



# Towards Adopting Zero Interest Financing (ZIF) and Profit and Loss Sharing (PLS) Principle in Islamic Microfinance: The Case of Amanah Ikhtiar Malaysia

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## Abstract

Microfinance institutions evolved to alleviate poverty by providing micro-credit to the poor. Islamic microfinance evolved to provide alternative to the interest based conventional microfinance. However, the financing modes being used by the Islamic micro-finance institutions (IMFIs) are mostly debt based, which have resemblance to the interest based conventional modes. IMFIs shun away from using the PLS scheme, which they consider risky. Theoretically, it is argued that PLS mobilizes factors of production, encourages risk sharing and ensures distributive equity in income and wealth. There is hardly any literature that has shown that PLS is workable in a pristine environment of zero interest. Furthermore, there is hardly any studies that have discussed on the feasibility of financing the poor using a combination of PLS and zero interest financing (ZIF). This study will experiment on the feasibility of providing small financing using a combination of PLS and ZIF to empower the working poor. The research incorporates literature survey, field study and business model applications in its methodology to achieve the desired objectives. The results of this pioneering project are expected to promote the local socio-economic welfare of the poor and provide opportunities in applied areas for future research.

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*Keywords:* Poverty; Islamic microfinance; Amanah Ikhtiar Malaysia; Equity-based financing; Interest-free financing.

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## 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 of 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. IMFIs largely adopt Murabahah and Bai-Bithaman-Ajil modes of financing and their use of Profit and Loss Sharing (PLS) financing scheme is still negligible. For instance, in the Middle East, the Hodeida Microfinance Program in Yemen has adapted the Grameen Bank model and it uses Murabahah mode of financing instead of the PLS scheme. 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. Furthermore, Obaidullah and Khan (2008) reported that IMFIs in Indonesia use reasonably balanced array of products - based on Mudharabah, Musharakah, Murabahah, Ijarah and Qard al-hasan. This however is a new trend because Seibel (2005) reported that in BPRS (one of IMFIs operating in Indonesia), the main financing product is still Murabahah, i.e. a sale contract between bank and customer with a fixed profit margin for the bank. Flexible profit-sharing, which is considered cumbersome to calculate, is of minor importance.

The study is undertaken based on the belief that Microfinance as a method that provides small loans to empower the working poor can be replicated, but it requires tailored adjustments to the local socio-economic and cultural characteristics on the other (Segrado 2005 and Saad 2012). In the proposed pilot project that will be conducted in Malaysia, the underlying values of the project are based on promoting and innovating a socially ethical microfinance. That is, the priority is on the protection of the entrepreneurs seeking financing as well as on their performance on economic mobility. Specifically, zero interest financing are being pursued in which service fee on conventional loans are replaced by mechanisms that are Shari'ah compliant.

This research will also focus on the application of Mudharabah and Musharakah, 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 research will highlight that Mudharabah and Musharakah have several advantages over debt-based financing such as ownership of assets by the entrepreneur/client.

In addition to using ZIF and PLS models, the study will also experiment the application of pure Murabahah financing with AIM members. In this mode of financing, instead of giving cash, as is currently being practiced, AIM will purchase commodities needed by the members to start or expand their businesses and sell these commodities to the members at marked up price.

This study attempts to achieve the following objectives:

1. To conduct a pilot study on selected AIM members by giving them interest free financing and financing based PLS concept.
2. To test the level of amana (trust) and sense of syukur (appreciation) among the selected recipients based on the amount of money donated back to the general fund (a portion of their profit) when the recipients pay back their interest free financing.
3. To investigate the feasibility of adopting PLS mode of financing by Islamic microfinance institutions.

This will be the first study to experiment with interest free financing in its purest form, i.e., poor entrepreneurs will not be imposed with service charge on their financing, but they are encouraged to donate a portion of their profit when they repay their financing. This will be the first study to innovate Islamic Microfinance in which particular principles are pursued (i.e., Mudharabah and Musharakah) that do not burden entrepreneurs with debt but, at the same time, expect them to give charity (i.e., Sadaqah, Waqaf) through their own sense of trust and appreciation.

## 2. Literature Review

Islamic microfinance is rooted in a desire for economic growth and prosperity of socio-political system based on Islamic principles and carries same principles that have been applied to trading, business, investing and mortgages within Muslim communities. Islamic principles of equal opportunity, advocacy of

entrepreneurship, risk sharing, disbursement of collateral free financing, and participation of the poor are supportive of microfinance principles.

Ahmed (2002) noted several distinctions between conventional microfinance and Islamic Microfinance. In his opinion, both conventional microfinance and Islamic microfinance can mobilize external funds and savings of clients as their source of fund. However, Islamic microfinance can access Islamic charity such as zakat and waqf as sources for funding activities that serve the purpose of those charity funds. Regarding financing, conventional microfinance can easily adopt interest-based financing while Islamic microfinance should eliminate interest in their operation. Therefore, Islamic microfinance should explore any possible mode of Islamic financing for their operation. Conventional microfinance is criticized for neglecting the poorest.

On other hand, Islamic microfinance can maximize their social services by using zakat to fulfill the basic need and increase the participation of the poorest poor. In conventional microfinance, the institution can directly give cash to its client for financing. Several literatures have noted, however, that in some cases the clients (women) give the cash directly to their husbands for personal use. As a result, the objective of the microfinance to the client cannot be achieved. In contrast, Islamic microfinance institutions do not give cash to their clients. In principle, direct loan for business to the client is not allowed unless it is for social need, which is given as Qard (loan) with no interest or any incremental amount charged on the loan.

Therefore, Islamic microfinance uses Islamic financial products which are based on trading or equity rather than loan. In some of these instruments, goods needed by the client are bought by the financier and are directly transferred to the client, not in the form of cash. Conventional microfinance institutions put women as their target client. On the other hand, Islamic microfinance institutions do not only target women client but also family as a whole. Moreover, conventional microfinance uses group involvement to mitigate risk in their operation. Islamic microfinance also uses similar technique, but in addition takes advantage of Islamic ethics to ensure their client pay their dues regularly. Islamic microfinance also uses Islamic behavioral conducts and ethics in their social program, which is different from conventional microfinance that uses conventional secular principles in their program. Table 1 summarizes the differences between conventional microfinance and Islamic microfinance according to Ahmed (2002).

Table 1. Differences between Conventional and Islamic Microfinance

Items	Conventional MFI	Islamic MFI
Liabilities (Source of Fund)	External Funds, Saving of Client	External Funds, Saving of Clients, Islamic Charitable Sources
Asset (Mode of Financing)	Interest-Based	Islamic Financial Instrument
Financing the Poorest	Poorest are left out	Takes care of the poorest by integrating zakat with microfinance
Funds Transfer	Cash Given	Goods are transferred
Deduction at Inception of Contract	Part of the funds is deducted at inception	No deduction is made at inception
Target Group	Women	Family
Objective of Targeting Women	Empowerment of Women	Ease of availability
Liability of the Loan (Given to Women)	Recipient	Recipient and Spouse
Work Incentive of Employees	Monetary	Monetary and Religious
Dealing with Default	Group/Center pressure and threat	Group/Center/Spouse guarantee, and Islamic ethics
Social Development Program	Secular (non Islamic) behavioral, ethical, and social development	Religious (Includes behavior, ethics and social)

Source: Ahmed (2002)

Karim, Tarazi and Reille (2008) reported that the demand of Muslims for Shari'ah compliant microfinance products has led to the emergence of Islamic microfinance as a new market niche. They furthermore commented that Islamic microfinance has the potential of expanding financing to unprecedented levels throughout the Muslim world.

Ahmed (2002) conducted a study to gain empirical evidences from three Islamic microfinance institutions (IMFIs) operating in Bangladesh. The study found that IMFIs appear to have performed better than Grameen Bank, the largest conventional MFI operating in Bangladesh. Ahmed (2002) states that one possible explanation for this is that perhaps the IMFIs benefit from the social capital derived from Islamic values and principles. The study however, states that all of the three IMFIs report that the expansion of their activities is held back by lack of funds. Another finding from the study indicates that IMFIs have not yet tapped the sources of funds from Islamic institutions such as waqf.

A global survey conducted by CGAP on Islamic microfinance in 2007 found that the outreach of Islamic finance is very limited (Karim, Tarazi, and Reille, 2008). According to the survey, Islamic MFIs serve 300,000 clients through 126 institutions operating in 14 countries. The survey also found that Bangladesh has the largest Islamic microfinance outreach serving 100,000 clients. Furthermore, the survey found that Bangladesh also has the largest conventional microfinance outreach serving almost 8 million clients, and Islamic microfinance represents only 1 percent of the microfinance market. The survey concludes that in all Muslim countries, Islamic microfinance still represents a small percentage of the country's total microfinance outreach. Finally, the CGAP survey found that Islamic MFIs lack product diversification, offering only one or two Islamic financing products and over 70 percent of the products offered are Murabahah modes.

### **3. Proposed Financing Models**

#### *3.1 Zero Interest Financing*

By some accounts, if borrowers of Islamic microfinance programs in Malaysia can increase their income level and move out of poverty, they would soon become active contributors of zakat (Hamdan et. al., 2012). To be sure, there is evidence that AIM microcredit program, relative to other microfinance programs in Malaysia, has notably increased employment rates and income level along with improving human development and quality of life even for hardcore poor households (Mamun et. al, 2010 & 2011; Saad 2010 & 2011; Hamdan et. al., 2012). However, while AIM does not charge interest on loans due to restrictions of Shari'ah Law, it essentially replaced interest with management fees (Mokhtar 2012). Here, the proposed research suggests the utilization of zakat/sadaqah system to replace the use of management fees. Zakat is considered a temporary measure to allow the poor to graduate from the level of recipient to a level of donors. According to Mustafa (2011), al-Shaybani puts zakat at the third hierarchy of infaq (spending), which implies that it is compulsory for a Muslim to earn and spend for basic needs to the level that he is in a position to pay zakat. Therefore, it is just important for the needy as it is for the endowed to aspire and engage in zakat because zakat brings one closer to God, prevents miserliness, acts as a compensation for sins and a means to security (Senturk 2007).

The zakat system does render specific percent or a minimum amount that an entrepreneur from AIM's zero interest financing would eventually have to donate to. In the case that particular entrepreneur can't donate the expected percent or amount, then he can opt for sadaqah - a subcategory of zakat. In sadaqah, the entrepreneurs can perform virtuous acts by giving the most they can at a given time (Senturk 2007). Together, zakat and sadaqah, can effectively and efficiently create a general "Tabarru'Capital Fund" or a donation to capital fund. Such Shari'ah mechanisms could progressively attract various AIM clients to join the scheme. Lastly, to further innovate "Tabarru'Capital Fund," repeat and successfully AIM clients could later subject their business products and services to zakat, where a certain percent or amount of their products and services could go towards the capital fund; in fact, "zakat" products could result in more customers buying such products.

Under zero interest financing model proposed in this study, service fee on conventional loans are replaced by mechanisms that are Shari'ah compliant. For example, the Shari'ah mechanism will create a general "Tabarru'Capital Fund (TCF)" or a donation to capital fund. Core poor families and individuals that are selected for zero interest financing are expected to donate to this fund. They are encouraged to donate from their subsequent profits a minimum amount equivalent to 10% of their profit obtained from the zero interest financing scheme. Such donations are treated as sadaqah for helping other poor families to join the scheme. Contributions for Tabarru' Fund are not only limited to clients who obtain ZIF

financing from AIM but can be opened to sadaqah given by other members or zakat money paid by either staff or relatively well off AIM members.

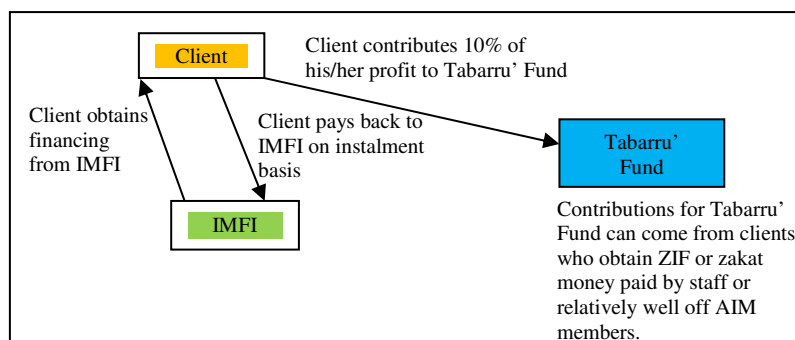


Figure 1. Illustration of Zero Interest Financing

### 3.2 Murabahah Financing

Murabahah is a contract of sale where seller discloses to buyer actual cost of commodity and profit margin added. In Islamic financing, murabahah financing is used to enable businesses to obtain funds to purchase equipment, machinery and other assets for commercial purposes. Murabahah financing is limited to cases where customer actually needs to purchase the commodity. It cannot be used to purchase commodities already owned by customer, to get cash or to pay for utilities or salaries. Financier must purchase commodity from a third party and not from customer itself. Financier must own the commodity, come into possession of the commodity and bear ownership risks of the commodity, even if only for a short period. In certain exceptional cases where it is not practicable for the financier to purchase the commodity directly from supplier, customer is allowed to act as an agent, on behalf of the financier, to purchase the commodity. Payment for goods under murabahah may be made on cash basis or deferred payment terms.

Murabahah is a sale contract; therefore, all the basic rules of sale prescribed by Shariah must be fulfilled in a murabahah contract. The basic rules of sale are as follows:

- Subject of sale must be existing at time of sale
- Subject of sale must be owned by seller at time of sale
- Subject of sale must be in physical or constructive possession of seller at time of sale
- Sale must be instant and absolute
- Subject of sale must be of value
- Subject of sale cannot be for *haram* use (eg. Selling grapes for brewery)
- Subject of sale must be specifically known and identified
- Certainty of delivery
- Certainty of price
- Sale must be unconditional

In addition to the above rules, there are additional specific conditions that need to be observed for the murabahah contract to be valid. These conditions are as follows:

- The cost price must be disclosed to the buyer/client
- The mark-up (profit) must be disclosed to the buyer/client

#### 3.2.1 Options on the Structure of Murabahah

It must be emphasized that murabahah is a sale that requires specific expertise which microfinance institution like Amanah Ikhtiar Malaysia may or may not have. It is possible however, to train all staff in trading, marketing and other areas of real sectors activities.

Ayub (2007) suggested that one possible option is to establish a limited company to conduct trading activities and staff with proper expertise may be assigned the job of trading in accordance with the Shariah

principles of murabahah. Another option suggested by Ayub is that trading activities may be conducted by appointing client as agent or through a third party agent. The possible structures of murabahah discussed by Ayub are described below:

#### *3.2.1.1 Direct Trading by Microfinance Institution*

Direct trading by microfinance institution is the most ideal structure to fulfill Shariah requirements under murabahah. This option could be used in cases of specific assets whereby AIM could buy any specific good or asset and sell it to its clients on a cost-plus basis. For example, in providing financing for food industry, AIM could purchase food processing machines and provide them to clients at a marked up price. The difficulty of implementing this structure is that it requires the staff of AIM to have expertise in trading assets or goods in different industries that the clients are involved in.

#### *3.2.1.2 Purchasing Goods Through a Third Party /Agent*

Under this option, AIM could appoint selected suppliers as agents for purchase as and when needed by the clients. AIM has to assume the risk of ownership and liabilities of the asset for the period between the purchase of the good from the supplier and the sale of the good to the client. In other words, AIM stand liable of any defect of the asset before it is being delivered to the client.

#### *3.2.1.3 Purchasing Goods Through Clients as Agent*

The structure of appointing client as AIM's agent is the most excellent way to evade assuming commodity-based risks. However, as pointed out in Ayub, this arrangement is likely to make murabahah transactions a back door to riba and, henceforth, requires careful treatment to fulfill the Shariah principles. The major condition is that the good is purchased under the ownership and risk of AIM. If AIM does not purchase and own the goods and only makes payment of the goods bought by the client, this arrangement is similar to a loan to the client and any profit made on this arrangement is nothing but riba.

#### *3.2.2 Steps in Murabahah Financing*

Figure 2 shows the flow of a murabahah financing. The steps are as follows:

1. Client identifies commodity/asset to be acquired from supplier.
2. Client approaches AIM to purchase the commodity/asset and promise to buy the commodity/asset from AIM.
3. AIM purchases the identified commodity/asset from the supplier on cash basis.
4. AIM sells the commodity/asset the client at a cost plus profit on credit basis.
5. Client pays AIM on instalment basis

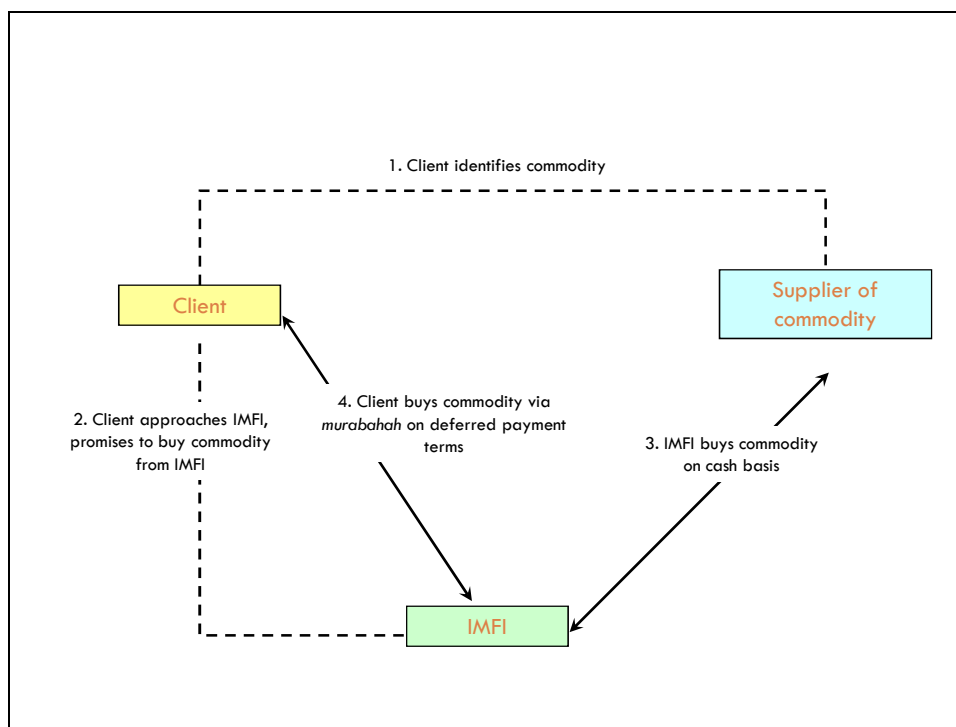


Figure 2. Possible Steps in Murabahah Financing

### 3.2.3 Cases of Murabahah Financing

#### 3.2.3.1 Bangladesh

Murabahah is the main mode of financing used by three Islamic microfinance institutions (IMFIs) in Bangladesh. These IMFIs are Al-Fallah, Rescue, and Noble. To make the transaction Islamically acceptable, the IMFIs should ideally buy the good/asset from the market and sell it to the client at a mark-up. Ahmed (2002) reports that during initial stages of their operations, the three IMFIs have tried to follow this principle. However, with the growth of their operations, the IMFIs have slowly moved away from this practice. The reasons given are that it is too costly (in terms of man-hours) and sometimes impossible to buy the goods/assets that clients require. For example, it becomes very hard to go along with a client who wants to buy a particular kind of good/asset if it is sold in a remote market. Rather than giving money to client, Ahmed (2002) reports that the IMFIs at a later stage entrust someone else to buy the good/asset. The staff of the IMFIs then examine if the money was used to buy the good/asset during the weekly meeting that follows.

#### 3.2.3.2 Yemen

Traditional banking products have been available in Yemen for many years, however, many people, especially the poor, are not keen to take credit, to some extent due to religious reasons. This is one of the most important reasons why the Hodeidah Microfinance Programme (HMFP) was established in 1997, in Hodeidah, Yemen.

Under murabahah financing of HMFP, once a financing application has been approved, the HMFP officer purchases the required goods/commodities and resells them to the clients at a mark-up of 2% per month. The client then, signs a contract indicating the final price of the resold items, the repayment period, and the instalment amount.

To manage the model, HMFP financial department opens an account for each client indicating the number and size of each instalment and the due date. The HMFP officer issues receipts to clients when collecting repayments. Monitoring of clients' projects are done by the district supervisor, project manager, and assistant project manager in the form of random field visits to clients' projects to verify the survival and sustainability of their businesses.

In addition, the project management team, working together with the financial department, prepares monthly progress reports indicating the amount of funds distributed, types of businesses, gender distribution of borrowers, repayment rate, overdue rate, delinquency rate, and age of arrears. Clients who manage their businesses prudently and competently and pay back their instalments on time are eligible for a consecutive financing for the same or a larger amount, based on their business needs.

### 3.3 Musharakah Mutanaqisah Partnership (MMP)

Based on the provisions given by the AAOIFI Standard (2004-5), "MMP is a form of partnership in which one of the partners promises to buy the equity share of the other partner gradually until the title to the equity is completely transferred to him. This transaction starts with the formation of partnership, after which buying and selling of the equity take place between the two partners. It is therefore necessary that this buying and selling should not be stipulated in the partnership contract. In other words, the buying partner is allowed to give only a promise to buy. This promise should be independent of the partnership contract. In addition, the buying and selling agreement must be independent of the partnership contract. It is not permitted that one contract be entered into as a condition to concluding the other". (Page 214)

The rules of Sharikat al-inan applies to MMP. The following are the salient necessary conditions:

- i. It is permitted that the contract of MMP include clauses that give any of the parties right to withdraw his share in the capital
- ii. It is not permitted to stipulate that one of the party bears all the cost of maintenance, insurance
- iii. Each party should contribute part of the capital. The contribution may be in the form of cash or tangible assets that can be translated into monetary values, for example building, land and equipment.
- iv. The ratio of profit or income of the partnership that each partner is entitled to should be clearly determined. However, it is permissible for the partners to agree on a ratio of profit sharing that is disproportionate to the ratio of equity ownership.
- v. Losses are determined in accordance with the ratio of equity share of ownership.
- vi. It is permissible for one of the partners to give a binding promise that entitles the other partner to acquire, on the basis of sale contract, his equity share gradually, according to the market value or a price agreed at the time of the acquisition. However, it is not permitted to stipulate that the equity share be acquired at their original or face value, as this would constitute a guarantee of the value of the equity shares of the partner by the other partner, which is prohibited by Shari'ah.
- vii. It is permissible for either of the partners to rent or lease the share of the other partner for a specified amount and for whatever duration, in which case each partner will remain responsible for the periodical maintenance of his share on a timely basis.

[AAOIFI, pages 214-5]

#### 3.3.1 Options on the Use of MMP

Presently, MMP is widely used by Islamic financial institutions for home financing. The following are the salient steps in MMP home financing: where the bank and the customer jointly purchase the house.



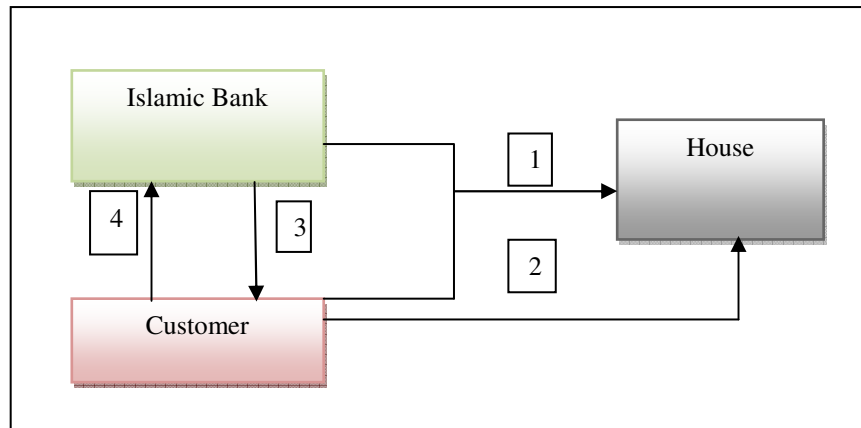


Figure 3. Options on the use of MMP

#### Salient operational Steps

1. The Islamic bank and customer jointly purchase and own the house through Sharikat Milk
2. The customer signs a separate binding promise to purchase the Islamic bank's equity in the house (Wa'd)
3. The bank leases its equity to the customer through al-Ijarah Overtime, the bank's equity diminishes and the customer's equity increases
4. In the end, customer purchases the house from the bank through murabahah sale

According to Imran Taqi Usmani (2005), MMP application can be extended to working capital and services. These two applications are very much relevant to AIM, as follows.

#### 3.3.2 MMP for Working Capital

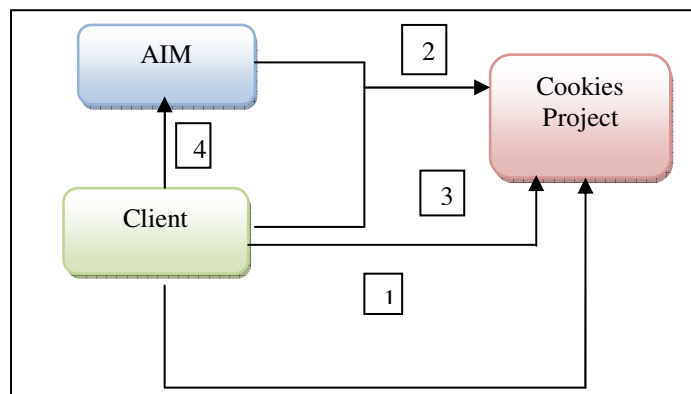


Figure 4. MMP Working Capital

#### Salient Operational Steps

1. AIM client will first have to identify the project she wants to undertake, say the project of selling cookies. She then estimates the total amount of capital required, say RM1000.
2. She enters into partnership agreement with AIM (Shirkat) where AIM provides 90% (RM900) of the required working capital for the cookies project, and the client contributes the 10% (RM100)

3. The client signs a binding promise (Wa'd) agreement to purchase AIM's equity in the cookies project.
4. She periodically buys AIM's equity in the project with a mark-up. Her equity increases as AIM's equity diminishes

### 3.3.3 MMP for Services

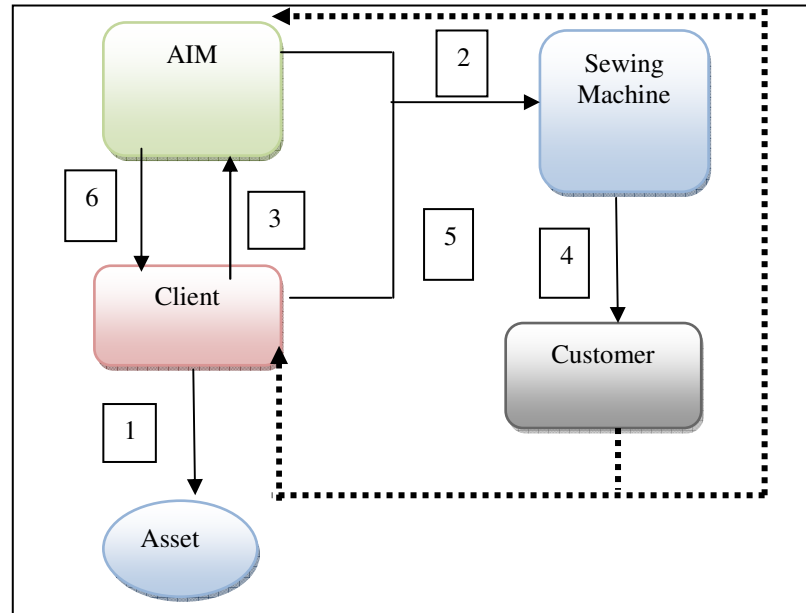


Figure 5. MMP for Services

### Salient operational Steps

1. AIM client will first have to identify the project she wants to undertake. She then estimates the total cost required for purchasing the machine, say RM700.
2. She enters into partnership agreement with AIM (Shirkat) where AIM provides 90% (RM630) of the required cost for purchasing the machine, and the client contributes the 10% (RM63)
3. The client signs a binding promise (Wa'd) agreement to purchase AIM's equity in the machine.
4. She leases the sewing machine to customers
5. Both agree on the ratio of sharing the returns from the lease proceeds
6. Meanwhile the client periodically buys AIM's equity in the machine with a mark-up. Her equity increases as AIM's equity diminishes

### 3.4 Mudarabah

Mudarabah is a partnership in profit whereby one party provides capital (rab al-maal) and the other party provides labor (mudarib) (AAOIFI, 2004-5).

#### 3.4.1 Generic Mudarabah Model

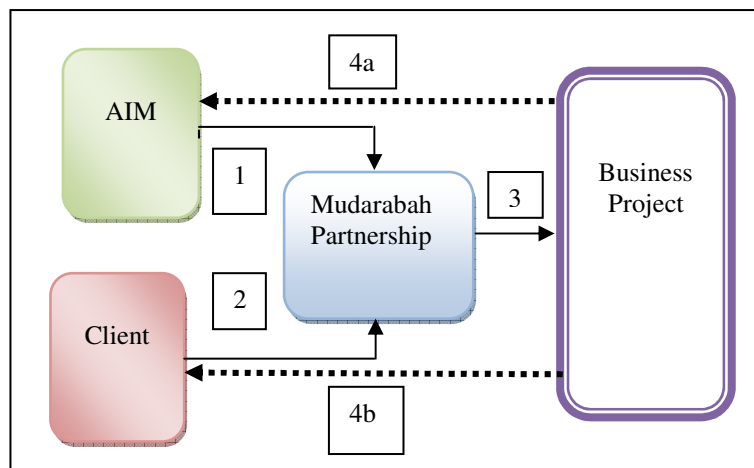


Figure 6. MMP for Services

### Salient Operational Steps

1. After the client has identified the project, AIM contributes capital to the mudarabah partnership.
2. The client contributes entrepreneurship to manage the fund in the partnership
3. The fund and the entrepreneurship are employed in managing the project.
4. From the business project, the two parties receive the returns (4a and 4b). In case of profit, it is distributed according to predetermined ratio. AIM will receive the profit portion plus the principle amount and loss is borne by the capital owner (AIM) and the client loses time and effort.

The agreement of mudarabah financing should include (AAOIFI, 2004-5):

1. It is permissible on the basis of general framework or a memorandum of understanding, to conclude mudarabah financing contracts for a particular sum of money and within a particular defined duration provided that the memorandum of understanding will be later implemented in line with specific or successive mudarabah transactions
2. The memorandum of understanding should define the general contractual framework, indicating the intention of the parties to use either unrestricted or restricted mudarabah financing instrument, either through revolving transaction or separate transaction. Also, the memorandum of understanding should indicated the profit ratio, and type of guarantee that shall be presented by the mudarib to cover situations of negligence, misconduct or breach of contract and other relevant issues in this regard.
3. If the mudarabah contract is actually concluded on the basis of the memorandum of understanding, the contents of the memorandum become an integral part of any future contract, unless the parties had originally agreed to exempt themselves from some of the obligations mentioned therein.
4. The mudarabah contract may be concluded using terms such as mudarabah, qirad or mu'amalah
5. Both parties should possess the legal capacity to appoint agents and accept agency. Therefore, a mudarabah contract may not be concluded in the absence of two contracting parties with absolute legal capacity or of the agents who enjoy legal capacity similar to that of the contracting parties.
6. The general principle is that a mudarabah contract is not binding, i.e., each of the contracting parties may terminate it unilaterally except in two cases:
  - a. When the mudarib has already commenced the business, in which case the mudarabah contract becomes binding up to the date of actual or constructive liquidation.

- b. When the contracting parties agree to determine a duration for which the contract will remain in operation. In this case, the contract cannot be terminated prior to the end of the designated duration, except by mutual agreement of the contracting parties.
7. A mudarabah contract is one of the trust-based contracts. Therefore, the mudarib is investing mudarabah capital on a trust basis in which case the mudarib is not liable for losses except in case of breach of the requirement of trust, such as misconduct in respect to the mudarabah fund, negligence and breach of the terms of mudarabah contract. In committing any of these, the mudarib becomes liable for the amount of the mudarabah capital.

### 3.5 Challenges of MMP and Mudarabah

Normally, the following challenges are associated with MMP and mudarabah, similar to other forms of partnership:

1. Adverse selection, which means AIM may select clients that are not supposed to be selected for the project and leave out those who are capable of undertaking the project. Therefore, AIM should carefully scrutinize the profiles of prospective clients
2. Moral hazard is another challenge. In this situation, there are tendency for clients to use funds for other no productive purposes other than on the intended purpose. This would necessitate AIM to enhance its weekly monitoring mechanism with new skills in the areas of al-shirkat (partnership).
3. Agency problem is common in partnership. The client may hide vital information in the business such as the amount of revenue and profit. Thus, again AIM has to strengthen its weekly monitoring mechanism.
4. Pricing should be based on the viability and cash flow of the project. This is unlike the present system which prices loans based on the cost of the capital
5. Ethical issues such as trust and honesty need to be enhanced by improving the ethical contents of AIM's training modules.

#### 3.5.1 Cases on Mudarabah

Presently, there are few known cases on the application of mudarabah in microfinance. However, there are two cases known to the authors, namely the Tazkiah case in Indonesia and the Chicago Islamic microfinance project. Both institutions using the partnership model are reported to be successful. There is a need to study their practices, though. Below is an extract from the Chicago model.

##### 3.5.1.1 Extract from the Chicago Islamic microfinance project

The Chicago Islamic Microfinance Project offers Shariah-compliant investment financing in targeted areas in the City of Chicago, administered by professors and students at a Chicago-based university. The project engages two professors for a five-year pilot period at an academic institution of higher learning. One business school professor and one law school professor is appointed to teach together in a joint clinical project. In addition to offering courses in Islamic law and finance, the professors supervise students in the actual administration of an investment fund providing small business financing on a profit and loss sharing partnership basis. The Chicago Islamic Microfinance Project will foster a sense of community and responsibility among participating entrepreneurs by additionally providing supportive services to encourage business development and success. By training university students in the practice of Islamic financial principles, the opportunity exists to positively impact the next generation of business people and lawyers. By directly investing in the targeted communities, the project will generate opportunities for entrepreneurs to develop their own solutions to the economic downturn on a small, healthy scale, while simultaneously providing useful and necessary services to benefit the community (Available at: [http://works.bepress.com/karen\\_hunt\\_ahmed/1](http://works.bepress.com/karen_hunt_ahmed/1))

#### 4. Data and Methodology

A pilot study will be conducted to test the feasibility of zero interest loans (ZIL) and PLS mode of financing as proposed above among selected AIM members. Recipients of ZIL will be selected from AIM members who are relatively new and do not possess steady businesses. On the other hand, the recipients of PLS financing will be selected among those who have been a member of AIM for several years, have a steady business, and demonstrate capabilities of managing and keeping proper account of their businesses.

#### 5. Expected Results of the Study

The results of this pioneering project are expected to promote the local socio-economic welfare of the poor and provide opportunities in applied areas for future research. The result is also expected to set a clear target of graduation from poverty, that is, the poor are expected to reach the level of becoming zakat donors. Furthermore, the Shari'ah modes of financing used in the model will mobilize resources in the real sector and spur genuine growth rather than debt creation, which is typical of the existing microfinance models. Finally, the results will encourage AIM workers to engage in genuine interaction with their clients and acquire first hand grass root feel of the situations on the ground.

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