Islamic Business Contracts and Microfinance

A case of Mudaraba

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"O ye who believe! When you deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing" and "Let a scribe write down faithfully as between the parties" (Al-Quran 2:282)

Microfinance is defined to be "providing small loans to the poor people who are traditionally excluded from financial system. Microfinance is a powerful tool to fight poverty. Microfinance means building financial systems that serve the poor and helps them raise income, build their assets, and cushion themselves against external shocks. Microfinance will reach its full potential only if it is integrated into a country's mainstream financial system. According a CGAP survey almost 72% of people in Muslim countries do not use the formal financial services because financial system is interest based which is prohibited in Islam (Karim, Tarazi and Reille, 2008)[2]

Islamic world is enormous with approximately 1.2 billion people across different countries. Poverty is rampant and widespread across Islamic world. Access to finance is very low based on their religious beliefs. This is a huge population under poverty and needs immediate and significant consideration to achieve the goal of making poverty history by 2015 as pledged in Millennium development goals.

These poor Muslim micro entrepreneurs need and demand access to financial services which do not compromise their religious beliefs of interest prohibition. Their demand can be met by designing financial products which are compatible with norms of Islamic finance which are based on prohibition of interest, avoidance from Gharar, Halal or permissible use of funds and non exploitation.

Islamic alternative to interest-based conventional loan is partnership based, trade based or lease-based credit that permits the ownership and/or use of commodities or physical assets needed for productive enterprise. Partnership based modes work on profit and

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[2] Islamic microfinance: an emerging market niche CGAP FN. No 49

loss sharing and there exists a mutual agreement between financier and micro entrepreneur for a specific business. Combination of business contracts in this category includes Mudaraba, Musharka and diminishing Musharka. Our current write up is focused only on Mudaraba.

What is Mudaraba

Mudaraba is an Arabic word which means a business (project) in which capital is provided by one party (a company or individual) while effort and skill are contributed by the other party (beneficiary, entrepreneur or borrower). "*Mudaraba*" is a kind of partnership where one partner provides financial capital or (Capital) to the other for investing it in a commercial enterprise. Owner of financial capital is called "*rabb-ul-mal*", and partner with entrepreneurial skills is called "Mudarib". Work and management is the sole responsibility of Mudarib and "Rabb-ul-Mal" or capital owner is sleeping partner. Capital owner has a choice to impose a restriction on "Mudarib" about the nature of business for investment. If he imposes a restriction on "Mudarib" this will be called as "Restricted Mudaraba" otherwise it will be "Unrestricted Mudaraba". Capital owner can engage more than one person as "Mudarib" but for the sake of simplicity we will consider the two parties "Mudaraba".

Distribution of profit in Mudaraba

It is necessary for the validity of Mudaraba that profit sharing ratio is agreed between the parties; right at the beginning of the contract Profit sharing has to be in proportionate terms and a "Lump sum" amount cannot be allocated either to capital owner (Rabb-ul-Mal) or to the Mudarib. Profit Sharing ratios may take many variations under different situation. Share in expected profit is the reward for both parties. "Mudarib" can claim any compensation as salary for the work he has done. However he can claim logical business expenses on actual basis subject to certain conditions. If the Mudarib has undertaken more than one business initiatives and has incurred loss in some transactions and has gained profit in some others, the profit shall be used to offset the loss at the first instance, and then the remainder, if any, shall be distributed between the parties according to the agreed ratio. In case of overall Loss Capital owner will lose his capital and "Mudarib" will lose his potential reward from profit. Neither party can claim financial compensation in case of Loss.

Termination of Mudaraba

The contract of Mudaraba can be terminated at any time by either of the two parties. The only condition is to give a notice to the other party. However to avoid adverse effects for both parties they can specify the conditions which may lead to termination of Mudaraba while entering into the contract.

A Mudaraba Model of Microfinance

Under a Mudaraba contract the bank provides the capital needed for a micro enterprise while the micro entrepreneur offers labor and expertise. The profits (or losses) from such financing are shared between the bank and the entrepreneur at a fixed ratio. Financial losses are assumed entirely by the microfinance program; the liability of micro entrepreneurs is limited to their time and effort. The contract between the Microfinance program and the entrepreneur is known as restricted Mudaraba because the Microfinance program agrees to finance specific business activities by micro entrepreneurs and to share relative profits according to an agreed percentage. To engage in Mudaraba transactions a bank must meet the following legal obligations:

- Details of the parties to the contract, description of the objects, nature of business to be undertaken, Period of contract and all other relevant details including any limitations and restrictions should be clearly documented. Contracting partners should ensure that the terms and conditions of contracts are clear, concise and unambiguous, and are not intentionally misleading in any way which would confuse an investment account holder or result in his entering into a relationship the impact of which he does not appreciate

- ❖ Microfinance program should bear the entire financial risk and should not demand collateral to reduce it.
- ❖ Profit-sharing ratios must be determined and agreed before execution of Mudaraba. These sharing ratios can only be a percentage of the profit. Fixing a lump sum amount is not allowed.
- ❖ It is right of the micro entrepreneur to have full control over the business management while effective supervision is right of Microfinance Program.

Assumptions of the Model

1. Since Muslims participating in Islamic Microfinance programs are devote Muslims and they do not indulge in cheating, deceit fraud and other malicious activities. They refrain away from Riba as well all other acts which can spoil their Halal earnings. They always keep in mind the sayings of Holy Prophet (P.B.U.H) that

"Whoever bears arms against us is not one of us, and whoever cheats us is not one of us." (*Saheeh Muslim*)

2. It is assumed that business activity being financed by Mudaraba gives a fixed profit per month. This is not an oversimplified assumption we may certain business which give fixed profit over a certain period of time e.g. an ice cream vendor who sells branded ice creams will get almost fixed profits due to the price tags on the products. Being a famous brand everybody knows the price. In this case profits are relatively easy to calculate.

3. Loan officers of Islamic Microfinance programs are competent and trained enough to carefully select the product type and successfully execute it.

A person approaches the Islamic Microfinance program with his request of financing. A loan officer from the program will check the qualifying criterion and if qualified will ask about his/her business activities. By interviewing client Loan officer assesses the suitable product. If the business nature of the customer is such that it is possible to calculate the profits easily he will adopt Mudaraba as the right product to be offered to client. We suppose that prospective "Mudarib" is a grocery store owner and he wants to add a cold dink corner to his existing business where he will be selling cold drinks of a famous brand like "Coca Cola or Pepsi". Since being the famous brand sale and purchase prices are known and profits can be calculated. It is assumed that prices and profits margins do not change over the span of Mudaraba so that assumption of fixed profit remains true.

Famous cold drink brands provide sellers with deep freezer to chill their products free of cost and electricity charges are to be paid by seller. It is assumed that prospective "Mudarib" is able to calculate the electricity cost of the deep freezer. Such an understanding of cost is necessary as he will not be selling cold drinks alone but a variety of other items as well.

Upon getting all the necessary details and successful completion of required verifications Islamic Microfinance program approves his application and enters into Mudaraba agreement with him on following terms and conditions.

i. Contribution of Islamic Microfinance program will be Rs, 10,000 and the "Mudarib" will contribute by his labor.
ii. Profit sharing ratio is 20:80 i.e. Share of Islamic Microfinance Program will be 20% while that of Micro enterprise or Mudarib is 80%.
iii. Tenure of Mudaraba will be one year.
iv. As Microfinance program cannot remain partner for indefinite period. For successful completion of Mudaraba "Mudarib" or micro enterprise will purchase the capital invested by the Microfinance program over the period of Mudaraba.

For the sake of simplicity it is assumed that Invested capital is divided into 12 equal shares and "Mudarib" will buy one (01) share on monthly basis. Profits will also be shared on Monthly basis. In this case "Mudarib" will buy a share worth Rs.833.33 on Monthly basis or 8.33% of total share.

Now the amount disbursed to the Mudarib for onward investment in Cold drinks business. According to our assumption of fixed profit micro enterprise earns a profit of Rs. 2000 till the end of 1st month. During the 1st Month Microfinance program was 100% owner of capital so it will receive Rs. 400 as profit share while the profit share of micro enterprise or "Mudarib" will be Rs. 1400. As per agreement micro enterprise will bur a share from invested capital worth Rs. 833.33/. Total payment by the "Mudarib" to the program will be

Profit Share of Microfinance program + Price of one Share from capital= Total Monthly Payment

Rs.400 (20% of 2000) + 833.33 (price of share) = Rs. 1233.33

The second month will start in a way that Microfinance program has sold one share from its total ownership of capital. Now Microfinance programs own 91.67% of the total capital and will be entitled to profit share according to its capital ownership. Share of capital sold to the "Mudarib" belongs to him and he has right over 100% of the profit generated by this unit or share. Now suppose that micro enterprise earns a profit of Rs.2000 during second month as well. 91.67% of total profit or Rs. 1833.4 will be shared according to profit sharing ratio. Total payment by Mudarib at the end of 2nd month will be

Profit Share of Microfinance program + Price of one Share from capital= Total Monthly Payment

Rs. 366.68 (20% 1833.4) + Rs. 833.33 (Price of share) = 1200

We can note that "Mudarib" or micro enterprise has to make a payment less than what he paid at the end of 1st month.

Now the 3rd month will start in a way that share of Microfinance program has reduced further. At the start of 3rd month Microfinance program owns 83.33% and its profit share will be less accordingly. Micro enterprise will have to make even lesser payment at the end of 3rd month. Similarly ownership and profit share of micro enterprise will rise in subsequent month while for Microfinance program both will recede over time. At the end of 12th month equity share of Microfinance program will be zero and Mudaraba will conclude. We can summarize a sample repayment schedule in a tabulated manner for better understanding.

Month (A)	Capital ownership of MFP at start Month (B)	Capital ownership of "Mudarib" (C)	%age of profit to be shared (D)	Total Profit (E)	Share of MFP (20%) (F) =D*20%(E)	Price of Share (G)	Total Payment (H)
1	100%	0%	100%	2000	400	833.33	1233.33
2	91.67%	8.33%	91.67%	2000	366.68	833.33	1200.01
3	83.33%	16.66%	83.33%	2000	333.36	833.33	1166.65
4	75.01%	24.99%	75.01%	2000	300.04	833.33	1133.37
5	66.68%	33.32%	66.68%	2000	266.72	833.33	1100.05
6	58.35%	41.65%	58.35%	2000	233.4	833.33	1066.73
7	50.02%	49.98%	50.02%	2000	200.08	833.33	1033.41
8	41.69%	58.31%	41.69%	2000	166.76	833.33	1000.09

9	33.36%	66.64%	33.36%	2000	133.44	833.33	966.77
10	25.03%	74.97%	25.03%	2000	100.12	833.33	933.45
11	16.7%	83.30%	16.7%	2000	66.8	833.33	900.13
12	8.37%	91.63%	8.37%	2000	33.48	833.37	866.81
13	0%	100%	0%	2000	0	0	0
Total						10,000	12600

Note: Row No.13 is for illustration purpose only

Compared to conventional microfinance programs which adopt an easy methodology of repayments in equal monthly installments this is rather complex to understand and manage. Such a program has many built in challenges which can be summarized as follows.

Challenges for the Model

Since Islamic Microfinance is a new phenomenon and like every other program has its own challenges. Every challenge needs to be considered and explored in order to find a way out.

- ***Monitoring of Loan***

Monitoring of a loan is important for each microfinance institution (MFI). Loan monitoring is very important for effective loan utilization and for timely repayments. Higher repayment rates drives profitability and enables MFI's to become price competitive profitability of MFI's. Higher repayment rates provide MFI's an opportunity for expansion and outreach. Effective loan monitoring helps MFI's overcome the some of the challenges like asymmetric information, adverse selection and moral hazard. It also helps MFI's improve their delivery mechanism, remove bottlenecks and design new products and services.

Mudaraba is the riskiest of all the financial products, since the capital (fund) provider has no "real" control over the management, while fully responsible for any financial losses arising from the business. Under a Mudaraba arrangement profit is shared on the basis of pre determined ratios while financial loss is to be absorbed by the Islamic Microfinance institution only. Such a situation when financier has no direct control over financial capital may lead to agency problem. Agency problem exists when the borrower may not work sincerely thinking that he has nothing to lose financially in case of business failure. In our example he may not give proper time to his cold drinks business, does not maintain proper backup inventory and variety of other reasons. This will put Islamic MFI under difficult situation and his outstanding portfolio will be at risk which has further implications. Microfinance experience suggests that borrowers show good repayment behavior at the start of loan and tend to default on later stages. In our example risk arising out of agency problem will be maximum at the start of loan and it will decrease with every installment. With more shares "bought back" by the "Mudarib" his behavior will become more of principle rather than agent. Besides this there are other reasons which can play a role in risk management of a Mudaraba contract.

Firstly, Muslims opting for Shari'ah compatible products are supposed to be devout Muslims who believe in the eternal concept of life, in which honesty is reward able and dishonesty punishable. This is a non-material incentive for people to be honest. **Secondly**, all financial Institutions tend to have a long term relationship with their clients based on their repayment behavior in case of borrowers. For this purpose they offer incentives in repeat loan cycles like enhanced loan amounts etc and such incentives compel borrowers to keep their credit history clean. On the same grounds there is a financial incentive for entrepreneurs to be honest and behave in a way acceptable to Islamic MFI.

- **Moral Hazard**

Portfolio of the Islamic Microfinance Institution will be at risk due to asymmetric information because principle or capital provider has limited or imperfect information. On the contrary, borrower of the money i.e. agent has exact and full information. Thus this gives rise to the concept of moral hazard for the lending party i.e. Islamic MFI. Research in the field of Islamic finance has outlined few factors that can reduce agency problem for Profit and Loss sharing contracts. These are business skill, business reputation, business commitment, financial health of the project, length of the project.

- **Adverse Selection**

Islamic Microfinance is a new and emerging concept. When Islamic Microfinance Institutions are entering new market and launching their initiatives in new place. They do not have complete information and credit history of their new borrowers. They have to rely on the available information and interview techniques of their prospective borrowers. Loan monitoring becomes very important in such scenarios. By exercising due diligence and effective monitoring Islamic Microfinance Institutions can have a good start in terms of portfolio quality which is required for their survival.

- **Uncertainty of profits**

In our example we have assumed that profits will remain fixed over time. This looks like a very oversimplified situation. Even in a situation where it is possible to calculate profits on the basis of sales and purchase it will be much difficult to calculate exact profit. This is because sales always fluctuate depending on different circumstances. In this case where micro entrepreneur can be trained to obtain bills from his vendor and keep a track of daily sales on a simple format. Since the product is being purchased from a vendor of repute, risk of counterfeit bills or over invoicing is minimized.

Situation can be more difficult in situations where sales and purchase prices are unauthentic. However investing in authentic brand names may be a good starting point for Islamic Microfinance programs.

- **Uncertainty of payment amounts**

The second difficulty with this model is that borrower has to repay a different amount each period (and the loan officer has to collect a different amount each period). This makes it bit difficult compared with EMI arrangements. The margin for error is high in these situations. However this can be managed to some extent by rigorous training to loan officers. Once they have grasped the idea and the logic behind such calculation then it will get relatively easy. Loan officers usually have the ability to do mathematics and calculations. Under conventional Microfinance programs loan officers has to perform calculation in case of bullet loans.

It is often argued that Micro entrepreneurs do not keep accounts. This is partially true as they keep their accounts but in a very informal manner. They always maintain a record of their credit sales to the households, their sales and purchase. They always do calculate profits and returns of their investments. This shows that they have calculation skills and they need to be trained to change their way of book keeping in way that can serve the purpose of Microfinance program as well

Application of such a model may be less hectic and more straightforward in other forms of trade like livestock fattening where calculations will be easier.

Conclusion

Microenterprises has a role to play in economic development of poor countries. A World Bank study pointed out the advantages of microenterprises as increasing the aggregate output, enabling the efficient use of capital and labor, initiating indigenous enterprise and management skills, bringing a regional balance, and improving the distribution of income

Microenterprises can significantly generate economics activities, employment, and demand and can contribute significantly to the economic development. Access to financial resources is very important for economic development. Access to financial services remains low all over the Muslim world partly due to religious beliefs. This gave rise to the evolution of Islamic Banking to serve the Muslim population with violating their religious beliefs. This new industry got a very welcome response and has witnessed enormous growth since its inception. Although development of Islamic Finance has improved access to finance to some extent but Micro entrepreneurs mainly remain excluded from financial services. They lack collaterals and are unable to fulfill certain requirement to gain access to finance. Conventional microfinance played an important role in providing financial services to poor entrepreneurs on collateral free basis. Islamic Microfinance needs to be developed in the same manner to help Muslim micro entrepreneurs.

Islamic finance is need to seen in a very broader sense. It promotes risk sharing, entrepreneurship, materiality, and non exploitation. Islamic prohibits involving in activities which are harmful for the society as a whole. Islamic financial services have a good degree of compatibility with microfinance. If promoted and developed properly Islamic Microfinance can have a big impact on overall poverty and economic development of many countries.

Islamic law allows room for financial innovation, and several Islamic contractual arrangements can be combined to design new products. Islamic Microfinance is capable to adopt microfinance best practices without compromise on Shari'ah compliance. Islamic Microfinance needs patronage especially by Islamic financial institutions that have developed over time and it will bear fruits and will contribute significantly towards poverty reduction. This will be a significant step towards Millennium development goals.

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