Interest-Free Microcredit Program

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Interest-Free Microcredit Program

Introduction

Where there is poverty, there is microcredit. The majority of the population of Bangladesh are extreme poor people. Since the independence of Bangladesh in 1971, a large number of microcredit or microfinance organizations have been doing their business there with a very high rate of interest. Their clients are all extreme poor people who are not eligible to borrow money from any conventional bank. Their objective was not to alleviate poverty but to make profit. So the majority of the population of Bangladesh have been economically exploited by these organizations. After a long time of Micro credit operation in Bangladesh, the economic condition of the extreme poor people did not change at all. The main reason for this is the high rate of interest. Another reason is the absence of a proper guideline for using the borrowed money. These microfinance or microcredit organizations are earning huge profits every year. In Bangladesh, they have registered themselves as Non Government Organization (NGO) or Development Organization (DO), so that they do not have to pay any income tax. To mitigate the sufferings of the extreme poor people of Bangladesh and to assist them to get out of the vicious circle of poverty; an alternative system of micro credit program is required.

Applying Islamic economic principles in microfinance

An Islamic bank may be defined as a financial intermediary whose objectives and operations as well as principles and practices must conform to the principles of Islamic Law (Shariah); and, consequently, is conditioned to operate all its activities without interest (Alam, 2001). The aim of Islamic economics as observed by Ahmad (1984) and Molla et. al. (1988) is not only the elimination of interest-based transactions but also the establishment of a just and balanced social order free from all kinds of exploitation. An Islamic bank is not only a financier but also a partner in business. The system essentially

involves sharing of risk between the owner of capital and the entrepreneurs, as well as sharing the result of the collective efforts. Thus, it differs from an interest based system in which the risk is mainly borne by the entrepreneur or by the user of capital. In other way we can call Islamic banking as participatory banking.

Many elements of microfinance could be considered consistent with the broader goals of Islamic banking. Both systems advocate entrepreneurship and risk sharing and believe that the poor should take part in such activities. At a very basic level, the disbursement of collateral-free loans in certain instances is an example of how Islamic banking and microfinance share common aims. Thus Islamic banking and microcredit programs may complement one another in both ideological and practical terms. This close relationship would not only provide obvious benefits for poor entrepreneurs who would otherwise be left out of credit markets, but investing in micro enterprises would also give investors in Islamic banks an opportunity to diversify and earn solid returns.

A mudaraba model

In a mudaraba-based transaction the microfinance program and the microenterprise are partners, with the program investing the money and the micro entrepreneur investing the labor. The micro entrepreneur is rewarded for his or her work and shares in the profit; the program only shares in the profit. The profit-sharing rates are predetermined, but the profit is unknown. In effect, the microfinance program takes "equity" in the micro enterprise through the loan. Initially, the program may own 100 percent of the shares and would hence be entitled to its predetermined share of all the profit. But as each loan installment is repaid, the micro entrepreneur "buys back" shares. As a result the microfinance program earns less profit with each repayment received. Consider, for example, a case where the micro entrepreneur is a vegetable trader and makes a weekly (or monthly) profit of 1,000. (For simplicity, the units of currency in these examples will be generic.) The microcredit program provides a loan of 10,000 to be repaid in 20 weekly (or monthly) installments. With each loan repayment the entrepreneur buys back a share of 500. Profit per share is 50 (1,000/20). The program and the entrepreneur agree that the program will receive 10 percent of the weekly (or monthly) profit, and the entrepreneur

will receive 90 percent. In the first week (or month) the microfinance program owns 100 percent of the shares and is entitled to 10 percent of the weekly profit of 1,000; thus it receives 100. The entrepreneur receives 90 percent of the weekly (or monthly) profit, or 900. The entrepreneur uses 500 of this 900 to buy back one share. In the second week (or month) the microfinance program is entitled to 10 percent of 19/20 of the weekly (or monthly) profit of 1,000, since it now owns only 19 of the 20 shares. Thus the program is entitled to 95. The entrepreneur gets the rest (1,000 – 95 = 905). Put another way, the entrepreneur receives (0.90 x 950) + 50. The 950 is the profit to be shared with the program; the 50 is the profit per share. (Remember that the entrepreneur owns the share he "bought back" the previous week for 500; he does not have to share the profit made on his own share.) Again, the entrepreneur uses 500 of his profit to buy back a second share. This process would continue for the 20 weeks (or months) of the mudaraba agreement, with the program earning total income of 1,050 and the entrepreneur earning total income 18,950 (table 1). A conceptual visualization of this loan structure is shown in figure 1; the entrepreneur's repayment schedule is shown in table 2.

Table 1. Program and entrepreneur profits under the mudaraba example

Week / Month	***Profit to be shared***	***Program income***	***Entrepreneur income***
1	20/20 x 1,000 = 1,000	1,000 x 10% = 100	1,000 x 90% + 0 = 900
2	19/20 x 1,000 = 950	950 x 10% = 95	950 x 90% + 50 = 905
3	18/20 x 1,000 = 900	900 x 10% = 90	900 x 90% + 100 = 910
4	17/20 x 1,000 = 850	850 x 10% = 85	850 x 90% + 150 = 915
5	16/20 x 1,000 = 800	800 x 10% = 80	800 x 90% + 200 = 920
6	15/20 x 1,000 = 750	750 x 10% = 75	750 x 90% + 250 = 925
7	14/20 x 1,000 = 700	700 x 10% = 70	700 x 90% + 300 = 930
8	13/20 x 1,000 = 650	650 x 10% = 65	650 x 90% + 350 = 935
9	12/20 x 1,000 = 600	600 x 10% = 60	600 x 90% + 400 = 940
10	11/20 x 1,000 = 550	550 x 10% = 55	550 x 90% + 450 = 945
11	10/20 x 1,000 = 500	500 x 10% = 50	500 x 90% + 500 = 950
12	9/20 x 1,000 = 450	450 x 10% = 45	450 x 90% + 550 = 955
13	8/20 x 1,000 = 400	400 x 10% = 40	400 x 90% + 600 = 960
14	7/20 x 1,000 = 350	350 x 10% = 35	350 x 90% + 650 = 965
15	6/20 x 1,000 = 300	300 x 10% = 30	300 x 90% + 700 = 970
16	5/20 x 1,000 = 250	250 x 10% = 25	250 x 90% + 750 = 975
17	4/20 x 1,000 = 200	200 x 10% = 20	200 x 90% + 800 = 980
18	3/20 x 1,000 = 150	150 x 10% = 15	150 x 90% + 850 = 985
19	2/20 x 1,000 = 100	100 x 10% = 10	100 x 90% + 900 = 990
20	1/20 x 1,000 = 50	50 x 10% = 5	50 x 90% + 950 = 995
Total		1,050	18,950

From a microfinance perspective this model has several drawbacks. The most important is the uncertainty of the profit. An important assumption in developing this example was a fixed weekly profit of 1,000.

In reality, although microfinance programs have information on local market behavior, weekly profits fluctuate. Fluctuating profits also create a challenge for microlending within Islamic banking principles.

Figure 1. Distribution of program and entrepreneur income and ownership under the mudaraba example

Total income

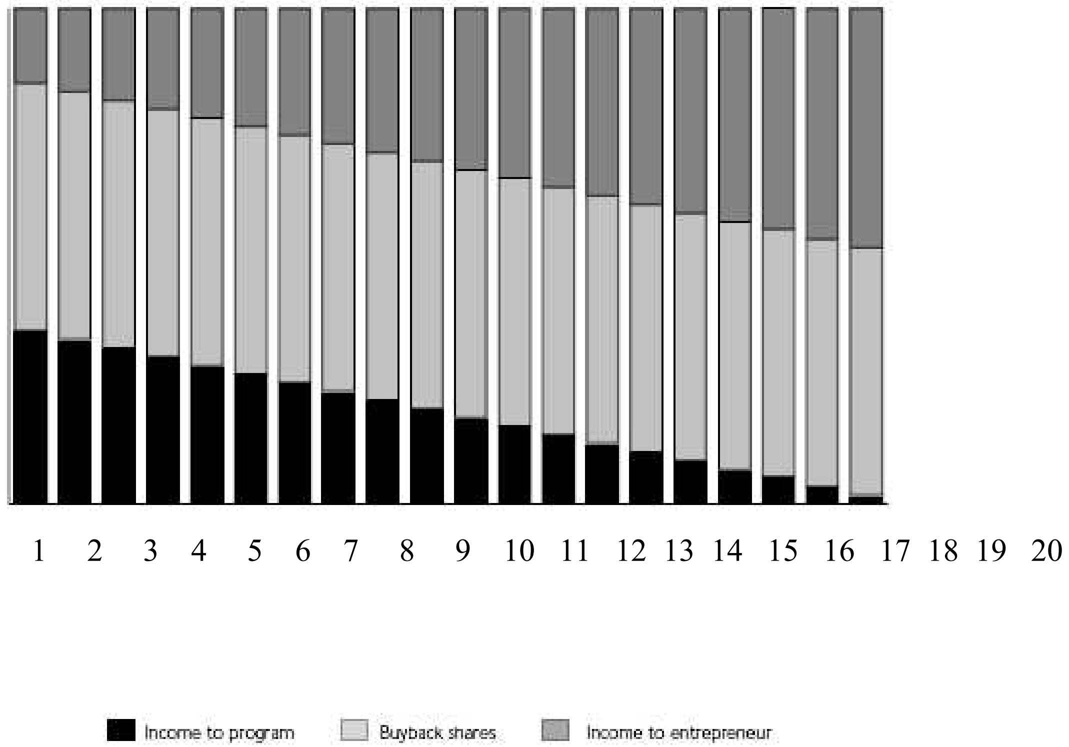

Table 2.The entrepreneur's repayment schedule under the mudaraba example

Week / Month	*Share buyback*	*Profit distribution*	*Total payment*
1	500	100	600
2	500	95	595
3	500	90	590
4	500	85	585
5	500	80	580
6	500	75	575
7	500	70	570
8	500	65	565
9	500	60	560
10	500	55	555
11	500	50	550
12	500	45	545
13	500	40	540
14	500	35	535
15	500	30	530
16	500	25	525
17	500	20	520
18	500	15	515
19	500	10	510
20	500	5	505

Moreover, most micro entrepreneurs do not keep accurate accounts. How, then, are profits to be calculated and distributed? In addition, the model is difficult to understand for loan officers and borrowers alike. The second drawback of the model is the burden of loan administration and monitoring. Even in the hypothetical situation that profits were known, the borrower has to repay a different amount each period (and the loan officer has to collect a different amount each period). This lack of simplicity— relative to equal repayment installments— also would confuse borrowers and loan officers. The margin for error is considerable given that a single loan officer often manages 100–200 borrowers. The key issue in using this profit-sharing model is whether it is possible under Islamic banking principles for the lending agency and the entrepreneur to agree on the weekly (or biweekly, monthly, or some other interval) profit prior to disbursement of the loan. Different settings may allow for different arrangements. Given that very few micro

entrepreneurs— no matter what country they are in— keep track of their accounts in a way that would permit the independent verification of, say, weekly profits, the acceptability of the above model depends rather heavily on whether such an agreement is in accordance with Islamic banking principles. As with other forms of Islamic banking, the lending agency would not be entitled to a distribution of its share if the entrepreneur were to suffer losses. But the lending agency could also agree that if the entrepreneur were to generate more profits, he would be entitled to retain 100 percent of the same.

Applying the mudaraba model might be more straightforward for businesses with a longer profit cycle. Calculating the profit (or loss) of any business on a monthly basis is easier than weekly, so installments should be paid weekly. Say that a micro enterprise takes a loan of 20,000 to raise four goats. Such an undertaking may be considered common, and people will know the profit well in advance. Normally the business will raise the goats and resell them after five to eight months for 40,000, a profit of 100 percent. The "working capital" (that is, the food eaten by the goats) is considered free because the goats live around the dwelling and eat whatever they can find. In this case the microfinance program takes "equity" of 20,000, with 20 shares of 1,000 each. The program and the entrepreneur agree that 15 percent of profits will go to the program and 85 percent will go to the entrepreneur. After five months, when the entrepreneur has sold the goats and made a profit of 20,000, he repurchases the 20 shares at 1,000 each and pays the program its share of the profit: 15 percent of 20,000, or 3,000.

A murabaha model

The murabaha contract is similar to trade finance in the context of working capital loans and to leasing in the context of fixed capital loans. Under such a contract the microfinance program literally buys goods and resells them to the micro enterprises for the cost of the goods plus a markup for administrative costs. The borrower often pays for the goods in equal installments. This model is easier for borrowers to understand and simplifies loan administration and monitoring. The microfinance program owns the

goods until the last installment is paid. How would this Islamic model work with the group liability mechanism common to microfinance? A microfinance program introduced in Yemen in mid-1997 provides an example. Today this program has more than 1,000 active borrowers, 30 percent of them women, and $150,000 in outstanding loans. Target clients are the entrepreneurial poor in urban slum districts. The loan turnaround is one week.

Loan application procedures are simple. Existing or startup micro enterprises interested in obtaining microfinance are asked to form a five-person group. Group members then submit a loan application— which includes basic business data, personal information, and the proposed loan size— to a loan officer. Group members are also asked to sign a guarantee form indicating their agreement to vouch for one another and their willingness to pay in case of arrears or delinquency. After a simple appraisal of each group member's business by the loan officer, the loan officer forwards the group's application, business appraisal, and the guarantee form to the district supervisor and district loan committee for review and approval.

Once a loan application has been approved, the loan officer buys the chosen business items and resells them to the borrowers after adding a specific margin—a markup—to the actual purchase amount. In this example, the markup determined by the project is 2 percent a month. Finally, the borrower signs an agreement indicating the final price of the resold items, the repayment period, and the installment amount.

To administer the model, the microfinance program's financial department opens an account for each borrower indicating the number and size of each installment and the due date. The loan officer issues receipts to borrowers (from a receipt book issued by the program) when collecting loan installments. In addition, the loan officer collects 30 rials a week from each group member for the insurance fund and deposits them with the financial department. The insurance fund has a separate account that indicates its income and expenses. This fund compensates borrowers who face emergencies—such as fire, flood, and death—that affect their business. Borrowers are eligible for compensation from the insurance fund if group members and the responsible loan officer approve.

To ensure proper follow-up, the district supervisor, project manager, and assistant project manager conduct random field visits to project clients to confirm the existence and

sustainability of their businesses. In addition, the project management team, working with the financial department, prepares monthly progress reports indicating number of loans distributed, types of businesses, gender distribution of borrowers, loans per loan officer, repayment rate, overdue rate, delinquency rate, aging of arrears, and the like. Borrowers who manage their business wisely and efficiently and pay back their loans on time are eligible for a consecutive loan for the same or a larger amount, based on their business needs.

Hodeidah Microfinance Programme (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. Loans go to individuals within the group and group members are expected to provide guarantees and some support to one another. All group members get loans at the same time. 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).

Experience with mudaraba and murabaha in microfinance

Borrower feedback from the field indicates an initial preference for the profit-sharing mechanism— that is, mudaraba. This preference may reflect borrowers' familiarity with this mechanism, as it is commonly used for supplier credit and other types of informal finance. But not all borrowers may understand that the profit-sharing mechanism may, under certain designs, be more expensive for them than other alternatives within Islamic banking. Moreover, some borrowers recognize the potential for conflict between the microfinance program and the borrower in determining profit. Other borrowers did not like the profit-sharing of mudaraba because they did not want to reveal their profits to the program (and their group). Many borrowers initially expressed doubts about the

appropriateness of the “buy-resell” mechanism (murabaha) because it appeared too similar to the forbidden practice of fixed interest rates (riba). But experience has shown that once the mechanism is properly explained to borrowers and local religious leaders, it is accepted. Borrowers accept that a microfinance program incurs costs and that these costs have to be recovered in order for the program to continue offering financial services. Borrowers also appreciate the simplicity and transparency of the model. The “buy-resell” model, which allows repayments in equal installments, is easier to administer and monitor. In addition, it seems to conform to practices in regions where even the handling of money is considered haram— that is, in discord with the Islamic code. In such areas borrowers would not receive the loan in the form of money, but in the form of goods that the microfinance program would purchase on their behalf and then “resell” to them. An important constraint of this model for microfinance, however, is the program’s higher administrative cost, since loan officers need to get involved in the market operation. But experience indicates that these initial higher transactions costs are offset by the lower costs of loan administration and monitoring. Moreover, an increase in lending volume suggests that these initial higher transactions costs can be lowered to acceptable levels. A microfinance program has to make several tradeoffs when selecting an appropriate loan methodology based on Islamic banking principles (table 3). The program must account for the administrative costs and risks of a particular methodology not only to the program but also to borrowers.

Table 3. Islamic finance models and their applicability to microfinance

Issue	*Mudaraba (profit sharing)*	*Murabaha (buy-resell)*
Most applicable for	Fixed assets (investment capital) and potentially working capital	Working capital and investment capital
Cost to borrowers	Potentially higher because of higher profit sharing with the microfinance program as a result of higher risk	Lower
Initial acceptance by borrowers	Higher	Lower
Risk to borrowers	Lower if no predetermined minimum profit is allowed	Higher
Risk to the program	Higher if no predetermined minimum profit is allowed	Lower
Administrative costs	Administration is potentially complex, although this could be resolved by predetermining a minimum profit. Still, costs of loan administration and monitoring are high given the complexity of the repayment schedule.	Initial higher transactions costs because of the large number of buy-sell transactions. Costs of loan administration and monitoring are substantially lower, however, because the repayment schedule is simple.
Enforcement	Difficult if profit must be determined for each installment, because most borrowers do not keep sufficiently accurate accounts	Less difficult because the program owns the goods until the last installment is paid

Islamic banking techniques could give thousands of entrepreneurial poor access to microfinance— an option they might not consider if traditional, interest-based commercial loans were offered. More experimentation and practice in the field should contribute to more knowledge and a better understanding of effective loan delivery mechanisms using Islamic banking principles.

The operation of an interest-free micro credit program may be considered as a social business with different approaches such as:

Solidarity lending takes place through ‘solidarity groups’. These groups are a distinctive banking distribution channel used primarily to deliver microcredit to poor people. Solidarity lending lowers the costs to a financial institution related to assessing, managing and collecting loans, and can eliminate the need for collateral. Since there is a fixed cost associated with each loan delivered, a bank that bundles individual loans together and permits a group to manage individual relationships can realize substantial savings in administrative and management costs. In many developing countries the legal system offers little, if any support for the property rights of poor people. Laws related to secured transactions– a cornerstone of Western banking– may also be absent or not enforced. Instead, solidarity lending levers various types of social capital like ‘peer pressure’, mutual support and a healthy culture of repayment. These characteristics make solidarity lending more useful in rural villages than in urban centres where mobility is greater and social capital is weaker. Efforts to replicate solidarity lending in developed countries have generally not succeeded. For example, the Calmeadow Foundation tested an analogous 'peer lending' model in three locations in Canada: rural Nova Scotia and urban Toronto and Vancouver during the 1990s. It concluded that a variety of factors-- including difficulties in reaching the target market, the high risk profile of clients, their general distaste for the joint liability requirement, and high overhead costs -- made solidarity lending unviable without subsidies. However, debates have continued about whether the required subsidies may be justified as an alternative to other subsidies targeted to the entrepreneurial poor, and VanCity Credit Union, which took over Calmeadow's Vancouver operations, continues to use peer lending. How it is Distinctive: Tapping social capital to lend money is not new to microfinance. Earlier precedents include the informal practices of ROSCAs and the bonds of association used in credit unions. In India, the practice of self-help group banking is inspired by similar principles.

However, solidarity groups are distinctly different from earlier approaches in several important ways. First, solidarity groups are very small, typically involving 5 individuals who are allowed to choose one another but cannot be related. Five is often cited as an ideal size because it is: (1) small enough to ensure a maximum level of joint responsibility and discourage free riders, and (2) large enough to prevent the misfortune

or incompetence of one person from causing the group to collapse. Much evidence has also shown that social pressure is more effective among women than among men. The vast majority of loans using this methodology are delivered to women. Learning from the failure of the Comilla Model of cooperative credit piloted by Akhtar Hameed Khan in the 1950s and '60s, Grameen Bank and many other microcredit institutions have also taken an assertive approach to targeting poor women and excluding non-poor individuals entirely. A major reason for the prior failure of credit cooperatives in Bangladesh was that the groups were too big and consisted of people with varied economic backgrounds. These large groups did not work because the more affluent members captured the organizations.

A bank unit is set up with a Field Manager and a number of bank workers, covering an area of about 15 to 22 villages. The manager and workers start by visiting villages to familiarize themselves with the local environment in which they will be operating and identify prospective clientele, as well as explain the purpose, functions, and mode of operation of the bank to the local population. Groups of five prospective borrowers are formed; in the first stage, only two of them are eligible for, and receive, a loan. The group is observed for a month to see if the members are conforming to rules of the bank. Only if the first two borrowers repay over a period of twelve weeks do other members of the group become eligible themselves for a loan. Because of these restrictions, there is substantial group pressure to keep individual records clear. In this sense, collective responsibility of the group serves as collateral on the loan.

Peer pressure uses moral and other linkages between borrowers and project participants to ensure participation and repayment in microcredit programs. Peers could be other members in a borrowers group (where, unless the initial borrowers in a group repay, the other members do not receive loans. Hence pressure is put on the initial members to repay); community leaders (usually identified, nurtured and trained by NGOs); NGOs themselves and their field officers; banks etc. The 'pressure' applied can be in the form of frequent visits to the defaulter, community meetings where they are identified and requested to comply etc.

Appendix

Mudarabah

A form of partnership where one party provides the funds while the other provides expertise and management. The latter is referred to as the Mudarib. Any profits accrued are shared between the two parties on a pre-agreed basis, while loss is borne by the provider(s) of the capital.

Mudarabah is a special kind of partnership where one partner gives money to another for investing it in a commercial enterprise. The investment comes from the first partner who is called "rabb-ul-mal", while the management and work is an exclusive responsibility of the other, who is called "mudarib".

There were several Traditions from the Prophet, which demonstrated his approval of this type of contract. The Traditions attributed to the Prophet are an unequivocal endorsement and approval of those engaging in trade by means of *al-mudarabah* as follows:

Abd Allah b. Masud, a prominent Companion of the Prophet, and al-Abbas b. Abd al-Mutalib, the uncle of the Prophet, engaged in *mudarabah* contract. The latter having obtained the Prophet's approval for the conditions he imposed upon his agent to whom he entrusted his money. Further, according to al-Kasani, the practice of *al-mudarabah* was carried out by the Companions, but no disapproval was ever stated by the Prophet . This seems to indicate that he permitted such practices, this permission amounting to his acknowledgement of the legality of *al-mudarabah*. Therefore, it is permissible.

The above Traditions showed that the Prophet approved of engagement in trade in the form of *al-mudarabah*.

Business of the Mudarabah

The rabb-ul-mal may specify a particular business for the mudarib, in which case he shall invest the money in that particular business only. This is called al-mudarabah al-muqayyadah (restricted mudarabah). But if he has left it open for the mudarib to undertake whatever business he wishes, the mudarib shall be authorized to invest the money in any business he deems fit. This type of mudarabah is called 'al-mudarabah al-mutlaqah" (unrestricted mudarabah)

A rabbul-mal can contract mudarabah with more than one person through a single transaction. It means that he can offer his money to A and B both, so that each one of them can act for him as mudarib and the capital of the mudarabah shall be utilized by both of them jointly, and the share of the mudarib shall be distributed between them according to the agreed proportion. In this case both the mudâribs shall run the business as if they were partners inter se.

The mudarib or mudâribs, as the case may be, are authorized to do anything which is normally done in the course of business. However, if they want to do an extraordinary work, which is beyond the normal routine of the traders, they cannot do so without express permission from the rabb-ul-mal.

Distribution of the profit

It is necessary for the validity of mudarabah that the parties agree, right at the beginning, on a definite proportion of the actual profit to which each one of them is entitled. No particular proportion has been prescribed by the Shariah; rather, it has been left to their mutual consent. They can share the profit in equal proportions, and they can also allocate different proportions for the rubb-ul-mal and the mudarib. However, they cannot allocate a lump sum amount of profit for any party, nor can they determine the share of any party at a specific rate tied up with the capital. For example, if the capital is Rs. 100000/- they

cannot agree on a condition that Rs. 10000/- out of the profit shall be the share of the mudarib, nor can they say that 20% of the capital shall be given to rabb-ul-mal. However, they can agree on that 40% of the actual profit shall go to the mudarib and 60% to the rabb-ul-mal or vice versa.

It is also allowed that different proportions are agreed in different situations. For example the rabbul-mal can say to mudarib, "If you trade in wheat, you will get 50% of the profit and if you trade in flour, you will have 33% of the profit". Similarly, he can say "If you do the business in your town, you will be entitled to 30% of the profit, and if you do it in another town, your share will be 50% of the profit.

Apart from the agreed proportion of the profit, as determined in the above manner, the mudarib cannot claim any periodical salary or a fee or remuneration for the work done by him for the mudarabah.

All the schools of Islamic Fiqh are unanimous on this point. However, Imam Ahmad has allowed for the mudarib to draw his daily expenses of food only from the mudarabah account.

The Hanafi jurists restrict this right of the mudarib only to a situation when he is on a business trip outside his own city. In this case he can claim his personal expenses, accommodation, food, etc., but he is not entitled to get anything as daily allowances when he is in his own city. If the business 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, then the remainder, if any, shall be distributed between the parties according to the agreed ratio.

Termination of Mudarabah

The contract of mudarabah can be terminated at any time by either of the two parties. The only condition is to give a notice to the other party. If all the assets of the mudarabah are in cash form at the time of termination, and some profit has been earned on the principal amount, it shall be distributed between the parties according to the agreed ratio. However,

if the assets of the mudarabah are not in the cash form, the mudarib shall be given an opportunity to sell and liquidate them, so that the actual profit may be determined.

There is a difference of opinion among the Muslim jurists about the question whether the contract of mudarabah can be effective for a specified period after which it terminates automatically. The Hanafi and Hanbali schools are of the view that the mudarabah can be restricted to a particular term, like one year, six months, etc, after which it will come to an end without a notice. On the contrary, Shafii and Maliki schools are of the opinion that the mudarabah cannot be restricted to a particular time.

However, this difference of opinion relates only to the maximum time-limit of the mudarabah. Can a minimum time-limit also be fixed by the parties before which mudarabah cannot be terminated? No express answer to this question is found in the books of Islamic Fiqh, but it appears from the general principles enumerated therein that no such limit can be fixed, and each party is at liberty to terminate the contract whenever he wishes.

This unlimited power of the parties to terminate the mudarabah at their pleasure may create some difficulties in the context of the present circumstances, because most of the commercial enterprises today need time to bring fruits. They also demand constant and complex efforts. Therefore, it may be disastrous to the project, if the rabb-ul-mal terminates the mudarabah right in the beginning of the enterprise. Specially, it may bring a severe set-back to the mudarib who will earn nothing despite all his efforts. Therefore, if the parties agree, when entering into the mudarabah, that no party shall terminate it during a specified period, except in specified circumstances, it does not seem to violate any principle of Shariah, particularly in the light of the famous hadith, which says:

المسلمون على شروطهم الا شرطا احل حراما اوحرم حلالا

All the conditions agreed upon by the Muslims are upheld, except a condition which allows what is prohibited or prohibits what is lawful.

Murabahah

Literally it means a sale on mutually agreed profit. Technically, it is a contract of sale in which the seller declares his cost and the profit. This has been adopted by Islamic banks as a mode of financing. As a financing technique, it can involve a request by the client to the bank to purchase a certain item for him. The bank does that for a definite profit over the cost which is stipulated in advance.

It is a sales contract between a bank and its customers, mostly for trade financing. The bank purchases goods ordered by the customer; the customer pays the original price plus a profit margin agreed upon by the two parties. Repayment is made by installments within a specified period.
The murabaha contract is similar to trade finance in the context of working capital loans and to leasing in the context of fixed capital loans. Under such a contract the microfinance program literally buys goods and resells them to the micro enterprises for the cost of the goods plus a markup for administrative costs. The borrower often pays for the goods in equal installments. This model is easier for borrowers to understand and simplifies loan administration and monitoring. The microfinance program owns the goods until the last installment is paid.

Some Issues Involved In Murabahah

So far the basic concept of Murabahah has been explained. Now, it is proposed to discuss some relevant issues with reference to the underlying Islamic principles and their practical applicability in murabahah transaction, because without correct understanding of these issues, the concept may remain ambiguous and its practical application may be susceptible to errors and misconceptions.

Different pricing for cash and credit sales: The first and foremost question about murabahah is that, when used as a mode of financing, it is always effected on the basis of deferred payment. The financier purchases the commodity on cash payment and sells it to

the client on credit. While selling the commodity on credit, he takes into account the period in which the price is to be paid by the client and increases the price accordingly. The longer the maturity of the murabahah payment, the higher the price. Therefore the price in a murabahah transaction, as practiced by the Islamic banks, is always higher than the market price. If the client is able to purchase the same commodity from the market on cash payment, he will have to pay much less than he has to pay in a murabahah transaction on deferred payment basis. The question arises as to whether the price of a commodity in a credit sale may be increased from the price of a cash sale. Some people argue that the increase of price in a credit sale, being in consideration of the time given to the purchaser, should be treated analogous to the interest charged on a loan, because in both cases an additional amount is charged for the deferment of payment. On this basis they argue that the murabahah transactions, as practiced in the Islamic banks, are not different in essence from the interest-based loans advanced by the conventional banks.

This argument, which seems to be logical in appearance, is based on a misunderstanding about the principles of Shariah regarding the prohibition of riba. For the correct comprehension of the concept the following points must be kept in view:

The modern capitalist theory does not differentiate between money and commodity in so far as commercial transactions are concerned. In the matter of exchange, money and commodity both are treated at par. Both can be traded in. Both can be sold at whatever price the parties agree upon. One can sell one dollar for two dollars on the spot as well as on credit, just as he can sell a commodity valuing one dollar for two dollars. The only condition is that it should be with mutual consent.

The Islamic principles, however, do not subscribe to this theory. According to Islamic principles, money and commodity have different characteristics and therefore, they are treated differently. The basic points of difference between money and commodity are the following:

(a) Money has no intrinsic utility. It cannot be utilized for fulfilling human needs directly. It can only be used for acquiring some goods or services. The commodities, on the other hand, have intrinsic utility. They can be utilized directly without exchanging them for some other thing.

(b) The commodities can be of different qualities, while money has no quality except that it is a measure of value or a medium of exchange. Therefore, all the units of money, of same denomination, are 100% equal to each other. An old and dirty note of Rs. 1000/- has the same value as a brand new note of Rs. 1000/-, unlike the commodities which may have different qualities, and obviously an old and used car may be much less in value than a brand new car.

(c) In commodities, the transaction of sale and purchase is effected on a particular individual commodity or, at least, on the commodities having particular specifications. If A has purchased a particular car by pin-pointing it and seller has agreed, he deserves to receive the same car. The seller cannot compel him to take the delivery of another car, though of the same type or quality. This can only be done if the purchaser agrees to it which implies that the earlier transaction is cancelled and a new transaction on the new car is effected by mutual consent.

Money, on the contrary, cannot be pin-pointed in a transaction of exchange. If A has purchased a commodity from B by showing him a particular note of Rs. 1000/- he can still pay him another note of the same denomination, while B cannot insist that he will take the same note as was shown to him.

Keeping these differences in view, Islam has treated money and commodities differently. Since money has no intrinsic utility, but is only a medium of exchange which has no different qualities, the exchange of a unit of money for another unit of the same denomination cannot be affected except at par value. If a currency note of Rs. 1000/- is exchanged for another note of Pakistani Rupees, it must be of the value of Rs. 1000/- The price of the former note can neither be increased nor decreased from Rs. 1000/- even in a

spot transaction, because the currency note has no intrinsic utility nor a different quality (recognized legally), therefore any excess on either side is without consideration, hence not allowed in Shariah. As this is true in a spot exchange transaction, it is also true in a credit transaction where there is money on both sides, because if some excess is claimed in a credit transaction (where money is exchanged for money) it will be against nothing but time.

The case of the normal commodities is different. Since they have intrinsic utility and have different qualities, the owner is at liberty to sell them at whatever price he wants, subject to the forces of supply and demand. If the seller does not commit a fraud or misrepresentation, he can sell a commodity at a price higher than the market rate with the consent of the purchaser. If the purchaser accepts to buy it at that increased price, the excess charged from him is quite permissible for the seller. When he can sell his commodity at a higher price in a cash transaction, he can also charge a higher price in a credit sale, subject only to the condition that he neither deceives the purchaser, nor compels him to purchase, and the buyer agrees to pay the price with his free will.

It is sometimes argued that the increase of price in a cash transaction is not based on the deferred payment; therefore it is permissible while in a sale based on deferred payment, the increase is purely against time which makes it analogous to interest. This argument is again based on the misconception that whenever price is increased taking the time of payment into consideration, the transaction comes within the ambit of interest. This presumption is not correct. Any excess amount charged against late payment is riba only where the subject matter is money on both sides. But if a commodity is sold in exchange of money, the seller, when fixing the price, may take into consideration different factors, including the time of payment. A seller, being the owner of a commodity which has intrinsic utility may charge a higher price and the purchaser may agree to pay it due to various reasons, for example:

(a) His shop is nearer to the buyer who does not want to go to the market which is not so near.

(b) The seller is more trust-worthy for the purchaser than others, and the purchaser has more confidence in him that he will give him the required thing without any defect.

(c) The seller gives him priority in selling commodities having more demand.
(d) The atmosphere of the shop of the seller is cleaner and more comfortable than other shops.
(e) The seller is more courteous in his dealings than others.

These and similar other considerations play their role in charging a higher price from the customer. In the same way, if a seller increases the price because he allows credit to his client, it is not prohibited by Shariah if there is no cheating and the purchaser accepts it with open eyes, because whatever the reason of increase, the whole price is against a commodity and not against money. It is true that, while increasing the price of the commodity, the seller has kept in view the time of its payment, but once the price is fixed, it relates to the commodity, and not to the time. That is why if the purchaser fails to pay at the stipulated time, the price will remain the same and can never be increased by the seller. Had it been against time, it might have been increased, if the seller allows him more time after the maturity.

To put it another way, since money can only be traded in at par value, as explained earlier, any excess claimed in a credit transaction (of money in exchange of money) is against nothing but time. That is why if the debtor is allowed more time at maturity, some more money is claimed from him. Conversely, in a credit sale of a commodity, time is not the exclusive consideration while fixing the price. The price is fixed for commodity, not for time. However, time may act as an ancillary factor to determine the price of the commodity, like any other factor from those mentioned above, but once this factor has played its role, every part of the price is attributed to the commodity.

The upshot of this discussion is that when money is exchanged for money, no excess is allowed, neither in cash transaction, nor in credit, but where a commodity is sold for money, the price agreed upon by the parties may be higher than the market price, both in cash and credit transactions. Time of payment may act as an ancillary factor to determine the price of a commodity, but it cannot act as an exclusive basis for and the sole consideration of an excess claimed in exchange of money for money.

This position is accepted unanimously by all the four schools of Islamic law and the majority of the Muslim jurists. They say that if a seller determines two different prices for

cash and credit sales, the price of the credit sale being higher than the cash price, it is allowed in Shariah. The only condition is that at the time of actual sale, one of the two options must be determined, leaving no ambiguity in the nature of the transaction. For example, it is allowed for the seller, at the time of bargaining, to say to purchaser, "If you purchase the commodity on cash payment, the price would be Rs. 100/- and if you purchase it on a credit of six months, the price would be Rs. 110/-" But the purchaser shall have to select either of the two options. He should say that he would purchase it on credit for Rs. 110/- Thus, at the time of actual sale, the price will be known to both parties.

However, if either of the two options is not determined in specific terms, the sale will not be valid. This may happen in those installment sales in which different prices are claimed for different maturities. In this case the seller draws a schedule of prices according to schedule of payment. For example, Rs. 1000/- are charged for the credit of 3 months Rs. 1100/- for the credit of 6 months, Rs. 1200/- for 9 month and so on. The purchaser takes the commodity without specifying the option he will exercise, on the assumption that he will pay the price in future according to his convenience. This transaction is not valid, because the time of payment, as well as the price, is not determined. But if he chooses one of these options specifically and says, for example, that he purchases the commodity on 6 months credit with a price of 1100/- the sale will be valid.

Another point must be noted here. What has been allowed above is that the price of the commodity in a credit sale is fixed at more than the cash price. But if the sale has taken place at cash price, and the seller has imposed a condition that in case of late payment, he will charge 10% per annum as a penalty or as interest, this is totally prohibited; because what is being charged is not a part of the price; it is an interest charged on a debt.

The practical difference between the two situations is that where the additional amount is a part of the price, it may be charged on a one time basis only. If the purchaser fails to pay it on time, the seller cannot charge another additional amount. The price will remain the same without any addition. Conversely, where the additional amount is not a part of the price it will keep increasing with the period of default.

Bay' al-murabahah is the re-sale at specified surcharge or rate of profit on the stated original cost. According to Udovitch, it may be speculated that its use was limited to a

particular circumstance. For instance, purchaser may have been willing to pay a retailer who was at hand a specified surcharge on the cost of certain goods in order to prevent himself from any trouble of buying them from a- wholesaler. It may also serve as a form of commission sale, when the purchaser is permitted to obtain commodities on credit and resell them with the surcharge of either a fixed price or a fixed rate of profit based on the original price. This type of sale was normally practiced in pre-Islamic times.

The Companions

This type of transaction was not mentioned by the Prophet and he did not say whether it was permitted or not. But some of the Companions initiated a discussion about bay' al-murababah. Basically partnership between investors and borrowers in profit-sharing re-sales was allowed by the Companions. But Abd Allah b. Masud disliked the idea of taking profits by putting a high price on goods to cover the cost of maintaining them. Bay' al-murabahah means that an investor is not reckoned to be entitled to the wage of an agent, or any allowance for such things as ironing, folding or straightening cloth, for other expenses or for the rent of a warehouse. According to Malik the cost of transporting drapery should be included in the basic price, and should not be allocated to the share of the profit, unless the agent makes all this clear to the investor from the beginning. If knowing the facts they agree to share the profits accordingly then there is no harm in that. Further, Jabir b. Abd Allah prohibited a man to sell foodstuffs which are not with him and then buy them after selling them on the owner's behalf, while he knows the price of the market and he knows they are profitable.

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