Towards an Application of *Musharakah Mutanaqisah* Principle in Islamic Microfinance

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Abstract

Microfinance institutions have been established in many developing countries to solve the problem of poverty. In Muslim countries, Islamic microfinance can be a powerful tool to fight poverty if these institutions are managed in the right way. Islamic finance scholars have argued that the provision of equity based financing by Islamic financial institutions will facilitate toward achieving the Islamic socio-economic objectives which include social justice, economic growth, efficiency and stability. This paper illustrates that *Musharakah Mutanaqsah*, an equity based financing instrument, is better than debt-based financing because of its flexibility and end result in the ownership of assets on the part of the customer. The paper also highlights *Musharakah Mutanaqisah* as an innovative mode of financing and should be a preferred instrument of financing by Islamic microfinance institutions.

Keywords: Islamic microfinance, Profit-loss sharing, *Musharakah Mutanaqisah*, Microfinance, Poverty.

1. Introduction

The Islamic banking and finance was first established on the principle of profit and loss sharing (PLS) and the prohibition of *riba* (usury). As an alternative to *riba*, it is anticipated that PLS mode of financing will notably eradicate the inequitable distribution of income and wealth and may escort to a more efficient and optimal allocation of resources. Studies however, have shown that there has been a complete shift in Islamic banking and finance from supposedly PLS banking to a sales-based and debt-based system (Saeed, 2004; Dusuki and Abozaid, 2007; Asutay, 2007). The activities of Islamic banks depend largely on contracts that are regarded as "mark-up" based, which is similar to lending on the basis of fixed interest. The use of the more risky PLS contracts such as a *Mudharabah* and *Musharakah* has been very minimal.

The current practice in Islamic microfinance is very much similar to that of Islamic banking. According to Obaidullah (2008), Islamic microfinance institutions (IMFIs) across the globe utilize a variety of *Shariah*-compliant mechanisms, such as *Murabahah,* Bai-*Bithaman-Ajil, Ijarah, Bai-Salam* etc. All these modes of financing create debt. In Indonesia, even though Obaidullah and Khan (2008) reported that IMFIs there uses reasonably balanced with an array of products - based on *Mudharabah*, *Musharakah*, *Murabahah*, *Ijarah* and *Qard al-hasan*, it is a new trend because Seibel (2005) reported that in BPRS (one of IMFIs operating in Indonesia), the main financing product is *Murabahah*, i.e. a sales contract between bank and customer with a fixed profit margin for the bank. Flexible profit-sharing, which is cumbersome to calculate, is of minor importance. In the Middle East, the *Hodeida* Microfinance Program in Yemen followed the model practiced by Grameen Bank in Bangladesh, however, it uses *Murabahah* mode of financing instead of PLS mode of financing. Obaidullah and Khan (2008) reported that in Bangladesh, the Islamic microfinance institutions there have been depending on deferred-payment sales (*Bai mu'ajjal*) mode of financing.

This paper will focus on the application of *Musharakah Mutanaqisah*, one of the equity-based modes of financing in Islamic microfinance scheme. Dusuki and Abozaid (2007) argue that the provision of equity based financing by Islamic financial institutions will facilitate toward achieving the Islamic socio-economic objectives which include social justice, economic growth, efficiency and stability. The paper will illustrate that *Musharakah Mutanaqsah* is better than debt-based financing because of its flexibility and end result in the ownership of assets on the part of the borrower. Section 2 of this paper presents the literature review on Islamic microfinance. Section 3 highlights *Musharakah Mutanaqisah* as an innovative mode of financing in Islamic microfinance, and finally, Section 4 concludes.

2. Literature review

According to Vento (2004), the three main services of microfinance institutions are microcredit or micro financing, micro leasing, and micro insurance. Islamic microfinance institutions (IMFIs) also offer similar type of services based on Islamic mode of financing. Several literatures on Islamic microfinance such as Dhumale and Scapcanin (1999) promote the use of equity based financing such as *Mudharabah, Musharakah* and debt based financing such as *Murabahah, Bai-Bithaman-Ajil* and *Ijarah* as the products of IMFIs. Even though most Islamic modes of financing can be applied in IMFIs activities, the implementations of these models should be different with current practices of Islamic banking since the nature of Islamic banking and Islamic microfinance are different.

Many Islamic scholars have argued that *Mudharabah* and *Musharakah* are the ideal products of Islamic banking because in principle, the products have the ability to bring about the socio- economic benefits of Islamic economics. IMFIs should consider these products as their main products since Islamic banking with their nature as a profit-oriented institution face difficulties in applying *Mudharabah* and *Musharakah* in their activities. However, it does not mean that IMFIs does not have profit motive if it use *Mudharabah* and *Musharakah* mode of financing in its activity since profit motive is one of the factors to successfully achieve financial sustainability of microfinance. In fact, since the nature of microfinance business makes account officers of MFIs closer to the entrepreneurs, it is an advantage for them as they can easily access, assist, and even involve in their clients' businesses, especially for *Musharakah* financing.

There are two methods in *Mudharabah* and *Musharakah* modes of financing which are direct, and indirect method. Although they use different term, Dhumale and Scapcanin (1999) explain and give example of these two methods in their paper. The direct method is easier to understand compared to that of indirect ones. For example, a micro-entrepreneur takes a loan of RM20, 000 to raise four goats. Let say that the micro-entrepreneur raises the goats and resell them after five to eight months for RM40, 000. After deducting the working capital such as for the food, cage, etc, the profit can easily divided between the micro-entrepreneur and the IMFI based on their agreement in *Mudharabah* or *Musharakah* contract. Of course, in *Musharakah* contract especially in the more complicated business ventures, there are many types of cost incurred and all these costs should be considered before the distribution of profit and sharing the loss.

The indirect method is almost similar to *Musharakah Mutanaqisah* project which is usually applied in mortgage financing. In this method, the ownership portion of IMFIs on business venture is reducing along the period of the partnership. For example, let say an IMFI owns 100% shares of one project under *Mudharabah* partnership or 70% under *Musharakah* Partnership. Along the period of the partnership, the IMFI client buys the IMFI's share on that project every month by giving certain portion of their profit to the IMFI. This process of buying back shares from the IMFI will continue until the client owns 100 share of the project.

Musharakah partnership has similar profit calculation and distribution like the *Mudharabah* ones. The main difference is *Musharakah* partnership starts not with 0% ownership on the micro entrepreneur's side. However, there are several critics on this method. First, many micro entrepreneurs do not keep their account and they even do not know how to make simple accounting treatment of their business. Therefore, it is difficult for them to understand this model. Second, this method requires a fix income of micro entrepreneurs businesses. In fact, not all businesses have a fix income especially for trade micro entrepreneurs. Therefore, to resolve these problems, IMFIs should provide good information system in place which can help their account officer to calculate and distribute the profit appropriately.

Beside *Mudharabah* and *Musharakah* equity financing, IMFIs also have the option of providing microfinance services by using debt financing modes such as *Murabahah* (or *Bai Bithaman Ajil*), *Salam and Istisna. Murabahah* is cost plus financing. In *Murabahah* or *Bai Bithaman Ajil* (BBA) products, clients approach IMFIs to buy goods that they need. An IMFI will buy that product and sell it to its client on cost plus basis. Client can pay back for the goods to the IMFI by cash or by installment. The repayment through installment better known as *Bai Bithaman Ajil* (BBA) or Deferred Installment Sale. If the client wishes to buy an asset, she can approach an IMFI and request it to buy for her a particular good to sell or if the IMFI client is a producer, the IMFI can use *Murabahah* and BBA to buy materials for the operations.

Micro-entrepreneurs can also use *Salam* and *Istisna* modes to finance their businesses. In *Salam*, an IMFI will request a micro-entrepreneur to make goods which will be delivered in the future. The IMFI should pay the micro- entrepreneur cash up front. In *Istisna* model, the IMFI can pay that client in several stages until the micro- entrepreneur finished producing that good. After producing that good, the micro- entrepreneur can sell the good on behalf of the IMFI.

IMFIs can also offer pawn broking service (*Rahn)* as one of their services. By providing this service, clients can easily solve their liquidity problem in their business. However, it has long been discussed that the main limitation of poor people to get financial access from commercial bank is collateral. Therefore, *Rahn* may not be a good solution for IMFIs clients.

IMFIs also can provide *Qardhul Hassan* loan (interest free loan) to finance their clients' businesses. This loan can be distributed not only for business purpose but also for fulfillment of clients basic needs such as to pay school fees of their children.

Ijarah is similar to micro-leasing offered by conventional microfinance. In *Ijarah* transaction, an IMFI buys the asset needed by the client and then lease the asset back to the client. As a lessor, the IMFI owns the ownership right of that asset and the micro- entrepreneur as the lessee should pay the rental based on an agreement between both parties. At the end of leasing period, the micro- entrepreneur can return back the asset or buy it from the IMFI or, if the economic life of the asset is similar to leasing period, the IMFI can transfer the asset to that client.

IMFIs also offer micro *takaful* product to their clients even though this is rarely practiced. Micro *takaful* product offered by IMFIs can be in the form of general *takaful* (which has purpose similar to life insurance), or other *takaful* program with different purposes especially to cover the risk of client's business failure. In micro *takaful,* client regularly put a certain amount of money called sharing account to their *takaful* account. By using *Mudharabah* or *Wakalah* (agency) concept, IMFIs then invest that money and the profit from that investment will be distributed according to the agreement between IMFIs and their clients. The portion of client's profit is further divided into *tabarru'* accounts and client or policy holders' own account. While client's money and profit in policy holder account will be distributed back to clients, the *tabarru'* account will be given for charity if any policy holders claimed for actual loss, damage, or any subsequent event depending on the coverage under the micro *takaful* product.

3. *Musharakah Mutanaqisah*: An Innovative Islamic Microfinance Product

3.1. The *Musharakah Mutanaqisah* Concept

The *Musharakah Mutanaqisah* (MM) is based on a diminishing partnership contract. The MM contract consists of two separate contracts. First, a client enters into an agreement with the IMFI under the concept of joint ownership (*Shirkat-al-Milik*). Under this part of the agreement, customer pays the initial share (for example, 20% of the price of a property/asset) to co-own the property/asset, and at the same time the IMFI provides fund for the remaining 80% of the share. The client will then gradually buy back the financier's 80% share at an agreed portion periodically until the property/asset is fully owned by the client. Second, the IMFI leases its share (80%) in the property/machine ownership to the client under *ijarah*, i.e. by charging rent. The client agrees to pay the rental to the IMFI for using its share of the property/asset. The periodic rental amounts are jointly shared between the client and the IMFI according to the percentage of share holding at the particular times which continues to change as the client redeems the financier's share. The client's share ratio would increase after each rental payment due to the periodic redemption until he/she eventually fully owned the property/asset.

Islamic scholars are basically in agreement on the implementation process of *Musharakah Mutanaqisah*. Bendjilali and Khan (1995) and Taqi Usmani (2002) for example, agreed that the MM can help people to rely less on other financing facilities such as the BBA, *Murabahah*, etc. Islamic scholars agree that MM is best implemented for house or machinery financing where both assets can be leased out according to agreed rental. Joint ownership of a house or asset is accepted by all schools of Islamic fiqh since the financier sells its share to the client (see Taqi Usmani, 2002).

The concept of *Musharakah Mutanaqisah* is not only limited to home ownership only. It can be applied when acquiring other forms of assets such as buying a truck or van for earning income and using it as a hired vehicle. Consider for example, a microfinance client wants to purchase a van to transport school children, but can afford to pay only 20% of the purchase price. The IMFI can provide assistance by providing 80% balance of the share. The profit obtained from the business is shared between them based on the capital contribution.

The IMFI's share is divided into eight units. After three months, for example, the client buys one unit of share from the microfinance institution. Therefore, the IMFI's share is reduced to 70% while the client's share increased to 30%. Due to the now higher percentage of ownership, the client is entitled to a higher profit ratio. This process will go on until after the expiry of two years whereby the van will be wholly owned by the client.

3.2. Illustration of *Musharakah Mutanaqisah* Financing

Consider an example where a client wants to purchase a property at the cost of RM40, 000. Let us assume that the client pays 25 percent of the price, i.e. RM10, 000 and the IMFI pays the remaining 75 percent, i.e. RM30, 000. The client wishes to redeem the IMFI's share in 40 months.

Cost of Property = RM 40,000

Amount of financing from IMFI (75%) = RM 30,000

Client (25%) = RM 10,000

Tenure for 40 months (3 years and 3 months)

Monthly rent = RM 170*

Client additional purchase of IMFI's share = RM 647.14

Total monthly payment = RM817.14

* Actual rental rate = $\frac{\text{RM } 170 \times 12}{\text{RM } 40{,}000} = 5.10\%$ p.a

Table 1

Payments Schedule for *Musharakah Mutanaqisah* Contract

Month	Monthly Rent (RM)	Additional purchase of share (RM)	Total Payment (RM)	Client's profit ratio	Rental Division		Client's Equity (RM)	IMFI's Equity (RM)	IMFI's Cashflow (RM)
					Client	Financier			
	A	B	C=A+B	D	E	F	G	H	
0				0.25			10,,000	30,000	(30,000)
1	170	647.14	817.14	0.250	42.50	127..50	10,689.64	29,310.36	817.14
2	170	647.14	817.14	0.267	45.43	124.57	11,382.21	28,617.79	817.14
3	170	647.14	817.14	0.285	48.37	121.63	12,077.73	27,922.27	817.14
4	170	647.14	817.14	0.302	51.33	118.67	12,776.20	26,522.47	817.14
40	170	647.14	817.14	1.00	170	0.00	40,000	0	817.14

Total payment = RM 32,685.60 (RM 817.14 x 40)

Rental distribution
E-1 (Customer's) = RM 42.50 (0.25 x RM170) F-1 (IMFI's) = RM 127.50 (0.75 x RM170)

Equity distribution
G-1(Customer's equity) = RM 10,000 + (RM 647.14 + RM 42.50) = RM 10,689.64
H-1 (IMFI's equity) = RM 40,000 – RM 10,689.64 = RM 29,310.36

The client will pay rental based on the actual rate of the property amounting to RM 170 per month (Mydin Meera & Abdul Razak, 2009). In addition, he purchases additional share from IMFI amounting to RM 647.14 monthly. Hence, the total monthly payment to be made to IMFI will be RM 817.14 (RM 170 + RM 647.14). As can be seen the rental distribution earned by the client (column E of Table 1) gradually increases from RM 42.50 in month 1 to RM 51.33 in month 4, as client's equity in the property increases from RM 10,000 to RM 12,776.20 (column G4). On the other hand, IMFI's ownership decreases correspondingly. In the end the client will own the entire property in the 40th month after full payment of RM 32,685 has been made to IMFI.

3.3. Flexibility and superiority of *Musharakah Mutanaqisah* (MM)

The main advantage and superiority of the MM contract over debt financing contracts such as *Murabahah* and *Bai Bithaman Ajil* (BBA) is its flexibility. This has two implications. Foremost, the later contracts are based on fixed profit rate whereby IMFI's profit rate has been included upfront in the selling profit rate. It is similar to conventional fixed interest rate whereby computation of profit is based on time value of money formula[1].The can be illustrated using the example below:-

Cost of Property = RM 40,000

Cost of financing IMFI (75%) = RM 30,000

Tenure for 40 months (3 years and 3 months)

Profit rate = 9.02 % p.a *

Monthly installment amount = RM 864.69

Selling Price = RM 34,587.60 (RM 864.69 x 40)

* 9.02 % p.a is bench marked based on average lending rate (Abdul Razak, D, 2011, p.203).

Table 2 compares the two different methods of computations using BBA and MM. As can be seen, the monthly installment computed using BBA (RM 864.69) is more expensive than MM which is only RM 817.14. This result is higher profit made by IMFI i.e. RM 1,902. If the client uses the same monthly installment of RM 864.69 he pays for BBA for MM financing, he can own the property earlier i.e. 37.4 months instead of 40 months. Moreover, BBA profit rate is fixed until the end of tenure whereas MM rental rate is flexible and can be revised within the tenure of financing. This flexibility enables the IMFI to structure the client's monthly installment based on the prevailing economic conditions.

[1] Conventional standard formula for present value of annuities as computation for conventional housing loan, i.e. $PV = \frac{Pmt}{i}\left[1-\frac{1}{(1+i)^n}\right]$ which gives $Pmt = \frac{i(1+i)^n PV}{(1+i)^n - 1}$.

Table 2
Comparison of computation using BBA and MM financing

Types of financing	**BBA**	**MM**
Amount of financing	RM 30,000	RM 30,000
Profit rate / Rental rate	9.02 % p.a	5.1 % p.a
Tenure	40 months	40 months
Monthly installment	RM 864.69	RM817.14
Total cost of payment for the 40 months	RM 34,587.60	RM 32,685.60
Total profit paid to IMFI	RM 4,587.60	RM 2,685.60

The second implication on the flexibility of the MM structure is that it allows the client to make additional purchase of IMFI's share during the financing period. This is illustrated using Table 3 below. In the above situation, the client pays additional RM 200 in his monthly installment amounting to RM 1,017.14 compared to RM 817.14 in Table 2. The will reduce the tenure of financing to 31.4 months from the original period of financing of 40 months, hence savings the client to pay 8.6 months of profit to the IMFI. The cost savings to the client is possible due to the flexibility feature of the *Musharakah Mutanaqisah* which is based on PLS compared to debt financing structures such as *Murabahah* and *Bai-Bithman Ajil* which compute profit upfront.

Table 3

Payments Schedule for *Musharakah Mutanaqisah* Contract

Month	Monthly Rent (RM)	Additional purchase of share (RM)	Total Payment (RM)	Client's profit ratio	Rental Division		Client's Equity (RM)	IMFI's Equity (RM)	IMFI's Cashflow (RM)
					Client	Financier			
	A	B	C=A+B	D	E	F	G	H	
0				0.25			10,,000	30,000	(30,000)
1	170	847.14	1017.14	0.250	42.50	127..50	10,889.64	29,110.36	1017.14
2	170	847.14	1017.14	0.272	46.28	123.72	11,783.06	28,216.94	1017.14
3	170	847.14	1017.14	0.295	50.08	119.92	12,680.28	27,319.72	1017.14
4	170	847.14	1017.14	0.317	53.89	116.11	13,581.31	26,418.69	1017.14
40	170	847.14	1017.14	1.00	170	0.00	40,000	0	1017.14

Total payment = RM 40,685.60 (RM 1017.14 x 40)

4. Conclusion

Islamic microfinance can be an effective tool to alleviate poverty. With a combination of Islamic finance and microfinance, both of which seek justice for all parties not only the surplus unit, Islamic microfinance can be a powerful tool to fight poverty problem if these institutions are managed in the right way. Islamic microfinance institutions should refrain themselves from imitating Islamic banks by only focusing on debt financing products as a way of obtaining easy, risk-free, and steady flow of income. The practice of only concentrating on debt financing products defies the main purpose of the existence of microfinance institutions which is to alleviate poverty and to increase socio-economic condition of the poor.

This paper has illustrated that equity financing product, in specific, *Musharakah Mutanaqisah* is superior compared to debt financing product. If *Musharakah Mutanaqisah* is widely used in financing micro-enterprise activities, it has the potential to bring about positive effect on the distribution of income in the society and an increase in the socio-economic condition of the poor.

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