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TOWARDS AN APPLICATION OF *MUSHARAKAH MUTANAQISAH* PRINCIPLE IN ISLAMIC MICROFINANCE

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ABSTRACT

This paper is aimed at explaining the application of *musharakah mutanaqisah* into a newly context of Islamic microfinance. The term Islamic microfinance is similar to that of conventional but it is varied in terms of *Shariah* principles used and the prohibition of interest in business operations. Further, 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 mutanaqisah,* 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. Our study provides further evidence regarding the applicability of *musharakah mutanaqisah* into the context of microfinance, thus closing the research gaps. Limitation and potential future work are outlined to assist future researches in the area.

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

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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 *mudarabah* and *musharakah* has been very minimal.

The current practice in Islamic microfinance is very much similar to that of Islamic banking. We explain this assertion based on previous works (Obaidullah, 2008; Obaidullah and Khan, 2008; Seibel, 2005). According to Obaidullah (2008), Islamic microfinance institutions (IMFIs) across the globe utilize a variety of *Shariah*-compliant mechanisms, such as *murabahah, bay bithaman ajil* (BBA), *ijarah, bay al 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 *mudarabah, 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 (*bay al mu'ajjal*) mode of financing. The review of these studies has demonstrated that a study on the applicability of *musharakah mutanaqisah* remained limited and inconclusive. Creating an Islamic microfinance institution on the basis of *murabahah,* BBA and *ijarah,* to mention some is not sufficient to reflect an Islamic business philosophy (Haron and Shanmugam, 2001). These principles are debt-based and tend to be burdensome to those borrowers who are viewed particularly incapable to service debts and the charges related to such debts.

This study is motivated by two main reasons. Firstly, there is limited information established pertaining to the applicability of *musharakah mutanaqisah* in the context of Islamic microfinance. Earlier works have established their discussion on Islamic microfinance on the basis of other Islamic principles than that of *musharakah mutanaqisah* (Seibel, 2005; Obaidullah and Khan, 2008). Secondly, earlier works on Islamic microfinance have not provided an illustration of *musharakah mutanaqisah* for Islamic microfinance. These two reasons have led the current study to be undertaken. In addition, three contributions sourced from this current work are also explained. Firstly, our study is one of the few studies designed to determine the applicability of *musharakah mutanaqisah* in the context of Islamic microfinance. So far, a study by Mydin-Meera and Abdul-Razak (2005) has noted the importance of *musharakah mutanaqisah* in the context of home financing, however but there is no evidence suggested to observe the suitability of *musharakah mutanaqisah* in the context of Islamic microfinance. Secondly, this study provides invaluable information with respect to the aptness of *musharakah mutanaqisah* for better practice of current microfinance. Thirdly, this study establishes a mathematical illustration for *musharakah mutanaqisah* which can be used to quantify any figures of partnership if an Islamic banks/any enterprises plan to practice it in their business models.

This study is aimed at examining the applicability of *musharakah mutanaqisah* in the context of Islamic microfinance. 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 mutanaqisah* 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 the present study.

2. LITERATURE REVIEW

2.1. Theoretical Framework

According to Abdul-Rahman (2007) microfinance is defined as the "programme that extends small loans to very poor people for self employment projects that generate income in allowing them to take care of themselves and their families". Prior to Islamic microfinance, conventional microfinance was developed and grown in Latin America and South Asia (Abdul-Rahman, 2007). Many Islamic scholars have been influenced by the idea of microfinance popularized by Grameen Bank Bangladesh despite the un-Islamic nature of its operation (Dusuki and Abozaid, 2007; Obaidullah and Khan, 2008).

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 *mudarabah, musharakah* and debt based financing such as *murabahah,* BBA 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 *mudarabah* 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 *mudarabah* and *musharakah* in their activities. However, it does not mean that IMFIs does not have profit motive if it use *mudarabah* 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 *mudarabah* and *musharakah* modes of financing which are direct, and indirect method. Although they use different term, Dhumale and Scapcanin (1999) explain and offer 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 *mudarabah* 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 *mudarabah* 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 *mudarabah* 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.

Besides *mudarabah* and *musharakah* equity financing, IMFIs also have the option of providing microfinance services by using debt financing modes such as *murabahah* (or BBA), *salam and istisna*. *Murabahah* is cost plus financing. In *murabahah* or 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 is better known as 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 *mudarabah* 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.

2.2. Conventional Microfinance

Morduch (1999) examines the microfinance promise. The author argues that although microfinance promotes good intentions, however, it is seen to be costly and does little to help the intended beneficiaries. The author argues several mechanism used in microfinance operations in several countries. Morduch (1999) argues the idea for the Grameen Bank does not come from the academics or from high income countries. Instead the idea is developed in a developing nation that is Bangladesh and later it is replicated in Bolivia, Chile, China, Ethopia, Honduras, India, Malaysia, Malt and Philippines, to mention some (Morduch, 1999). Interestingly, Morduch (1999) further argues that Grameen has been considered as an early innovator in microfinance and has been particularly well studied. The microfinance in Bolivia is inspired by Grameen but differs in many ways from Grameen. Firstly its focus is sharply on banking not on social service. Secondly, repayment schedules are flexible, allowing some borrowers to make weekly repayments and others to do so on monthly basis. On the other hand, Indonesia has also introduced a form of microfinance known as Bank Rakyat Indonesia unit desa system. It is financially self-sufficient and also lends to better off and non poor

households with average loan sizes of $1007 during 1996. Unlike BancoSol and Grameen, however Bank Rakyat Indonesia does not use a group lending mechanism. This explains that the practice of microfinance is varied from one country to another.

Hartarska and Nadolnyak (2008) examine the impact of microfinance in Bosnia and Herzegovina. The study employs the financing constraints approach to study the impact of microfinance on access to credit for microenterprises in the country. It uses data obtained from the Living Standards Measurement Survey of the World Bank, the Local Initiative Project and the Association of Bosnian Microfinance institutions. The study discovers that the advent of microfinance institutions help to alleviate microbusiness' financing constraints. The authors also further note that the approach used in this paper evaluates the impact of the microfinance industry as a whole and captures important issues such as oversupply of microcredit and possibly over-indebtedness. It is further discovered that microfinance institutions has improved access to credit in municipalities where two or more microfinance institution offer financial products because investment in local microenterprises is less sensitive to availability of internal funds that is investment in microenterprises in municipalities where microfinance activities are limited or non existent. This study however is merely examining the impact of microfinance using financing constraints approach and there is no evidence rendered on a specific product of microfinance offered.

A study by Rhyne (1998) examines on the implication of microfinance towards alleviating the poor and also the sustainability context. According Rhyne (1998) conventional microfinance has two objectives, namely to improve the poor and to achieve financial viability. The author raises several issues pertaining to the microfinance. Firstly, the issue of cost or pricing to ensure that fundamental poverty can be tackled. Rhyne (1998) suggests that the services offered by microfinance should be affordable and cheaper to be service by clients (e.g. needy/poor). Secondly, the issue of government, private and donor involvement in ensuring the sustainability of microfinance is also of utmost importance. The author believes that microfinance should be assisted by donors and governments perhaps because those donors and governments have ongoing concern with the poor. The parties on the other hand fear that private institutions will ignore the poor if they are involved in this initiative. Rhyne (1998) asserts that microfinance should give emphasis on moral and humanitarian rather than publicity, popularity and profit. This explains that in conventional microfinance, the balancing need of the needy and the poor in society is of utmost importance.

Hulme (2000) examines the importance of micro-debt to poor people and the limitations rendered in the system per se. The author explains that microfinance debt can create considerable opportunities for people to utilize lumps of money so that they can improve incomes and reduce vulnerability. In contrast, the author argues that not all microfinance debt produces favourable results mainly for poor people working in low return activities in saturated markets that are poorly developed and where environmental and economic shocks are common. Instead of seeking for profit, it is explained in the study that microfinance institution should provide social support to tackle such issue and provides ways for improvement. This study concludes two important findings. Firstly, microfinance debt increases poor people's liability not only on their current burden but also extends it to the created debt of microfinance. Secondly, the

introduction of microfinance should be based on "social support" rather than profit per se. This means donors and government supports are of utmost importance.

A study by Lashley (2004) provides an overview of microfinance and its role in mitigating poverty in the Caribbean. Lashley (2004) defines microfinance as a lending of small amounts of money for enterprise development with the ultimate aim of achieving a sustainable rise in income above the poverty line. This concept however is not well understood by governments, donors and other stakeholders which resulted in the slow development of microfinance in the Caribbean. The author notes several factors which hinder the success of microfinance in the Caribbean. The factors, among others, are lack of understanding of the specific nature and characteristics of poverty which hampers the viability of microfinance to combat such issue. The political gain is another reason why microfinance has not grown effectively, to mention some. Interestingly, the author also stresses the importance of using microfinance in alleviating poverty and to do so he suggests several indicators. Those indicators include to properly define who are the poor, the financial needs of the poor and also the methods of understanding the impacts of microfinance to the poor and the needy.

2.3. Islamic Microfinance

Smolo and Ismail (2011) explore the contractual framework in modelling Islamic microfinance institutions (IMFIs). The authors have argued that earlier works on Islamic microfinance have focused on *mudarabah* and *murabahah* contracts whilst others focus on musharakah (Dhumale and Sapcanin, 1999; Akhtar, 1997). Smolo and Ismail (2011) argue that the *Shariah* principles used in IMFIs are not confined to *mudarabah, murabahah* and *musharakah* but also including *ijarah wa iqtina, qard hasan, bay al-salam, bay al-istisna* and *ijarah*. They note these *Shariah* principles are also applicable in the context of IMFIs. The authors suggest *mudarabah, musharakah* and *musharakah mutanaqisah* for financiang small and medium enterprises where the issues of bookkeeping and moral hazard are relatively small. The authors also bring forward the discrepancies between conventional and Islamic micro finance. The former is merely an interest based where the poorest are left out whilst the latter gives emphasis on the poorest in the implementation of IMFIs.

Ahmed (2008) evaluates the Islamic micro-finance practice with a particular reference to financing entrepreneurs based on equity participation contracts. The study uses the Sudanese banks balance sheets and annual reports for the period 1990-2005. On the same note, it also used survey questions to measure entrepreneurs' perception on *musharakah* mode of financing. Concerned with the data collected through the banks' balance sheets, it is discovered that *murabahah* has the biggest share of the fund with an average of 47.3 percent whilst *musharakah* is also popular with an average share of 29.3 percent of the total financing. Interestingly, the author finds that there is an increase in the application of profit and loss sharing (PLS) in Sudanese banks. In addition, the survey also found that the respondents believe that the losing control of the business is the worst factor when they are planning to choose equity financing.

Sadique (2008) captures the importance of financing micro and medium enterprises using *musharakah mutanaqisah*. The paper argues that "the reality of the underlying contracts should

be effectively highlighted through pricing the units and *ijarah* rentals realistically, rather than as an apportionment of the profit element calculated on the capital outlay" (Sadique, 2008, p.53). Technically, the author explains that any expenditures pertaining to partnership should be shared proportionately in which the profit share of the bank should decline corresponding to the bank's stake. It is also expounded that the unit price of the bank's share could be fixed based on a price negotiated at the time (Sadique, 2008). An interesting argument made by Sadique (2008) is that the Islamic bank should not restrict its involvement in the enterprise to that of a financer but also as an equity partner which permits them to actively involve in management, decision making and full participation to make the successful performance of the enterprise.

Ahmad and Ahmad (2008) examine the viability of microfinance in Australia. Like other authors, Ahmad and Ahmad (2008) explain several forms of Islamic microfinance schemes namely *mudarabah* and *murabahah*. Other forms of Islamic microfinance (e.g. *musharakah mutanaqisah*) are not explored. Of the two principles explained, the authors provide further illumination pertaining to *murabahah* model by taking Hodeidah Microfinance Programme in Yemen as the appropriate model to be extended in the context of Australia. The Programme is the first microfinance project of its kind in Yemen and consequently has had to develop its human resources itself (Ahmad and Ahmad, 2008). The selection of the Programme is based on the two reasons, firstly the Programme has set up appropriate modus operandi in the process of giving out financing to clients. Secondly, the Programme is conducted in Islamic manner in helping the *Muslims* to pursue the activities of Islamic economics.

Abdul-Rahman (2007) examines Islamic microfinance as part of important component of Islamic banking. Interestingly, Abdul-Rahman (2007) explains several principles which have great potentials to be advanced and adapted as Islamic microfinance schemes. The principles, among others, are *mudarabah, musharakah, murabahah, ijarah* and *qardhul hasan*. Of these, he argues that *qardhul hasan* concept is found to be reliable in helping the poor and the needy. Through this principle, Islamic bank can provide fund to entrepreneurs who are in need of small start-up capital and have no business experience (Abdul-Rahman, 2007). On the other hand, Abdul-Rahman (2007) also explains the significance of *musharakah mutanaqisah* to Islamic microfinance. Here, the bank and the entrepreneur will share the capital in which the former will contribute say 90 percent whilst the latter will contribute say 10 percent. At the end, the business will solely be owned by the entrepreneur once all capital repayments have been reimbursed. Yet, there is no information provided by the author with regard to the proper calculation of profit sharing and loss ratio between the transacted parties.

3. MUSHARAKAH MUTANAQISAH: AN INNOVATIVE ISLAMIC MICROFINANCE PRODUCT

3.1. The Musharakah Mutanaqisah Concept

The *musharakah mutanaqisah* concept is based on a diminishing partnership contract. The *musharakah mutanaqisah* 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 Usmani (2002) for example, agreed that the *musharakah mutanaqisah* can help people to rely less on other financing facilities such as the BBA, *murabahah,* etc. Islamic scholars agree that *musharakah mutanaqisah* 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 Usmani, 2002).

The concept of *musharakah mutanaqisah* is not only limited to home ownership. 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 = RM40,000
Amount of financing from IMFI (75%) = RM30,000
Client (25%) = RM10,000
Tenure for 40 months (3 years and 3 months)
Monthly rent = RM170*

Client additional purchase of IMFI's share = RM 647.14
Total monthly payment = RM817.14

$$\text{* Actual rental rate} = \frac{\text{RM170 x 12}}{\text{RM40,000}} = 5.10\% \text{ p.a}$$

Table 1: Payments Schedule for *Musharakah Mutanaqisah* Contract

Month	Monthly rental	Additional purchase of share	Total payment	Client's profit ratio	Rental division		Client's equity	IMFI's equity	IMFI's cashflow
					Client	Financier			
	(A)	(B)	(C=A+B)	(D)	(E)	(F)	(G)	(H)	(I)
0				0.250			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 = RM32,685.60 (RM817.14 x 40)

Rental distribution:
E-1 (Customer's) = RM42.50 (0.25 x RM170)
F-1 (IMFI's) = RM127.50 (0.75 x RM170)

Equity distribution:
G-1(Customer's equity) = RM10,000 + (RM647.14 + RM42.50) = RM10,689.64
H-1 (IMFI's equity) = RM40,000 – RM10,689.64 = RM29,310.36

The client will pay rental based on the actual rate of the property amounting to RM170 per month (Mydin Meera & Abdul Razak, 2009). In addition, he purchases additional share from IMFI amounting to RM47.14 monthly. Hence, the total monthly payment to be made to IMFI will be RM817.14 (RM170 + RM647.14). As can be seen the rental distribution earned by the client (column E of Table 1) gradually increases from RM42.50 in month 1 to RM51.33 in month 4, as client's equity in the property increases from RM10,000 to RM12,776.20 (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 RM32,685 has been made to IMFI.

3.3. Flexibility and superiority of Musharakah Mutanaqisah

The main advantage and superiority of the MM contract over debt financing contracts such as *murabahah* and 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:-

$$PV = \frac{Pmt}{i}\left[1 - \frac{1}{(1+i)^n}\right] \text{ which give } Pmt = \frac{i(1+i)^n \, PV}{(1+i)^n - 1} .$$

Cost of property = RM40,000
Cost of financing IMFI (75%) = RM30,000
Tenure for 40 months (3 years and 3 months)
Profit rate = 9.02 % p.a*
Monthly installment amount = RM864.69
Selling Price = RM34,587.60 (RM864.69 x 40)
*9.02 % p.a is bench marked based on average lending rate (Abdul-Razak, 2011).

Table 2 compares the two different methods of computations using BBA and *musharakah mutanaqisah*. As can be seen, the monthly installment computed using BBA (RM864.69) is more expensive than *musharakah mutanaqisah* which is only RM817.14. This result is higher profit made by IMFI i.e. RM1,902. If the client uses the same monthly installment of RM864.69 he pays for BBA for *musharakah mutanaqisah* 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 *musharakah mutanaqisah* 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.

Table 2: Comparison of Computation using BBA and MM Financing

Types of financing	**BBA**	***Musharakah mutanaqisah***
Amount of financing	RM30,000	RM30,000
Profit rate / Rental rate	9.02 % ph.a	5.1 % p.a
Tenure	40 months	40 months
Monthly installment	RM864.69	RM817.14
Total cost of payment for the 40 months	RM34,587.60	RM32,685.60
Total profit paid to IMFI	RM4,587.60	RM2,685.60

The second implication on the flexibility of the *musharakah mutanaqisah* 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 RM200 in his monthly installment amounting to RM1,017.14 compared to RM817.14 in Table 2. This will reduce the tenure of financing to 31.4 months from the

[1] Conventional standard formula for present value of annuities as computation for conventional housing loan, i.e.

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 BBA which compute profit upfront.

Table 3: Payments Schedule for *Musharakah Mutanaqisah* Contract

Month	Monthly rental	Additional purchase of share	Total payment	Client's profit ratio	Rental division		Client's equity	IMFI's equity	IMFI's cashflow
					Client	Financier			
	(A)	(B)	(C=A+B)	(D)	(E)	(F)	(G)	(H)	(I)
0				0.250			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	1,017.14

Notes: Total payment = RM40,685.60 (RM1017.14 x 40)

4. CONCLUSION

Islamic microfinance can be an effective tool to promote Islamic economics which in turn can 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 improve credit financing that is based on fundamental human right (Abdul-Rahman, 2010) 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. Concerned with practical application, the present study provides two policy implications. Firstly, our research provides invaluable insights into the practice of *musharakah mutanaqisah* for Islamic microfinance. Particularly, our findings provide important guideline to direct a proper practice along with the pricing (e.g. rental) of *musharakah mutanaqisah* for Islamic microfinance institutions. Secondly, our research indicates the active involvement of Islamic microfinance institutions in a joint venture with their clients. It is explained in more details that our findings will help Islamic microfinance institutions to work with small and medium sized enterprises to promote the Islamic economics better.

It is also worth noting that the present study contributes to body of knowledge. Firstly, the current work adds to the literature in the area of Islamic microfinance. Secondly, the current work offers general guideline for practitioners to handle with care when offering microfinance facilities. Despite these contributions, the paper acknowledges three limitations. The present study is particularly a conceptual paper where there is no empirical results being reported which may confine its contribution into the body of knowledge in the area of Islamic microfinance. Secondly, the present work does not extend any prior theories to Islamic microfinance. It is of prime importance for future studies to tackle such shortcomings. Thirdly, the study does not deliberate on the implication of profit sharing loss ratio to the different level of poor people who are diversed in terms of income level. As such, more works should be done to capture the importance of Islamic microfinance using empirical data, such as questionnaire survey and supported by qualitative data. Future works are necessary to apply any relevant theories for the purpose of testing and generalization. Future works are also welcomed to examine the implication of profit sharing loss ratio to the poor people who obtain the financing for the purpose of running businesses.

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