the industry is expanding rapidly. ... The growth of the sector has been explosive."[6]

This is a clear recognition of the viability of Islamic financial industry and its firm significance in today's banking worldwide.

The contemporary Islamic financial institutions come in the shapes and forms of banks and non-banks, large and small, specialised and diversified, traditional and innovative, national and multinational, regulated and unrestrictive etc. However, Islamic finance is a vastly complicated phenomenon, and cannot be captured

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[2] Incorporated in May 2001 the Bahrain based GCIBFI is an international autonomous non-profit corporate body aimed at promoting the Islamic financial industry in theory and practice, and improving multilateral understanding between Islamic banks, their customers and the public at large.

[3] Banker Middle East. 2003. "Drawing the Roadmap for Islamic Banking", accessed at: http://www.bankerme.com/bme/2003/dec/islamic_banking.asp

[4] Figures of between $200 and $300 billion are commonly cited for the existing market size as an annual growth rate of around 15%. These figures need to be considered as indicative only and not as an actual estimate of the industry's size.

[5] Islamic Banking Consulting Web site, available at: http://www.globalislamicbanking.com/

[6] The Institute of Islamic Banking and Insurance Website, available at: http://www.islamic-banking.com/news/uae/archive/funds_grow_1199.php

without a full understanding of Islam and finance, and also law, economics, business and culture.

The objective of this paper is to examine the viability of Islamic financial institutions vis-a-vis their microfinance facilities in the interest-based economy of Australia, which contradicts the ideals of Islamic financial system. The examination has been carried out within the general framework of Islamic financial principles and precepts.

In line with the above objectives, this study offers an introduction to the emergence and development of Islamic Micro and Medium sized Enterprises (MMEs) finance in Australia, focusing the needs of financing a large and growing Muslim community in line with their Islamic tenets. It also studies the current realities of the Islamic financial system of Australia from the perspective of the theories of modern financial intermediation and Islamic micro finance contracting. This paper explains the key role of Islamic Financial Services Providers in Australia in fulfilling the micro finance needs of Muslim community. It also evaluates the Islamic microfinance techniques used by the Islamic Financial Services Providers of Australia.

The Islamic population in Australia has grown substantially in the last decade, particularly due to immigration from South East Asia and the Middle East. According to the Australian Bureau of Statistics, in 1991 there were 147,500 Islamic followers, and in 1996 this grew to 200,900.[7] Between 1996 and 2001, there were just over half a million new arrivals to Australia. Of these, 9% were affiliated to Islam.[8]

In response to the needs of this large and growing community mainly for microfinance, the Islamic finance emerged through establishment of the Muslim Community Co-operative Australia Limited, better known as MCCA in 1989. Although a few other Islamic Financial Services Providers are providing their services the MCCA is the largest in its kind in this country and it caters for microfinance needs of Muslims looking based on religious principles. In spite of the fact that the MCCA and other IFSPs who claim to operate in line with the principles of Sharīʿah have seemingly been operating successfully and playing an

[7] Australian Bureau of Statistics, *1998 Year Book*.
[8] The Australian Bureau of Statistics Census conducted in 1991 listed 281576 Australian Muslims, an increase of some 40 per cent in five years, while the Australian population as a whole only grew by 5.7 per cent in the same period. These figures may be very conservative as some recent estimates suggest that Australian Muslims now number more than 300000. See, Department of Foreign Affairs and Trade, the Commonwealth Government of Australia, "Islam in Australia". Retrieved December 29, 2006 from: http://www.dfat.gov.au/facts/islam_in_australia.html.

increasing role in community development and the country's economic growth,[9] there has been little comprehensive research on Islamic microfinance in Australia. This provides a proper field of study since to the researcher's knowledge; it has not been tackled before so extensively, as it deserves.

This study is limited in scope in a sense that it is not a comparative study of Islamic financial system with doctrines of other religions, ideologies and systems. The paper reviews within this limited scope and content the functions and practice of Australian Islamic Financial Services Providers in particular in Islamic microfinance.

Following the above introduction this paper discusses the issue in four major sections as mentioned below:

1. A general overview of Islamic financial system.
2. Microfinance: Islamic Perspectives
3. Islamic Financial Services Providers in Australia: an introduction.
4. Evaluating Islamic microfinance techniques used by the Islamic Financial Services Providers in Australia.
5. Summary, conclusion and recommendations.

2. A GENERAL OVERVIEW OF ISLAMIC FINANCIAL SYSTEM

Islam is not merely a religion; it provides for Muslims, a complete code catering for all fields of human existence, individual and social, material and moral, economic and political, legal and cultural, national and international.[10]

It is a comprehensive way of life, religious and secular; it is a set of beliefs and a way of worship; it is a vast and integrated system of laws; it is a culture and civilisation; it is an economic system and commercial norm; it is a polity and

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[9] According to a recent report provided by the Muslim Community Cooperative Australia Ltd. (MCCA) - one of Australia's leading Islamic financial services providers, its overall financial performance for the year 2003-2004 has been remarkable in comparison to the previous financial year. By June 2004, the MCCA had a total of 5,824 active members and on average more than 60 new members were registered every month. In the financial year ending 30th June 2004, its revenues increased by 19.45%, profit from ordinary activities grew by 50.64%, total assets increased 11.22%, net asset had increased by 4.89% and there was an increase in share capital by 4.74%. See, MCCA, "Financial Highlights for the Year Ended 30th June 2004", *Treasurer's Report.*

[10] See, Jansen, G.H. 1979. *Militant Islam*, London: Pan Books, p. 5.

method of governance; it is a society and a family conduct; it is a spiritual and human totality; thus worldly and other worldly.[11]

The Sharīʿah, which is the body of Islamic Law, is not a codified law. It is an abstract form of law capable of adaptation, development and further interpretation. The Sharīʿah does not prescribe general principles of law. Instead, it claims to deal with and cover specific cases or transactions and sets out rules that govern them. It is derived from two primary sources, the Qur'ān (the transcription of God's message to the Prophet Mohammad - pbuh) and the *Sunnah* (the word and living tradition of the Prophet Mohammad - pbuh), in addition to two dependent sources, namely *Ijmāʿ* and *Qiyās* which are meant to provide interpretation, and thereby facilitate future development and implementation of the Islamic judicial system. *Qiyās* is the deductive analogy by which a jurist applies to a new case a ruling made previously in similar case. *Ijmāʿ* is the consensus of the scholars of Islamic laws. It is through this principle that democracy makes its impact on the conduct of Islamic polity. While it opens up law to popular opinion, it is a conservative exercise as the consensus has to be by a very large proportion of the scholars.

The recent surge of religious consciousness or Islamic revival amongst the Muslims has provided the drive towards implementing and adopting Islamic principles in financial transactions. In other words, an outcome of this revival is the emergence of a new discipline, i.e. Islamic Finance. This discipline is based on the knowledge and application of the injunctions and norms of Sharīʿah which prevent injustice in the acquisition, management and disposal of material sources. To this end, in an attempt to purify assets in the eyes of Islam, Muslims are seeking a greater balance between their lives in the modern technological world and their religious faith and beliefs.

Among the most important teachings of Islam for establishing justice and eliminating exploitation in business transactions, is the prohibition of all sources of unjustified enrichment and the prohibition of dealing in transactions that contain excessive risk or speculation. Accordingly, Islamic scholars have deduced from the Sharīʿah three principles which distinguish Islamic finance from its conventional counterpart. These are briefly as follows:

2.1. The prohibition of *Ribā* or Interest/Usury

The prohibition of *Ribā* or interest/usury is clearly the most significant principle of Islamic Finance. *Ribā* translates literally from Arabic as "an increase, growth or accumulation". In Islam, lending money should not generate unjustified income. As

[11] Pervez, Imtiyaz. 1994. "Islamic Banking and Finance" in S. Nazim Ali and Naseem N.Ali et al (eds.), *Information Sources on Islamic Banking and Economics 1980-1990,* London: Kegan Paul International, p.9.

a Sharīʿah term, it refers to the premium that must be paid by the borrower to the lender along with the principal amount, as a condition for the loan or for an extension in its maturity, which today is commonly referred to as interest.

Ribā represents, in the Islamic economic system, a prominent source of unjustified advantage. All Muslim scholars are adamant that this prohibition extends to any and all forms of interest and that there is no difference between interest-bearing funds for the purposes of consumption or investment, since Sharīʿah does not consider money as a commodity for exchange. Instead, money is a medium of exchange and a store of value.

2.2. Profit and Loss Sharing (PLS)

PLS financing is a form of partnership, where partners share profits and losses on the basis of their capital share and effort. Unlike interest-based financing, there is no guaranteed rate of return. Islam supports the view that the Muslims do not act as nominal creditors in any investment, but are actual partners in the business. It is comprised of equity-based financing. The justification for the PLS-financier's share in profit is the person’s effort and the risk he/she carries, since his/her profit would have been impossible without the investment. Similarly, if the investment has made a loss, his/her money would bear the loss.

2.3. *Gharar* or Uncertainty and Speculation

Any transaction that involves *Gharar* is prohibited. Parties to a contract must have actual knowledge of the ‘subject matter’ of the contract and its implications. An example of an agreement tainted with *Gharar* is an agreement to sell goods which have been already lost.

Over the last fourteen centuries banking and finance have developed dramatically and various scholars have endeavoured to explain how, in practice, finance and business should be undertaken in accordance with the Islamic faith. The first thorough studies of Muslim scholars devoted to the establishment of Islamic financial institutions appeared in the 1940s. Although Muslim-owned banks were established in the 1920s and 1930s, they adopted similar practices to conventional banks. In the 1940s and 1950s, several experiments with small Islamic banks were undertaken in Malaysia and Pakistan. However, the 'modern era' of Islamic finance began in the 1960's with the foundation of the pioneering 'social bank' in the Egyptian village of Mit Ghamr. It follows the establishment of the Inter-Governmental Islamic Development Bank (IsDB) in Jeddah in 1975, and a number of commercial Islamic Banks such as the Dubai Islamic Bank, the Kuwait Finance House and the Bahrain Islamic Bank in the 1970s and 1980s. Commercial banks have also realised the potential of this new field, and a number of major worldwide institutions have grasped Islamic banking as a significant mechanism for more diversified growth.

3. MICROFINANCE: ISLAMIC PERSPECTIVES

3.1. The Basic Principles of Microfinance

Microfinance is constituted by a range of financial services for people who are traditionally considered non bankable, mainly because they lack the guarantees that can protect a financial institution against a loss risk.

The true revolution of microfinance is that this tool gives a chance to people who were denied the access to the financial market opens new perspectives and empowers people who can finally carry out their own projects and ideas with their own resources, and escape assistance, subsidies and dependence. Microfinance experiences all around the world have now definitely proved that the poor demand a wide range of financial services, are willing to bear the expenses related to them and are absolutely bankable. The target group of microfinance[12] is not constituted by the poorest of the poor, who need other interventions such as food and health security, but those poor who live at the border of the so called poverty line. Those who could reach more easily a decent quality of life and who have entrepreneurial ideas but lack access to formal finance.[13]

[12] According to the Consultative Group to Assist the Poor (CGAP), the clients of microfinance - female heads of households, pensioners, displaced persons, retrenched workers, small farmers, and micro-entrepreneurs—fall into four poverty levels: destitute, extreme poor, moderate poor, and vulnerable non-poor. While repayment capacity, collateral availability, and data availability vary across these categories, methodologies and operational structures have been developed that meet the financial needs of these client groups in a sustainable manner. More formal and mainstream financial services including collateral-based credit, payment services, and credit card accounts may suit the moderate poor. Financial services and delivery mechanisms for the extreme and moderate poor may utilize group structures or more flexible forms of collateral and loan analysis. The client group for a given financial service provider is primarily determined by its mission, institutional form, and methodology. Banks that scale down to serve the poor tend to reach only the moderate poor. Credit union clients range from the moderate poor to the vulnerable non-poor, although this varies by region and type of credit union. NGOs, informal savings and loan groups, and community savings and credit associations have a wide range of client profiles.

[13] These people usually do not lack finance in a broad sense: they can borrow money from friends, relatives or local money lenders, but of course they cannot access a wider and safer range of services. They need a formal financial institution to rely on, to ask not only for credit but also saving or insurance services, to deal with on a transparent basis (usury is usually a high risk for these people). Microfinance is filling this vacuum, the gap that until a few decades ago kept these people away from the realization of their own projects.

Beginning in the 1950s, development projects began to introduce subsidized credit programs targeted at specific communities. These subsidized schemes were rarely successful. Rural development banks suffered massive erosion of their capital base due to subsidized lending rates and poor repayment discipline and the funds did not always reach the poor, often ending up concentrated in the hands of better-off farmers. In the 1970s, experimental programs in Bangladesh, Brazil, and a few other countries extended tiny loans to groups of poor women to investment in micro-businesses. This type of micro-enterprise credit was based on solidarity group lending in which every member of a group guaranteed the repayment of all members. Through the 1980s and 1990s, micro-credit programs throughout the world improved upon the original methodologies and bucked conventional wisdom about financing the poor. First, it showed that poor people, especially women, had excellent repayment rates among the better programs, rates that were better than the formal financial sectors of most developing countries. Second, the poor were willing and able to pay interest rates that allowed microfinance institutions (MFIs) to cover their costs.

These two features - high repayment and cost-recovery interest rates - permitted some MFIs to achieve long-term sustainability and reach large numbers of clients. In fact, the promise of microfinance as a strategy that combines massive outreach, far-reaching impact, and financial sustainability makes it unique among development interventions.[14]

Microfinance is considered a very effective development tool: for this reason, year 2005 has been declared by the General Secretary of the United Nations "International Year of Micro-credit". Microfinance is also a very flexible tool that can be adapted in every environment, based on the local needs and economic and financial situation. For example, in Asia group micro-lending proved to be very effective, while in Egypt or in Brazil beneficiaries prefer individual lending. One more example: MFIs (Microfinance Institutions) and NGOs (Non Governmental Organizations) in India mostly rely on savings collection to support their institution and become sustainable while in Egypt they are forbidden by law to collect savings. Microfinance can be effective both in the South of the world and in Western countries, equally characterized by financial and social exclusion.[15]

Following this logic, microfinance can easily be adapted to certain cultural environments, such as countries characterized by a majority of Muslims that follow the Islamic law. Moreover, the similarities in the principles of the two make

[14] See, Consultative Group to Assist the Poor (CGAP) Web site, retrieved December 29, 2006 from: www.cgap.org

[15] Viganò L. a cura di. 2004. "La microfinanza in Europa", Giuffrè ed., Milano.

microfinance easier to expand in those countries, giving life to the new hybrid reality of Islamic microfinance.

A few studies have been carried out on the subject and experience on the field is still relatively small, but it proves to have huge potentialities both to fight against poverty financial and social exclusion and to enlarge and enrich the basin of clients of financial institutions in developing countries with an Islamic cultural substratum.[16]

3.2. Islamic Microfinance

Islamic convictions on the responsibility go well beyond mere profitability goals and coincide with the renewed perception on business recently at stake within the most advanced sectors of western business and civil societies. Far from the limits imposed by neo-classical thought, this new wave implies new sorts of responsibilities on behalf of the company falling under the rubric of corporate social responsibility (Ferro, 2005).As its ultimate goal is the maximization of social benefits as opposed to profit maximization, through the creation of healthier financial institutions that can provide effective financial services also as grass roots levels, some authors (Al Harran, 1996) argue that Islamic finance, if inserted in a new paradigm, could be a viable alternative to the socio – economic crisis lived by the Western paradigm.

As stated before, a relatively few studies and a few experiences on the field are concentrated on Islamic microfinance.

Between the most complete researches on the topic, Dhumale and Sapcanin (1999) drafted a technical note in which they tried to analyze how to combine Islamic banking with microfinance. They took into consideration the three main instruments of Islamic finance (*muḍārabah, mushārakah* and *murābaḥah*) trying to use them as tools to design a successful microfinance program.

1. A *muḍārabah* model: the microfinance program and the microenterprise are partners, with the program investing money and the micro-entrepreneur investing in labour. The micro-entrepreneur is rewarded for his/her work and shares the profit while the program only shares the profit. Of course the model presents a series of difficulties, given most of all by the fact that microentrepreneurs usually do not keep accurate accountability which makes it more difficult to establish the exact share of profit. As stated before, these models are complicated to understand,

[16] Segrado, Chiara. 2005. "Islamic Microfinance and Socially Responsible Investments", A case study, University of Torino.

manage and handle which implies that those who are involved need specific training on the issues. For this reason, and for an easier management of the profit sharing scheme, the *muḍārabah* model might be more straightforward for businesses with a longer profit cycle.

2. A *murābaḥah* model: under such contract, the microfinance program buys goods and resells them to the microenterprises for the cost of the goods plus a mark-up for administrative costs. The borrower often pays for the goods in equal instalments, and the microfinance program owns the goods until the last instalment is paid.

A *murābaḥah* model example: Hodeidah Microfinance Programme, Yemen.

Although traditional banking products have been available in Yemen for many years (and are still the predominant type of finance), many people, especially the poor, have been reluctant to take credit, in part due to religious beliefs.

This is one of the main reasons why the Hodeidah Microfinance Programme (HMFP) was implemented in 1997, in Hodeidah, a port city with a population of nearly half a million. It is characterized by an active economy based on trading, fishing, food production, small industries, handicrafts and transportation. In the early 1990s, during and after the Gulf War, many families returned to this city from Saudi Arabia and other Gulf States. Now, roughly 30 percent of the total population in Hodeidah are returnees, a key market segment for HMFP. Much of the population has conservative Islamic beliefs. The population studied showed a clear preference for the methodologies of Islamic banking in terms of receiving credit.

HMFP is the first microfinance project of its kind in Yemen and consequently has had to develop its human resources itself. It had 1770 active clients as of June 2000, 23 percent of whom were women and $350,000 in outstanding loans. The average loan size is 38,000 Yemeni Rial (YR) ($240 US dollars). There is a cycle of loans the clients go through but each level has a wide scope. The first loan can be up to 50000 YR ($300 US). The maximum loan for the final level is 250,000 YR ($1500 US).HMFP uses a group-based methodology. Group members are not confined to the same loan amounts or the same activities, although loan amounts need to be within the range of the cycle set by HMFP. There is also a small percentage of individual loans (10 percent).

The procedure is as follows: upon receipt of the loan application, the credit officer investigates the group and does feasibility study for their activities. From this study, the officer can estimate the precise loan amount. If the feasibility study is positive, the client should identify items (commodities/equipment) needed from the wholesaler and negotiate a price. The credit officer then purchases items from that source and resells them immediately at that price to the client. HMFP has two elements of accounting/finance, which differ from most microfinance organisations. Both have implications for content of financial statements. The first is capitalization of the service charge expected upon disbursement, which affects the balance sheet. The second is the absence of the "principle of interest" on outstanding loan balances affecting yield on the portfolio and thus income earned.

Range, in his paper (2004), underlines how the prohibition of *Ribā* in Islamic finance does not constitute an obstacle in building sound microfinance products; on the contrary, the side effects of an Islamic foundation could probably enhance it. These effects are: the high rate of return (compared to a fixed interest rate), the holistic approach in supporting businesses and productive activities, a more effective mobilization of excess resources, a fairer society.

4. ISLAMIC FINANCIAL SERVICES PROVIDERS IN AUSTRALIA: AN INTRODUCTION

The major Islamic financial institutions that have been conducting their functions in Australian are as follows.

i. Muslim Community Co-operative (Australia) Ltd.,
ii. Islamic Cooperative Finance Australia Limited,
iii. Iskan Finance Pty Limited, and
iv. Al Salam Home Loans.

4.1. Muslim Community Cooperative (Australia) Ltd.

According to the information provided in MCCA's web site, Muslim Community Co-operative (Australia) Limited (MCCA) is a non-bank financier that is based on unique system that recognises and meets the communities' religious needs and on a philosophy of providing finance on a fairer and more equitable basis, which in the long-term should be better for society at large. Its membership is open to all whether Muslims and non-Muslims. Anyone who is interested in alternative finance is encouraged to become a member.[17]

Given the above, MCCA was established in February 1989 with ten members and a starting capital of A$22,300. Operating from its head office in Burwood, Victoria. MCCA's activities involve financial dealings and transactions based on Islamic finance principles. Transactions that involve interest are completely

[17] See MCCA Web site available at: http://www.mcca.com.au/

excluded from MCCA's activities. Its activities also include the provision of an institutional framework for converting the charitable funds into a socially beneficial and economically productive tool.[18]

MCCA manages mainly five types of funds: *murābaḥah, mushārakah, muḍārabah, qarḍ ḥasan* and *zakāt* funds. The MCCA's Shared Equity Rental (SER) Scheme looks akin to what the Australian Prime Ministerial Taskforce on home ownership had announced in June 2003, in which the homeowner and a bank or other mortgage lender would co-own a home. Under the proposal, the financier would own about 30% of the home's value – reducing the amount of the homebuyer's mortgage and making it easier for people to buy a home. In keeping with the Islamic principles of the financier and the buyer sharing the risks and reward of the venture, the MCCA takes an equity stake in the property and buyer pays monthly rent with a capital repayment component – eventually to assume full ownership.

The main constraint facing MCCA is attracting more capital, which now is provided about 6000 shareholders, centered around the key Muslim strongholds of Melbourne and Sydney. Given that it cannot pay interest to depositors, MCCA instead sells shares to investors and pays a dividend. Because better returns are available elsewhere, these investors tend to be driven at least partly by altruistic reasons. An important consideration is that, unlike deposits, the shares are not protected by the Australian Prudential Regulation Authority.

The house financing is based on fixed monthly payment of rent plus principal amount over a 15-year period, with MCCA willing to finance up to 80% of the value of the property. An example may be given in the case of a house worth of A$200,000, for which MCCA 'lends' A$160,000, giving the MCCA 80% ownership of the house. Each month the purchaser makes a payment equivalent to an annual rate of 8.55% of the A$160,000 provided. The figure is based on the Real Estate Institute of Australia's estimate of median rental values in the relevant state, as well as a repayment component. MCCU's equity share of the property gradually reduces and by the end of the 15 years the buyer fully owns the house. If the buyer sells the house before then MCCA proportionately shares in the increase or decrease in the property's values.

So far the MCCA's success and failure are concerned it has enjoyed phenomenal growth since its inception and at present it has an asset base of A$28,549,000 compared to only A$105,700 in 1991. The rate of return on investment has jumped from 5.4% in 1991 to around 9.75% in 1995, a return which is much higher than fixed rate of return offered by interest-based banks. MCCA's audited financial report for the year ending 30 June, 2003 showed an operating

[18] Ibid.

profit of A$507,452. Even though it was lower compared to previous year's operating profit, revenue had increased by 16% to a total of $28 million. Nevertheless, MCCA incurred a loss of A$197,452 due to the write-off of subordinated debt to the Muslim Community Credit Union (MCCU) of A$956,333 (the loss incurred in the sale of MCCU's office), as a result of which MCCA could not offer any dividends for its shareholders for the same year, but no loss was incurred by any member.[19]

The Muslim Community Credit Union (MCCU) which was considered as the first Muslim Credit Union in Australia commenced its operation in early 2000 to provide Muslim community with retail banking and other financial facilities avoiding *ribā* or interest.[20] It was a separate entity to MCCA with its own board, staff and members. MCCA's involvement with the MCCU was as a sponsor with the offering of a sub-ordinated debt for a limited time. Subsequently, when it became apparent that MCCA's funds were not enough to sustain operations,[21] and concerns developed about the MCCU management and board, it took executive decision not to financially support MCCU any more and to join the MCCU board and later assume chairmanship in the interest of MCCA and its members. After discussion with the government regulatory body, the Australian Prudential Regulation Authority (APRA) and other parties concerned it was unanimously concluded that the best course of action was the cessation of MCCU. Subsequently, MCCU was wound down and its license was withdrawn in August 2002.

In an interview conducted in October 1994, Peter Moody of the Australian Taxation Office summed up the activities and purposes of MCCA as follows:

a. "A place for the advancement of the principles of the Muslim faith, and the evolution of a 'community' that overlooks its members and shareholders. MCCA funds can be, and are used to help those in need within the community. Donations are received and applied for this purpose. A separate fund has been created for this end, and is known as the *Qarḍ Ḥasan* Fund.
b. To operate as a housing co-operative that assists with the purchase of mainly residential properties for and on behalf of its shareholders. The purchase of other asset classes is undertaken in a similar fashion,

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[19] Muslim Community Co-operative (Australia) Ltd. 2003. *Islamic Finance & Investment, Financial Report,* (17th October)
[20] Under subsection 9(3) of the *Banking Act 195,* the MCCU was granted by the Australian Prudential Authority (APRA) the ACN 089 927 837 (the "ADI"), an authority to carry on banking business in Australia.
[21] Under paragraph 9(4) (a) of the above mentioned Act, the APRA imposed on the MCCU among other conditions the condition of maintaining a minimum ratio of capital to risk-weighted assets of 15% at all times.

mostly the purchase of motor vehicles, computers, and some limited business finance. The purpose of the provision of this facility is solely centered around the Muslim doctrine that forbids the payment of interest. MCCA charges an upfront 'administrative' charge for their involvement, but thereafter, the loan is interest free. This conforms to all the requirements of their religion, and such transactions are held to be *Ḥalāl,* which means that they are 'allowable' under Muslim doctrine. Repayments under these types of transactions are known as repayments of *Murābaḥah*.

c. To accept funds and issue shares in the co-operative from time to time, and to distribute the trading surplus of the co-operative back to the members in the form of dividends."[22]

As far as MCCA's objectives are concerned they are as follows as mentioned in its official web site.

a. "to build up funds available for investment to A$ 45 million;
b. to educate and train on the concept and operations of Islamic finance aiming to qualify at least 10 Muslims in managing and operating an Islamic financial institution: 5 in Victoria, 3 in NSW and 2 in WA;
c. to open 3 branches for MCCA : 1 in Victoria, 1 in NSW and 1 in WA; (in addition to its head office in Victoria at present it has one branch in Sydney); and
d. to establish and develop an institutional framework aiming for the best possible utilisation of charitable funds into economically productive and socially beneficial structure."[23]

4.2. Islamic Co-operative Finance Australia Ltd.

The Islamic Co-operative Finance Australia Limited, better known as ICFA was officially endorsed and registered by the Registry of Co-operatives, Department of Fair Trading, the Government of the State of New South Wales in May 1998 under the Co-operatives Act 1992 (NSW), sections 8, 9 and 10 to function as co-operative within the New South Wales.

The objectives of ICFAL as mentioned in its undated brochure titled 'ICFA Limited at a Glance' are as follows.

[22] See Hamdi, Abdat Abdul. 1999. "Islamic Banking System", accessed at: http://www.mail-archive.com/indoz-net@cc.utas.edu.au/msg01221.html
[23] Ibid.

> "The objects of the co-operative shall be to: (i) establish an interest free economic and financial system under the guidelines of the Islamic Law (Sharīʿah) on the basis of profit and loss sharing; (ii) provide *ḥalāl* investment opportunities for its members; (iii) facilitate ownership of real and personal property such as home, vehicle and other approved tangible assets for members; (iv) facilitate performing of social and religious obligations for Muslim members such as *Zakāt* distribution and *Hajj*; (v) establish feasible joint venture partnership agreements with members and similar financial organization; (iv) facilitate social justice through equitable distribution of wealth in the community."[24]

At present, ICFA provides the following products and services for its members.

a. Housing finance under *murābaḥah, mushārakah* and *ijara wa iqtināʿ* financing scheme. It follows almost all the terms and conditions and procedures followed by MCCA for its house financing scheme.
b. Vehicle finance under *murābaḥah* and *ijārah wa iqtināʿ* modes of finance.
c. Buying consumer's durables for customers and reselling to them under *murābaḥah* mode of finance.
d. Small business finance under *mushārakah* and *murābaḥah* financing schemes.
e. Hajj Fund under *muḍārabah* mode of investment. Under this scheme a customer wishing for performing Hajj deposits money by installments to this fund over a specified period to be able to bear Hajj related expenses when the fund is matured. The accrued dividend is distributed among the participating members for the whole period of investment.
f. Children education fund under *muḍārabah* mode of investment. Under this fund ICFA provides financial facilities to cover the costs of education expenses of the participating members' children wishing to join at the later stage of high school and tertiary levels. To meet eligibility criteria of an active membership provision a children under 18 years will pay at least 10% of joining fee of A$100 plus10% of 5 shares (each share is valued at A$100) and will agree to pay the remaining portion by equal installment basis during the first financial year. The period of the maturity of this fund package to be purchased must be at least for 5 years.

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[24] Islamic Co-operative Finance Australia Limited, *ICFA at a Glance*, (an undated brochure.)

g. *Zakāt* Fund. Under this scheme ICFA acts on behalf of each member, if requested to calculate, collect and distribute *Zakāt* to the poor and other deserving needy as outlined in the Islamic Sharīʿah.

As regards the membership requirements, any person residing in the State of New South Wales may be eligible for becoming a general member of ICFA by paying a one-off membership fee of A$100 and by purchasing minimum 5 shares (of valued at A$100 each) for becoming an active member. An active member is entitled to get ICFA's finance under the schemes mentioned above subject to the down payment of 20% of the total price for the house, commodity or other products wishing to purchase.

4.3. Iskan Finance Pty Ltd.

Iskan Finance, as mentioned in its official web site is a wholly owned Australian business established in 2001 with the core objective to offer better services to the home financing needs of the Australian Muslim community. In 2002, Iskan Finance commenced business with its *Murābaḥah* Facilitation Programme and building on the success of this core home financing product, has developed its *Ijārah wa Iqtināʿ* ("lease to purchase") facility. Both the *Murābaḥah* Facilitation Programme and the *Ijārah wa Iqtināʿ* facility have been modeled on *fatwās*[25] issued by various Islamic scholars and on opinion that Iskan has sought from Al Azhar University in Egypt. At the same time, Iskan Finance has worked hard to ensure that the financing will have longevity and consistency of delivery by engineering both its funding products to comply with the Australian Uniform Consumer Credit Code.

At a practical level, Iskan Finance has established links with a number of third party providers to service its customers. For instance, the custodian of Iskan's mortgages is Perpetual Trustee Australia Limited, Mortgage Insurance is provided by G. E. Mortgage Insurance Services and the Programme Manager is RESIMAC Limited. Iskan has contracted with Advance Investment Securities Australia Pty Ltd to manage distribution of its facilities and strategic alliances have now been forged around Australia to service a growing customer base.

Iskan Finance believes its *Murābaḥah* Facilitation Programme and its *Ijārah wa Iqtināʿ* offer a sound foundation for a growing suite of financing products that are planned to service the Australian Muslim Community.

[25] *Fatwās* are legal statements in Islam, issued by a scholar of Islamic laws, on a specific issue. They are asked for by judges or individuals, and are needed in cases where an issue of Islamic law and jurisprudence is undecided or uncertain. Lawsuits can be settled on the basis of a *fatwa.*

Iskan's *Murābaḥah* Facilitation Programme is designed to offer a 'better alternative' for Australian Muslims who are seeking the security, stability and financial independence of home ownership. It is a contract of sale between Iskan and its customer that establishes a fixed *murābaḥah* price including a profit mark-up, secured by a mortgage and settled over a fixed period of time, up to 30 years. A *Murābaḥah* Property Facility provided by Iskan starts at A$50K and ranges to A$500K. Under this programme following settlement, Iskan's customer is the sole owner of the property, enjoys the full benefit of any capital gain and on repayment of the facility there are no lingering stamp duty or capital gains tax concerns.[26]

Iskan customers require a minimum 10% deposit toward their property purchase. However, because they do not need to open a savings account with Iskan to qualify for a *Murābaḥah* Property Facility, there is no lengthy waiting time to qualify. Applying for *Murābaḥah* Property Facility is simple. Most of the requirements are contained on the web site and an application can usually be approved within 48 hours of receipt of supporting information. Settlement can usually be finalised within 4-6 weeks.[27]

The Iskan's *"Ijārah wa Iqtinā'"* financing model as it claims in its web site is also designed to be a 'better alternative' for Australian Muslims who are seeking the security, stability and financial independence of home ownership. The model is based on the concept of 'leasing to purchase' a home. Iskan's customer agrees to lease the property and pay rent, either fortnightly or monthly. Rent is reset at twelve monthly intervals and each rental payment made increases the customers' equity, ultimately retiring Iskan's equity. Iskan customers have the flexibility to retire the facility in part or full on yearly anniversary dates when the rental payments are reset.

The *Ijārah* facility is secured by a mortgage on the property, starts at A$50,000, ranges to A$1,200,000 and can be for a term up to 30 years. Under this scheme Iskan customers require a deposit of at least 5% toward the purchase price of the home and Iskan provides the balance. However, as Iskan customers do not need to open a savings account with Iskan, there is no lengthy waiting time to qualify. The *Ijārah* facility does not require the customer to enter into any partnership with Iskan and the customer enjoys the full benefit of any capital gain in the property.

Like Iskan's *Murābaḥah* Property Facility, applying for an *Ijārah* facility is also simple. Most of the requirements are contained on the web site and an application can usually be approved within 48 hours of receipt of supporting information. Settlement can usually be finalised within 4-6 weeks.

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[26] See Iskan Webpage available at: http://www.iskan.com.au/intro_murabaha.htm
[27] Ibid.

4.4. Al Salam Home Loans

Al Salam Home Loans Programme as mentioned in its official web site is specifically designed for the Muslim community in Australia. The facility attracts no interest, rather a Mortgage Facility Rental Fee (MFRF) which conforms to Islamic beliefs. It is also mentioned that the loan under this programme is available to those individuals who:

a. are currently employed and are subject to PAYG (Pay As You Go) taxation;[28]
b. that have been self-employed, or have been full-time Investors, for at least the past two years.[29]

The loan under Al Salam Home Loans program is also available for corporate entities who:

a. are currently trading as a registered Australian company and subject to company taxation;
b. are a trustee company acting on behalf of a family trust;
c. are a partnership entity.

The above mentioned MFRF charged by Al Salam, which looks very similar to that of Iskan's *Murābaḥah* Facilitation Programme applies the following:

- No interest will be charged on the loan.
- A MFRF covering the cost of funding management and profit will be charged on a monthly basis.
- The MFRF maybe variable reflecting the variable cost of funding or fixed for nominated periods of 1,2,3,4 or 5 years.
- Repayments will be a combination of principal and the MFRF.
- Repayments may be made weekly, fortnightly or monthly.

The loan size under this programme varies from A$50,000 to A$1.25 million per security property subject to conditions. The Loan to Value Ratio (LVR) of this programme is as follows:

[28] It is an Australian taxation system under which taxes are payable towards taxpayers expected tax liabilities on their businesses and investment incomes.
[29] See Al Salam Home Loans Webpage available at: http://www.alsalamhomeloans.com.au /alsalam/loandescription.php

a. 95% for loans up to A$350,000;
b. 90% for loans up to A$500,000;
c. 80% for loans up to A$600,000;
d. 70% for loans up to A$1,OOO,OOO;
e. where the security is vacant land the LVR is limited to 90%.

A non-refundable application fee of total A$695.00 is payable by the customer to get facilities under Al Salam Home loans programme, which includes one standard valuation up to A$750,000. Although lenders mortgage insurance is required for this loan, premium is only payable by the borrowers when the loan amount is greater than A$500,000 and/or the LVR is greater than 80%. For loans over 90%, savings history may be required to be verified by the lenders' mortgage insurers.

5. MICROFINANCE TECHNIQUES USED BY THE ISLAMIC FINANCIAL SERVICES PROVIDERS IN AUSTRALIA: AN EVALUATION

The Islamic Financial Services Providers in Australia although have seemingly been functioning in line with the central objective of Islamic finance to provide facilities and services to their clientele their practice need to be thoroughly investigated. As the nature of transactions of the Islamic financial institutions look similar to their conventional counterparts, the functions of Islamic financial institutions are almost the same as conventional financial system mainly in terms of accepting deposits from the depositors and operating functions of customers as agents as long as they do not contradict the principles permissible by Sharīʿah. Given this, the Islamic financial institutions in Australia have adopted the traditional financing tools and procedures for their functions. These institutions apparently use following four conditions set by the Islamic scholars and are required to effect a valid contract in order to attract funds and to provide Islamic financing to their customers.

a. A price that is agreed mutually and not under compulsion;
b. Between parties that are sane and have the legal capacity to understand the implications of their actions;
c. At the time of contracting, the subject matter of the contract be in existence and able to be delivered without uncertainty or deception;
d. The contract must not be based upon a consideration that is itself prohibited under the Sharīʿah (e.g. alcohol, gambling, construction of casino, weapons of mass destruction, pork products, etc.).

As against the wider scope of its investment, financing responsibilities and operations such as meeting the socio-economic objectives of Islam, safeguarding the interests of the investors by an efficient decision-making and management process etc., Islamic financial institution even at this stage has access to very limited modes of financing. However, the major microfinance techniques under which the Islamic Financial Services Providers in Australia operate and provide services to their clientele are: *muḍārabah, mushārakah, murābaḥah, ijārah* and *qarḍ ḥasan.*

5.1. *Muḍārabah* or Trust Financing

Muḍārabah is a form of partnership in which one partner provides the capital required for funding a project (known as *rabb al māl*), while the other party manages the investment using his expertise (known as *muḍārib*). Although similar to a partnership, it does not require a company to be created, so long as the profits can be determined separately. Profits arising from the investment are distributed according to a fixed, pre-determined ratio. The loss in a *muḍārabah* contract is carried by the capital-provider unless it was due to the negligence, misconduct or violation of the conditions pre-agreed upon by the provider of the capital.

In a *muḍārabah*, the management of the investment is the sole responsibility of the *muḍārib*, and all assets acquired by him are the sole possession of *rabb al māl*. However, the *muḍārabah* contract eventually permits the *muḍārib* to buy out the *rabb al māl's* investment and become the sole owner of the investment.

Muḍārabah may be concluded between the Islamic financial institution, as provider of funds, on behalf of itself or on behalf of its depositors as a trustee (not the English law concept of trustee) of their funds, and its business-owner clients. In the latter case, the bank pays its depositors all profits received out of the investment, after deducting its intermediary fees. It may also be conducted between the financial institution's depositors as providers of funds and the Islamic financial institution as a *muḍārib.*

5.2. *Mushārakah* or Partnership Financing

Mushārakah is often perceived as an old-fashioned financing technique confined in its application to small-scale investments. Although *mushārakah* is substantially similar to the *muḍārabah* contract it is different in that all parties involved in a certain partnership provide capital towards the financing of the investment.

Profits are shared between partners on a pre-agreed ratio, but losses will be shared in the exact proportion to the capital invested by each party. This gives an incentive to invest wisely and take an active interest in the investment. Moreover, in *mushārakah,* all partners are entitled to participate in the management of the investment, but are not necessarily required to do so. This explains why the profit-sharing ratio is left to be mutually agreed upon and may be different from the actual investment in the total capital.

In a typical *mushārakah* between a bank and a customer (i.e., partner), at the time of distribution of profits, the customer pays the bank its share in the profits and also a pre-determined portion of his own profits, which then reduces the bank's shareholding in the investment. Eventually, the customer becomes the complete and sole owner of the investment.

5.3. *Murābaḥah* or Cost- Plus Financing

Murābaḥah is the most popular form of Islamic financing techniques used by the Islamic financial institutions in Australia. Within a *murābaḥah* contract, the financial institution agrees to fund the purchase of a given asset or goods from a third party at the request of its client, and then re-sells the assets or goods to its client with a mark-up profit. The client purchases the goods either against immediate payment or for a deferred payment.

This financing technique is sometimes considered to be akin to conventional, interest-based finance. However, in theory, the mark-up profit is quite different in many respects. The mark-up is for the services the financial institution provides, namely, seeking out, locating and purchasing the required goods at the best price. Furthermore, the mark-up is not related to time since, if the client fails to pay a deferred payment on time, the mark-up does not increase due to delay and remains as pre-agreed. Most importantly, the financial institution owns the goods between the two sales and hence assumes both the title and the risk of the purchased goods, pending their resale to the client. This risk involves all risks normally contained in trading activities, in addition to the risk of not necessarily making the mark-up profit, or if the client does not purchase the goods from the financial institution and whether he has a justifiable excuse for refusing to do so. However, a customer's promise to purchase the goods in a *murābaḥah* is an ethically binding promise. Accordingly, the customer is bound to compensate the financial institution for any out of pocket expenses the latter incurs as a result of the refusal of the customer to purchase the goods.

The purchase of goods under the *murābaḥah* contract may be funded by the Islamic financial institution either from its own funds, or from the funds of its depositors. In the latter case, the financial institution acts as its depositors' agent, retaining its fees from the mark-up profits. In such circumstances, the depositors will own the purchased goods during the period pending its resale, and therefore assume its risk.

5.4. *Ijārah* Financing or Leasing

Ijārah is defined as 'sale of right to utilise the goods for a specific period'.[30] The *ijārah* contract is very similar to the conventional lease. Under Islam leasing began as a trading activity and then much later became a mode of finance. *Ijārah* is a contract under which the financial institution buys and leases out an asset or equipment required by its client for a rental fee. The jargon accorded to the financier, that is the financial institution, is 'lessor', and to the client, 'lessee'.

During a pre-determined period, the ownership of the asset remains in the hands of the lessor who is responsible for its maintenance so that it continues to give the service for which it was rented. Likewise, the lessor assumes the risk of ownership and in practice seeks to mitigate such risk by insuring the asset in its own name. Under an *ijārah* contract, the lessor has the right to re-negotiate the quantum of the lease payment at every agreed interval. This is to ensure that the rental remains in line with prevailing market leasing rates and the residual value of the leased asset.

There are two kinds of *ijārah* contracts used by the financial institutions in Australia. The first is the *ijārah* or true lease, which represents an exchange transaction in which a known benefit arising from a specified asset is made available in return for a payment, but where ownership of the asset itself is not transferred. The second type is *ijārah wa iqtināʿ* (literally, 'higher purchase' or 'lease and ownership'). This is a lease whereby the lessee derived economic use and ultimate ownership on the nature of a higher purchase. This is equivalent to a financial lease, or a lease with a purchase option. The purchase option stems from either a portion of the rental being allocated to a capital savings account, or a pre-agreed balloon payment, at the end of lease. For example, an Islamic financial institution agrees to buy and rent a building, equipment or other facility for its client, in conjunction with an undertaking by the client to make incremental payment into an account. At the end of each year, profits are added to the instalments paid until such time as the investment account contains the identical amount the financial institution paid to purchase the building equipment or facility. The client becomes owner of the financed equipment and the contract ends.

5.5. *Qarḍ Ḥasan* Financing or Interest-Free Loan

Qarḍ Ḥasan is a benevolent type of loan provided by some of financial institutions in Australia free of any charge usually to the needy on humanitarian grounds if their resources allow providing such loans without unduly effecting their profitability for investors and shareholders. Under this type of Islamic finance, the

[30] Al-Jaziri, 'Abdal-Rahman. Undated. *Kitab al-Fiqh 'ala al-Madhahib al-`Arba'ah*, Beirut: Dar al-Kutub al-'Ilmiyyah, pp. 86-87.

client undertakes unconditional obligation to repay the amount loaned. Islamic financial institution has the right to ask for collateral to secure its exposure. It may also seek full recourse against the client for recovery of its amounts due from him.

6. SUMMARY, CONCLUSION AND RECOMMENDATIONS

Although the Islamic financial institutions operating in Australia are very small in terms of their size, assets, profitability, number of investors etc. the signs for their continued growth appear positive. With a view to the limited access to their data and information, and adequate information are not available in their official web sites and publications all relevant data and information of these Islamic financial institutions could not be obtained to the researcher. Since all of the financial activities of these institutions are mostly involved in house financing they worked so far in a mainly benign economic climate, with rising property values. They have yet to be tested with a sharp fall in property values.

Another important consideration is that, unlike deposits, the shares of the Islamic financial institutions in Australia are not protected by regulators. So, MCCA and ICFA are not governed by the Australian Prudential Regulation Authority (APRA). As discussed earlier in this study the MCCU – an APRA-governed credit union which was supported by MCCA proved disastrous.

In pure financial terms, the MCCA and ICFA's shared equity arrangements appear not much attractive – and arguably, dearer than a conventional loan. It is therefore, surprising take-up of the product has been confined to devout Muslims. With all these realities, as the nature of the Islamic financial institutions is that they are based on profit sharing they should always carry the risk along with homeowners or other clients. At the same time, as they are based on the system that recognises and meets the communities' religious needs they have community involvement. Therefore, it is hoped that these Islamic financial institutions will play a significant role in meeting the communities' religious needs and the economic development of Muslim community in Australia. Time will prove whether they will make lasting impact on multicultural society in Australia.

We recommend to decision-makers in Islamic Financial Services Providers, Islamic financial cooperatives, relevant government authorities and Islamic micro-lenders to cautiously examine the following opportunities for the development of a healthy Islamic financial sector in Australia.

1. The considerable growth of the Islamic Financial Services Providers in Australia can be achieved through Islamically accepted mortgage broker and possibly through a link with global wholesale banks such as HSBC Amanah Finance Citibank, etc.

2. The MCCA and ICFA may merge with each other for their future growth and development through attracting more capital.
3. At present all these Islamic financial institutions are providing investment facilities rather than retail banking facilities, which is not enough. In order to attract more clientele thus providing the twin engines of fulfilling communities' religious needs and economic development of the country through microfinancing Islamic investment and retail banking facilities must be integrated.
4. More creative Islamic microfinance techniques need to be undertaken to suit the financial needs of individuals and groups to facilitate their contribution in community development in particular and the economic development of Australia at large.

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TAX ENGINEERING PERTAINING TO *ZAKĀH* AND WAQF FOR POVERTY ALLEVIATION AND MICRO-FINANCING IN SOUTH AFRICA

FAIZAL AHMAD MANJOO

ABSTRACT

Most Muslims in South Africa do not fall within the poverty line. However, they have a duty to help the poor. Zakāh and Waqf are two financial tools that can be used to assist in alleviating the poverty-stricken nation. This paper argues that due to a proper application of the Income Tax Act 1962 (as amended), Zakāh can be converted into an economic stimulus for poverty alleviation. It makes an attempt to analyse the manifestation of poverty in South Africa and also to assess the amount of cash owned by Muslims and which will attract Zakāh. Consequently this will open an avenue to explore the possibility of developing a proper National Zakāh Fund by using the existing tax system to optimize poverty alleviation. It is submitted that a National Zakāh Fund can be created as a Public Benefit Organization (PBO) and this will create room for tax engineering in generating more fund for poverty alleviation.

1. INTRODUCTION

South Africa is considered as the most economically advanced country in Africa with a Gross National Product of \$229 billion and a Gross Domestic Product of \$570 billion with a. per capita of \$12 161 in 2005. South Africa is rated 18th in the world in terms of its GDP but 55th in terms of its per capita. This shows the disparity in income distribution. (Wikipedia, South Africa). Unfortunately, with the legacy of apartheid this country is also called the “two-nation syndrome” because extreme wealth coexists with extreme poverty. (Kekker, 2004, p.216). In fact, poverty is considered chronic and there is no short term or even medium term solutions.

Before delving into the discussion pertaining to poverty in South Africa, first a proper of understanding of poverty is necessary so that a focus is maintained as to how solutions can be developed.

1.1. Modern Understanding of Poverty

It is problematic to define poverty since there is no uniform way of measuring poverty. (Sirageldin, 2002, p.29). This is also due to the fact that poverty can be viewed from various perspectives. Poverty can be analysed in the following yardstick (Kekker, 2004, p.212):

(i) Monetary terms;
(ii) Deterioration of living conditions;
(iii) Instability to meet basic needs;
(iv) Lack of resources or access to resources; and
(v) Lack of living with human dignity.

Poverty was examined at the world Summit for Social Development in Copenhagen, 1995 as having:

Various manifestations including lack of income and productive resources sufficient to ensure sustainable livelihoods, hunger and malnutrition, ill-health, limited or lack of access to education and other basic services; increased morbidity and mortality from illness; homelessness and inadequate housing; unsafe environments; discrimination and exclusion. It is also characterized by lack of participation in decision-making and in civil, social and cultural life.

The United Nations differentiates between extreme/absolute poverty, overall poverty and human poverty.[1]

Absolute poverty is when *a lack of income necessary to satisfy basic food needs – usually defined on the basis of minimum calorie requirement.*

Overall poverty means *a lack of income necessary to satisfy essential non-food needs such as for clothing, energy and shelter – as well as food needs*.

Human poverty is considered to be *a lack of basic human capabilities such as illiteracy, malnutrition, abbreviated life span, poor maternal health, illness from preventable diseases. Indirect measures are lack of access to goods, services and infrastructure, energy, sanitation, education communication, drinking water – necessary to sustain basic human capabilities.*

[1] United Nations Development Programmes, *Overcoming Human Poverty* Report 2000 (20).

The South African Committee of Inquiry viewed poverty as *the inability of individuals, households or entire communities to command sufficient resources to satisfy a socially acceptable minimum standard of living*. (Committee of Inquiry, 2002, p.26)

1.2. Islamic Perspective of Poverty

Islam is a universal religion that will remain until the Last Day. It has most definitely addressed the issue of poverty. In fact, the *infāq* sector (voluntary sector) which is being debated in modern society has already been debated by Muslim scholars. (Haneef & Anwar, 2005, p. 245-348). It is of utmost importance for South African Muslims to appreciate the dynamism of the *infāq* sector, especially by means of *Zakāh* and *Waqf;* and at the same time to contextualise these poverty alleviating tools for the South African disadvantaged groups. Islam has defined poverty from another angle. The verse in surah *al-Taubah* dealing with the recipients of *Zakāh* focuses on poverty and destitution mainly.

Zakāh is strictly earmarked in the Qur'ān primarily for the poor and secondarily for specific public needs. (Al-Jarhi & Zarqa, 2004:47). Primarily *Zakāh* is intended for the Muslims in distress. The Arabic terms in the Qur'ānic text to express the conditions of poverty are two terms: *Faqr* and *Maskanah*.

Faqr is derived from the root verb *faqarā*, which means to overcome a person. For example, a misfortune overcoming a person. Hence the verb *faqarā* means to be in need and the noun *faqr* means poverty. The plural of *faqīr*, *fuqarā*,' would hence mean needy or poor people. Imam Abu Hanifa refers to a *faqīr* as a person who lacks something necessary, i.e. who is in straitened circumstances. (de Zayas, 2000:285). Thus, *faqr* indicates the conditions of those who are insufficient to adequately provide the basic lawful material necessities of life.

Maskanah is derived from the root verb *sakana* meaning to become calm, motionless. And in the figurative sense to be poor. Hence, *maskanah* means poverty, destitution. The noun *miskīn* means in dire need. *Miskīn* would thus designate he who possesses nothing, i.e. is a destitute. *Maskanah* indicates a condition of those whose means are either to totally lacking or are as deficient as to deny the basic lawful necessities of life. (de Zayas, 2000, p.287). According to Islamic law the basic lawful material necessities of life are; sufficiency in food, shelter and clothing basic education and medical aid. Food clothing and shelter are classified as *Ghina* .i.e. the state in which one can dispense with material help of others. In other words, they will be excluded from *Zakāh.*

Therefore the *Fuqarā'* are the poor of straitened means. These include all Muslims whose means are inspite of their best effort or due to some disability or are so deficient as to deny them the basic lawful material necessities of life. The

Masākīn are the poor and destitute. These include all Muslims whose means are, inspite of their best efforts or due to some physical disability either totally lacking or are so deficient as to deny them the basic lawful material necessities of life. However, if person is in good health and has the basic necessities for at least one day, such person should not beg. (Shafi'i, 1994, p. 396).

From the above discussion, it is clear that the absolute definition for poverty as given by the UN is embraced in the concept of *masākīn*. In fact, Islam does not encourage a person to sit and beg whereas in the secular world a person not having a job may apply for unemployment grants. This type of lazy job seekers will not be accommodated in the bracket of poor in Islam. It is important to take cognizance of the fact that Sharīʿah has set two limits for distribution of wealth. The first is the sufficiency line (*hadd al- kifāyah*) which would be enough to provide for a satisfactory standard of living. The second is called the subsistence line (*hadd al-kafāf*) which would be sufficient to provide an individual with his basic needs. Both limits would be set in light of the general economic conditions in the country as well as generally accepted conventions. (Al-Jarhi & Zarqa, 2005, p.48).

Zakāh proceedings are allocated with its priority to give to the poor and destitute according to two principles: wealth maintenance and income maintenance. But if one is to consider the limits of *nisāb* for *Zakāh* this becomes problematic in attaining those principles. Presently (as at 29.02.2007) the *nisāb* amounts to R 15,055. 30 when gold is used as yardstick for estimating *nisāb*; and it amounts to R 2, 265.73 when silver is used as a yardstick.[2] The disparity in values causes problems in establishing a line of poverty. South African Muslim organisations have developed a scheme of using the silver yardstick when calculating *nisāb* for the donor of *Zakāh* and use the gold standard for the *nisāb* for the deserving recipients of *Zakāh*. In this way the reality of poverty is catered for in that the poor are assessed on a higher amount in that they will be more entitled to receive *Zakāh* and the rich discharge their *Zakāh* using a lesser amount as yardstick. Both figures fall within the boundary of Sharīʿah.

There is however a problem in that despite the highest *nisāb* is used, i.e. 24 carat gold, this is not resolving the poverty issue in that the maintenance of income and maintenance of wealth still remain resolved. This is due to the fact when one considers the poverty line in South Africa, estimated at R800 per month, then the objectives of *Zakāh* are not really met in addressing poverty because annually a person is receiving R 9600.00 (R 800 x 12), a difference of R5455.00 (R 15,055.00 – R 9600.00) over a year. Practically in South Africa R5455.00 cannot maintain wealth or income. This demands a restructuring of the *Zakāh fiqhi* issue as rose by some contemporary jurists (Sadeq, 2002, p.43)).So the Islamic concept of poverty will need some serious thought if the socio-economic objectives of *Zakāh* are to be

[2] R stands for rands, the South African currency. R 7 is approximately equal to $US 1.

met. In fact the issue of human poverty category is not sufficiently debated, from a *Zakāh* perspective, by most Muslim scholars. It is difficult to attain the sufficiency line wealth maintenance and income maintenance with the existing *nisāb*. From poverty alleviation policy, Muslims in South Africa will either reconsider the *nisāb* limit and also generate more money either from their *Zakāh* or develop other schemes.

To be able to attend to the issue of poverty an analysis of the cause of poverty is important so that viable solutions can be identified,

1.3. Causes of Poverty in South Africa

a. *Unemployment* and *Unpaid work:* Primary cause of poverty is a lack of income which is due to lack of paid work. The situation in South Africa is clearly reflected in table 1.

Table 1. Key Indicators and the Corresponding March 2006 Estimates

Labour Market	Levels	Estimate for March 2006
Indicators		In Thousand
A	Employed	12 451
B	Unemployed (official definition)	4 275
C	Labour force = a + b	16 726
D	Not in the labour force	13 126
E	Population of working age = c + d	29 852
F	Discouraged work-seekers	3 683
	Rates (percentages	Percentages
G	Unemployment rate = b / c x 100	25.6
H	Labour force participation rate = c / e x 100	56.0
I	Labour absorption rate = a / e 100	41.7

Source Statistics South Africa 2006

South Africa is characterized by a labour surplus economy that is unlikely to change in the foreseeable future. A labour surplus economy with high skills deficits at the lower end has significant implications for the design of a comprehensive social security system in the short to medium term. (Committee Inquiry, March 2002). Official unemployment figures show that unemployment increased from 2, 2 million (19, 3%) in 1996 to 4, 3 (26,4%) by 2006.

b. *Dependency.* Due to a high level of employment, the level of dependency is high in South Africa. Forty five percent (45%) of the African people are below 15 years of age or above 64 years. This implies that the burden of supporting the dependents of the population is much heavier among Africans because the dependency ratio is high. 44 versus 56 per cent of the total population live in urban and rural areas respectively, (Mhone, 2003, p.4). This in turn restricts access to resources and social facilities.

c. *Education:* Despite the government has in vested much in education for the black community, this is not really resolving the problem of poverty because there is not really capital targeting investment by the state or tax break for capital investment. The level of education attained by individuals and groups have a bearing on their potential for employment and income generation in the economy. The 1999 OHS showed that only 22% of African males and 20% female passed their matric (final year secondary school). This is the lowest compared to all categories of ethnic group.

d. *Income inequality*. Income inequality is another legacy left for the black community. Despite affirmative action and other legislation being enacted to even out income inequality, the state of affairs has hardly changed. The average Black South African is still living on $ 2 a day. (Committee Inquiry, 2002, p.1)

e. A*ccess to resources*. When no financial security is available this in turn restricts access to resources such as bank, education and business. Consequently, this hinders progress to uplift poverty. Inequality refers to both to economic and social aspects and to conditions of opportunity. Measured by the Gini-coefficient, inequality in South Africa is ranked fifth highest in the world. (Committee Inquiry 2002, p.16).

Table 2. Estimated Adult HIV-Prevalence Rates, 2001 – 2006

Age	2001	2002	2003	2004	2005	2006
Women 15-49 years	16.1	16.9	17.7	18.5	19.3	20.0
Women 20-64 years	14.7	15.4	16.1	16.7	17.2	17.8
Men 20-64 years	14.3	15.0	15.6	16.3	16.9	17.5
Adults 20-64 years	14.5	15.2	15.9	16.5	17.1	17.7
Adults 15-49 years	14.7	15.4	16.1	16.9	17.5	18.2
Total population	8.5	9.0	9.5	10.0	10.4	10.9

Source: Statistics South Africa 2006

f. *Aids*. This disease is definitely destroying the country. The life span of the average male South African has dropped to 49 years. The adult HIV-

> prevalence rate (the proportion of adults who are infected with HIV) is shown in Table 2. As expected, the prevalence rate is highest among women aged 15-49. The overall prevalence rate of this group is 20%. The estimated total HIV-prevalence rate increase to about 11% in 2006 (from less than 9 percent in 2001). The HIV-positive population is estimated at 5, 2 million which compares to an UNAIDS estimate of 5,5 million at present.This in turn will affect production in the near future and also the breadwinner is decreasing.

From the above analysis, it can be deduced that the way forward to alleviate poverty, priority should be given to the following areas, which demands urgent attention:

(i) Creation of employment
(ii) Education
(iii) Health and food

The situation in South Africa is that we are faced with a chronic poverty. No short term or even medium term solutions are available. Muslims should focus on these areas.

1.4. Snapshot of Statistics about Poverty

To appreciate the seriousness of poverty in South Africa some figures are quoted over here (Extracted from Committee of Inquiry 2002 and Mhone 2004):

The rate of poverty (which measures levels of absolute poverty stands at about 45%. An estimation of 43% has been found to live in absolute poverty. The level of poverty is generally higher in rural areas (71%) manifesting mainly among Africans (61%)

45% of the population lives on less than $2 a day as measured by the World Bank.

25% African children are stunted i.e. short for their age.

10% of Africans are malnourished i.e. underweight for their age

5,2 million of the population the population is affected by Aids. There has been an increase of 11% in 2006 compared to 2001.

45% of the African population is under 15 years or above 64 years. Which means only 55% constitutes the working force out of which 51% are females.

12% of Africans are still living in shacks.

The income of the richest 10% of Black South African households rose by 17%, whilst income of the poorest 40% of Black South African household fell by 21%.

It is clear that the basics of life are not being met.

1.5. Proposed Solutions by the South African Government in 2003

Briefly the governmental policies to redress the alarming poverty situation are:

(i) Establish a social security system
(ii) Overt will be targeted by means of prevention alleviation and reduction.
(iii) Development of people's capacity to take charge of their own circumstances in a meaningful way.
(iv) Offering a basic income grant to elimination of destitution.
(v) Job creation policies such as affirmative action, reserved jobs for indigenous people in firms employing 50 or more employees.
(vi) Poverty is higher in rural areas, thus looking into means to raise productivity of the poor in those areas. (Kekker, 2003:217).

It is very difficult for the government to achieve all these on its own. Muslims with a statutory management can come to the rescue by at least organizing their *Zakāh* collection and distribution properly and focusing on the *infāq* sector of Islam.

2. ROLE OF MUSLIM OF SOUTH AFRICA

To appreciate the role Muslims can play in poverty alleviation in South Africa, an analysis of their demographic background, financial worth and their responsibility both as citizens and as Muslim is undertaken in this section.

2.1. A Synoptic Analysis of Muslims Demography

The earliest record of Muslims immigrants dates from 1652 who came as slaves and landed in Cape province. Then the Indian came to work as labourers and others came as businessmen. They had to live under stringent conditions of the whites' apartheid regime.

They were treated as second-class citizens under laws such as:

Land Act of 1913, which confined the land area that non-white, could own.
The 1913 *Mines Act*, which reserved jobs for whites.
The *Group Area Act* of 1956, which limited the movement and economic access.

Unfortunately due to the legacy of apartheid there were no official records regarding Muslims. They were classified as Indians, which included the Hindus, Tamils etc. But Muslims comprised of Coloured (mix of whites and black) and Malays as well. Different statistics have been forwarded by different academics. An estimate by Professor Nadvi is that South African Muslims constitute 3 % of the population(1994:1) However, Professor Naude claims that Muslim represent only 1.34% of the total population(1992:17) Moreover to maintain that percentage of Muslims of the total population will rather be power than higher due to demographic tendencies. The African Muslim Agency quoted 1.67% (750 000) out of 45 million. The 1996 census the population of Muslims 1.38 and 2001 estimated 640 000! (Statistics of South Africa, 2001). All these figures are debatable and do not reflect the actual Muslim population.

According to an informal survey carried by the writer a safe approximate would be 3% of the population. This estimate is based on three factors:

(i) The influx of foreigners from North Africa is primarily from Muslims. Presently South Africa has approximately 5 million immigrants. Many come from Somalia an estimate of 200,000, Sudan Bosnia and Kashmir. These are predominantly Muslim Countries. South African law grant asylum seekers a good status which allows them to enhance themselves quite freely, even economically.

(ii) The number of indigenous people embracing Islam is on the increase. In the distant past, Muslims were prohibited from practicing Islam in public. The law in 1967 stipulated:

No one shall trouble the Mardyekers (Muslim soldiers) in the Dutch colony about their religion or among them as long as thy do not propagate it among Christians or heathens. Offenders were to be punished with death. (Nadvi, 1994:41)

This limitation place on *da'awah* (preaching) was really waived in 1994, when freedom of movement and freedom of religion were entrenched in the new constitution. Since then Muslims have been engaged in *da'awa* openly and a marked increase in conversion has been observed.

(iii) Many Muslims do not reveal there real states of religion and many Muslim names have even been changed in the past, it will take time to rectify all these anomalies created by apartheid.

Hence, the Muslim population is estimated informally around 1.5% million then they will constitute 3% of the population.

2.2. Financial Analysis

It is virtually impossible to have a precise figure regarding the wealth of South African Muslims because so far no official survey has been carried out regarding the amount of money circulating in the economy. However, with the modest revival of Islamic finance some extrapolation can be useful. For *Zakāh* calculation purposes, it is not feasible to assess the assets worth of Muslims. But for cash it is possible with some degree of precaution.

Analysing the cash flow among Muslims can be a good starting point. The most evident source will be the Albaraka (Islamic) bank, which is 100% Muslim-owned with at least 99% of their clientele being Muslims. These figures will be reliable due to the audit performed on it.

Table 3: Comparison of Figures from 2003 to 2005

Items	2003	2004	2005
Deposits	749249	885419	1,003 968
Advances & receivables	543 366	836 463	1 009 303
Income paid to Depositors	40 781	46 132	57 092

Source: Albaraka Bank Annual Report 2005

From these figures, it is clear that there is more visibility of Muslim incomes. The Deposits and Income paid to depositors are figures revealing the extent of *Zakāh* payable after deducting the loans advanced to clients. Between 2004 and 2005 the deposits increased by almost 18%.

Should we consider the deposit figure of 2006 (not published yet) the bank received deposits in the sum of R1.2 billion. The number of clients is estimated to be around 40 thousand. This gives a *cash per capita* of R25 000. Assuming this figure reflects the average Muslim in the community which is informally 1,5 million then we should expect an average of R37 billion cash in the Muslim community.

The First National Bank of South Africa, has estimated the cash in Muslims to be around R26 billion. (Patel, 2006). The big banks have on average 200,000 Muslim clients. This should amplify the amount of cash deducted from Albaraka, because size wise it is rated as the 16th bank in South Africa.

However, at the equity market the leading asset management company is Oasis. The Oasis Crescent Management Company has many funds. A brief description of their different values of non-current assets as well as current assets for the year 2005 are quoted below.

Table 4. Assets of Oasis Funds

Funds	**Non-Current Assets**	**Current Assets**	**Year**
Oasis crescent Equity	1,567,035,277	98,032,738	2005
Oasis Crescent International Feeder Fund	219,294,729	220,678,995	2005
Crescent Balanced Progressive Fund of Funds	81,948,865	14,702,749	2005

Source: Oasis Brochure 2005

These figures are astonishing and reflect the trend of cash in Islamic equity fund. These are considered to be disposable income or even stock in trade for those who want to deal on stocks. In both circumstances, they are liable for *Zakāh*. Almost two billion rands worth of assets are reflected in one company. This indicates the level of cash in the Muslim community. It can be argued that not all investors are Muslims, but it is assumed that the majority are Muslims as the marketing for these funds are directed towards Muslims. If disposable income is so high then the real cash will be much higher in the Muslim community.

In the above exercise it is assumed that Muslims should have at least R26 billion which are subjected to *Zakāh*. Stock in trade, jewelries, money abroad etc are excluded. If an assumption of 20% debt on this figure, this amounts to approximately to R5 billion. The remaining R20 billion are subjected to *Zakāh* at 2.5%. Theoretically approximately R 500 thousand million worth of *Zakāh* is payable! (The figures have been rounded off for convenience in this section).

This figure is astronomical but unfortunately, it is not well managed and remains only in theory. If *Zakāh* is well managed and discharged, then Muslims can contribute in poverty alleviation in South Africa. Eventually Muslims will have to reveal their real financial situations due to modern legislation regulating financial transactions. Some of the implication is discussed below.

2.3 Main Financial Legislations

The last 20 years have seen the acceleration of international money laundering, fraud and theft efforts. Standards have been adopted, bodies have mushroomed globally and legislation had been passed and implemented by governments. South Africa joined initiatives by its admission as a member of the Financial Action Task Force (an international organization to monitor laundering in June 2001 and 1999 ESAAML.(Eastern and Southern Africa Anti-Laundering Consolidating Group) (Compliance Institute, 2004:9)

In South Africa money laundering refers in general to any act that disguises the criminal nature or changes the proceeds of crime. The South African Law Commission defines it as "the manipulation of illegally acquired wealth in order to obscure its true source or nature. This is achieved by performing a number of transactions with the proceeds of criminal activities that, if successful, will leave the illegally derived proceeds appearing as the product of legitimate investments or transactions". (Malliniks Corporate Services: 2007:1)

South African legislation has broadened the definition of money laundering to include every act or transaction involving funds or property derived from criminal activity, these can be committed outside South Africa and it does not matter when it was committed. There is a plethora of legislation that has made it very difficult to juggle one's financial position:

1 The Prevention and Combating of corrupt Activities Act (POCA), 2004 this Act defines the money laundering act. It lays down the penalties for doing so. There is imprisonment not exceeding 15 years and / or a fine not exceeding R10 million for the person/institution who is supposed to report the criminal transaction or suspected criminal financial transactions.

2 The Financial Intelligence Centre Act (FICA) 2003 that compels the business community to take steps to control and prevent money laundering. FICA creates a number of compliance obligations for banks, estate agents, brokers, attorneys, insurance companies. They have the following obligations. The main one is to report suspicious or unusual transactions to Financial Intelligence Centre.

The following transactions are suspicious or unusual for purposes of FICA report:

(i) A transaction which resulted (or is about to result) in the above-mentioned institutions or professionals receiving proceeds of a crime.

(ii) Facilitated a series of transactions with the above-mentioned of listed organization or profession that:

- Facilitated or is likely to facilitate the transfer of proceeds of crime
- Has no apparent business or lawful purpose
- Is conducted fro the purpose of avoiding taxes giving rise to a reporting duty under FICA

Or

- May be relevant to an investigation into evasion or attempted evasion of any tax duty or levy administered by the South African Revenue Services.

(iii) Any other use or abuse of the group for money laundering purposes which has been occurred or is about to occur.

There are cases where to prove that one can lose all his estate if there is financial or economic crime involved; e.g. State versus Gayadin (2001, case no. 41/900/01 Regional Court of Durban)).

This brief analysis of FICA and POCA indicates South African citizens cannot do unofficial dealings. No black money transaction will be tolerated. Hence, for Muslims all their transactions will have to go through the proper monetary channel. If this is the case then, the cash flow in the community demands that a proper approach be adopted for *Zakāh*. It is of utmost importance that the estimated amount identified be used in a more efficient way. There is a correlation between *Zakāh* to be paid and an efficient tax system.

2.4 An Efficient Tax System

For a tax system to be efficient, the following four characteristics must prevail:

(i) *Efficiency in collection*. There must be no corruption. Unfortunately, South Africa has been rated 63 out 159 for corruption (Wikipedia, South Africa).

(ii) *Incentive.* There must be proper incentive given to the people so that they do not void too much of taxes. Again in South Africa the tax incentive is not enough especially when helping social causes.

(iii) *Equity*. With the progressive tax system prevailing, it does not really show the commitment to limit the extent a person should pay tax. In addition, the Value Added Tax for instance is quite high for the laymen.

(iv) *Stability*. The tax system is however fairly stable as the government does meet to a great extent its expenditures, despite a negative Balance of Payment.

From the above it can be gauged that it is preferable for Muslims to organize themselves in redistributing their wealth to the poor because *Zakāh* is an *ʿibādah* and secondly the focus is really redistribution of wealth in the proper sense. For Muslims it is time to ponder on the impact of FICA and whether the tax they pay is efficient or should they distribute there *Zakāh* from a more organized way instead the money goes in other avenues of government expenditure which may not be appropriate, because when the law does make provision to have exemption for taxes if money is donated to religious organizations, then this advantage should be benefited from.. This will be discussed later.

To appreciate this discussion let us see the tax implication for Muslims.

3. INCOME TAX AND *ZAKĀH*

3.1. Relevant Sections of the Income Tax Act (ITA) 1962 (as amended)

Though *Zakāh* is an *ʿibādah* (worship), it is also a socio-economic tool. When it is discharged in a secular state, it can legally be considered as a donation. Donation is defined as a any gratuitous disposal of property including any gratuitous waiver or renunciation of right. (section 55 of ITA).[3]

In this definition, property means any right in or to property movable or immovable, corporeal or incorporeal wheresoever situated. According to South African law a person can donate to a maximum of R50 000.00 per annum. (Financial Budget of 2006) Any amount above this sum will be taxable at the rate of 20%. Such tax is payable by the donor within three months from date of donation. (Section 60 ITA)

Hence, if a person is to give tax, on any amount above R50 000.00 he will have to pay 20% donation tax of the excess amount within three months. It can be argued that he needs not reveal it as a donation, but the tax may make an inquiry with the recipient.

However, another problem is that if a person donates a sum of money to someone, he cannot claim any benefit from it but if he gives it to a Public Benefit Organisation (PBO) then the amount donated can be deducted from his total income for income tax purpose provided the PBO issues a certificate of exemption for him. (Section 18A of ITA)

[3] For the purpose of this article ITA would mean Income Tax Act 1962 as amended; and VAT would mean Value Added Tax.

Another issue to consider is that when purchasing any commodity, (with the exception of few, there is Value Added Tax (VAT) at the rate of 14% levied. When a PBO purchases commodities then it can claim the VAT it back as refund. (Section 10 (1) (cN) of ITA).

These few issues are very important to analyse how way Muslims are losing money. Suppose there is 20% donation tax on *zakātable* money, which we estimated around R500 thousand million, this will amount to a figure of R100 thousand million. This money can be saved if we set up a Public Benefit Organization. According to section 10(1) (cN) of the Income Tax Act due to exemptions afforded to a PBO, the latter can claim back these VAT or any tax. Paid by itself.

The *fiqhi* issue is that what is the nature of the refund claimable from the tax department? It is submitted that this refund cannot be *Zakāh*, because the PBO acts as an agent for the *Zakāh* donor. Once the *Zakāh* is donated, *tamlīk* (passing on ownership to the recipient of *Zakāh*) takes place and thus the agent's responsibility is discharged. However, the money refunded is gained on the basis of being a registered PBO. Thus nature of the money is changed. It is a considered as a *tabarru*ʿ (gift) from the government just as old age pension which one receives on the basis of age, while the money emanates from then tax that citizens pay. There is no link really between the *Zakāh* money given and the refund obtained by the PBO.

Another point to ponder over is that all expenses incurred by Muslims in discharging their *infāq* sector duties attract VAT at the rate of 14%. If the responsibility of discharging the *infāq* sector is given to a registered PBO, these can be claimed as explained earlier.

If all these VAT paid are added Muslims should be losing approximately R100 thousand million in tax every year. While such can be tax engineered to claim back the VAT paid from South Africa Revenue Services and same can be ploughed back in other projects.

3.2. A Proposed Solution for Tax Engineering

Upon pondering upon the Income Tax Act, if a PBO is registered to take advantage of the issues raised above.

Section 30 (1) of the Income Tax Act defines a PBO as either a company formed and incorporated under section 21 of the companies Act N0. 61 of 1973, or a trust or an association of persons.

The Act requires the PBO to conduct its activities in a non-profit manner with an altruistic or philanthropic intent. Furthermore, the activities conducted by the PBO cannot directly or indirectly enhance the economic self-interest of any person in a fiduciary capacity for the PBO or for an employee thereof, except in the form of reasonable remuneration payable to that fiduciary or employee for services rendered. In addition, at least 85% of the activities conducted by the PBO, measured either as the cost related to the activities in terms of the time expended relating thereto must be carried out for the benefit of persons in the country, unless the Minister having reference to the circumstances of the PBO directs otherwise. Where the PBO conducts activities both within and outside south Africa , the cost incurred for the persons who are resident in the country.

With such a structure, Muslims may be in a position to claim the VAT and also individuals will be in a position to ask for deduction from income tax. To do so they should obtain a certificate of exemption from a PBO as per section 18A of the Act which reads:

There shall be allowed from the taxable income of any taxpayer so much of any bona fide donations by that taxpayer in cash or of property made in kind, which was actually paid or transferred during the year of assessment to: (a) any

(i) public benefit organization approved by the Commissioner under section 30.

The definition requires that the PBO conducts its activities for the benefit of or is widely accessible to the public at large, including any sector thereof. The activities conducted by the organization must be carried out for the benefit of or readily accessible to the poor and needy or the organization must be funded at least by donations, grants from any organ of state or by foreign grants.

To qualify for recognition as a PBO the organization must conduct a public activity, which is defined in Part 1 of the Ninth Schedule of the Income Tax Act. There are eleven main categories of activities listed. For the purpose of *Zakāh* and other types of *infāq* contributions, the following activities can be used to apply for such PBO exemption:

(i) Welfare and Humanitarian
(ii) Healthcare
(iii) Education and development
(iv) Religion, belief and philosophy.
(v) Providing funds assets and other resources

These are important activities as per the areas identified for poverty alleviation earlier.

The authorities accept that activities listed need amendment thus Minister can approve of activities for benevolent nature

Section 30(3) states the following conditions in order exemptions for tax be granted:

1 *Must submit its constitution to commissioner of tax. Full description of at least 3 persons who will run the organisation.*
2 *Must use funds solely for the object for which it was established and is require to invest its funds with either a financial institution as defined in the Financial Services Board Act no 97 of 1990, or in an South African listed shares or in such other prudent investments in financial instruments and assets as the commissioner may determine*
3 *In case a PBO is dissolved it must transfer its assets to a similar PBO which has been approved In terms of section 30 or to an institution exempted s 10(10(cA) (i)*

A PBO enjoys a privileged position in that it is not subject to tax on the income derived by it. Thus, the PBO must comply with requirements of exemption on an ongoing basis and also comply with Section 30.

Under section, 30(A) the Commissioner may grant approval in respect of group of organizations sharing common purpose or which carry on any public benefit activity under the direction of a regulating or coordinating body.

From the above it is clear that Muslims should adopt the idea of PBO to have a better control over their *Zakāh* and other disbursement in the *infāq* sector. So far there is no official National/ Central *Zakāh* Fund in South Africa but what is important is that the *Zakāh* paid should be reconsidered at national level due to the voluminous amount of refund that cannot be claimed from the tax office such as claims for VAT, donation tax and also tax deductibility for individuals or companies. All these taxes are lost if paid by individuals or corporates.

The different provinces may have various pocket *Zakāh* organizations for collection whereby registration as PBO is necessary. The purchases for food, clothing etc to be distributed among the *Zakāh* recipient should be done at a more sophisticated level before *tamlīk* is transferred and the claim of 14% of VAT can be organized in a more scientific way.

3.3. Developing a Model for Poverty Alleviation in South Africa

In developing a model for *Zakāh* organization there three important issues to consider:

1 The collection of the *Zakāh*;
2 The disbursement of the *Zakāh*; and
3 The administration of the organization itself.

So far compulsory *Zakāh* collection like in Malaysia and voluntary *Zakāh* collection like in Kuwait are identified at a national level. These are legally recognized organizations found in Muslim countries. But in countries where Muslims are minorities, there is no real model at national level. A model is proposed which hopefully can be useful for other countries.

To be able to benefit from the tax laws and make the project viable it is proposed that first organizations collecting *Zakāh* should first try to get a PBO status as per section 30 of the Income Tax Act. Once this is done the various *Zakāh* organizations should try to set up National/Central *Zakāh* Fund, which will be a PBO as well as per section 30A which entitles such organizations to be grouped under one umbrella. This will be at a national level so that work can be coordinated with the authorities and also the main object is to make the bulk purchase of the commodities that are distributable to the poor. This will also entitle the National *Zakāh* Fund to claim the VAT and other taxes paid.

The goods purchased should be delivered at the provincial offices who then distribute the foods etc to the poor from local offices.

3.4. The Application of the Concept of *Muallafah al-qulūb* or *Waqf* as a Further Plan for non-Muslims in *Zakāh* Plan

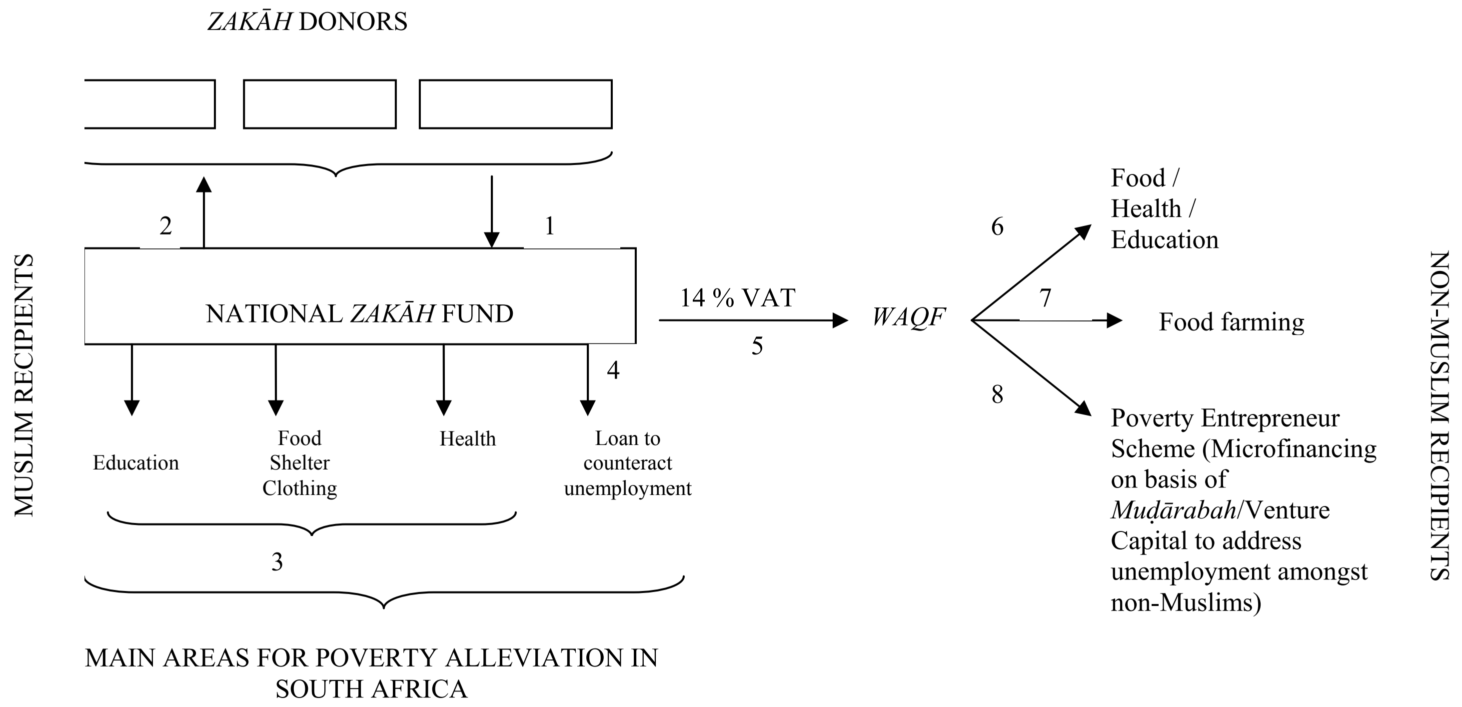
In disbursing the *Zakāh* however, there is a major problem in that the majority of the poor living under the poverty line are non-Muslims. Approximately 45% of the African people fall within the poverty line as discussed earlier. Africans constitute about 80% of the total population. So it is submitted that the way forward in resolving this issue is to consider the concept of *muallafah al-qulūb* (those whose hearts are inclined towards Islam or to soften their hearts towards Islam) as a category of *Zakāh* recipient. Despite the recipients of *Zakāh* has been clearly earmarked to be Muslims but one area which can be considered in the case of South Africa in order poverty can be alleviated is the case of *muallafah al-qulūb*.

Muslim jurists are mostly unanimous that even *muallafah al-qulūb* is geared towards Muslims, but some modern scholars are of the opinion that *Zakāh* can be given to non-Muslims as well. Shaik is of the view that *Zakāh* money may e paid to non-Muslims after meeting the needs of the Muslims. (1980:66). Abu Saud argues that *Zakāh* may be paid to non-Muslims as long as they do not fight against the Muslims. (1988:176).

It is submitted that as there is no clear text prohibiting distribution of *Zakāh* to non-Muslims on the basis of *muallafah al-qulūb*, therefore this issue should be reconsidered because the underpinning *ʿillah* (cause) for giving *Zakāh* to this group was to consolidate their views of Islam. This *ʿillah* still prevails, despite it was not acted upon during the time of Abu Bakr and Umar. Qurtubi argues that the Prophet did not give *Zakāh* money to any-non-Muslim. (1985:179). Al-Nawawi says that Safwan ibn Umayyah received money from the *khumus* of the *baitul māl* and not from *Zakāh* money. (Shafi'i,1994: 307). But these arguments do not negate giving *Zakāh* money to non-Muslims from an explicit text, except for the advice given to *Mu'ādh* by the Prophet when the latter was appointed as the governor of Yemen. The Prophet told him to take (*Zakāh*) from their rich Muslims and distribute it among their poor Muslims. In some *riwayah* the word Muslims does not occur, but it can be inferred. The fact that Umar told the non-Muslims that Islam is strong and there was no need to give them *Zakāh* is ample evidence that in his time *Zakāh* was being given to non-Muslims. Therefore, there is room for reconsidering this issue in the case of South Africa where the Muslims are only 1.5 million and the majority who are suffering absolute poverty as non-Muslims. It is conceded that the objective of *Zakāh* is primarily to redress poverty and destitution, mainly among Muslims, but Muslims are living as a minority in this country where Islamophobia is prevailing, but at the same time poverty is chronic. In case the *ʿUlamās* are prepared to reconsider the issue of distributing *Zakāh* to non-Muslims then a major part of *Zakāh* can be used to help them. In case this is not endorsed then another solution is warranted.

The solution is that the exemption on VAT, can be invested in another fund such as a *Waqf.* This fund can then be used for helping the poor. As pointed out already the major cause of poverty is unemployment. The *Waqf* can be used to develop a sort of micro financing from the major part of its refund. It can be named *Poverty Entrepreneurship Scheme*. A *Muḍārabah* joint-venture contract can be developed to enhance the poor by creating job. With the *Muḍārabah* concept, money can be generated for the *Waqf* as well. Alternatively, an Islamic venture capital model can be designed so that after a period of time the *Waqf* share can be sold at a higher rate and the partner can reach a level of self-sufficiency.

MODEL FOR A NATIONAL *ZAKĀH* FUND IN A SECULAR STATE WITH MUSLIM MINORITIES

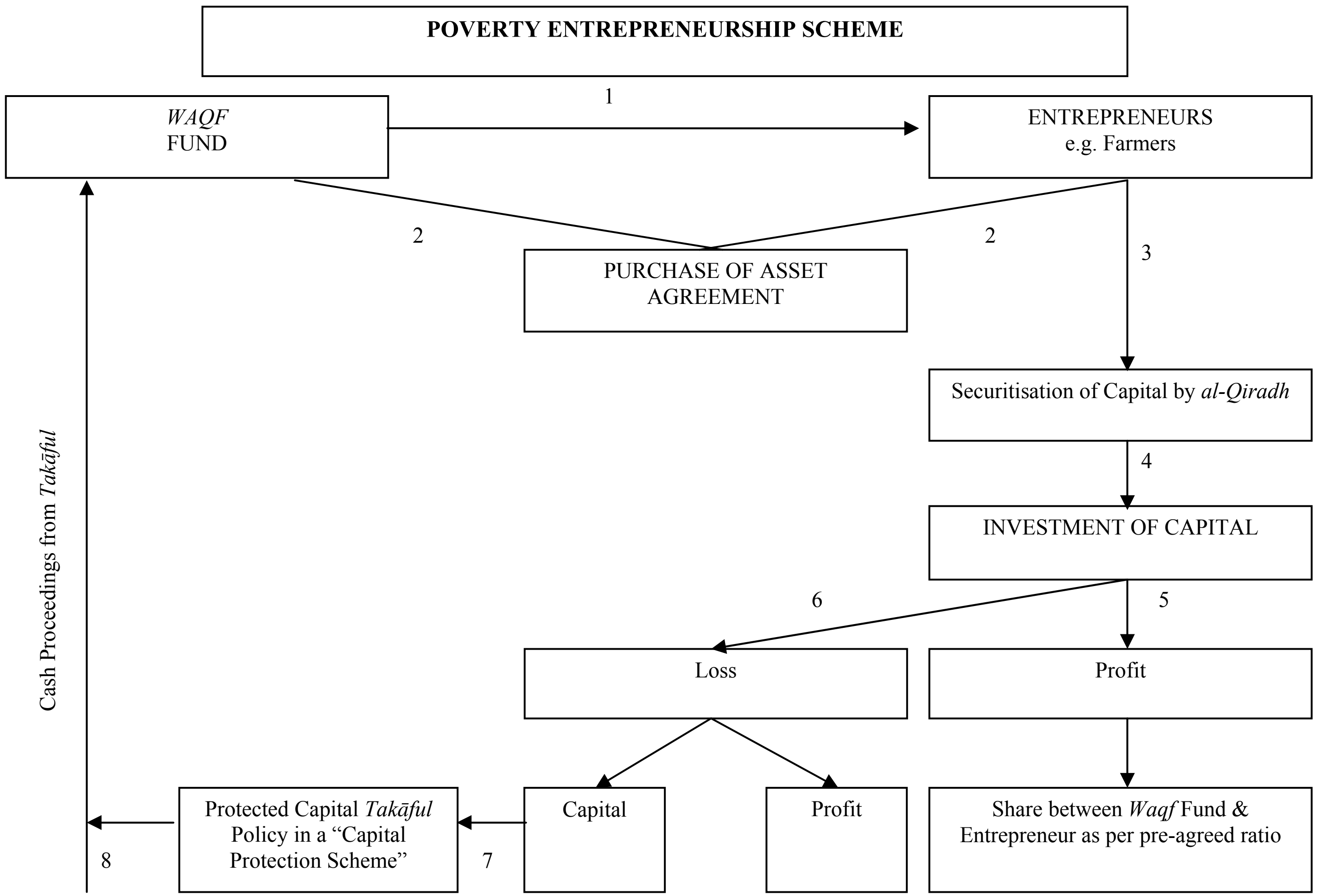


However, the above chart depicts a proposed model for National *Zakāh* Fund. There are three main stages to consider. First is that part of the scheme that focuses on Muslims only; the second stage focuses on non-Muslims recipients and the third stage focuses on the *Poverty Entrepreneur Scheme*. The proposed *Zakāh* structure is explained chronologically according to the digits figured in the chart as follows:

1. *Zakāh* donors will give their *Zakāh* to the National *Zakāh* fund, which is a registered PBO as per section 30 of the Income Tax. Alternatively, the registered *Zakāh* fund at the local and provincial levels can pool all their *Zakāh* collections in the National *Zakāh* Fund.
2. The money donated will not be taxable for donation tax but individuals or corporates will benefit because their donations will be deductible for tax purpose, provided they receive the certificate of exemption from the PBO as per section 18A of Income Tax Act.
3. The fund will distribute the *Zakāh* in kind and not cash by purchasing the necessities to alleviate poverty as per identified areas. This will entitle them to claim Value Added Tax (VAT) as per section 10(1)(cN) (of the ITA)
4. Part of the *Zakāh* can be given as short-term loan according to the views of Shehata (1989: 65). This is in line with the Ninth Schedule of the Income Tax Act, which allows PBO to provide financial help. However, one should be careful with this issue. The loan (*qarḍ*) should be for less than one year and the donor must give *wakālah* (agency) to the PBO to loan it out so that the issue of *tamlīk* is not raised, i.e. the donor will transfer the nature of the money after the money is paid back then only it is transferred in the *baitul māl* as *Zakāh*. This money should then be distributed within the time frame for which *Zakāh* is to be discharged.
5. The VAT refund received is transferred or donated to a *Waqf*, which is especially created for helping non-Muslims. The *Waqf* will also be a PBO. However, it can also involve businesses. Section 10 provides for the PBO to do business on condition that anything above their allowance i.e. the income derived from trading, does not exceed the greater of 5% of total receipts and accruals of the PBO during the relevant year of assessment or R50 000-00, or the trading income so derived, would be exempt from income tax.
6. Part of the *Waqf* disbursement will be for the caring of the poor and destitute non-Muslims and the bulk will be directed towards encouraging employment by engaging either in a *Muḍārabah* or venture capital model. There will be tax of 29% after deduction of expenses.

7. The *Waqf* should also involve food-producing projects such as farming, as these are labour intensive projects and it can help provide food at a lower price. This will help in alleviating poverty.
8. The bulk of the *Waqf* fund should be used to create employment on the basis of *Muḍārabah*/Venture Capital by creating a *Poverty Entrepreneur Scheme* whereby the capital forwarded from the *Waqf* fund will be securitised by *al-Qiradh*. This will pave the way hopefully for the poor to attain a level of self sufficiency. The income generated by the *Waqf* can be used to uplift the *infāq* sector.

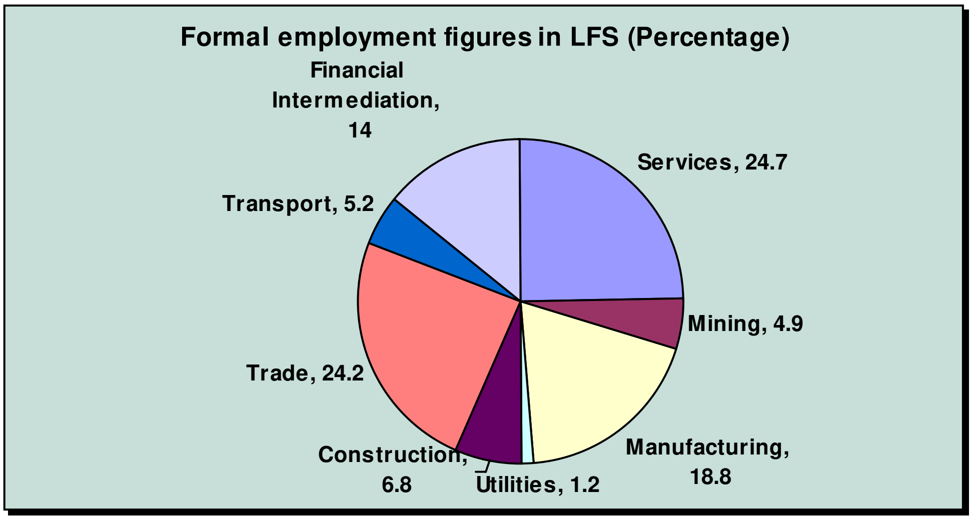
(N.B. The mechanism for the Poverty Entrepreneurship Scheme is explained on the following page with an appropriate diagram)


POVERTY ENTREPRENEURSHIP SCHEME
WAQF FUND
1
ENTREPRENEURS e.g. Farmers
2
2
PURCHASE OF ASSET AGREEMENT
3
Securitisation of Capital by al-Qiradh
4
INVESTMENT OF CAPITAL
6
5
Loss
Profit
Capital
Profit
Share between Waqf Fund & Entrepreneur as per pre-agreed ratio
Protected Capital Takāful Policy in a "Capital Protection Scheme"
7
8
Cash Proceedings from Takāful

The chart describes the following suggested mechanism for protecting the capital disbursed from the *Waqf* fund to finance projects of the basis of *Muḍārabah* or Venture Capital. The numbers figured in the chart are explained below.

1. A financing agreement is entered into between the *Waqf* and the potential deserving entrepreneur.
2. The *Waqf* and the entrepreneur agree as to the assets needed for the identified project that need to be financed and that the capital should be securitized by *al-Qirādh*.
3. The entrepreneur should guarantee the *Waqf* that he will pay back the capital amount disbursed should there be a loss of capital only and not profit. This is done on the basis of *al-Qiradh*.
4. The *Waqf* disburses the money and the entrepreneur invests the capital to start his business. Subsequently, he can either make a profit or a loss.
5. In case profit is made, the *Waqf* and the entrepreneur will divide it as per their predetermined agreed ratio.
6. In case of a loss, there will be two scenarios. First is the loss of profit. In this case both parties will have to bear the loss. The second loss will be such that even the capital is lost.
7. In case the capital is lost, then the entrepreneur should beforehand take a *takāful* policy (from a capital protection scheme) for capital protection before the money is disbursed to him. This should be done at stage 3 in the chart. Such policy will entail that the entrepreneur will have an insurable interest against liability to the *Waqf* fund.
8. The *takāful* proceeds (cash disbursed) from the *takāful* company will be given to the *Waqf* as a cover for its capital invested. So the capital of the *Waqf* is protected based on a*l-Qirādh*.

From the model suggested, poverty can be alleviated among both Muslims and non-Muslims. However, the main concern for poverty alleviation remains within the arena of employment. Therefore, areas, which are more appropriate, should be tapped. The chart below reflects the formal employment sector in South Africa.



Source: Statistics South Africa 2006

There is still room to create employment in the construction, utilities and transport industries according to the above pie chart. The *Waqf* fund can be used in these avenues to absorb unemployment.

A proposed formula as to have the proposed *Waqf* model can be beneficial for South Africa even on a small scale is given below.

$Y = (x – c) - \beta \% M + G$

Y is the total income generated by *Waqf* project.
x is VAT refund generated from purchases from *Zakāh* donated
c is administrative cost
β is the agreed profit ratio from the potential profit generated from venture capital project
or *Muḍārabah.*

M is the profit from the *Muḍārabah* (or venture capital project).
G is grant from government or other sources of income besides *Zakāh*.

The proposed model can be implemented in countries having a fair and efficient tax system and where there is no legislation for *Zakāh*.

To avoid abuse, some level of control is required for this model. For example, signatories for cash account should be credit worthy persons. Good screening processes should be established to avoid moral hazard and information asymmetry. Proper audit report should be in place on regular basis etc.

With this model, not only *Zakāh* can become a more efficient tool for poverty alleviation for the poor and destitute but also Muslims can extend financial help to non-Muslims with refunds from *Zakāh* disbursed. This can give a better leeway for developing systems for creating employment.

One issue that needs to be overcome is that when dealing with micro-financing, usually South African law provides for the advancement of a loan to the needy, who will repay by an automatic deduction from their pay. This model is not really resolving the problem because it discriminates against those who are not working. The proposed model is an improvement over the existing system.

4. CONCLUSION

South African Muslims have a fundamental role to play in alleviating poverty, for which there is no short term or medium term solutions. By using their *Zakāh* donation efficiently within the perimeter of the Income Tax Act, VAT paid on the goods to be distributed to the poor can be claimed back. At the same time, Muslim donors can have tax exemptions. It is submitted that a National *Zakāh* Fund can be structured so that the *Zakāh* objectives can be optimized with the refunds from VAT and the other exemptions available. A *Waqf* can be set up as a PBO. The VAT refunds received from the goods purchased from the *Zakāh* donations can be invested into the *Waqf*. This in turn can be used as a poverty alleviation tool in South Africa, mainly by developing a Poverty Entrepreneur Scheme. This will address the issue of unemployment, which is the main cause of poverty in South Africa among the non-Muslim Black Africans. This scheme can also be a great source of *da'awah* as well.

Of course, to realise such a gigantic project involving thousands of millions of rands, certain proficiency and control is needed. Muslims must be encouraged to put their shoulder to the chart especially in a country where they are living as a minority group. Proper discharge and organization of *Zakāh* fund can be a means of *da'awa* and their salvation as a minority group.

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THE ROLE OF *ZAKĀT* ORGANIZATION IN EMPOWERING THE PEASANTRY: A CASE STUDY OF THE RUMAH *ZAKĀT* YOGYAKARTA, INDONESIA

DANI MUHTADA

ABSTRACT

The peasantry is among the oppressed people in Indonesia. They have experienced a process of marginalization for decades. In dealing with this situation, zakāt can be a potential instrument to empower such oppressed people. However, very little is known about the nature of zakāt organizations and their efforts to promote peasant empowerment. It is important due to the significant number of the peasantry in this country (44%) and because Indonesia is the largest Muslim country in the world. This paper reports an exploratory and descriptive study on a zakāt organization in Indonesia (i.e., the Rumah Zakāt Yogyakarta) that has an empowerment program for peasants. The result of this study shows that the Rumah Zakāt had contributed to solve the peasantry's problems (i.e., low level of income and urbanization). However, the use of the scriptural paradigm of zakāt along with the reformation paradigm of social transformation had made this organization fail to deal with the fundamental problems of the peasantry.

1. INTRODUCTION

The peasantry is among the oppressed people in Indonesia. They have experienced a process of marginalization for decades. In dealing with this situation, *zakāt* can be a potential instrument to empower such oppressed people. However, very little is known about the nature of *zakāt* organizations in Indonesia and their efforts to promote peasant empowerment. In fact, this is important due to the significant number of the peasantry in this country (44%) and because Indonesia is the largest Muslim country in the world.

This paper reports an exploratory and descriptive study on a *zakāt* organization in Indonesia (i.e., the Rumah *Zakāt* Yogyakarta) that has an empowerment program for peasants. The study was intended to analyze the nature of *zakāt* organization (i.e., the paradigms behind its *zakāt* management), its efforts in promoting peasant empowerment, and its contribution to the solution for the peasantry's problems. To begin with, this paper provides an overview of the Indonesian peasantry's problems to give backgrounds to the study. Then, the concept of *zakāt* and its potential role in promoting social justice is discussed. After that, the research methods used in the study are explained. Finally, research findings and recommendation are presented.

2. THE PEASANTRY: INDONESIAN PICTURE

Scholars have discussed the peasantry's problems in Indonesia. Many of them indicate that the problems are a result of a long process of social, economic and political marginalization (Faqih, 2004a, p. 31-7; Fauzi, 1999, p. 153-207; Hanani et al, 2003, p. 27-59; Yustika, 2003, p. 22-42; Afandi, 2001, p. 31-58; Suharso, 2002, p. 8-22). This process has led to massive impoverishment among the peasants for decades. Two key phrases can explain such an impoverishing process: green revolution program and neo-liberalism

Green revolution program was introduced in Indonesia at the beginning of Soeharto regime (i.e., 1970s). It was intended to enhance rice production across the country through the modernization of agricultural management and technologies. It was thought to be an integral element of industrialization using the logic of economic growth (Fakih, 2004a, p. 31 & 2002b, p. 272-3).

Although it succeeded in enhancing Indonesia's rice production until the end of 1980s, yet it negatively influenced the peasantry's lives in many ways. Khudori (2004, p. 39-40), for example, suggests that the program had forced peasants to negotiate all farming processes to agricultural corporations as they had to purchase hybrid seeds, chemical fertilizers, pesticides and all instruments of modern farming management and technologies. Research by Yustika (2003, p. 32) shows that transactional costs spent by peasants during production process can reach up to 60% of total production costs. The costs mostly emerge in the peasants' interaction with agricultural manufacturers or government's officials. In addition, a study produced by Fauzi (1999, p. 166) shows that only 20-30% of households in Indonesian rural areas had benefited from the Green Revolution. They were households of rich farmers that had close relationships with local officials, which enabled them to receive subsidies and to have access to modern farming management and technologies.

The Green Revolution has also made capital investment in farming machinery more valuable than strengthening the labor force. No wonder the number of unemployed people in rural areas reached 50% in 1980 (Fakih, 2004a, p. 38) and job opportunities in the agricultural sector decreased significantly from 64% in 1971 to only 50% in 1990 (Yustika, 2003, p. 23). This situation eventually resulted in urbanization. Today, those who go to the city work mostly in informal sectors, while those who remain in their villages work as subsistent or landless peasants

(Hanani et al, 2003, p. 34; Wahono, 2000, p. 134). Yustika's study (2003, p. 27) shows that around 80% of peasants' incomes are from off-farm sectors. They work as porters, laborers, small merchants, and other informal workers. Therefore, although they are formally farmers, they earn money through non-agricultural sectors.

These effects of green revolution had been worsened by some neo-liberal policies in the agricultural sector. As a consequence of the IMF's structural adjustment packages (SAPs), Indonesia had to liberalize its domestic food market and applied low import tariffs upon agricultural commodities. This was ironic as developed countries are still applying high import tariffs to protect their agricultural sector. While Indonesia is forced to liberalize import tariffs (ranging between 0-10%), the USA is maintaining very high tariffs on imports to protect their domestic market (e.g., sugar 244%, peanuts 174%). The European Union is doing the same thing (e.g., wheat 360%, eggs 236%), and so are Japan (e.g., wheat 353%, rice 351%) and Canada (e.g., margarine 260%, eggs 236%) (Khor, 2003, p. 42). Consequently, this policy had made Indonesia the most liberal developing country in the economic world. A survey produced in 2001 showed that the transparency index of trade in Indonesia reached 80%, which was much higher than that of the USA whose index reached only 54% (Khudori, 2004, p. 199). IMF had also forced the Indonesian government to castrate its state trading enterprise (i.e., Bulog) by limiting its special rights, including its power to stabilize the domestic market for food. In fact, other countries, such as the USA, Canada, and Australia are still maintaining the role of their state trading enterprises to stabilize the domestic market for food (Khudori, 2004, p. 228).

The government had been also asked to cut subsidies for Indonesian peasants. This was also unfair since developed countries keep supporting and protecting their agricultural sectors very strongly. The USA, for instance, subsidizes its agricultural sector and farmers to the amount of US$ 5 billion per year. It had also produced more than 100 regulations to protect farmers and the agricultural sector, such as the Sugar Act 1774, the Homestead Act 1862, the Agricultural Adjustment Act 1938, the Agricultural Marketing Act 1946, the Commodity Distribution Reform Act and the WIC Amendments of 1987 (Khudori, 2004, p. 48, 324).

Another fundamental problem of Indonesian peasants is the ownership of farmland. The number of landless peasants has been rising year by year. On Java, the number of landless peasants reached 48.6% in 1995, and it increased to 49.5% in 1999. On islands other than Java, the number of such peasants reached 12.7% in 1995 and rose to 18.7% in 1999 (Khudori, 2004, p. 226-7). There is also an imbalance in the distribution of farmland ownership among the peasants. Around 28% of landless peasants only had control over 10.1% of the total farmlands across the country; 29% peasants (having 0.10-0.49 hectares) took control of 15.7% of the farmlands; 18% peasants (having 0.50-0.99 hectares) took control of 53.8% of the farmlands; and 2% peasants (having more than 5 hectares) took control of 20.4% of the total farmlands (Yustika, 2003, p. 26).

This problem of farmland ownership will be more obvious if we compare the average land ownership per peasant in Indonesia to that in other countries. Quoting a study produced by Hayami and Kikuchi, Yustika shows that the average land ownership in Indonesia was no more than 0.5 hectares in the 1980s. However, presently, the average has dropped to only about 0.25 hectare per peasant (Yustika, 2003, p. 25). This average is dramatically lower than that in the USA and Japan. The average amount of farmland owned in the USA is 125 hectares per farmer, while that in Japan is 20 hectares (Khudori, 2004, p. 46-7).

Using the Young's theory of oppression (Mullaly, 2002, p. 42-50), the Indonesian peasantry experiences at least three forms of oppression: exploitation, marginalization, and powerlessness. Exploitation happens in the exchange process of agricultural inputs and outputs (Yustika, 2003, p. 21-43). Marginalization can be seen from the decreasing labor force in the agricultural sector and from the decreasing contribution to the national income by this sector during 1971-2001 (see table). Powerlessness is implied in the lost of political and bargaining powers of the peasantry (Fauzi, 1999, p. 121-207) and in their inferiority to capital forces (Yustika, 2003, p. 25; Khudori, 2004, p. 39-40)..

These forms of oppression show that there is oppression at the structural, cultural, and individual level. At the structural level, the government policies have marginalized peasants systematically. At the cultural level, the peasants lose their local wisdom of farming management. The agricultural direction given by the government during green revolution had replaced traditional farming management with modern management, which is not always compatible with the local condition (Hanani, 2003, 47-8; Baswir, 2003, p. 58-9, 77). At the personal level, peasants in general are often stereotyped either on the basis of bodily characteristics, such as being dirty and ugly, or on the basis of inferior intellect and character, such as being lazy and underdeveloped.

3. *ZAKĀT* FOR PEASANT EMPOWERMENT

As one of the Islamic pillars, *zakāt* was instrumental in Muḥammad's missions. This is related to one of the prophet's missions of liberation – that is, economic liberation (Engineer, 2000, p. 47-54), which was intended to establish economic justice in the society. If we look at the socio-historical situation of Mecca at the Prophet era, we understand why Muḥammad advocated such an idea of liberation.

Mecca was one of the trade centers in the Arabian Peninsula. It was located on an international trade route between south Arabian and Mediterranean, and between Gulf of Persia and Red Sea. People was transforming from the collectivism of clan to individualism. People tended to be more materialistic. Several large clans dominated the economic climate of the city. There was a great gap between the rich and the poor. The wealth was circulated only among dominant clans and rich people in the city (Engineer, 1999, p. 59-132). Social equity did not exist and a patriarchal culture dominated the society.

In such situation, Muḥammad campaigned for social and economic justice. One of the campaigned points was *zakāt*. The Qur'ān has stressed *zakāt* as part of the faith. Several verses, which were revealed during the Mecca period, imply the practice of *zakāt* as part of the virtues of the true believer (the Qur'ān 13: 22; 35: 29). The spirit of such verses is in line with the Muḥammad's mission of socio-economic justice. Islamic economic system prohibits the concentration of wealth or income in the hands of a few rich persons (the Qur'ān 59: 7). This system requires a fair distribution of wealth among people by means that are acceptable in sharī'ah. Islam idealizes equity and equality among human beings (the Qur'ān 49: 13). This ideal of equality and equity is embodied in the spirit of *zakāt*.

The ideal of the socio-economic justice of *zakāt* is implied in the practice of *zakāt* at the Prophet era. Although the Qur'ān (9: 60) has determined eight classes of mustaḥiq, the practice of *zakāt* during Muḥammad's time and the opinions of legal scholars have emphasized the poor and needy in the distribution of *zakāt* (Kahf, 1999, p. 28). These people have priority in receiving *zakāt*. Since *zakāt* brings the idea of socio-economic justice and gives priority to the poor and the needy, the message of empowerment in the management of *zakāt* is clear. Ignoring the idea of empowerment in the distribution of *zakāt* might neglect the core objective of *zakāt* – that is, socio-economic justice. *Zakāt* is therefore a very significant instrument of the poor people empowerment.

In addition, *zakāt* has the potential to motivate people's productivity. According to Islamic jurisprudence, *zakāt* does not include the means of production, such as factories, cattle, equipment or tools, which provide added incentives for investments. *Zakāt* excludes income, which is used for consumption, and items of wealth, which are used for personal and family purposes. *Zakāt* is only applicable on income, which is saved during the year, and on agricultural products. It is also applied to wealth that are characterized as stocks (e.g., gold, silver, the inventory of trade and livestock). (al-Zuhaylī, 2000, p. 135; Sâbiq, 1983, p. 308; al-Qarḍâwī, 1994, p. 188-92; Kahf, 1999, p. 30; Mannan, 1997, p. 258). On the one hand, this regulation potentially encourages rich people to use and invest their wealth. Otherwise, they must disburse part of the wealth for *zakāt*, so that other people can use the *zakāt* to improve their welfare. On the other hand, the poor and the needy have the opportunity to get capital and develop it for their prosperity.

Thus, *zakāt* has at least four benefits in relation to the establishment of socio-economic justice. First, *zakāt* minimizes the social and economic gap between the haves and the haves not. Second, it decreases the accumulation of unused wealth and encourages public productivity. Third, it diminishes the monopoly of product resources in the hands of a few people in the society. Fourth, *zakāt* increases the purchasing power of the poorest groups among the society and increases effective aggregate. Eventually, *zakāt* leads to higher employment and economic output, and it brings positive impacts in economic development and social justice.

Since one of the principles of *zakāt* is to establish socio-economic justice, Indonesia peasants must be one of the prioritized mustaḥiqs. Three reasons why the peasants must be mustaḥiq and why *zakāt* must play an important role to solve the agricultural problem in Indonesia are drawn as follows.

Firstly, *zakāt* is distributed to empower the poor (*al-masākīn*). The problem of *al-masākīn* can be seen very clearly in the phenomenon of the Indonesian peasantry. In 1999, paddy production (gabah kering giling, unhulled paddy) across the country reached 50 million tones. The number was aggregate production of about 40 million peasants. It means that a peasant had about 1.25 tones of paddy per year. If we assume that the price of paddy was Rp 1,000/kg, the production value per peasant was 1.25 million rupiahs in that year. It meant the peasant' income per month was about 100 thousand rupiahs. The income did not include production costs, which could reach up to 75%. Eventually, net income of the peasant was around 312,500 rupiahs per year or 25,000 rupiahs per month or 866.7 rupiahs per day (Khudori, 2003, p. 226). This amount of income has qualified the peasant as *al-masākīn* since he or she does not possess enough money to meet his or her basic needs (al-Shâfi'ī, 1983, p.77; al-Jazīrī, 1990, p. 565).

Secondly, using the framework as defined by Iris Young (Mullaly, 2002, p. 42-50) that is previously mentioned, Indonesian peasants are among oppressed and marginalized people in the country. This condition has reflected the peasants' position as the slave of today's world system (fī al-riqâb). Since the Qur'an (9: 60) mentions the slave as one of the eight mustaḥiqs, the Indonesian peasants must inevitably be object of *zakāt*, not the other way around.

Thirdly, the Indonesian peasantry is situated in an unfair and injustice socio-economic system. *Zakāt* is regulated to establish socio-economic justice and the fair distribution of wealth among the society. This instrument of Islamic economics opposes the concentration of capital and wealth, which blocks fair access to the public welfare. Since the peasants are trapped in such a situation, no doubt that they must be one of the mustaḥiqs, and *zakāt* administrators cannot neglect their position as the prioritized mustaḥiq.

Thus, from the perspective of Islamic jurisprudence, the peasantry is legally accepted as one of the mustaḥiqs. They must be even compulsory mustaḥiqs because of their fundamental problems and their positions as the majority workers of the country (44%). The Indonesian peasantry can be qualified both as al-masakīn (the poor) and fī al-riqâb (in the slavery). Moreover, in a ḥadīth transmitted from Ibn ‘Abbâs and reported by al-Bukhârī and Muslim, the Prophet Muḥammad told Mu‘âdh bin Jabal, when he was sent to Yemen (10 AH), that *zakāt* must be taken from rich persons and must be distributed to the poor among the society (al-‘Asqalânī, 1994/1414, p. 126; al-Ṣan‘ânī, n.d., p. 589). In the case of the Indonesian peasantry, they are among the poor communities of the country.

4. METHOD

4.1. Subjects for Study

Using purposive sampling, which allows the researchers to “intentionally select elements that are rich in information” (Marlow, 2001, p.139), the researcher chose the Rumah *Zakāt* Yogyakarta as the subject for study. It was chosen because of its reliability and availability. It had managed *zakāt* funds professionally and had worked with some groups of peasants through its economic program.

Peasants involved in the Rumah *Zakāt’s* program were also subjects for the study. The researcher observed the peasants that were recommended by the Rumah *Zakāt*. The organization’s recommendation was expected to get the best sample of the clients. Five peasants have been studied in this research. All of them were members of the peasant group participating in the Rumah *Zakāt’s* empowerment program. The report of this study uses respondents’ pseudonyms to maintain research ethics.

4.2. Measurement

This research was exploratory and descriptive using a qualitative design. There were three variables in this research. The Rumah *Zakāt* was an independent variable. The organization’s ways to promote the peasant empowerment through *zakāt* funds was dependent variables. Characteristics of the organization, including the professionalism of the management and the empowerment program for the peasantry, were controlled variables. Study of the relationship between these variables had not been established. We did not know much about the reasons for the nature of the *zakāt* organization (i.e., the Rumah *Zakāt* DSUQ Yogyakarta) and its efforts to empower peasants. This study sought to address this lack of information.

4.3. Data Collection Methods

First of all, the researcher read secondary data, such as the organization yearly reports, case records, project reports, and newspapers or magazines related to the research. Afterwards, semi-structured observation (Marlow, 2001, p. 93-4) was used to explore the nature and the behavior of the *zakāt* organization in the management of *zakāt* and in promoting peasant empowerment. Following the observation, the researcher established several interviews with the staff and officers of the organization, in particular the director of the organization. Then, the researcher observed the process of *zakāt* management for peasant empowerment and established interviews with the peasants. Finally, based on the interviews, the researcher provided questionnaires for the peasants to reach the same standard of the clients' perspectives and responses to the program.

4.4. Analysis Methods

Based on the exploration of the peasantry's problems and on the role of *zakāt* in promoting peasant empowerment, the researcher establishes three stages of analysis upon the subject for study (i.e., the Rumah *Zakāt* DSUQ Yogyakarta). Firstly, the researcher analyzed the nature of the Rumah *Zakāt*. The researcher analyzed paradigms carried by the organization. Secondly, the researcher analyzed the Rumah *Zakāt's* efforts in promoting peasant empowerment (i.e., the organization's specific programs for peasant empowerment). The researcher analyzed to what extent the organization pays particular attention to the peasantry's problems. The researcher looked specifically at the organization's methods and approaches to empower the peasants. Finally, the researcher analyzed to what extent the program contribute to the solution to the peasantry's problems in this country.

4.5. Conceptual Framework

This study examined two kinds of paradigms implemented by the Rumah *Zakāt*: the paradigm of *zakāt* and the paradigm of social transformation. In analyzing the paradigm of *zakāt*, the researcher mapped two mainstream *zakāt* paradigms in Muslim societies i.e., scriptural-conservative and substantial-transformative paradigms (see figure 1). The scriptural-conservative paradigm refers to the Muslims' formal and conventional understanding of *zakāt*, which is reflected in many classic works of fiqh. The substantial-transformative paradigm of *zakāt* refers to new interpretations of *zakāt* in Islamic jurisprudence. The interpretations are directed to actualize the principle of socio-economic justice within *zakāt*. This transformative paradigm of *zakāt* has been reflected in several today's studies of *zakāt* (Mas'udi, 1991, p. 126-38; Kahf, 1999, p. 24-44; Mannan, 1995, p. 248; Engineer, 1999, p. 90-6). From the perspective of the substantial-transformative paradigm, peasants are seen as "*al-masākīn*" (the poor) and "fī al-riqâb" (in the slavery).

In analyzing the paradigm of social transformation, the researcher uses the map of NGO paradigms, which has been discussed by Mansour Fakih (2004b, p. 122). Fakih introduces three paradigms of the NGOs in Indonesia: conformism, reformation, and transformation (see figure 2).

Figure 1. Map of the Paradigm of *Zakāt*

Items	Scriptural – Conservative	Substantial – Transformative
Approach of Interpretation	Textual – Formal	Substantial – Transformative
Actualization of the Sayings	Based on the textual understanding of the Sayings	Based on the substantial meaning of the Sayings
Goal	To perform religious obligation To give sympathy with the needy	To establish fair distribution of the wealth To establish economic justice To empower the people
Distribution Style	Charity	Charity with social mapping and priority Productive alms giving

Figure 2. Map of the NGO Paradigm

Items	Conformism	Reformation	Transformation
Roots of the Problem	Situation of the local people God's predestination Bad destiny	The weak of education Loaded citizens Traditional values Corruption	Exploitation Unfair structure Capitalist hegemony
Objectives	To minimize people's anguish and suffering To give expectation To pray	To enhance production To make the system work To change people's values	To challenge exploitation To develop new economic and politic structures Contra discourse
Programs	Children foster Clinics Feeding starving people	Technical training Small business People improvement Legal aid Supplementary service	Raising people's consciousness Alternative economic development Labor union Cooperation
Type of the Social Change and Assumption	Functional – Social Order	Functional – Social Order	Structural Criticism
Type of leadership	Believe in the government Consultative	Participatory Collective Responsibility	Participatory Facilitator Strong discipline
Type of service	Giving charity Welfare oriented	Assisting the people to help themselves Green Revolution Community development Non formal education Skill education	Land reform Participatory Research Popular education
Inspiration	Conformation	Reformation	Emancipation Transformation

The researcher uses Adam's definition of empowerment in examining the process of empowerment established by the Rumah *Zakāt*. Referring to the Dictionary of Social Work, Adams (2003, p. 8) offers a definition of empowerment that refers to "the user participation in services and to the self-help movement generally, in which groups take action on their own behalf, either in cooperation with, or independently of, the statutory services". He defines empowerment as "the means by which individuals, groups or communities become able to take control of their circumstances and achieve their own goals, thereby being able to work towards helping themselves and others to maximize the quality of their lives". In this study, empowerment refers to the process established by the Rumah *Zakāt* to assist the peasants in order to take control of agricultural resources, which belong to them, and to assure their welfare through their own efforts.

5. FINDINGS AND DISCUSSION

5.1. The Rumah *Zakāt*: An Overview

The Rumah *Zakāt* is one of leading zakat organizations in Indonesia. It was established firstly in Bandung in 1998, and then expanded to other main cities. Until 2006, it has had 21 branch offices throughout the country. It opened its branch offices in Yogyakarta in 2000. Abdul Aziz was the founder of the Rumah *Zakāt* for this city. Bimo, a young Muslim activist, supported him to establish this social organization. At the beginning, it employed only 15 staff and volunteers. However, the number doubled to 32 staff in 2005.

Its vision is, "to be a prominent and trustworthy zakat organization", while its missions is "to develop the poor people's reliance and independence through empowerment programs and to improve its service quality for people's satisfaction through developing its human resources". To meet these vision and missions, the Rumah *Zakāt* implements four principles of organization management: (1) independence and transparency; (2) professionalism ; (3) establishing social justice through effective and efficient distribution of funds; and (4) the improvement of networking, system, and human resources.

Basically, the Rumah *Zakāt* has four main programs: (1) scholarships for poor students, (2) free health service for the poor, (3) economic empowerment, and (4) free ambulance service. It also has special programs in specific moments such as Ramadhan and Qurban programs. The Ramadhan program is a program that is implemented during Ramadhan (i.e., the month of fasting). In this program, the Rumah *Zakāt* distributes gifts to the poor and provides free dinner service for fasting people. The Qurban program is conducted in Dhu al-Qa'da (the last month of the Islamic calendar), in which the organization distributes meats (e.g., beef and lamb) to the poor and the needy.

To attract potential donors, the Rumah *Zakāt* shows the public their achievements and activities. It publishes brochures, leaflets and bulletins, which illustrate its professionalism in public fund management to raise people's trust. Sometimes, it advertises its programs and achievements through billboards posted in the street. The Rumah *Zakāt* also posts boxes in strategic places such as stores, malls, banks, hospitals and government offices. It promises the owners of these places to carry their institution or corporation names in all activities funded by the boxes to encourage their participation. They will also get financial reports, which inform the amount of money collected from the boxes. The Rumah *Zakāt* puts brochures or leaflets on the boxes, so that people could read the Rumah *Zakāt's* programs and achievements.

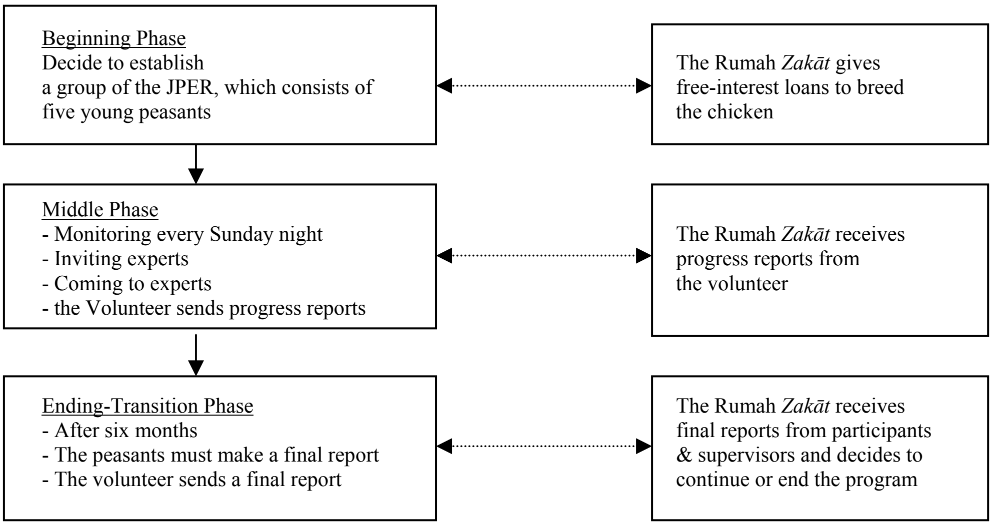
5.2. Program for Peasants

Since May 2004, the Rumah *Zakāt* Yogyakarta had developed an empowerment program called Jaring Pengembang Ekonomi Rakyat (JPER/People's Economic Developing Net). In this program, the organization worked with small groups of people to develop their economic welfare. The groups had to run entrepreneurship programs approved by the Rumah *Zakāt*. Among these groups was a group of five young peasants, which became the subject of this study.

These peasants joined the program in February 2005 and established a program of chicken husbandry. Previously, they sent a proposal about the program. The Rumah *Zakāt* approved it and provided them interest free loans to breed chickens. The peasants received two million rupiahs or four hundred rupiahs per peasant. They must return the loans within six months.

To monitor the program, the Rumah *Zakāt* sent a supervisor that arranges meeting with the members of the group regularly. The meeting between the supervisors and the group was designed in a religious forum. In other words, it was not just a meeting to monitor the development of program, but also a meeting to teach the members about Islamic teachings. Interestingly, while the supervisor had educational background in Islamic studies, he did not have any background in chicken husbandry. However, the supervisor said that he had an expert to consult whenever the group found any problems regarding the husbandry.

Figure 3. Peasant Empowerment Process



All participating peasants saw that the JPER was a good program. It gave them opportunity to improve their welfare. Yet, all of them also said that the given loan was not enough to develop chicken husbandry. If they could suggest, they would recommend the Rumah *Zakāt* to increase the amount of loan in the future. They believed the bigger loan the more opportunity to improve their welfare.

When they were asked why they proposed chicken husbandry program instead of a program related farming management or the development of agricultural sector, they said that today's agricultural sector was not promising a better life for the peasantry. One of the peasants had a sentence to illustrate the situation of the Indonesian peasantry: "tuku larang, adol murah" (the expensive price of buying, the cheap price of selling), meaning that the cost of agricultural outputs cannot cover all production costs. As a consequent, the peasantry often suffers financial losses. When they were asked why it happened, they replied nothing.

The case of the Rumah *Zakāt's* peasant program indicated that neither the supervisor nor the participating peasants knew the roots of the peasantry's problems in Indonesia. Indeed, the supervisor had established regular meetings with the group, but the meetings were more for religious teachings. It was also monitoring program, but it was limited to know whether the peasants still worked on their husbandries and to assure that the peasants could return the money back within the time limit.

Table 4. The Peasants' Situations and Perceptions

No	Questions	Dw	Tgrn	Skrmn	Hr	If
1	Age	25	27	27	23	24
2	Education	Senior High School	Undergraduate (not finished)	Senior High School	Junior High School	Senior High School
3	Marital Status	Unmarried	Unmarried	Unmarried	Unmarried	Unmarried
4	Land ownership	No more than 0.25 hectare	Around 0.25 hectare	Around 0.25 hectare	No more than 0.25 hectare	Around 0.50 hectare
2	Reason for the program	To enhance income	To develop the husbandry	To develop the husbandry	To enhance income	To develop the husbandry
3	Having husbandry before the program	Never	Yes	Yes	Never	Yes
4	Number of chickens after the program	16	30	50	17	40
5	Target at the end	Paying the loans and continuing the husbandry	Paying the loans	Paying the loans	Paying the loans and continuing the husbandry	Paying the loans
6	Perception on the adequate amount of loans	Not adequate	Less adequate	Not adequate	Less adequate	Adequate
7	Obstacles of the program	Limited funding	Limited funding	Limited funding Difficulties to find good fledgling	Limited funding	Limited funding
8	General opinion upon the program	Very good	Fair enough	Good	Good	Good
9	Expectation after finishing the program	Getting more loans	Getting more loans	Getting more loans	Getting more loans	Getting more loans
10	Suggestion	Give loans according to the proposal	Give higher loans and give more time to return the loans	Give higher loans to cover all costs	Give higher loans	Give higher loans to develop the husbandry

5.3. Paradigms Behind the Program

Two paradigms are examined in this section: the paradigm of *zakāt* and the paradigm of social transformation. The paradigm of *zakāt* refers to the Rumah *Zakāt's* ideology, values and methods, which is the basis of its *zakāt* management to promote peasant empowerment program. The paradigm of social transformation refers to the Rumah *Zakāt's* ideology, values and methods, which is the basis of its movement to establish social transformation among the peasantry.

5.3.1. Paradigms of *zakāt*

This study found that the Rumah *Zakāt* had managed its funds using certain principles of modern management, which was reflected by its organizational architecture (e.g., organizational structure, human resource management, fund management, annual planning and evaluation, etc.). However, some findings showed the use of the scriptural-conservative paradigm in managing *zakāt*.

For example, in interpreting the Sayings of *zakāt*, the Rumah *Zakāt* implemented a textual-formal approach. The list of mustaḥiqs shown by the director of the organization implied that this organization followed the rules of *zakāt* according to the classic works of fiqh, which rest on textual and formal interpretation of the Sayings. All terms of mustaḥiqs (i.e., faqīr, miskīn, 'âmil, muallaf, ghârim, musâfir, fī sabīlillâh and ibn sabīl) were understood according to conventional works of fiqh. For instance, ibn sabīl was just defined as travelers who run out of money. Such definition was similar to conventional rules on ibn sabīl in classic fiqh works (Sâbiq, 1983, p. 334-5; al-Qarḍâwī, 1994, p. 720-21; al-Shawkânī, n.d., p. 60; Ibn Juzâ, n.d. 98; al-Sharbīnī, n.d., p. 200). It was different from Mas'udi's definition of ibn sabīl, which qualifies street children, homeless people, and refugees as ibn sabīl too (Mas'udi, 1993, p. 138).

The distribution of *zakāt* was also rigid under a formal approach. The Rumah *Zakāt* differed between the allocation of *zakāt* and the allocation of infâq or ṣadaqah. According to the director of the Rumah *Zakāt*, the allocation of *zakāt* must be for the eight groups of people (mustaḥiqs) mentioned in the Sayings, and all of them must be Muslims. However, the allocation of infâq or ṣadaqah could be for those beyond the eight groups of people, and they could be non-Muslims.

Even if empowerment became one of the Rumah *Zakāt's* missions, most of the funds were allocated for charity or consumptive alms giving. There were no funds allocated specially for economic empowerment until 2004. This organization started to allocate their funds for empowerment in May 2004, when the JPER program was launched. Nevertheless, the amount of funds allocated for economic empowerment was much lower than that allocated for charity and consumptive alms giving. According to the director, this imbalance of fund allocation was because most mustaḥiqs need funds for consumptive reasons. Only a few of them need funds to run businesses and small entrepreneurship.

5.3.2. Paradigm of social transformation

Research found that this organization was conformism and reformation as well. The organizational objectives were to minimize people's anguish and suffering and to give hope to the clients. Thus, it gave charity to the poor and created programs such as free clinics, food aids and foster parents for orphans. All of these reflected the NGO's paradigm of conformism. However, in empowerment program (i.e., the JPER), it aimed at improving people's productivity. It established skill training and support for small business among the poor. Its volunteers of the Rumah *Zakāt* assisted the poor in order to help themselves. It developed communities, created small groups and raised a collective responsibility among the members. They also provided supplementary services, such as free ambulances. It considered the lack of education as the root of social problems, so that it offered scholarships for the poor children. All of these indicated the adoption of the reformation paradigm.

None of the Rumah *Zakāt's* activities implied that it embodied the idea of transformation (i.e., the third category of paradigm). The Rumah *Zakāt* did not see exploitation and unfair systems as the roots of the social problems. This was obviously indicated from the way the organization managed empowerment program for the peasantry which implemented reformation paradigm. The JPER program for the peasants merely aimed at enhancing their welfare through chicken husbandry and at changing people's values through regular religious teachings.

It is previously mentioned that the situation of Indonesian peasants had qualified them as the poor (*al-masākīn*) as well as marginalized people (fī al-riqâb). Unfortunately, the Rumah *Zakāt* just considered the peasants as the poor (*al-masākīn*). No wonder the empowerment program for the peasantry only assisted the peasants to meet their basic needs. The Rumah *Zakāt* did not see exploitation and unfair structure as the roots of peasant problems. The organization did not directly challenge peasant exploitation because it did not consider their position in oppressive systems (i.e., in the slavery).

5.4. Contribution to the Solution

Although the Rumah *Zakāt* did not deal with the roots of the peasantry's problems, it had contributed to solve at least two peasants' problems: a low level of income and urbanization.

The Rumah *Zakāt* dealt with the first problem by providing interest free loans to develop chicken husbandries. Interviews with the peasants and the results of questionnaires showed that one of the reasons why the peasants joining the JPER was to enhance their incomes. The amount of loans might not be adequate to develop the husbandry, but this program had given them opportunity to improve their capitals to improve their welfare. This program had also raised their productivities. Some peasants that had already had chicken husbandries could increase the number of their chickens. While those that were beginners had opportunity to develop alternative income sources besides farming.

The organization also tried to solve the problem of urbanization. According to the program supervisor, one of the objectives of the JPER was to minimize urbanization. He said that the condition in rural areas led many young peasants to leave their villages and to go to the city for work. Consequently, there was a crisis of young generation in rural areas. It is interesting to note, however, that such an objective was closely connected with religious interests. When he was asked why the organization had to deal with the problem of urbanization, the supervisor said that it was because urbanization might affect the management of mosques and religious activities in the village. The JPER program was provided for the young peasants to minimize the wave of urbanization among the youth, so that they wished to stay in their villages and could be prepared to be the mosque cadres of the village.

However, as far as Adam's definition of empowerment is concerned, what the Rumah *Zakāt* had done so far did not empower the peasants. The program did not lead them to take control of their circumstances (i.e., the agricultural sector) in order to maximize the quality of their lives. Although it provided opportunity for the peasants to improve their welfare, it did not release them from their dependency on agricultural capital forces. The program even highlighted Yustika's study (2003, p. 27), saying that today's peasants earn money from off-farm sector – that is, they are formally farmers, yet they live from non-agricultural sector resources. Clearly, this was a result of the second category of paradigm embodied by the Rumah *Zakāt* (i.e., the reformation paradigm).

6. CONCLUSION AND RECOMMENDATION

This study highlights several important points as follows. First, the Rumah *Zakāt* Yogyakarta had managed the *zakāt* and social funds professionally. This can be seen from its organizational architecture. Second, the Rumah *Zakāt's* paradigm of *zakāt* was scriptural-conservative. This was reflected by the use of textual and formal approach employed in interpreting the Sayings and in the model of *zakāt* distribution, which was slightly rigid and formal according to conventional works of fiqh. Third, instead of using transformation paradigm, the Rumah *Zakāt* used reformation paradigm to empower the peasants. This organization did not see exploitation and unjust systems as the roots of the peasantry's problems. The Rumah *Zakāt* merely considered the peasants as *al-masākīn* (the poor), not included fī al-riqâb (people in the oppressive system). Fourth, as the consequence of the reformation paradigm, the Rumah *Zakāt* did not actually solve the real problems of the peasantry in Indonesia. However, the organization had contributed two solutions for two peasantry's problems (i.e., low level of income and urbanization).

To sum up, the Rumah *Zakāt* had managed *zakāt* to empower the peasantry and had contributed to solve some of the peasantry's problems. Nevertheless, it did not solve the fundamental problems of the peasantry due to the implementation of scriptural-conservative paradigm of *zakāt* and the reformation paradigm of social transformation. Instead of scriptural-conservative paradigm, it needs to actualize substantial-transformative paradigm of *zakāt*. This means that it needs to consider the peasants as *al-masākīn* as well as fī al-riqâb. It also needs to actualize transformation paradigm, so that they can deal with the roots of the Indonesian peasantry's problems (i.e., exploitation and unjust socio-economic structures).

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THE NEED TO EDUCATE MUSLIMS ON ISLAMIC FINANCIAL PRINCIPLES AND PRACTICES: A STEP TOWARDS FERTILIZING MMEs IN THE ISLAMIC WORLD

AGUNG AWS WASPODO

ABSTRACT

The growing trend of Islamic financial institutions and banking in countries where Muslims are the majority of the populace may be seen as a promising sign of increasing adherence of Muslims towards Islamic principles in their native lands. Moreover, Islamic financial institutions and banking are becoming widespread even in countries where Muslims are not the majority of the populace. A looming question remains whether a growing popularity of Islamic financial practices is consistent with an increasing observance of Muslims towards Islamic principles – starting with Islamic financial principles and affecting positively towards observance of other Islamic principles. This paper addresses two closely connected issues relating to the challenges and consequences in educating Islamic financial principles and practices to the Muslims masses that depend heavily on the sustenance of Micro and Medium Sized Enterprises (MMEs) for their living.

1. INTRODUCTION

Islam demands no less than full submission of Muslims in every aspect of their lives (Qur'ān 2:208). A regular check-up may be needed to make sure that a growing trend in public acceptance for Islamic financial institutions (IFIs) – strongly identified by its commitment to apply Islamic financial principles and practices in its operations – is positively connected with a resurgence of Muslims adhering to Islamic principles (*sharīʿah*) and practices (*muʿā malāt*). This paper refers to Islamic financial principles and practices as an integral part of the Islamic economics dealing specifically with finance and banking, a theme considered to have received more of the attention from Islamic economics scholars (Khan, 1995, p. 277).

A universal model of the formalization for substantive and procedural contents of sharīʿah was modeled by Choudhury and Malik (Choudhury & Malik, 1992, p. 7-11). Using their model we may infer that any social order – including financial institutions and banking – undergoing functional transformation based on Islamic principles and practices are determined by the *taqwā* set within the *tawhīd* set. If *taqwā*, according to Choudury and Malik, is "the temporal representation of *ākhira*, the sure reality of the Hereafter," then a growing trend of public acceptance for IFIs is an indication of Muslims becoming more Islamic. In the case where these IFIs are found outside the predominantly Muslim world, then we may also positively interpret it as precursors that Islam financial principles is being acknowledged as well as being practiced even by non-Muslims.

This paper will slightly move away from the mainstream discussions of Islamic economics by inquiring the necessary requirements to effectively educating the common Muslims on Islamic financial principles and practices. A study by Bley and Kuehn (no date) founded that educating the market with a friendlier packaging of Islamic financial products would aid in the competitiveness of Islamic financial services relative to conventional financial services. Furthermore, facilitating the understanding of Islamic financial products by making comparability to similar conventional financial products would help consumers make better choices. This has the added benefit of insuring that providers of financial services provide comparative values to consumers, be it Islamic or conventional. By acknowledging the findings of this study we may conclude that most consumers of Islamic financial services are selecting their financial providers largely based on religious preferences. Taking this study as a point of reference, I take a stand that an educated mass may induce the above mentioned process a bit faster.

Finally, I feel compelled to clarify early on that however criticizing my paper may read; it is intended to augment scholarly works on Islamic economics and not to vilify the work done so far. That I owe great debts to scholars before me in this field is beyond all doubts.

2. OBJECTIVES

The objective of this paper is twofold. *First*, Islamic financial principles and practices is an integral part of Islamic principles and tenets. Thus, educating Muslims on Islamic financial principles and practices should be seen as a strategic initiative in developing human capital and knowledge in Islamic finance within the Muslim populace. A crucial issue arises to question how far the local authority is willing to tolerate – and may be forced to curb – un-Islamic economic practices when the majority of Muslim populace constitutionally demands full compliance to sharīʿah. In the case where Muslims are a minority, how far the local authority is willing to formally acknowledge sharīʿah compliant financial practices in their economy?

Second, educating Muslims on Islamic financial principles and practices is an important step towards empowering them to address their economic problems[1] and to alleviate these problems autonomously. A crucial issue arises to question what kind of educational approach that would enable Muslims to augment their local financial resources with a network of global Islamic financial resources. A related issue in hand would be how to network financial resource hubs scattered among Muslims countries and communities accessible to an honest Muslim business manager or a trusting Muslim entrepreneur without the bureaucratic complexity typical of world financial institutions.

Both of these objectives are paramount in fertilizing the grass-roots of populace that made up the majority of shareholders in Micro and Medium Sized Enterprises (MMEs) throughout the Islamic world. A point worth mentioning in regards to fertilizing the grass-roots is a model proposed by Choudhury (2002) in developing micro enterprise using Islamic financing and organizational instrument.

3. DEVELOPING SOCIAL CAPITAL

Thus far, scholarly discussions on Islamic finance and banking have rarely touched a crucial issue pertaining to the methods and its effectiveness of educating Muslims on Islamic financial principles and practices. We may rightly argue that the more pressing matters lay on recovering the Islamic economic intellectual heritage (el-Ansary, 1999) as a necessity to building Islamic civilization. While that may be true, we shall keep in mind that "knowledge ensures the best use of resources and piety guarantees a compassionate society" (Rashid, 1979). Thus now, we may find it urgent to devote more energy in "the maximization of human talent throughout the Muslim world[2]" (Rashid, 1979) that IFIs are well on their way to becoming widely available and justifiably provided alongside the dominating interest-based banking and finance. Moreover, the rebuilding of Islamic civilization also mandated a special attention to social capital to help carry the Islamic principles and practices[3] across a wide stretch of different cultures in the Muslim world.

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[1] These problems are mainly found in the alleviation of poverty, generating sustainable economic growth, and navigating towards an equitable distribution of wealth.

[2] Ehsan Rashid have discussed of setting up an International Islamic Educational Foundation, very similar to the conception of INCEIF, the organizing entity of the present colloquium, to activate and bring together academics, intellectuals, and policy-makers throughout the Muslim world (p.198).

[3] The sources of social capital are generally accepted as rules, networks, norms, and beliefs that induce trust and mobilize social capital in developing its values each associated with its own benefits and risks (Adler & Kwon, 2000, p.110).

A central issue in building social capital is balancing between "bonding" and "bridging" social capitals. The former refers to the group activities that reinforce exclusive identities and homogeneity but tends to be inward looking, while the latter refers to network forming that cut across social, religious, and class divisions that tend to be inclusive and outward looking (Thomas, 2004, p. 138). We may expect to find both "bonding" and "bridging" social capital within the Muslims communities. However, a general finding of the Muslim world is not so encouraging, especially in the theme of cooperation among Muslim economies (Khan, 1995, p. 285). Khan repeatedly pointed out that although Islamic economics has covered considerable grounds in the last decade, there remain three foremost obstacles[4] that hinder economic cooperation among Muslim countries:

1. Different Muslim countries are being governed by elite groups whose vested interests diverge from Islamic teachings. This reality disturbs a scholar (Gauhar, 1979, p. 73) so intense that he demands the appeal to a new Islamic world economic order be made directly to the people "bypassing all repressive national systems and arbitrary geographical barriers." The idealized *Ummah* may be fractured at the political levels but it endured on the social plane (Malik, 2004, p. 72).
2. There exists an unusually stiff resistance of individual Muslim countries in protecting their existing trade patterns that does not always include partners from other Muslim countries nor benefiting each other, a fact that were also much earlier identified by other scholar in detail (Kahf, 1979, p. 199-209). The three groupings of all Middle East states (Ismael & Ismael, 1999, p. 142) clearly show that divisions, even across different GNP per capita states, are subject to dependence of their foreign policies to accommodate the U.S. interests and policies in the region.
3. Any cooperation between Muslim countries can only be meaningful if it has an ideological foundation that is reflected in the level of individual adherence to the Islamic tenets. In light of the urgent need to the effective utilization of the resources in the Muslim world, three Islamic principles – such as *self-help*, *joint responsibility*, and *the obligation to provide economic security*– were suggested beforehand (el-Banna, 1979, p.155).

Therefore, we may presume that education may start innocently as a method of making Muslims aware of the benefits of Islamic financial principles and practices. Then, education may progressively be lead towards inducing the need to replace

[4] The obstacles that Khan mentions are not new that it has been elaborated during an International Economic Conference at the Commonwealth Institute, 4-9 July 1977, carrying a theme "The Muslim World and the Future Economic Order."

non-Islamic financial institutions with IFIs. The process of transforming[5] into a more Islamic setup of society may start from financial institutions and working up towards governing structures and administrative machinery around it. This turn of event should be closely watched and guarded against the possibility of free-riders that may take over the steering wheel and turning a peaceful social transition into an agitated social unrest. Ultimately, education may reinforce the quality[6] of adherence to the Islamic tenets as self-fulfilling needs (Chapra, 2004, p. 175), however time-consuming and uphill it is. No small task indeed. Even when partially successful in achieving it may open an opportunity for making headway into influencing the elite groups governing different Muslim countries towards Islamic interests.

With over nine million Muslims currently living in Western Europe, Islam is the largest religious minority in the region since the first wave that came after the end of World War II. Muslims who were low-skilled workers were considered "temporary" by many Western European countries and by early 1970s these countries gradually began closing their borders except for family members or as political asylums. This change of policy did not restrict migration; instead it encourages the "second wave" of Muslim immigrants eager to join their family who came earlier. Currently, the most important political issue in Western Europe is "state accommodation of Muslim religious practices" (Soper & Fetzer, 2003, p. 40). Soper & Fetzer (2003) concluded that there is no single model that describes the pattern of accommodation of Muslim religious practices in France, Britain, and Germany. Rather, it is the legal, historical, and constitutional patterns of church-state relations in each nation that "significantly structure the political debate." If we take their findings face value, then Islamic educational institutions have a varying degree of challenges facing them in each country they resided. Reflecting from the social capital perspective, we may infer that "bridging" efforts should also be on top of Islamic educational to-do list along with "bonding" efforts. Meanwhile, trust is the key to mobilize a congruent political effort in promoting a common Islamic accommodation across different Muslim ethnic cultures.

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[5] Chapra ("Mawdūdī's Contribution to Islamic Economics," 2004) suggests that a faster and greater success in bringing about a moral, cultural, and social revolution may be achieved using "a strategy of gradual socio-economic and political reform with the help of all reform-oriented parties," p. 175.

[6] Mawdūdī's own critique to Sirhindī and Shahīd's failures is that "they wanted to establish an Islamic state in a society which was not mentally and morally prepared for this and hence, not capable of shouldering the associated responsibilities," as Chapra ("Mawdūdī's Contribution to Islamic Economics," 2004), commented that "there is a great need for educating people about the high moral standards that Islam expects from its followers," p. 175.

4. INFERENCES DRAWN

Maybe the most frustrating of all endeavors to educate Islamic economics is the critique that it is lacking a general theory[7] of the Islamic economy. A general theory of an economy can only be derived from the study of real-life conditions. Realizing the fact that currently there is no one truly Islamic society in the world, a general theory may not be developed with reference to an absent society (Khan, 1995, p. 286). That is why Khan (1995) declared that it is "unfair to demand a general theory of Islamic economy." He proposed to produce a "general theory of transition" to an Islamic economy. He also realizes that this proposal also presents serious problems as Muslim economies differ enormously in resource endowment, adherence to Islamic principles and practices, and social infrastructure.

Taking all of the above concerns into account, a serious research on the effectiveness of education along with the development of social capital throughout the Muslim world can not be over emphasized. Generally speaking, human beings are distinctive in that they dependent upon "the medium of culture and the forms of organism-environment interactions that culture supports in order to sustain and reproduce themselves[8]" (Cole, 2005, p. 196). Insofar as civilization building is concerned, education is not only cross-cultural but also fundamental for "the preparation of the next generation[9]" (Cole, 2005, p. 198). It may be useful to think about the task of educating Muslims on financial principles and practices based on Cole's framework that education is a particular form of schooling and schooling is a particular form of institutionalized enculturation:

1. Education as an organized effort to "bring out" (*educe*) the full potential of the individual. In light of Islamic education, each and every individual of the Islamic society shall need to be facilitated through public educational institutions the freedom to discover and enhance his or her physical, mental, and spiritual potentials.
2. Schooling as a deliberate instruction for specific skills. In the context of Islamic education, the most urgent schooling to meet the challenge in the 21st century may be to provide experts in every field of science with an exceptional capability in developing advanced procedures, structured problem solving, and practiced procedures.

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[7] As noted by Khan (1995) from Nienhaus, V. "Islamic Economics: Policy between Pragmatism and Utopia," *Economics* (25). (1982)

[8] Referred by Cole (2005) from Tomassello, M. *The Cultural origins of Human Cognition*. Cambridge, MA: Harvard University Press. (1999).

[9] Referred by Cole (2005) from Reagan, T. *Non-Western Educational Traditions: Alternative Approaches to Educational Thought and Practice.* Matwah, NJ: Erlbaum. (2000).

3. Enculturation as an induction into the cultural order of the society. In view of the Islamic principles and practices, enculturation is close to what may be considered *sibghah* of the Islamic ways that pleases *Allah*.

Hence, it may be beneficial to seek a holistic appreciation of economic development in connection with Islamic religious values as transmitted through education, schooling, and enculturation. With this approach, successful (economic) development “can only occur if social and economic change corresponds with the moral basis of society” (Thomas, 2004, p. 136). Thomas further argued that if this does not happen and a country is forced to select development over “authenticity[10]” it will lead to policy failure, political instability, sectarian and state violence, and revolution.

It may be useful to envisage that with globalization the physical distance between two groups of societies are now reduced to almost nothing. Cultural and religious pluralism is not an alien thing in some far off places. Muslims are so spread out across the globe now that they constitutes as some of the largest minorities in several non-Muslim countries. The growing attitude of global communities is summarized in Michael Goldberg’s phrase; “it’s not what you know, it’s who you know” (Thomas, 2004, p. 139). With regards to the development of social capital, bonding and bridging social capital is really about ways of learning to enact, embody, and disseminate Islamic principles and practices. The growth of pluralism has enabled the development of a Muslim “socio-cultural niche” in places where they are considered minority (Malik, 2004, p. 79). A positive outlook of the Islamic *Diaspora* may lead us to believe that it is possible to enculture what Malik (2004) saw as “spatially bounded, culturally separate” socio-political (Muslim) communities that are “comfortable with fluid and plural identities” while retaining a deeply conscious Islamic selfhood and being part of the *Ummah*. Now it may seem that the *Ummah* is like an abstract idea or even a myth, but give it another generation or two, we may be surprised to find how much reality[11] will be taken into account.

To answer some of the problems in connection with building a network of Islamic global financial resources we may need to refer back to the self-help, joint responsibility, and the obligation to provide economic security “trilogy” before pushing for a more technical advice. El-Banna (1979) has proposed early on for a close cooperation in the following scheme:

[10] Authenticity is defined as ways of gaining economic prosperity and fashioning political, economic, and social systems that are consistent with a country’s moral base, its cultural heritage, and its religious traditions (Thomas, 2004), p. 134.

[11] Malik (2004, pp. 79-80) went as far as quoting Ernest Gellner that Muslims in the West are on their way to a “moral homecoming” that reinforces their “shared identity” in the wave of global Islamic resurgence.

1. Regional development planning,
2. Promoting intra-trade in the Muslim world,
3. Agriculture and nutrition planning,
4. Industrial development planning,
5. Financing development.

Surely el-Banna had such an early start in thinking about transforming MMEs in the Islamic world into a network of trade that by today's standard should be beyond what MMEs are defined. However, we should always be reminded that education is the underpinning of any "humanistic development" defined as the collective vision of society (Ahsan, 2004, p. 186), especially in the Muslim world where human insecurity and human deprivation are rampant while human capital are left behind during the socio-economic transformation. The poor performance of Muslim states in the development of human person and self-actualization is not simply due to ineffective domestic policies but also from external factors such as unequal terms of trade in the world market (Huq, 2005, p. 40).

5. CONCLUSION

Education of Islamic financial principles and practices should be measured in terms of how effective it is increasing Muslims adherence to Islam principles and tenets. To bring into fruition self-help, joint responsibility, and the obligation to provide economic security for the needy across the Islamic world is a venture that should not be underestimated. Knowing that a large number of Muslims are living abroad in countries where they are a minority, education should also be elaborated towards developing "bonding" as well as "bridging" social capital.

I am graciously tempted to quietly acquiesce with Khan's consideration when he pointed that "Muslim economists should not worry about the recognition of Islamic economics. If they are able to offer adequate solutions to the economic problem of man, recognition will come by itself," (Khan, 1995, p.276). However, I feel that "recognition" is a phase in the "bridging" of social capital. Recognition may come earlier than thought, but it is not necessarily a sign that Islamic economics are closer to serving the economic problem of Muslims, let alone for mankind. Recognition should not be a distraction when Islamic economics – especially Islamic banking systems – is already showing early signs of viability in providing some effective solutions to the economic problem of Muslim countries (Yudistira 2003; Hassan, 2003, Mokhtar et al, 2003, to name but a few). By having said that, the IFIs still need to prove that they can "outshine" interest-based financial institutions in terms of efficiency and upholding ethical content (Rosly & Abu Bakar, 2003).

In its secular form, economics and the study of its conception – taking the form of political economy – has taken numerous turns and divergences from the "tools of politics," to the classical "calculus of pain and pleasure," to the "role of institutions in mobilizing individual utilitarianism," and "scientific problem-oriented approach" (Choudury and Malik, 1992, p. 11-14). A common denominator is that economics itself is a critical self-preservation feature of a dominant civilization functioning similar to a defense-mechanism. It is critical of itself in the sense that mainstream economics shall always find critics and proponents throughout its lifespan. It may even show up during periods of "efflorescence" that may put a civilization on an inertial state prone to decay (Goldstone, 2002, p. 378).

The source of knowledge that led to the formulation of Islamic economics is, first, ideational as envisioned by the Qur'ān and *Sunnah*, then turning empirical as Muslim societies began to waver and deviate from its authentic period and norms (Siddiqi, 1995, p. 255). As Islamic economics is beginning to take more active roles in replacing secular economies in Muslim countries, it is bound to face more challenges from the dominant civilizations, not less. The MMEs are not a feature unique to the Islamic world, rather it is found throughout the developing world. An educated Muslim populace would have a better chance in developing MMEs towards becoming more agile to tackle a global world. The road ahead for Islamic economics is probably rough, but it may be an indication that it is heading in the right direction.

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BUILDING CAPACITY OF MICRO AND MEDIUM ENTERPRISES THROUGH SPIRITUALITY TRAINING

AMY MARDHATILLAH
RONALD RULINDO

ABSTRACT

This study seeks to investigate the relationship between spirituality of a businessman and the success of his/her business. It examines the correlation between spirituality and success of entrepreneurs through a survey of women (Muslim)-managed micro enterprises in Malaysia. The survey consists of two models of spirituality: Daily Spirituality Experience Scale (A spirituality scale based on Western values) and ESQ Asma'ul Husna Model (an Islamic spirituality scale). The survey also undertakes a qualitative analysis of the influence of spiritual training on business performance. The results of this research show that spirituality has high correlation with performance of Muslim entrepreneurs. The Islamic spirituality scale (ESQ Asmau'ul Husna Model) has higher correlation to MME success than the western ones (DSES). The qualitative analysis shows that entrepreneurs who have attended the ESQ spirituality training became more satisfied with their businesses. They also noted that spirituality training helped them in managing stress and persuaded them to be more persistent to achieve success. Lastly, they believed that their business performance have increased after attending the ESQ spirituality training.

1. INTRODUCTION

Spirituality has become an important issue for people since last decade. A USA weekend poll in July 1998 revealed that 47 percent of Americans viewed spirituality as the most important element of their happiness. In the scientific world, there are over 200 articles on spirituality that have made their way into management journals between 1999 and 2001. (Kale and Shrivastava, 2003) This issue arises because people in the workplace tend to lose the meaning of work (Dunton, 1997, Jackal, 1999). This dilemma has increased cases of workplace stress and it cost American Business $3 billion in 1999 (Marquez, 2006).

To solve the dilemma, practitioners and academician propose the concept of spirituality in the workplace. According to Cavanagh, (1999), spirituality enables a business person to gain a more integrated perspective on their firm, family, neighbors, community and themselves. Therefore, it can reduce their tension and stress in their work life. Researches also show that spirituality can bring benefit to the business organization especially in facing organizational changes. People who have good spirituality can cope with new and existing performance targets rapidly and effectively (Heaton et al, 2004) Furthermore, Hendrick and Ludemon (1996) mentioned that successful corporate leaders of twenty first century will be spiritual leaders who become comfortable with their own spirituality, and know how to nurture spiritual development to other. This opinion is based on their research on successful CEOs in the USA.

According to Kale and Shrivastave (2003), in the early years of the movement to bring spirituality to the workplace, scholars addressed the notion of spirituality espousing a religious orientation. Hawley (1993) promoted the Hindu approach; Ibrahim et al. (1991), Cowan (1993), Chappell (1993), Fox (1994), and others adopted the Christian perspective; Boldt (1991) and Low (1976) used the Zen Buddhist approach, while Tauber (1990) offered a Jewish perspective on spirituality. The literature on spirituality with religious orientation however, precluded any study of spirituality using Islamic approach to workplace ethics. The problem of scarcity in Islamic literature on spirituality is probably because of two reasons. First, Muslim scholars discuss spirituality more as ritual or worship-based activity. Second, much of such literature uses non-English language, such as, Arabic, Indonesian, Malay, Persian, etc.

While spirituality have been adapted as a tool to increase workplace performances, it is hard to find literatures which study the importance of spirituality of entrepreneurs especially for micro and medium enterprise (MME). With high pressure of fulfilment of their daily needs, lack of capacity in running business, and high degree of competition in the market, MME (owners and staffs) also find stress in their work and life. Based on this condition, this research tries to investigate the importance of spirituality for business people under category of MME. If it can prove that spirituality has influence on business performance; perhaps spirituality training can be one of the capacity building strategies used by microfinance institutions and other institutions.

2. LITERATURE REVIEW

Most of the studies on spirituality have been undertaken since the beginning of the last decade and published in management and psychology journals, such as, the Journal of Organizational Change and Management, Journal of Managerial Psychology, Journal of Management Development, The Leadership and Organizational Development Journal, etc. There are studies which discuss the relation between spirituality and the workplace in general (Lips-Wiersma, 2002, Howard 2002, Fornaciari and Dean 2001, Caciope 2000, Konz and Ryan 1999, spirituality and leadership (Kakabadase et al, 2002) spirituality and career development (Lieps-Wiersma, 2002), research on spirituality (King and Crowter, 2004, Heaton et al, 2004, Benefiel, 2003), spirituality and religion (Kale and Shrivastava, 2002, Delbecq, 1999)

According to Neck (1994), spirituality can positively affect employee and organizational performance in several ways. First, spirituality can lead individuals to experience consciousness at a deeper level, thereby enhancing their intuitive abilities. Second, spirituality-based intuition can also facilitate employees to develop a more purposeful and compelling organizational vision, which can also increase innovation. Third, organizations which offer spirituality oriented work goals provide opportunities for employees to experience a higher sense of service and greater personal growth and development. In turn, the sense of growth can significantly increase employee energy and enthusiasm. Fourth, spiritual-based values can enhance teamwork and employee commitment to the organization

Realizing the importance of spirituality in the workplace, for the past two decades, enlightened companies have encouraged employees to participate in various human potential programs or what could be called psycho-spiritual disciplines or technologies. Meditation, prayer, and guided imagery (visioning or “futurizing”) are three of the more common practices in these programs (Butts, 1999). Moreover, the spiritual practices such as yoga, meditation, prayer are also getting attention among Americans since it is important to the mind, body and spirit of the individual (Bradley and Kaunui, 2003) while many consultants in the U.S provide spirituality training to help people in finding deeper meaning of life.

In academic research, several efforts have been made to measure people’s spirituality. There are several scales such as Religion Scale (Bardis, 1961), Religious Value Scale (Sandage, 1999), Spiritual Well Being Scale (Paloutzian et al, 1978) Religious Experience Questionnaires (Edward, 1986) and others, available in the academic as well as business world. These scales have their own strengths, weaknesses and have been subjected to critical examination in a number of studies.

One of spirituality scales that have been used among spirituality research is Daily Spiritual Experience Scale (DSES). It was proposed by Underwood (2002) as an instrument which can provide a self-report measure of spiritual experience as an important aspect of how religiousness/ spirituality is expressed in daily life for many people. It was used in several fields of studies such as health and medicine (Curlin, et al, 2005, Wachholtz et al, 2005), law and crime (Unnever, et al, 2005, Polcin, 2004), religion (Rulindo and Mardhatillah, 2006, Chiarocchi, 2004, Dunn et al, 2004), psychology (Pearce, et al, 2003), and women (Fowler, et al, 2004). It consists of sixteen-items such as awe, gratitude, mercy, sense of connection with the transcendent, compassionate love, and desire for closeness to God. It also includes measurement of awareness of discernment/inspiration and transcendent sense of self.

Among spirituality scale, none of these scales use Islamic orientation in their construction method. This research proposes a new scale with underlying Islamic principles based on ESQ (Emotional Spiritual Quotient) model proposed by Agustian (2001). The explanation of this model and its scale will be further discussed in Part Four.

3. METHODOLOGY

This research uses quantitative method as well as qualitative method. For quantitative research, we distribute questionnaires to micro enterprises managed by Muslim women under the assistance of Amanah Ihtiar Malaysia, a successful replication of Grameen Bank model in Malaysia. The questionnaires consist of two models of spirituality: Daily Spirituality Experience Scale (A Western spirituality scale) and ESQ *Asma'ul Husna* Model (Islamic Spirituality Scale). Together with these scales, the questionnaires also seek data on the yearly increment of their business profits as the benchmark of success.

In the beginning, this study distributed 30 questionnaires to MMEs receiving assistance from two governmental institutions, namely, Amanah Ikhtiar Malaysia (AIM) and Small Medium Industry Development Corporation (SMIDEC). However, this study received no response from MMEs under the assistance of SMIDEC while only 25 out of 30 responses were received from AIM. Among 25 questionnaires, there are only 13 questionnaires which can be subjected to further analysis in the study.

To cover the limitation of the quantitative method used by this research, this research conducted qualitative research by interviewing 10 entrepreneurs who attended ESQ training. This training proposes the use of Islamic spirituality to increase and direct people's ability in leadership and human capital towards improving their life performance. There are three research questions addressed to the respondents:

1. Does spirituality training help entrepreneurs to manage their stress (business pressure)?
2. Does spirituality increase their business performance?
3. Does spirituality affect their life and business satisfaction?

4. DISCUSSION

4.1. Overview of ESQ Concept

In year 2000, Zohar and Marshall pioneered the concept of Spiritual Quotient (SQ). They argued that there is another quotient in every human being besides Intellectual Quotient (IQ) and Emotional Quotient (EQ). It is his/her Spiritual Quotient (SQ). They continue the research conducted by Michel and Ramahandaran in California University who found the existence of God spot in human brain. In simple terms, God spot means a location in human brain which is in-born and functions as a spiritual center where the process of neuron concentrates on the efforts to integrate and give meaning to human daily life experience. The ability to direct behavior following the God spot is called as Spiritual Quotient.

Agustian (2001) criticized this current SQ concept and claimed that the concept is not final yet because it does not touch the presence of God. Agustian (2001) proposed his own concept called Emotional Spiritual Quotient (ESQ) which combined the Emotional Quotient and Spiritual Quotient. The ESQ has parallels in the Islamic concepts of *Iḥsān*, *Imān*, and Islam.

According to ESQ concept, the ability to direct behavior following the God spot or Spiritual Quotient (SQ) is given by Allah (God in Islam). The behavior is guided by inner voice which can be used when some one's heart is pure. In Islam, Allah has 99 beautiful names (*Asma'ul Husna*). After Allah creates human (physically), He blows His spirit (*ruh*) into human body. That's why, according to ESQ concept, if some one's heart is pure, he can act like the 99 *Asma'ul Husna* such as beneficent, merciful, honest, fair, generous, innovative, etc. According to ESQ model the 99 *Asma'ul Husna* summarize into seven core values: honesty, responsibility, vision, discipline, integrity, justice and care

In making some one's heart become pure, Agustian (2001) proposed the concept of Zero Mind Process (ZMP). ZMP consists of seven steps, such as avoiding prejudice, way of life, experience, self-interest, viewpoint, comparison and literature in valuing anything and acting only because of Allah and always feeling that Allah sees what we are doing (*Iḥsān*). If we can do these, then we have good SQ. Moreover, Agustian also proposed, how to develop good EQ based on six principles of *Imān*. First, rely on Allah for everything. Second, do everything because of Allah. Third, have leadership such as Prophet Muhammad. Fourth, learn continuously. Fifth, have visions. And sixth, believe in destiny.

In maximizing IQ, Agustian (2001) offered the use of five principles of Islam, which can give benefits for personal strength and social strength. For personal strength, one should have a mission statement in his/her life (through *shahadah*), develop character building (through solah /prayer), and exercise personal control (through fasting). For social strength, one must have strategic collaboration with others (pay *zakāh*) and do total action (such as perform hajj). The principles of Islam are neither meant to be rituals nor meant for followers of this religion alone. It has universal values which can apply in daily life of every human being. We need to make a mission statement if we want to achieve our goal of building our character and inculcate values, such as, discipline, responsibility, vision and honesty. We need to have good emotional control so that we can easily pass any barrier that we come across in pursuing our goal. However, personal strength is of no use if we do not make a move (total action). Further, our success will be partial if others are not benefited in any way by our success. Therefore, we need strategic collaboration with others.

All the above ideas are clearly contained in ESQ training. Until January 2007, ESQ has trained more than 270,000 people across Indonesia as well as Malaysia, Singapore, Brunei and Netherlands. This training is specially addressed to executives and professionals. A report from several clients (companies) shows that this training has successfully increased company performance.

Even though the ESQ concept has been accepted and applied by many people and companies, it is not yet well accepted in academic arena. Realizing the benefits of this training, this research attempts to bring this concept to the academic arena by applying scientific methods to a study of this concept. It uses 99 *Asma'ul Husna* application questions from ESQ book as the 99 *Asma'ul Husna* model and tested it through validity and reliability tests. The complete discussion about the results of these tests are presented in the next part.

4.2. Findings and Discussion

As we mentioned in section on methodology, we only got 25 filled-in questionnaires out of 30 from Amanah Ikhtiar Malaysia. Further, out of these 25 questionnaires, only 13 were found to fulfill all of our research requirements. Among the 13 respondents, there were 2 males and 9 females (Mean: 1.81; Standard Deviation: 40) while two respondents failed to provide information on their gender. Out of 13 respondents, 10 respondents experienced profit growth of around 1% - 20% compared to last year period while only three respondents experienced profit growth of around 20.1% - 50% compared to last year period.

We analyzed the reliability of the data by using Correlation Cronbach Alpha with .05 significance alpha level. If the index of reliability is more than 0.85, it will considered as having high reliability (Cohen and Swerdick, 2004)

The results of this research showed that there was significant correlation (50.4%) between ESQ *Asma'ul Husna* model and the success of entrepreneurs while there was no significant correlation between DSAS and the success of entrepreneurs. The researchers also found that ESQ *Asma'ul Husna* has high reliability in measuring spirituality with .94 Cronbach Alpha.

The results of quantitative research were strengthened by the results of qualitative research. There were three questions addressed to entrepreneurs who have attended ESQ Spirituality Training. 1) Does spirituality training help entrepreneurs to manage their stress (business pressure)? 2) Does spirituality increase their business performance? 3) Does spirituality increase their life and business satisfaction?

The results of qualitative research show that all respondent mentioned that spirituality training helped them in managing stress as a result of the pressure of their businesses. It was possible because a realization that the life hereafter is more important than life in this world. After training most of respondents also realized that since the purpose of their life is only to worship Allah, they are also doing business only for the sake of Allah. They also believe that spirituality helps them in managing stress because they believe that Allah will give them the best once they put in their best efforts. There is no reason to be worried over material loss as long as Allah would still reward them for being a good Muslim.

In the words of one respondent, "*since attending ESQ spirituality training, I became more patient and happy with my life. I can calm down my tension and stress if my business is not running well. I just pray to Allah, and believe that He always give the best for His Believer.*"

Furthermore, respondents reported that the income from their businesses also increased after they attended the training. The reason behind this is that their attitude towards business has changed. They are more sincere and honest in their businesses and more polite in dealing with customers. These led to increased customer satisfaction and a better network to expand business.

As stated by another respondent, "*After I attended ESQ training and applied spirituality aspects in my business my business performance and income has increased,. I think it is because I changed my attitude in business. I now approach customers in a more pleasant and polite way. I do business sincerely for the sake of Allah not for material gain. Therefore, people who want to be my business partners are increasing in number.*"

Applying spirituality to business, according to the participants, helped them to be more satisfied with what they have and what they do. In the words of another respondent, "*Before attending the ESQ training and applying spirituality in my business, I was never satisfied with what I have; I always want more in terms of profits. However at the end I found that money cannot make me happy. Not only that, I was easily put under stress if I failed in my business. Now-a-days I feel more* *joy in doing business. I work hard for the sake of Allah, then leave the rest to Him for the results. I realized that worldly life is only a transition for the hereafter life."*

Based on these results we can conclude that there is a positive relationship between spirituality and business performance. It is supported by the previous research such as Cavanagh, (1999) who noted that spirituality enables business people to gain a more integrated perspective on their firm, family, neighbors, community and themselves. Therefore, it can reduce their tension and stress in their work life. Heaton et al (2004) noted that spirituality can bring benefit to the business organization especially in facing organizational changes. People who have good spirituality can cope with new and existing performance targets rapidly and effectively.

Furthermore, the ESQ spirituality training itself can help the participants because it inculcates seven core values among their participants, such as honesty, responsibility, vision, discipline, integrity, justice, and care. All of these values are important to develop a good Muslim and transform him/her into a good entrepreneur.

5. CONCLUSION

In conclusion, the present study showed that there is relationship between spirituality and success and performance of the entrepreneurs. The result of this study also shows that ESQ *Asma'ul Husna* Questionnaire has high reliability in measuring spirituality. However, there are several limitations of this study. First, the size of the sample is too small. Therefore, the findings of this study may be sample-specific. Second, the samples included Muslim entrepreneurs only. It would be better if the sample includes non Muslim entrepreneurs as well. Lastly, there are still many un-researched questions relating to spirituality. The relationship between spirituality and other variables such as: job satisfaction, gender, commitment, etc needs to be investigated in order to get comprehensive understanding of the benefits of spirituality.

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APPENDIX A

DAILY SPIRITUALITY EXPERIENCE SCALE (DSES)

Question	Many times a day	Every day	Most days	Some days	Once in a while	Never or almost never
I feel God's presence.						
I experience a connection to all of life.						
During worship, or at other times when connecting with						
God, I feel joy which lifts me out of my daily concerns.						
I find strength in my religion or spirituality.						
I find comfort in my religion or spirituality.						
I feel deep inner peace or harmony.						
I ask for God's help in the midst of daily activities.						
I feel guided by God in the midst of daily activities.						
I feel God's love for me, directly.						
I feel God's love for me, through others.						
I am spiritually touched by the beauty of creation.						
I feel thankful for my blessings.						
I feel a selfless caring for others.						
I accept others even when they do things I think are wrong.						
I desire to be closer to God or in union with the divine.						
I feel God's presence.						
I experience a connection to all of life.						

APPENDIX B

ESQ *ASMA'UL HUSNA* SCALE

No	Impulse	Reality			
		Never	Seldom	Occasionally	Always
		0	1	2	3
1.	I want to be a caring person				
2.	I want to be a loving person				
3.	I want to be able to control my self				
4.	I want to be holy in my thoughts and action				
5.	I want to lead a peaceful life				
6.	I want to be trusted				
7.	I want to always maintain and preserve				
8.	I want to always be gallant and respected				
9.	I want certainty in my life				
10.	I want to have a big hearted and soul				
11.	I want to create				
12.	I want to plan things				
13.	I want to paint, design, and realize my ambitions				
14.	I want to forgive and relieve others from their guilty feeling to me				
15.	I want to have the power to implement goodness				
16.	I want to be a giving person				
17.	I want to be constantly giving				
18.	I want to open my heart, be a pioneer and a role model for others				
19.	I want to constantly learn and gain knowledge				
20.	I want to control things				
21.	I want to make way for other people				
22.	I want to humble my self for the sake of justice				
23.	I want to elevate my self for the sake of justice				
24.	I want to clear things up				

No	Impulse	Reality			
		Never	Seldom	Occasionally	Always
		0	1	2	3
25.	I want to debase the immoral to assume justice				
26.	I want to listen to and empathize with other				
27.	I want to notice others				
28.	I want to control successfully				
29.	I want to be fair				
30.	I want to be gentle and sensitive to others				
31.	I want to be cautious				
32.	I want to be polite and tender person				
33.	I want to have a grand character				
34.	I want to forgive other people mistake and keep my knowledge of the fault				
35.	I want to appreciate other people's good deeds				
36.	I want to be a person with dignity				
37.	I want to have a big heart				
38.	I want to constantly guard and maintain				
39.	I want to take notice of other people complain				
40.	I want to pay attention to every detail				
41.	I want to have dignified character				
42.	I want to be noble				
43.	I want to be constantly on the watch				
44.	I want to fulfill other people's wishes				
45.	I want to be knowledgeable				
46.	I want to be wise				
47.	I want to be sympathetic and serene all the time				
48.	I want to do good things to others				
49.	I want to motivate others				
50.	I want to witness everything				

No	Impulse	Reality			
		Never	Seldom	Occasionally	Always
		0	1	2	3
51.	I want to defend the righteous				
52.	I want to be trustworthy				
53.	I want to have strength and great spirit				
54.	I want to be strong minded				
55.	I want to be protective				
56.	I want to be well behaved				
57.	I want to pay attention to small details				
58.	I want to have the initiative to do something				
59.	I want to return things as they were for the sake of justice				
60.	I want to lighten other people spirit				
61.	I want to stop my own and other people’s negative thoughts				
62.	I want to give “life” to other				
63.	I want to be strong and independent				
64.	I want to be innovative				
65.	I want to have noble character				
66.	I want to be number one in my community				
67.	I want to fix things				
68.	I want to be needed by others				
69.	I want to be competent				
70.	I want to encourage others to have certain abilities				
71.	I want to initiate something for the sake of the truth				
72.	I want to stop something for the sake of justice				
73.	I want to be the first in every way (inventor)				
74.	I want to be the person who take the final decision				
75.	I want to have real integrity				
76.	I want to pay attention to the condition of my own and other people’s soul				
77.	I want to educate and protect others				

No	Impulse	Reality			
		Never	Seldom	Occasionally	Always
		0	1	2	3
78.	I want to have a personal status				
79.	I want to distance myself from bad things				
80.	I want to understand other people's mistakes				
81.	I want to warn people who err for the sake of good				
82.	I want to be forgiving and forgetting other people mistake				
83.	I want to be compassionate to those who suffer				
84.	I want to succeed				
85.	I want to be grand, noble, and respectable				
86.	I want to give fair punishment				
87.	I want to collaborate and work together				
88.	I want to be wealthy physically and mentally				
89.	I want to encourage others				
90.	I want to prevent bad things from happening				
91.	I want to give punishment in the name of justice				
92.	I want to give benefit to others				
93.	I want to be educated and noble				
94.	I want to be a person who like to guide others				
95.	I want to look the best that I can and create good things				
96.	I want to maintain my belonging for the long term				
97.	I want to inherit and delegate matters				
98.	I want to be smart and witty				
99.	I want to be patient and not in rush				

APPENDIX C

Reliability Statistics

Cronbach's Alpha	Cronbach's Alpha Based on Standardized Items	N of Items
.941	.952	99

Reliability Statistics

Cronbach's Alpha	Cronbach's Alpha Based on Standardized Items	N of Items
.728	.789	17

Correlations

		profit	totesq	totsdes
Pearson Correlation	Profit	1.000	.504	-.324
	ESQ	.504	1.000	.049
	SDES	-.324	.049	1.000
Sig. (1-tailed)	Profit	.	.040	.140
	ESQ	.040	.	.436
	SDES	.140	.436	.
N	Profit	13	13	13
	ESQ	13	13	13
	SDES	13	13	13

Significant at .05 alpha level

THE ACCOUNTABILITY OF ISLAMIC MICROFINANCE INSTITUTIONS: EVIDENCE FROM INDONESIA

ERSA TRI WAHYUNI

ABSTRACT

The development of Islamic Saving and Loan Cooperatives or BMTs in Indonesia has been exceptional. However, the rapid development of BMTs, is not followed by the development of reporting regulation and accounting standards. This paper aims to investigate and provide information on the accountability of BMTs in Indonesia. Lack of a supervisory board and low demand for audited financial statements provide little incentive for BMT managers to get their financial statements audited by independent auditors. Statistical estimation reveals that only 7-20% of BMTs are audited by independent auditors. The paper explores the reasons for most BMT managers not opting for a process of audit and transparent reporting practices.

1. INTRODUCTION

Indonesia has been developing its system of microfinance since 1970s. It is important for Indonesia to have a strong microfinance system as SMEs constitute the backbone of the economy. It is estimated that 89% of Indonesian people are employed in small enterprises (including household and cottage enterprises) and account for 41% of Indonesian gross domestic product (Rice, 2000). The Yogyakarta Communiques 2004 declared by Indonesia and other 10 Asian Countries identified strategies for Central Banks and Governments to promote Microfinance and Rural Finance. They have committed to promote good microfinance principles which are very important for poverty alleviation. (Jansen, Hamp & Hannig, 2004)

Indonesia is fortunate that Microfinance has received full support from the government and state regulators. Bank Rakyat Indonesia (BRI) with its 4049 profit centre units in 2003, mostly at rural areas, is a pioneer in sustainable microbanking system (Robinson, 2004). Besides BRI major players in microbanking industry include independent rural banks (BPR), and village credit banks (BKD) and other semi-formal and non-formal microfinance institutions (MFI). Many rural banks and semi-formal MFIs run their operations following the Sharīʿah.

Saving and loan cooperatives also play an important role as microfinance institutions. As on December 2003, there are 36,376 saving and loan cooperatives (KSP) and saving and loan units (USP) in Indonesia registered in Ministry of Cooperatives and SME. With total assets at more than IDR 6 trillion, they serve more than 11 million members and depositors (Depkop, 2004).

In non-banking microfinance sector, Perum Pegadaian (National Pawnbroker Services) plays an important role in providing access to financing for SMEs. The informal microfinance institutions are a variety of organisations that give small loans and sometime accept deposits. In some ways most of them are connected to the government or to an NGO. One of them is LDKP (Lembaga Dana dan Kredit Pedesaan) promoted by various provincial governments. Indonesia has also an informal microfinance network that includes loan sharks, rotating credit arrangements (arisan), trade credit providers, non formal pawnbrokers, etc.

BMT or *Baitul Māl wat Tamwīl* is a unique Islamic microfinance institution. BMTs are not banks, although most of them operate exactly like banks. Some BMTs are registered with the Ministry of Cooperation and Small Enterprise as Sharīʿah saving and loan cooperatives. Some BMTs operate as parts of Islamic cooperatives or as the business units of Islamic charity organizations. Most operate informally with minimum regulation and supervision.

The development of Islamic Saving and Loan Cooperatives or BMTs in Indonesia has been exceptional. The number of BMTs has risen from 300 at the end of 1995, to 1501 at the end of 1997, and 2470 BMTs in 1998 (Timberg). As on December 2005, there are 3037 BMTs registered with PINBUK (Pusat Inkubasi Usaha Kecil). That number includes BMTs who are legal bodies as cooperatives, or "pre-cooperatives" who operate with PINBUK "Operation Eligibility Statement." The definite number of BMTs is almost impossible to find as many of BMTs are not registered with PINBUK or affiliated to other NGOs. Together, BMTs are estimated have consolidated assets of more than Rp. 1 trillion; employ more than 30,000 workers with more than 40% of them being women. BMTs serve 2 million depositors and distribute micro credit to more than 1.5 million micro entrepreneurs (Aziz, 2000).

BMTs have more outreach than Islamic banks. The outreach of Islamic Banks is usually at big cities and provincial capital cities. BMTs on the other hand have their outlets and offices in small rural cities, villages, suburbs or big cities' slum areas. They also serve people who never have access to finance before. BMTs distribute loans starting from IDR 100.000 (US$10) to micro entrepreneurs to IDR 50 million (US$5000). BMT as bottom up initiatives of the people have advantages of informal network with their members. With their unique approach, they serve large constituency, many of them are not bankable and do not have access to financial institutions before.

However, the rapid development of BMTs, is not followed by the development of reporting regulations and accounting standards. The precise definite legal status of BMTs is somehow in doubt. Due their informal nature, many BMTs do not have any legal form. Some small BMTs are "pre-cooperatives", run by operation eligibility statement from PINBUK, some have notarial deed as their legal form, some have a legal form as cooperation or a non profit foundation. Nevertheless, currently most of medium and large BMTs take cooperatives as their legal form and are registered with the Ministry of Cooperatives and SME.

Currently there is no accounting standards specially made for BMT. The accounting standards for cooperatives is available. However as the nature of BMT business is closer to Islamic banking, some of BMTs are adopting the new Accounting Standards for Islamic Banking, recently published by Indonesian Institute of Accountants (IAI)

Some NGOs whose their main focus is developing and mentoring BMTs have been experiencing difficulties in monitoring the financial conditions of their BMTs. Unless a BMT is receiving some capital or financing grants from the NGOs, the NGOs can not force the BMT to submit its financial report. The reporting format of the financial statements also permits low comparability.

Lack of accounting standards, and a supervisory and regulatory body of BMTs provide little benefit for BMT managers to make good quality financial reports. As most of the BMTs have a cooperative organizational form, the members as the major stakeholders should ideally be the major users of their financial statements. However, as most of the BMT members are not knowledgeable users of financial statements, this creates little demand for audited financial statements. On the other hand, as largely unsupervised financial institutions, many of the BMTs are run by relatively inexperienced staff, especially in accounting area. This clearly presents prudential dangers, especially for depositors.

Research about BMTs in Indonesia is not easy to find. The fact that BMTs are grass root organizations makes the data collection process extremely challenging. In some research papers, BMTs are discussed as part of Islamic banking in Indonesia (Timberg,1999). Another research study by Yayasan Akatiga about financing model of BMT (widyaningrum, 2002) is one of the BMT case studies in Bogor that provide evidence how BMTs improve the economic level of their members.

The present paper will examine the accountability of BMTs in Indonesia. More specifically it would seek to understand what BMTs do to make themselves accountable to their members or to other financial statement users. This paper also will describe the current condition of BMTs as to how many BMTs are audited by independent auditors and how many of them are not, and audited by internal auditors instead. The reason(s) for not being audited by independent auditors will also be explored in this paper.

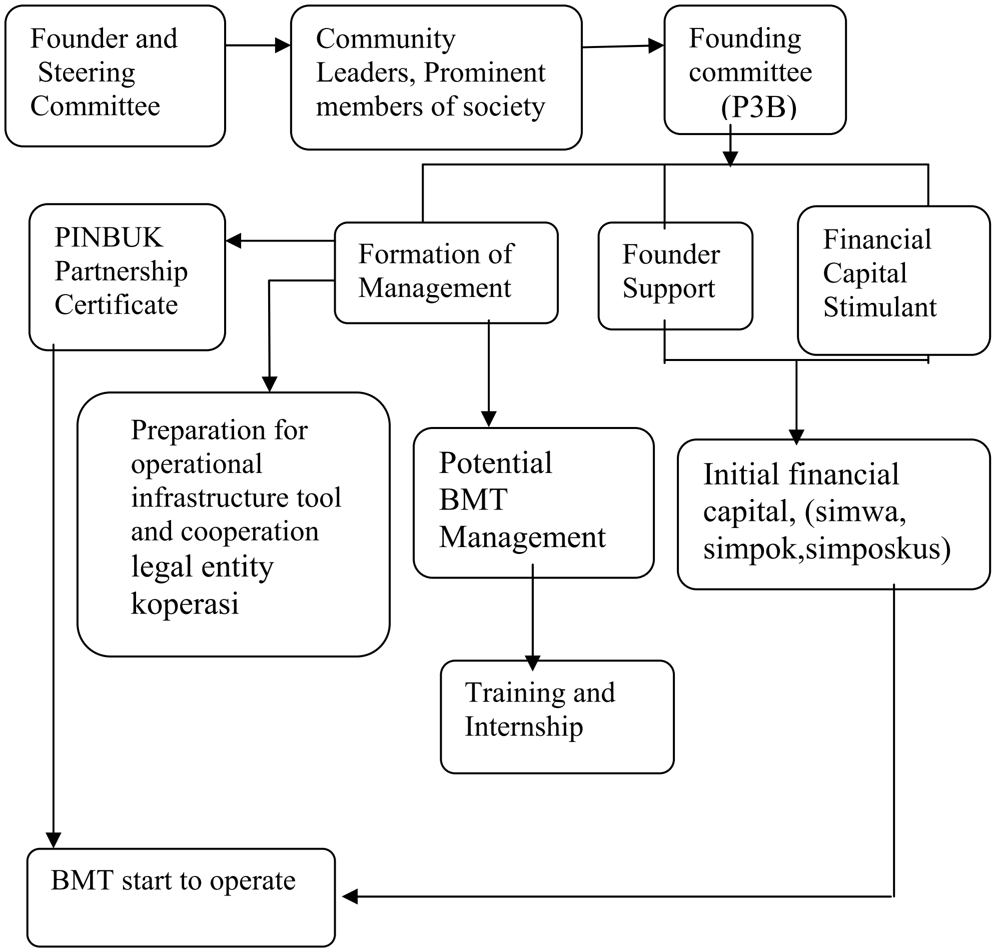
2. BMT BUSINESS MODEL

BMT is a Microfinance Institution that integrates all economic and social activities in the nearest society. The activity of BMT as *Baaitul Tamwīl* is to develop productive business by promoting saving activity and helping financing economic activities its members and the society in the area. BMT as *Baaitul Māl* also has social function by supporting social funds such as *zakāt*, *infāq*, *ṣadaqah* and distributed with the principle of society empowerment in accordance with the rules and regulations.

To establish a BMT is not a complicated process. A group of people who are interested to establish a BMT in their society need find support from their community leaders and prominent members of the society. With the approval and support of the community leaders, this group can make founding committee (P3B) consist of 5 people. The main job of this committee is to get 20-40 people as First Founders who would like to invest in BMT (pay initial shares/ Simpoksus). BMT then issues share certificates for the investors. Once BMT has initial capital of Rp.20-35 million, they can have first general meeting to formally establish BMT. In the first general meeting they can form BMT management board. The management board then will be responsible in attaining the business permit from PINBUK and prepare the operational infrastructure. BMT managers need to have 2 weeks trainings from PINBUK before they can officially run the business. For more details, the BMT establishment process is shown in flowchart diagram 1.

BMTs use the Sharīʿah principle of profit sharing and are not interest based. Their products can be categorised into three: Purchase form, profit sharing form and borrowing form. For the purchase form, the major instruments of BMT are *murābaḥah* (cost plus margin), *istiṣnāʿ* (purchase with specification), *bayʿ al salam* (purchased with deferred delivery), *ijārah* (lease and hire purchase). Ninety to ninty-five percent of BMT transactions are purchase form transactions, especially *murābaḥah*. In the profit sharing form, some BMTs have started to go for *muḍārabah* (trust financing) and *mushārakah* (partnership) although the percentage is very small. A major factor that prevents profit sharing form from becoming popular is the absence of neat transaction records or an accounting process. Proper accounting record is a mandatory requirement for profit-sharing scheme.

Diagram 1. BMT Establishment Process



Source: PINBUK,2005

3. BMT DEVELOPMENT AGENCIES IN INDONESIA

Besides the Ministry of Cooperatives and SME, there are many NGOs currently working side by side with the government to develop BMTs in Indonesia. Below we describe the role and characteristics of four major development agencies.

3.1. BMT Center

Established recently in 14 June 2005, it has by now 100 members comprising mostly BMTs which have a cooperative legal form. Members of BMT Center together have total assets of more than Rp.251 billion with 1,626 total employees. BMT Center as a coordinating body aims to develop networking among members and develop their potential. The institution tries to stay as non-government, professional, transparent and managed by independent people who are not BMT managers.

The BMT Center initiative came from Dompet Dhuafa (DD) and fully supported by 13 BMTs mostly from Jakarta and Central Java. Currently BMT Center has cooperation with PT. PNM (PT. Permodalan National Madani), a state-owned enterprise to distribute funds to the tune of Rp. 15 billion to eligible BMTs.

Members of BMT Center need to submit their financial statement as one of the eligibility criteria to become members or to receive such capital funding. Interviews with BMT Center personnel revealed that financial statements generally have different structures. Different accounting standards applied also produce low comparability of financial statements. The presentation of financial statements are also varied. Some are generated from accounting software, some are typed using mechanical typewriter, and there are still one or two that using handwriting.

3.2. PINBUK (Pusat Inkubasi Usaha Kecil)

Established in 1995, PINBUK has established around 3000 BMTs all over Indonesia, of which around 2000 are still active and some are growing. The focus of PINBUK is quite different from BMT Center. While the main focus of BMT Center is networking and channeling, PINBUK's focus is on developing Microfinance Institutions (not always BMTs) to support small and micro industries.

Although PINBUK also has training programs for BMT officers, their main focus is to facilitate the establishment of BMT. Currently PINBUK is also developing a new Grameen Bank approach or what they call POKUSMA (Kelompok Usaha Muʿāmalāt).

My interview with people in PINBUK revealed that it requires monthly reports from BMTs who are participating in their program (i.e. receiving money from them as loan or capital). Those who are not participating in their programs have no responsibility to report to PINBUK.

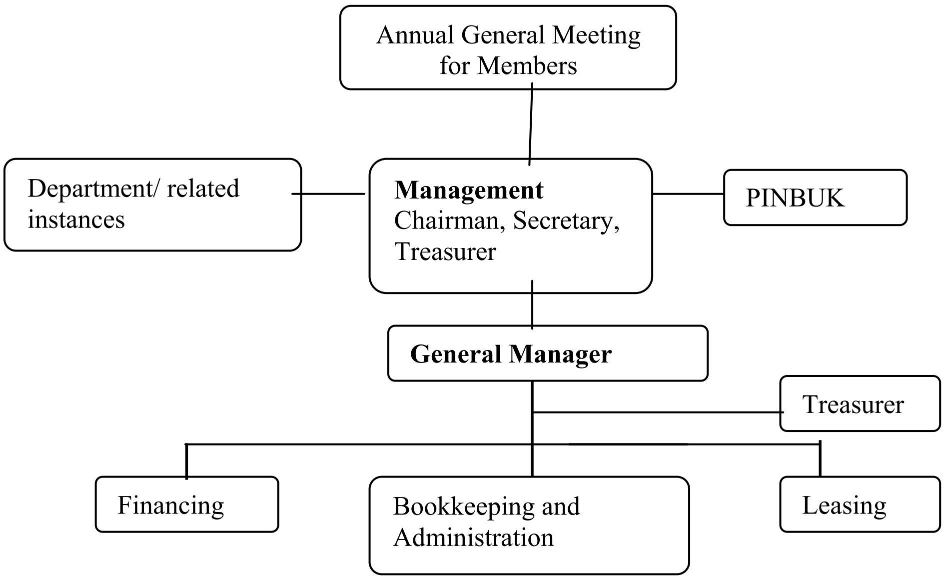
3.3. Microfin Indonesia

Established 2 years ago, Microfin Indonesia has 700 BMT partners. Cooperation among partners has varied forms - channeling funds, training, establishment and legal assistance and management consultancy. Microfin Indonesia has 8 branches mostly in big cities in Java.

They have a strong relation with *Baitul Māl* Muʿāmalāt (BMM) as many of the founders also come from BMM. Many BMT development programs of BMM are executed by Microfin Indonesia. The recent program involved 107 BMTs from Java and Lampung that included funding assistance, trainings and IT development support for BMTs who are ready to adopt IT.

Microfin also has cooperation with Ministry of Cooperatives and Small Medium Enterprise. In 2003 and 2004 it distributed funding grants from the Ministry to 127 BMTs. In 2005, there were about 200 BMTs that received similar funding grants. Their duties include progress monitoring of funding recipients.

Diagram 2. BMT Organisational Structure



Source: Azis, 2004.

4. THE DEMAND SOURCE FOR BMT ACCOUNTABILITY

4.1. BMT Members

As cooperatives, BMT usually has organisational structure as shown in diagram 2 above. If BMTs fully adopt cooperative institution model, they should only serve their members. However in the practice, as BMTs operate like banks, they have many customers and depositors. BMT Beringharjo in Yogyakarta with assets of IDR 12 billion serves 11000 members and depositors. As the Director of BMT Beringharjo said in a lighter vein "if we have to make AGM and invite all our depositors and members, we will have to hold it in the soccer field."

As it is shown in the diagram above, it is clear that BMT managers are accountable to Annual General Meeting (AGM). Because inviting all BMT members in the AGM is not practicable, usually BMTs invite their special members only to the AGM. Their special members consist of their first founder, and members who have BMT share certificate. The AGM usually holds for 20-40 members. By having less people in the AGM, BMTs can take decisions faster. Another argument is that these 20-40 special members are the ones who have more concern about BMT performance and have the power to direct managers. It is questionable as to whether a member who borrows $10 from a BMT or have a deposit of merely $10 can get involved in its strategic decision making process.

As cooperatives, the major demand for financial statements for BMTs comes from its members. Thus, the quality of financial statements is determined also by members' expectations, which explains the lack of standardization in reporting practices.

4.2. Monitoring Agencies

Supervisory Board should be one of the major financial statement users of BMTs. Some BMT practitioners and analysts I interviewed express their concerns of the lack of supervisory body in the BMT industry. Different from Sharīʿah Rural Banks (BPRS) who are supervised by Central Bank, BMTs as mostly cooperatives who do not have any monitoring body.

Currently the Ministry of Cooperatives and Small Medium Enterprise only gives their status as legal entity but does not closely monitor the financial condition of BMTs. This is where the monitoring organisations such as BMT Center, PINBUK and Microfin Indonesia may play an important role to set up benchmarks and monitor the development of their members.

However, most people in these monitoring organisations also find difficulties in collecting financial data of their members.

"It is quite hard to ask for financial statements to our BMT members. We usually need to call them and ask them. They usually become more excited in submitting financial statements where it becomes one of requirements to get capital funding." Ida, BMT Center.

"*It is very hard for us to impose our BMTs to submit their financial statements. We do not have any share or capital placement in the BMT, so the submission of the financial statement must be voluntarily. We also have communication difficulties to reach BMTs in rural areas. We usually can get financial statements from BMTs which are close to us or are easy to reach by common communication tools*." Budi Laksana, PINBUK.

"*For BMTs who received funding grants from us, they usually need to submit their financial statements or progress reports every month or in every three months. We usually do not have problems in asking the report as they know that it will determine their assessment. If they fail to do so, they might not be able to get the same grant next year. The downside of it is we can only force BMTs who receive grants or in joining our channelling program*." M. Sholeh, Microfin Indonesia.

The absence of a national supervisory board for all BMTs in Indonesia imposes a great risk for BMTs. Although very rare, there are some cases where the treasurer or BMT managers committed fraudulent actions by stealing money and left the cash vault empty.

4.3. Ministry of Cooperatives and SME

Ministry of Cooperative and SME represents the government agency that gives legal status to BMTs. Recently, in 2004, the Ministry issued a new cooperative type; Sharīʿah financial service cooperatives (KJKS). The new cooperative type is intended to be the legal form for BMTs. However many BMTs have already registered under Sharīʿah cooperatives type, especially those who are registered before 2004.

However, BMTs who already have their cooperatives license are unwilling to reregister under the new form as it is quite expensive. Also there is no sanction against BMTs who are not registered as KJKS, so there is no incentive for BMTs to change their legal status.

Nevertheless, as per the new regulation for KJKS, UU No: 99/Kep/M.KUKM/IX/2004, Article 35, BMTs who have assets more than IDR 1 billion have to be audited by an independent auditor or audit service cooperatives. Those who are not obliged to be audited, need to have internal audit by internal auditor or special officer assigned by the cooperatives policy. The audited report need to be disclosed in Annual General Meeting and disclosed to public through announcement board or mass media. For those who do not comply with the regulation; the sanction would take the form of a reduced credit rating.

Based on the explanation above, BMT should be accountable to the Ministry. However as the sanction is too light, this would not be enough to provide incentive for BMTs to get audited by independent auditors.

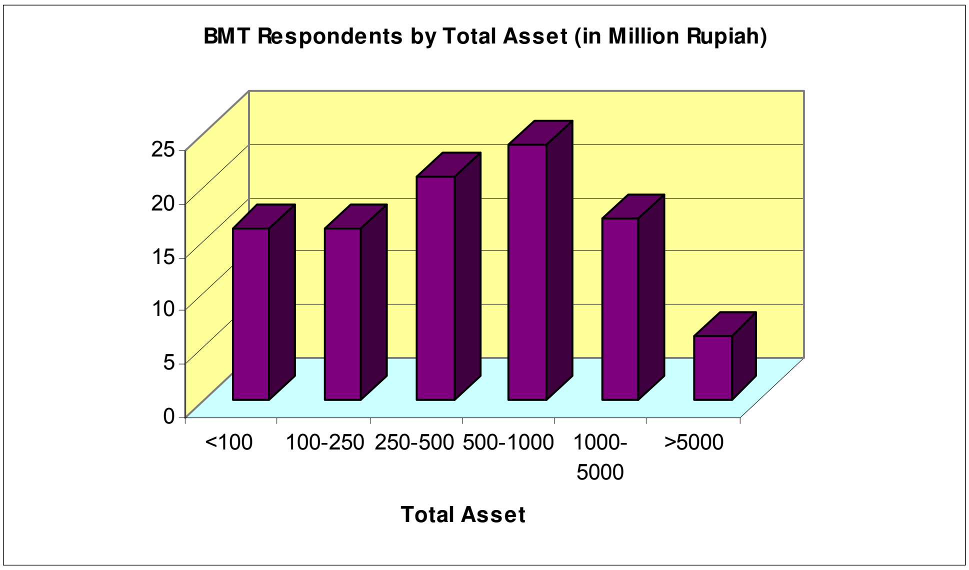
5. DATA COLLECTION AND RESEARCH METHODOLOGY

To gain knowledge about BMT's accountability, a random survey to 101 BMT Directors/Managers has been conducted. This survey was carried out in the first BMT National Conference in Jakarta, 2-5 December 2005. 101 BMTs surveyed came from 24 provinces in Indonesia (table 1)

Table 1. BMT Respondents Profile by Provinces

No	Provinces	amount
1	Aceh	2
2	Bali	2
3	Banten	3
4	Bengkulu	3
5	Gorontalo	2
6	West Irian Jaya	1
7	Jambi	1
8	West java	14
9	Centra Java	20
10	East Java	3
11	West Kalimantan	5
12	South Kalimantan	8
13	Lampung	4
14	Maluku	2
15	West Nusa Tenggara	5
16	East Nusa Tenggara	2
18	Riau	3
19	Sorong	1
20	South Sulawesi	1
21	West Sumatera	3
22	South Sumatera	5
23	North Sumatera	5
24	Yogyakarta	6
Total Respondents		101

Chart 1. BMT Respondents Profile by Total Asset



A Survey with a set of questions was given out to the random respondents. Some directors/managers were also interviewed to know more about the details of their BMTs.

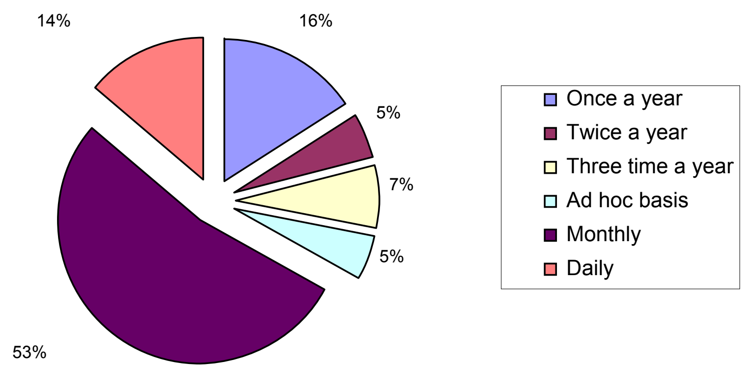
6. FINDINGS AND DISCUSSION

6.1. BMTs Print Their Financial Reports Regularly

Despite the impression that BMTs are informal and lack human resources with accounting knowledge, 97% of BMTs claimed that they produce balance sheets and income statements. 3 respondents who admitted that they never make financial statements is because they are just newly established (less than a year). 93% percent use cash basis accounting while the other 7% use accrual accounting. Some BMTs admitted that they use cash accounting for revenue but apply accrual accounting for expenses.

When respondents are asked "how often do you print your financial report?" Most BMTs claimed they print and analyze their income statement and balance sheet on monthly basis (53%); even 14% of respondents claimed that they print their financial reports every day. They are able to do that as they have integrated accounting software installed in their operations. Thus to derive financial reports from the system on a daily basis is not difficult.

Chart 2. The Frequency of BMT's Financial Report



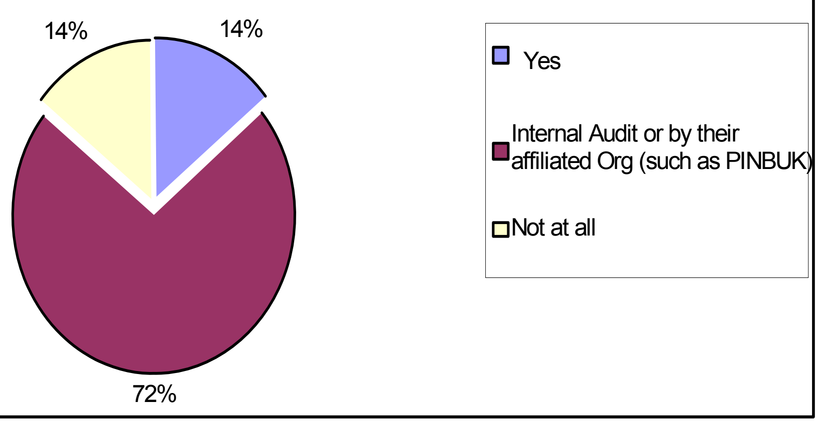
6.2. Most BMTs are not Audited by Independent Auditor

Financial audit by independent and professional auditors can provide a high level of assurance through enhanced credibility and accountability. Auditors also have limited obligation to detect frauds and other illegal acts (Gill, et al, 2001). However, from 101 respondents, only 14 BMTs admitted that they ask independent auditors to audit their operations and financial report. Interestingly, some BMTs who are audited are not BMTs who are required to be audited by independent auditors. Based on the regulation of Ministry of SME and cooperatives, only BMTs with assets more than IDR 1 billion are required to be audited by independent auditors (Article 35 of UU NO.91/Kep/M.KUKM/IX/2004). From those 14, only 9 BMTs have assets more than IDR 1 billion, thus required by the law, the other 5 BMTs actually are not required.

There are 23 BMTs among the respondents with assets more than IDR 1 billion; however only 9 of them claimed that they were audited by independent auditors. This data processed by using statistical estimation technique about one sample proportion, gives an estimation of between 7-20% of BMTs audited by independent auditor with 95% confidence level. That number is very low and again imposes a prudential risk for BMT members and depositors.

Nevertheless, it is important to note that almost all BMTs claimed they are audited, to some extent by their development agencies (PINBUK, Dompet Dhuafa or Local Representative of Minstry of SME and Cooperatives). However, knowing the fact that the main business of PINBUK and Dompet Dhuafa is not auditing, the level of audit that they perform is somewhat questionable. Officials in PINBUK central office admitted that they do not have manpower to conduct a proper audit of their 3000 members.

Chart 3. BMT Audited by Independent Auditor

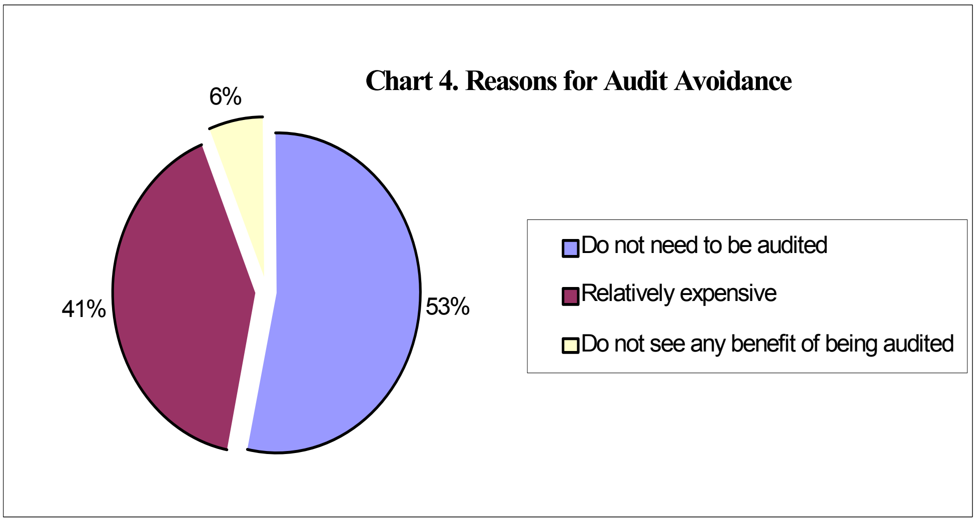


Three BMTs who have internal audit process claimed that they plan to be audited by independent auditors very soon. One of them said that they will be audited in year 2006.

6.3. The Reasons for Independent Audit Avoidance

As discussed before, only 14 out of 101 BMT respondents have their financial statements audited by independent auditor. The main reason for other BMT who are not audited because they do not need audited financial statements. 53% claimed that they do not need to be audited mostly because their members or AGM do not require audited financial statements. 41% claimed that the cost for audit is relatively expensive and only 4% answered they do not see the benefit of being audited.

Many BMT managers I interviewed gave the reason that they did not need an audit by independent auditor because their asset base was still relatively small. The Director of BMT Beringharjo with assets about IDR 12 billion admitted that the main reason that her BMT was not being audited was because it was relative expensive. She admitted that the auditor asked for IDR 12 million for audit fee, or 1% of the total asset.



Some managers admitted that they feel they do not need an independent proper audit because they see many other BMTs are not being audited either. If many BMTs with assets of more that IDR 1 billion can get away without being audited, why would smaller BMTs have to spend money to pay an independent auditor? They closely benchmark themselves with big BMTs. Thus if big BMTs start to hire independent auditors it would attract other BMTs to do the same.

7. CONCLUSION AND RECOMMENDATIONS

The development of Islamic Saving and Loan Cooperatives or BMT in Indonesia has been exceptional. However, the rapid development of BMTs, is not followed by the development of reporting regulations and accounting standards. Currently there is no accounting standards specially made for BMTs.

However despite the absence of accounting standards for BMTs, from the survey, it is revealed that more than 50% BMTs print their balance sheets and income statements on monthly basis. 14% even claimed that they print their financial statements on a daily basis.

BMTs have three parties who can become their demand source for accountability - BMTs members, monitoring agencies such as PINBUK and Ministry of Cooperatives and SME. However, due to the low enforcement from these parties, BMT managers are not encouraged to have their financial statements audited by independent auditors. They need more incentives to pay independent auditors to run financial audit.

The numbers of BMTs who are audited by independent auditors is very low. Only 14 BMTs from 101 respondents are audited by independent auditors, while 72% claimed that have internal audit processes or being audited by their monitoring agency or Ministry of cooperatives and SME, and the other 14% admitted that they do not run any audit process at all.

The main reason for independent audit avoidance is the absence of audit necessity. 53% BMT managers feel that they do not need an independent audit. The other 41% feel that the cost for an audit would relatively be expensive.

Lack of supervision and regulations create prudential dangers to BMT depositors and members. As the role of BMTs in developing microfinance industry is increasing rapidly, Indonesian Government needs bring in appropriate regulations a and national supervisory agency for BMTs. Government also needs to create more incentives for BMT managers to improve their accountability to their members and society.

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THE ROLE OF INDONESIAN GOVERNMENT IN ENHANCING ISLAMIC FINANCING FOR SMALL AND MEDIUM ENTERPRISES (SMEs)

DODIK SISWANTORO

ABSTRACT

Small and Medium Enterprises (SMEs) proved to be more resilient during the economic adversity that hit Indonesia in late 1997 in comparison with big companies that were largely tied to foreign debts and imported materials. Because of its proven resilience and if developed well, SMEs have the potential to bring in better economic landscape of Indonesia. The sustainability of their existence in many ways depends on many value chains in the business environment. One of them is strong financial institutions or banks. In Indonesia, Islamic banking has been viewed as a new and promising alternative for financing SMEs. This paper aims to analyze and discuss the government's intervention strategies and efforts to support such financing.

1. INTRODUCTION

Small and Medium Enterprises (SMEs) have played a vital role in promoting economic development for people belonging to lower strata of the Indonesian society. A study by Berry et. al (2001) suggests that SMEs have a significant role in manufacturing sector in Indonesia. This is because this sector is labor-intensive and a large workforce is available in Indonesia. In addition to that, SMEs are relatively more stable in facing monetary crisis because of their labor-oriented structure. Weyerhaeuser et. al (2006) highlighted that it needs collective actions and strong efforts to create effective SMEs. Some commonly identified weaknesses of SMEs include poor bookkeeping system, limited access to finance and inadequate managerial knowhow and skills. Studies by World Bank (2005) in Indonesia highlight the following constraints to the development of SMEs: (a) too much regulations (b) poor financing (c) tax burden (d) quality of labour (e) poor education (f) inconducive policies and (g) less opportunities. Therefore, the government must be able to solve those problems in order to develop SMEs. Similarly, Timberg (2000) and Beyene (2004) identified that rules and collateral can be the biggest problem areas for SMEs, especially when minimum requirement of capital cannot be reached by SMEs. Financing can be a challenge for banks to deliver loans to SMEs as it may not fulfill minimum requirements (Winter, 1995). Furthermore, Klapper et. al (2002) suggested that there must be supporting financing for long term financing for SMEs. Others flexible financings must be available for SMEs to be resistant to fluctuating economic conditions. Monopoly companies added to the constraints SMEs to grow and compete fairly (Rodriguez et. al, 2002). They indentified 3 main constraints for SMEs, i.e., (a) constraints in policy and regulatory framework (b) contstraints in managerial capacity and (c) constraints in access to financial markets. It needs comprehensive technical assistance to create good SMEs.

Biggs & Shah (2006) studied that good governance in private sector can support the development of SMEs significantly in Sub-Saharan Africa. In other case, Itoh & Urata (1994) identified that SMEs are supported by private and public sectors through private channels and supporting financing. Thus, it resulted in conducive environment for SMEs to operate well. Mira & Gracia (2003) identified that SMEs have a comfort level for their leverage and amount of financing that needed. Therefore, it may not be useful for SMEs to have a high degree of leverage. Similarly, Mira (2003) stated that capital structure of SMEs is affected by some factors such as debt, tax and asset. Furthermore, Danset (1998) stated that SMEs have comparative advantages for efficient capital, employee and product transformation but not for staff cost and working capital from large enterprises. In addition, SMEs must have a good relationship with banks in order to address financing constraints.

Some people view that Indonesia is already equipped with conducive and strong rules and regulations, yet they are not enforced as they have to be (Prananingtyas, 2001). However, there have been some efforts made to address issues faced by SMEs. These include socialization and education on SME products (Philips, 2006).

Wijono (2005) stated that the government must support Micro Financing Institutions which have a positive correlation with the development of SMEs. This is because MFIs can better understand the characterictics of SMEs. Islamic financing scheme for SMEs can be delivered optimally by Islamic banks (Ashari & Saptana, 2005). This paper tries to evaluate the role of the government of Indonesia in the development of Islamic financing for SMEs. Actually, the government has set supporting rules and regulations to develop SMEs. The problems may occur in the implementation, small number of supporting Islamic financing institutions and inconducive environment and system.

2. SOME FACTS ABOUT SMEs IN INDONESIA

SMEs are defined differently across regions and coutries. In America, SME is a firm that employs less than 500 people, in Europe less 250 people (Prananingtyas, 2001). According to Presidential Decree No. 10/1999,

A small enterprise is defined as,

> Economic activity which has net asset less than Rp 200 millions, excluding land and building or revenue less than Rp 1 billion and is owned by an Indonesian.

A medium enterprise is defined as,

- having net assets of more than Rp 200 million-Rp 10 billions, excluding land and building
- is owned by an Indonesian
- is independent and us not a subsidiary or branch which is affiliated directly or indirectly to big enterprise
- has proprietary status or under law or otherwise

As stated before, problems may exist in SMEs even though the government has facilitated supporting rules and policies - especially for Islamic financing which is unfamiliar to some SMEs. In addition, the number of SMEs is very big which can cause administrative and monitoring problems.

In Indonesia, there is a Ministry of Cooperatives and Small Medium Enterprises whose main job is to supervise and to support the development of cooperatives and small medium enterprises (SMEs). Historically, the development and progress of SMEs in Indonesia including cooperatives is quite interesting. These phases include:

2.1. Before Independence Period

The term “SMEs” has become popular since 1999. Before that, the closest reference to SMEs was “cooperartives”. In Indonesia, cooperative ideas were introduced for the first time by Patih R. Aria Wiriatmadja at Purwokerto, Central Java in 1896. He founded a bank for government official staffs. In 1927, Islamic Trader Union (Serikat Dagang Islam) was founded to develop bargaining power among indigenous entrepreneur. In 1929, Indonesian National Party (Partai Nasional Indonesia) was founded which had activities in promoting cooperative spirit. Up to now, government still cares about Cooperatives existence by founding the institution which specifically deals with empowering and developing Cooperative.

2.2. After Independence Period

Year	Activities
1945	Establishment of Cooperatives Bureau and Domestic Trade under The Ministry of Wealth
1946	Provision of autonomy to Cooperatives Bureau to manage Cooperatives affairs.
1949	Bureau of Cooperatives Center United of Indonesia Republic (Republik Indonesia Serikat) set up in Yogyakarta, its duty was performing contacts with Cooperatives Bureau in some other districts.
1950	Cooperatives Bureau Union of Indonesia in Yogyakarta merged with Cooperatives Bureau United of Indonesia Republic in Jakarta
1958	Cooperatives Bureau became part of Ministry of Wealth
1960	Cooperatives affair managed by Minister of Transmigration of Cooperatives and Rural Society Development
1963	TRANSKOPEMADA altered to Cooperatives department and still under Minister's control
1964	Cooperatives Department changed into Transmigration and Cooperatives Department

Source: www.depkop.go.id

In the transition period, cooperative affairs were under different departments, which eventually narrowed down to one independent department.

2.3. In 1966-2004 Period

Year	Activities
1966	Cooperatives Department became self supporting again, changed to become Trading and Cooperatives Ministry
1967	Cooperatives became part of Domestic Affair Department with directorate general status
1968	Directorate General of Cooperatives separated from Domestic Affair Department, then merged with Transmigration and Cooperatives Department
1974	Directorate General Cooperatives joined with Department of Labour
1978	Directorate General Cooperatives joined with Department of Commerce and Cooperatives
12.1.1 1983	Directorate General Cooperatives specified to become Cooperatives Department, through Presidential Decision No.20 Year 1983, date of 23 April 1983
1991	Changed the procedures of organizational formation
1993	Name of Cooperatives Department changed to Cooperatives and Small Entrepreneur Construction Department
1996	Directorate General Urban Cooperatives Construction, Directorate General Rural Cooperatives Construction, Directorate General Small Entrepreneur Construction put under Cooperatives and Small Entrepreneur Department
1998	Strengthening the Cooperatives and small entrepreneurs in entering free trade areas and globalization era which addressed many challenges
1999	Cooperatives Department and Small Enterprises changed into State Ministry of Cooperatives and Small Medium Enterprises
2000	It formed the Council of Cooperatives and Small Medium Entrepreneur Resources Development
2001	State's Minister of Cooperatives and Small Medium Enterprises specified directly by State Ministry Secretariat (Setmeneg)

Source: www.depkop.go.id

3. THE ROLE OF COOPERATIVES AND SMES IN ECONOMIC DEVELOPMENT

SMEs contributed almost 55.77% from GDP in the period 2001-2003 on average. Specifically, it increased from 54.51% in 2000 to 56.72% in 2003 and provided 43.8% from national products and services, while big enterprises only provided 42.1% and the rest were 14.1%, were imported. This showed that SMEs have given a big contribution to Indonesian economy. If the government can create conducive environment to support the growth and development of SMEs, it will be a significant contribution to Indonesian economy in the future. In addition, the Indonesian economic growth in 2003 was 4.1%, the 2.37% growth was contributed by SMEs (www.depkop.go.id). Similar facts occurred in Latin America where SMEs have significant roles in the country's economic development (Berry, 2002). Similar idea was proposed by Beyene (2004) and Beck at. al (2003) who stated that SMEs can minimize poverty and reduce unemployment level. Whilst, Ho (2006) argued that SMEs were more succesfull in market economy than planned economy; this occurred in Cambodia.

Table 1. GDP Structure Based on Scale of Business in 2000-2003

Field	Average 2000-2003			
	SE	**ME**	**BE**	**Structure**
Agriculture, cattle, forestry and fisheries	85,74	9,09	5,17	16,89
Mining	6,73	2,96	90,30	12,20
Manufacture	15,14	12,98	71,89	25,10
Electricity, gas and water	0,52	6,80	92,68	1,73
Building	43,88	22,57	33,55	5,93
Trading, hotel and restaurant	75,60	20,81	3,59	16,15
Transportation and communication	36,69	26,64	36,67	5,50
Finance, rental and service	16,80	46,47	36,73	6,64
Service	35,59	7,16	57,25	9,86
GDP	**40,55**	**15,22**	44,24	100,00
GDP non-oil	**46,22**	**17,19**	36,60	87,74

Note: SE= small enterprises, ME= medium enterprises, BE= big enterprises
Source: www.depkop.go.id

SMEs are at times considered as having a weak influence on the economy. inherent factors. The fact say otherwise. Indeed SMEs have a significant contribution to Indonesian economics (Prananingtyas, 2001)

Each enterprise has its own comparative advantages. In this case small enterprises are reliable in natural and capital resources focuses, middle enterprises in value added focuses. In comparison, big enterprises are reliable in manufacturing, electricity, gas, communication and mining. However, these three types of enterprises should support in the practice. In fact, enterprises also sometimes took other enterprises field which can cause unfair competitive. Furthermore, Aidis (2002) analyzed that gender factor may influence the characterictics of SMEs, especially for size and revenue. So, it can be mapped the strategy of SMEs based on gender in one country.

In general, Micro and small's contribution in GDP increased before monetary crisis and in 2003 while medium enterprises decreased and enterprise increased insifgnicantly. Micro and small enterprises recover quickly compared to other enterprises type. In general, micro and small enterprises mainly contributed to Indonesia's GDP before and after monetary crisis consistently. Compared to Thailand, SMEs were difficult to recover their NPLs after monetary crisis. So, the government had to inject capital to solve the problems and restructure SMEs' loans (Chaipravat & Hoontrakul, 2000).

Table 2. Comparation on Enterprises Type Based on GDP and Constant Price 1993 (Rp billions)

No	Type	1997	2003	Change
1	Micro and small	171,048 (40.45)	183,125 (41.11)	7.06%
2	Medium	78,524 (17.41)	75,975 (15.61)	-3.25%
3	Big	183,673 (42.17)	185,352 (43.28)	.91+
	GDP	433,245 (100)	444,453 (100)	2.59%

Source: www.depkop.go.id

In fact, SMEs absorbed human resources almost 99.45% in Indonesia, and the trend will remain in the future, making this as a reliable sector. During the period 2000-2003, micro and small enterprises created 7.4 millions new employment, while medium enterprises was 1.2 millions. On the other hand, big enterprises only created 55,760 new employment in the same period. This indicates that SME's is a stabilisator in Indonesian economy.

Table 3. Labor's Growth by Enterprise Type (2000 and 2003)

No	Type	1997	2003	Change
1	Micro and small	62,856,765 (88.79)	70,282,178 (88.43)	7,425,413 (11.81%)
2	Medium	7,550,674 (10.67)	8.754.615 (11.02)	1.203.941 (15.94%)
3	Big	382,438 (0.54)	438.198 (0.55)	55,760 (14.58%)
	Total	70,789,877 (100)	79,474,991 (100)	8,685,114 (12.27%)

Source: www.depkop.go.id

On the other hand, micro and small enterprises showed the lowest investment market (18.58%), followed by middle enterprises (23.05%) and big enterprises (58.37%). While for investment per unit was Rp 1.4 million per year for small enterprises, Rp 1.29 billion for medium enterprises, and 91.42 billions for large enterprises. This indicates that SMEs, particulary micro and small enterprises have limitation for capital support which can cause limited development and lower productivity.

The growth itself for micro and small enterprises was only 4.98% lower than medium enterprises. Therefore, the Indonesian government must support the development and growth of SMEs.

Table 4. Investment Criteria and Performance (2000-2003)

Type	Investment (Rp billions)	Market (%)	Investment per Unit (Rp million)	Growth
Micro and small	58,884	18.58	1.5	4.98
Medium	73,191	23.05	1,290.6	6.12
Big	185,043	58.37	91,424.2	4.64
Total	317,118	100.00	7.9	5.56

Source: www.depkop.go.id

4. REGULATORY STRUCTURE FOR FOR SMEs

Some regulations have been issued by Indonesian government to support and develop SMEs in Indonesia. These regulations include:

a. Act No. 9/1995 about small enterprises
b. Presidential Decree No. 56/2002 concerning SMEs loan restructurization
c. Governmental Regulation No. 32/1998 concerning the development of SMEs
d. Governmental Regulation No. 44/1997 concerning partnership
e. Presidential Decree No. 127/2001 about SMEs' reserves with partnership requirements

Those regulations support the development of SMEs; however, SMEs need other institutions in order to be able to grow and to compete with big enterprises. Otherwise, they will always be left behind and cannot be a significant and reliable institution in Indonesia. Other main regulations and some facts that support SMEs are (Herwidayatmo, 2002):

a. Politically through People Council Representative Decree No. XVI/MPR/1998 stated that SMEs are pillars of national economic development in the future.
b. The Out Line of State Direction (GBHN) 1999 stated SMEs as a national economic development pogram.
c. SMEs have lower risk and healthier financial performance compared to big enterprises based on Economic and Monetary Directorate Bank Indonesia in 2002.
d. Act No. 8/1995 on capital market which can be a source of capital and investment for SMEs. There is a big potential capital for SMEs to raise funds from capital market.

5. INSTITUTIONAL INFRASTRUCTURE FOR SMEs

5.1. Ministry of Cooperatives and Small and Medium Enterprises

Duties and function of Ministry of Cooperatives and Small and Medium Enterprises are stated in Government Regulation No. 09/2005 about position, duty, function, organizational structure and authorization of the Ministry of the Republic of Indonesia, article 94 and 95: to assist the President in formulating any policies and coordinating on the field of Cooperative and Small and Medium Enterprises.

Ministry of Cooperatives and SMEs should put serious efforts to overcome financing problems that are always faced by cooperatives and SMEs in Indonesia. Therefore, there should be strategic planning to see a clear path in the medium term. Those programs for 2005-2009:

1. To create 100 advanced and 2000 medium saving cooperatives through management and technology development
2. To strengthen capital for 10,000 saving cooperatives through lingkages through banking and non-banking financing and utilizes secondary cooperative network
3. To empower 1,000 Islamic financial service cooperatives with administered regulation and supervision which is in line with Islamic teaching
4. To transform 10,000 non-formal micro financing institutions to legal institutions
5. To facilitate 10 Regional Loans Guarantee Institution for SMEs in advanced provinces economically referring to related regulations

In spite of that, cooperative operates using profit sharing which is in line with Islamic teachings. It still needs to equip them about the concept and contract of Islamic financing. This is because to avoid problems and conflicts that may occur in the transaction. In addition, other alternative financing programs which were proposed by Department of Cooperatives and SMEs are:

1. To provide regular funds to strengthen SMEs capital through banking (including regional bank) or saving cooperatives;
2. To provide regular funds through profit sharing to strengthen SMEs capital through Islamic banks such as Bank Muamalat Indonesia and Bank Syariah Mandiri;
3. To facilitate loans for export oriented SMEs by cooperating with Bank Ekspor Indonesia;
4. To facilitate non-credit loans such as via mortgages, factoring, capital market and pension funds; and
5. To facilitate “start up loans” with venture capital to set up new business, especially for technology and market basis, in cooperation with PT Bahana Artha Ventura.

The number of Islamic financing to SMEs through Islamic banks depends on the number of Islamic banks itself in Indonesia. So far, the percentage of assets of Islamic banks is only 2% of total assets of all banks in Indonesia.

5.2. Islamic Banks, Rural Banks and Bank Indonesia

Timberg (2006) stated that as Islamic financial institutions were relatively small. It is quite difficult to have big ones without strong commitments from government and effective strategy. He implied that,

> Islamic banking should be mainstreamed by maximizing the interaction between Islamic institutions and the rest of the financial system, subject to the constraints of Shariah. The financial system and its regulation should be adjusted as necessary to accommodate the other two thrusts.

However, the potency of SMEs is very big. Based on *Danamon Simpan Pinjam*'s research in November 2003 there was only 36% from 94% that were willing to borrow loans from banks (Rica, 2005).

In 2006, Ministry of Cooperatives and SMEs delivered Rp 76 billions for 860 Islamic micro financing projects. So far, the return has been high compared to the conventional system. Previously, 476 established Islamic micro financing institutions borrowed Rp 58 billions (Media Indonesia, 3 May 2006). In addition, some Islamic banks have strong commitment not to deliver their loans to big enterprises (Ashari & Saptana, 2005).

5.3. State Owned Enterprises (SOE)

In the past, state owned enterprises could deliver loans directly to SMEs. To be efficient and controllable, they deliver such loans through banks. However, this can be collateral-based if loans were non-performing.

State Owned Enterprises must create allowance for SME financing as amount 1-1.5% from their net income such as Pertamina (oil company). Based on the policies of ministry of State owned enterprises No.236/MBU/2003, there is a partnership program for SMEs which is under SOE. There were many successful SMEs in this program (www.ummigroup.co.id).

5.4. Permodalan Nasional Madani (PNM)

As a financing institution and agency for SMEs empowerment, PNM provides three main services:

- Credit program

- Micro financing
- Islamic institutional and non-financial assistance.

PNM is owned by the government of Indonesia under government regulation No. 38/1999. In providing its services to Micro Finance and Islamic Institutions, PNM is in charge of fostering, empowering, capital sharing and financing activities to strengthen the capital structure of the institutions. This is carried out in cooperation with other institutions, such as Islamic general banks, Micro Finance Institutions, Islamic Rural Banks (BPRS), Credit Cooperative and other Micro Financing Institutions. PNM's Islamic/Micro Financial Institutions aims to empower micro, small and medium enterprises and co-operatives through strengthening and development of alternative institutions such as Syariah Commercial Banks, Syariah Rural Banks and Co-operatives based on syariah principles. Financing made available to customers may take the form of equity participation, financing and restricted investment. So far, PNM has delivered more than Rp 4 trillions to SMEs directly and indirectly (Tempo, 2004).

5.5. *Zakāt* Institutions

Adnan (2003) stated that if *Zakāt* funds can deliver to SMEs, it can create significant effect on macroeconomics in Indonesia and reduce unemployment level. The amount delivered to SMEs from *Zakāt* is around 3%-38% from total *Zakāt* fund distributed to deserved people. Eventhough, the amount is still small but, the monitoring system and control is very good. The debtor is also educated and equipped with management system. So, it will be strict in the monitoring and control.

Table 5. *Zakāt* Institution in SMEs's Distribution (Rp billions) in 2004-2005

	PKPU	**Rumah *Zakāt***	**Dompet Dhuafa**
Funds delivered to SMEs	.4	1.7	5.2
Total Fund delivered	9.0	49.1	13.8
%	4	3	38

Source: www.dompetdhuafa.or.id, www.pkpu.or.od, www.rumah*Zakāt*.org

It is permitted to deliver *Zakāt* fund to SMEs based on *Zakāt* act No. 38/1999 which allows on the basis of productive sectors (ruled in regulation of ministry of religious affairs No. 581/1999). So, it caused the poor and needy to work harder and survive in difficult conditions. In addition, the fund can increase and benefit other people.

6. CONCLUSION

From the above description and brief analysis, it may be concluded that the number of Islamic financial institutions is not so big in Indonesia. As a logical consequence, the amount of Islamic financing disbursed cannot exceed the capacity of those institutions. The role of government of Indonesia in enhancing the Islamic financing for SMEs through (a) Ministry of Cooperative and SMEs (b) Islamic banks, Islamic rural banks and Bank Indonesia (c) State Owned Company (d) PNM (e) *Zakāt* institutions and (f) National budget, has been quite effective. However, the growth and development of Islamic financing still depends on the SMEs themselves to compete with other enterprises. So far, the disbursement of Islamic financing in on proportional and periodic basis. The control and monitoring system for SMEs's loans may be so strict in order to minimize non-performing funds (NPF).

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