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Applicability of the Islamic Micro-Investment Model (IMIM) in Islamic Bank in Malaysia

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Abstract: The contemporary Islamic banking system started in the late 1970s as an attempt by some Muslims to avoid riba, which is prohibited by the religion of Islam. Conventional banks came into existence with the emergence of colonialism in Muslim countries. However, after independence, countries like Malaysia, Indonesia, Pakistan and some Middle Eastern countries established formal Islamic banks to serve as an alternative to the conventional banking system. Unlike the conventional system, one of the objectives of the Islamic banking system is to ensure a fairer wealth distribution in society. This could be achieved through providing capital to Micro, Small and Medium Enterprises (MSMEs). Inexplicably, Islamic banks seem to be sinking in the ocean of the conventional banking system by providing more or less similar products that are debt-based instead of partnership based that could develop enterprising cultures in society. In line with this development, this paper develops and proposes an Islamic Micro-Investment Model (IMIM) that could ensure the achievement of Islamic economic and financial objectives in society. The model is applicable in Islamic Banks in Malaysia and elsewhere.

Article Classification: Empirical Research
Key words: Islamic % Micro-Investment % MSMEs % Islamic Banks

INTRODUCTION

Islamic financial systems are based on five major principles derived from sharia. These are prohibition of taking and giving *riba* (interest), encouragement of profit and loss sharing, avoidance of *Gharar*, money as means of exchange and not commodity to derive returns and avoidance of *haram* in business activities [1]. Islamic banking and finance (IBF) particularly is a value-oriented ethical proposition that aims at socio-economic development as opposed to the financialisation of the economy [2].

Social responsibility is in-built in the form and spirit of IBF; however, recently, IBF has received several criticisms for social failure [3-5]. Neither conventional nor Islamic banks provide inclusive finance for all segments of activity in society, which has led to the emergence of microfinance aimed at fighting poverty and capacity building of the poor. However, as there is apprehension that conventional microfinance has violated the Islamic ethical and financial principles, it faces rejection from some Muslim poor across Muslim countries.

In view of this, some Islamic non-government organizations (NGOs) started to offer Islamic microfinance to satisfy the needs of Muslim entrepreneurs. However, these institutions face major obstacles in their effort to succeed. Apart from the high cost of capital and human resource shortages, the institutions resort to offer debt-like financial products and often more expensive services to the clients. This could lead to failure in the initial objectives of fighting poverty. In light of this background, this paper examines the applicability of Islamic micro-investments through Islamic banking in Malaysia.

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The model will promote genuine partnership and reduce the mismatch between the supply and demand of microfinance [3].

In addition, Islamic banks, being the major Islamic financial institutions in the society, are duty bound to offer a wide range of products and services that will meet the needs of all segments of society and ensure that risks and rewards are shared fairly in society [6]. Qur'an chapter 59, verse 7, prohibits wealth concentration among a few members of the society. It states that:

> *And what Allah restored to His Messenger from the people of the towns - it is for Allah and for the Messenger and for [his] near relatives and orphans and the [stranded] traveller- so that it will not be a perpetual distribution among the rich from among you. And whatever the Messenger has given you - take; and what he has forbidden you - refrain from. And fear Allah; indeed, Allah is severe in penalty (Q: 59:7).*

Similarly, the verse indicates that, ultimately, wealth and resources belong to Allah and humans serve as custodians. Hence, wealth must be channelled through businesses and other lawful transactions. This can be achieved through offering partnership based contracts particularly to low income earners and small and medium entrepreneurs. The paper is spread into five sections. Section 2 reviews related literature on development of Islamic banks and emergence of microfinance in Malaysia. Section 3 discusses Islamic microfinance; section 4 introduces the Islamic Micro-investment model (IMIM) and finally section 5 concludes the paper.

Related Literature Review: This section reviews the development of Islamic banking in Malaysia; microfinance policy and emergence of microfinance in Malaysia.

Development of Islamic Banks in Malaysia: Islamic Banking and Finance started as an alternative to the conventional system more than three decades ago, catering for the needs of Muslims who shy away from conventional banks that deal with interest. The industry started in Egypt and soon spread to Europe, Asia and parts of Africa. Singapore and the UK are both competing to be the leaders in Islamic Finance. The first Islamic bank in Malaysia, Bank Islam Malaysia Berhad was set up in 1983. Since then, other components of Islamic banking and finance started to grow in the country, such as *Takaful* companies, Islamic Trust funds and capital market. Malaysia is globally well known in its comprehensive approach to support Islamic Banking and Finance and has been recognized as the leader among global players in the market. This is due to the relative acceptance by the majority of the people, especially with support of the government in providing a conducive atmosphere for the growth and development of the industry, such as legal and institutional support. However, there is a need for a more target group approach to demonstrate the true spirit of Islamic finance, such as financing MSMEs.

With the relative comparative advantage of Islamic Banking and Finance, the industry could solidly support the MSMEs. With the recent financial crisis of 2008-2009 it has been proven that Islamic finance is unique and more sustainable to shocks and market failure [7, 8].

Moreover [9], based on the simple Keynesian macroeconomic model, advocates that an equity based system is not only feasible and viable but a better alternative to the conventional system. The author demonstrates that the fragmented approach to Islamic banking may only result in the change of nomenclature and not necessarily the essence. It is argued that Malaysia offers a wide range of consumer products and emulates almost all the conventional financial products [10].

Microfinance Policy in Malaysia: With increased liberalization, Malaysia emerges as the leading hub of Islamic finance globally. Malaysian banks managed the sum of RM240.2billion (USD78.8b). Within three decades, the Islamic banking industry expanded from 6% to 22% of the overall banking sector in the country, which represents a huge investment [11].

One of the requirements of Malaysia's financial sector blue print is inclusiveness, which means that the financial sector meets the needs across all segments of society, fair and equitable practice with empowered and educated consumers [11]. Similarly, a wide range of instruments, as part of the diversity of the system is also required in the blue print. Economic transformation to a high value added and high-income economy demands a wider spectrum of financial products and services beyond the traditional banking. This will ensure financial support to SMEs for start-up and expansion.

A financial eco-system requires transfers of resources from surplus units to deficit units for the efficient use of capital. The share of Islamic banks for total domestic financing was 29% in 2010 [12], which is expected to grow to 40% by 2020. To achieve this and

maintain compliance with sharia, Islamic banks have to develop their own niche area and offer products that meet the needs of the deprived and low-income earners. Islamic banks must nurture the growth of targeted sectors to benefit from financial inclusion for greater shared prosperity. Financial inclusion will enable all citizens, including the low-income and residents, to have the opportunity to undertake financial transactions, generate income, accumulate assets and protect themselves financially against unexpected adverse events, thereby enabling them to benefit from economic progress. This will, in turn, contribute to balanced and sustainable economic growth and development.

The successful implementation of an inclusive financial system in Malaysia would be characterized, according to Bank Negara Malaysia [11] by:

- Increased convenient access to financial services including in rural areas;
- More effective usage of financial services by all citizens including the underserved through an expanded range of products and services that meets the needs; and, finally,
- Enhanced quality of financial services that satisfies the financial needs of all citizens.

One way to increase outreach is through the use of agents, that is, the use of non-bank retail outlets by banks to deliver financial services to a wider range of clients. This has the advantage of lowering cost. For instance, the use of petrol stations, post offices and other retail outlets to supplement the branches of the bank.

Second, the establishment of a flexible Islamic micro financing unit that will offer a wide range of products to enable prompt drawdown of financing in times of need and pre-payment of financing during good times to meet the needs of micro-entrepreneurs that have irregular or seasonal income streams Third, the regulatory authority should encourage financial training providers to offer cost effective financial inclusion training for practitioners [11].

Emergence of Microfinance in Malaysia: Amanah Ikhitar Malaysia (AIM) was established in 1988 as a replica of Grameen Bank, Bangladesh, which was founded by the Nobel peace prize winner, Professor Muhammad Yunus. The idea was to provide banking services that will fit the poor segment of the population. The commercial banks consider the poor as too risky because they do not have collateral and there is no credit record to assess their level of capacity to repay loans from banks. However, this credit rationing itself increases the average risk banks may incur, thereby distorting the equilibrium market condition [13], since, in a normal situation; loanable funds will flow from the surplus segment to the deficit segment of the population in the market. In 1976, Yunus, resigned from Chittagong University as a professor of economics, based on the rising poverty and despite the elegant economic theory available at institutions of higher learning in Bangladesh. According to Yunus, he wanted to learn economics from poor people. The presumed success of Yunus led to the emergence of dozens of similar institutions all over the world. Amanah Ikhitar Malaysia is the largest replica of Grameen Bank, which was set up under the Trustee Incorporation Act 258 (revised 1981) [14] with the objective of helping hard core poor. Although AIM is a government subsidized programme, it charges 10% on the amount of loans borrowed by the clients [15]. AIM has disbursed more than RM2.3 billion (USD766.7m) since its inception [15].

Islamic Microfinance: Islamic microfinance is basically microfinance that employs Islamic financial principles in providing financial services to the poor [15]. It has been developed as a result of the apprehension of some Muslims in different countries and communities due to the belief that conventional microfinance violates the Islamic principles of finance. In other words, Islamic microfinance is developed just like the way Islamic banking has developed to overcome the obstacles inherent in the conventional microfinance. Therefore, it serves as an alternative to the conventional microfinance [15].

Since the emergence of Islamic banking and finance, Malaysia has been a pioneer in many practices of Islamic financial products, such as *Takaful* (Islamic insurance) and *Tabung Hajji*, which aims to finance the Hajj related expenditure of Malaysian low-income earners. In these initiatives, there is the popular ar-Rahnu (Islamic pawn broking), which is an economic tool to improve the socio-economic development of the lower and middle-income group in the society. The system is flexible to allow poor women to borrow by keeping their gold with the bank and the bank charge a fee for safekeeping the jewellery. The bank will then lend a certain amount of cash for the women to use as capital for business under the concept of *Qard*. Recent studies by [16] found that there is high demand of sharia compliant products by Muslim clients of Amanah Ikhitar Malaysia. This could be fulfilled or provided by Islamic banks in the country.

Partnership Based Financial Products:

Mudaraba: *Mudaraba* is a partnership based contract between the capital owner and a client. The ratio for sharing the profit is pre-determined. In the case of any loss the capital owner bears the total loss while the client loses his opportunity to make profit. However, if the loss is due to negligence of the client, misconduct or breach of trust then the loss shall be solely borne by the client [12].

Musharaka: As the term implies, *musharaka*is a partnership between two parties where two or more individuals contribute capital and labour to undertake certain economic activities. In this contract, profit and loss are shared based on the proportion of the capital contribution of each partner. If only one partner manages the capital then he would be compensated for his efforts in the form of a wage. The contract is more applicable to medium and existing entrepreneurs that accumulate some sort of capital. Therefore, the Islamic banks can partner with them to carry out projects and viable investments.

Exchange Contract: In addition to the partnership based micro-financing approach, banks can also offer microfinance based on Islamic contracts of exchange as follows:

Ijara: This contract enables the bank to purchase assets for subsequent leasing to a client for a certain period of time at a mutually agreed rent. The contract has the potential of meeting a wide range of micro-entrepreneurs since many of the micro-entrepreneurs come from different business lines and occupations that require seed capital or tools for start-up. For instance, the bank can purchase machines for extracting sugarcane and lease it to a micro-entrepreneur at an agreed rent payable on a weekly or monthly basis.

Salam: This is a contract between a buyer and a supplier whereby the buyer pays cash in advance for a designated quantity and quality of a certain commodity to be delivered in the agreed future date and price [1]. This contract is mainly applied in agriculture. The bank normally enters into a *salam* contract with a client who grows agricultural produce and the bank sells the expected output to suppliers also on a *salam* contract.

Istisna: If *salam* is applied in agriculture, *istisna* is applied in the industry and manufacturing sectors. It is a contract between a buyer and seller whereby the buyer pays cash progressively as the output is being manufactured or built. The agreement clearly identifies a designated quantity and quality of certain manufactured items to be delivered at a future agreed date and price.

In a study conducted by [17], he shows that the mode of financing in percentage to total financing in Bank Islam Berhad Malaysia. The average percentage of *murabahah*/*BaiBithamanAjil* (BBA) is 88.1% while the *musharakah*/*mudarabah* and *ijarah* are 1.7% and 5.6%, respectively.[1] This indicates that the products of Islamic banks in Malaysia do not encourage an enterprising culture, such as risk taking and innovation among the clients.

Corporate Social Responsibilities in Islamic Banking Through Islamic Microfinance: In the last four decades, Islamic banks have promised to implement a just and equitable distribution of wealth. Whether Islamic banks have achieved this or are even close is a hot topic of debate among the academic community [6].

The proponents of Islamic banks argue that the institution is just like a conventional one; the only difference is that the former has to comply with Islamic law. However, critics argue that Islamic financial institutions including Islamic banks are beyond an intermediary role. They tend to evaluate the system based on the promise made by the system.

The proponents also added that an Islamic financial institution is not charity based but a business organisation aiming to achieve the goal of its shareholders. However, if this goal of material accumulation causes harm to the member of society, then, it deviates and fails the very essence of Islamic financial institutions, which is based on justice and benevolence. Islam stresses both the source and manner in which acquired wealth is spent [18]. It has been reported that the Prophet (pbuh) said *"On the Day of Resurrection, no human being will be released from God`s presence until he has been asked where he obtained his material wealth and how he put it to use"*. Hence, material wealth has a significant social function and is not an end in itself, any attempt to hoard it, thereby keeping it out of circulation is a deviation from maqasid al sharia (objective of the sharia) [18, p. 215].

According to [6], the spirit of Islamic finance does not negate the profit goal of Islamic financial institutions. Islamic banking can ensure profitability yet be able to redistribute wealth and income fairly through micro

[1]Murabahah involves the purchase of merchandise by the bank on behalf of a client and its resale to the latter on a cost-plus-profit basis, for a cash/deferred price. Rather than advancing money to the borrower, the bank will purchase the goods from a third party and sell those goods on to the customer for a pre-agreed price.

financing. The founders of contemporary Islamic banking and finance believe that these institutions have a greater sense of social responsibility. However, this does not negate their competitiveness as well as profitability. This proposition requires a shift in the mind-set of the practitioners in Islamic banks to incorporate socio-economic objectives in their investment portfolios [6, p. 26].

An increasing awareness among stakeholders will certainly reduce the gap between the ideal and reality in Islamic banking and finance. [6] proposes a standard of corporate social responsibility (CSR) for Islamic Financial Institutions on two grounds. First, IFIs fulfil a collective religious obligation (*fard kifayah*) for Muslims that cannot be fulfilled individually. Second, IFIs hold an exemplary position in society.

The emphasis on Islam on redistributive justice in society can be achieved via small and medium enterprises as well as investments that will harness and unlock the potential of poor individuals and families. Islamic banks can harness the societal resources in this direction and this, in turn, will achieve the socio-economic development of the society [6, 18].

[7] proposes a decreasing partnership (*musharakamutanaqisah*) for financing micro and small and medium enterprises. He advocates that project viability should be the main motive for financing rather than perceived vulnerability and augmented risk. Thus, for short-term finance, the author advocates for *Mudarabah* and *Musharakah*. In the case of long-term financing, however, termination of equity partnership cannot be done abruptly, but gradual withdrawal through decreasing partnership could be applied.

Decreasing partnerships involve the joint purchase of an asset or the venture, which would be purchased by the former in stages. The share of the institution declines gradually as a result of consecutive purchase by the other party. Hence, Islamic banks can finance the purchase of machines or tools for the use of micro-entrepreneurs and, gradually, the latter takes possession of the asset on a diminishing partnership arrangement. The customer can commence using the asset once joint purchase is made but he would be paying fixed rental on a separate *Ijarah* (leasing) contract with the bank. As the client purchases more and more of the bank`s share in such an arrangement, the adjustment with regard to rental payment would be made accordingly [7]. If there is repair to be made on the asset, the bank will take the proportionate share of that as in *Ijarah*.

In fact, most Islamic banks have been found to focus on consumers' loans and mortgages rather than financing new ventures and capital expansion projects. Islamic banks mainly offer short-term loans as they argue they are pressured to offer reasonable returns to stakeholders. However, as they are matured and stable there is potential for them to carry out their intended responsibilities by providing long-term project financing services [1].

Developing new products will ensure success: the market of Islamic banks is still huge and mainly unexplored. Through innovation, marketing and research and development, Islamic banks will be a viable but suitable alternative. Although the human resource need is yet to be fulfilled, the Islamic banks can collaborate with other retail outlets to provide various ranges of products and services.

Theoretical nature of Islamic banks and their operations suggest that there is need for close supervision of the client after disbursement of the funds [15]. However, this will increase the cost of operations and reduce profitability [1]. Hence, effective management of the project could bring huge profits because returns on the investment depends on the market conditions, unlike conventional fixed rate, returns on investments during booms would be encouraging and certainly could mitigate the expenses carried out due to close supervision. Similarly, the modern information and communication technology could reduce some cost that is incurred using traditional channels of communication and supervisions.

According to [8], Islamic finance concentrates on commercial banking, while the relative size of small and medium financing, micro financing as well as investment banking is very small. The importance of SMEs to the economic growth and development of a nation cannot be under rated. Thus, Islamic banking and finance should encourage entrepreneurship development among the low-income group since this segment constitutes the majority of the population in the society. It is in recognition of this gap, that [15] developed models of *mudaraba* and *Ijara* in order to provide the framework through which practical Islamic finance can work to enhance entrepreneurship and develop Micro and Small Enterprises (MSEs) as well as Small and Medium and Enterprises (SMEs).

There fore, Islamic banking, rather than involving in what [8] called "reverse engineering"[2] can popularize itself in risk-sharing and other financial services like micro financing, which can lead to the realising of economic development goals. Islamic banks, therefore, should be guided by Islamic economic objectives to ensure that

[2]A situation where a conventional product is being replicated to conform to Shari'ah or a conventional product is wrapped in a Shari'ah-compatible deliverable, and the process may not be strictly following Shari'ah.

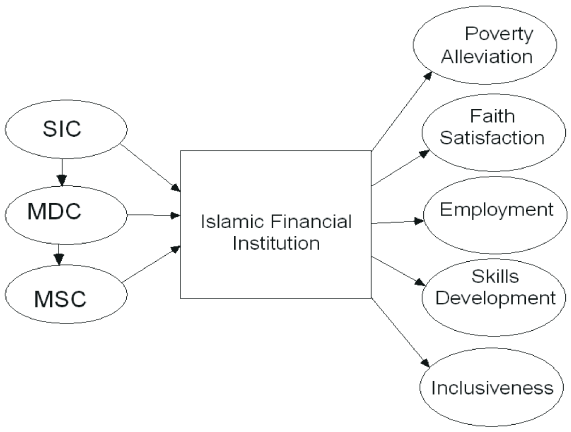
wealth is circulated among the people in society [5]. [21-23] emphasize the greater social welfare responsibilities of Islamic banks to achieve socio-economic goals as well as the equitable distribution of wealth and income in society.

Moreover, according to [19, 15], convergence between Islamic and conventional banking institutions would continue to take place. Therefore, unless considerable effort to save the system is put in place, Islamic banks and finance institutions would sink in the ocean of conventional practice or become a mere subsidiary of it. This is in line with [3] who argues that the structure or product of current Islamic banking does not fulfil the current needs of poor Muslims or entrepreneurs. According to [20] Islamic banks should i) mobilize various sources of funds intending to achieve microfinance objectives, ii) create a special purpose vehicle (SPV); iii) allocate certain amount of funds via SPV and iv) channel the funds to various clients depending on the needs and demands of the clients [2, 24] argues that microfinance can achieve the Islamic economic developmental objective; hence, Islamic banks, given their expected social responsibilities in the financial system, should venture and offer these services.

Concept of Islamic Micro-investment Model: The Islamic Micro-Investment Model (IMIM) that is being introduced in this paper can be defined as a business venture in line with the Shari`ah requirement of finance, intended to cater to the socio-economic needs of the poor in society.

Islamic Micro-investment focuses on the growth and development of the microenterprise sector. Generally, the micro and small business sector has an important economic and social impact on employment and income generation. The crux of the problem lies in the structure and objective of the programme. The Consultative Group to Assist the Poor [19] concludes that much of the supply of funds to the small businesses is ineffective, narrowly targeted and "poorly structured". This raises concern about the need for social investment funds to support the sector. Hence, the need for deep inquiry into the factors (belief system, right target etc. well designed instrument) in diverse societies is required so as to match objectives with actions.

Figure 1 depicts the 3-stage model developed from the combination of different contracts. These contracts, subsidized-*Ijara* Contract (SIC)[3], *Mudaraba* Contract (MDC) and *Musharaka* Contract (MSC) serve as building blocks of the model. In the first stage, Islamic



Source: [15]

Fig. 1: Structure of Islamic Micro-Investment Model (IMIM)

banks/financial institutions will offer subsidized services to the entrepreneurs by providing training free of charge through bank's corporate social responsibility. The micro-entrepreneur that graduated from the first stage could join *Mudaraba* as he/she might have possessed some skills for managing capital. However, if the entrepreneur is screened and found suitable for the second or third stage then the bank could apply the contract applicable to the micro-entrepreneur. What follows specifically describe some operational parts of the model.

The output of the model implementation is expected to significantly impact on the income of the poor; provide faith satisfaction to investors, operators and clients. Additionally, employment, skills development and enhancement, as well as inclusiveness, are expected to be realized.

In summary, Islamic banks, given their expected corporate social responsibility allocate at least 10% of their total financing in the form of financing MSMEs through applying IMIM. The amount consists of subsidized *Ijara* whereby the entrepreneur receives training if he/she has no relevant skills to apply in a business. The bank therefore has the potential to build an enterprising society that is likely to increase more savers in the bank in the medium and long-term.

Potential Risk and Risk Mitigation of the Model: Islamic banks face risks on the above presented contracts. Specifically the risks involved are as follows:

[3]SIC combines ijarah contract with some incentives such as cost free training to the client and this is expected to increase the client`s efficiency and reduce failure in the business undertaking.

- Risk of capital impairment, because the bank has to bear 100 percent in case of any loss.
- Cost of capital charge: It is required by Bank Negara Malaysia, for any bank that wants to apply *musharaka* and *mudaraba* to deposit 150 percent of the capital, which is far above some other contracts such as *murabaha* [12].
- Risk of non-performing by the partner: This could result from adverse selection.
- Cost of administration.

In the case of adverse selection the bank can mitigate this by assigning experts to closely monitor the clients. The bank can also require a performance guarantee and/or demand group collateral. In order to mitigate the risk of non-repayment, Islamic banks can apply various screening techniques, such as group lending, detail start and exit mechanisms in the case of partnership, risk assessment based on performance of business activities undertaken by the venture, rebates for early repayment, means test to select the best clients and minimize opportunists and partnership with family businesses and local NGOs, etc. [23, 12].

Apparently, Islamic banks are short in risk management infrastructures compared to conventional banks. Hence, Risk Adjusted Return on Capital (RORA) and other techniques are used by Islamic banks to allocate financing. However, applying these means less risky assets would be financed. In line with this, [23] advocate that there is need to introduce risk management culture in Islamic banks. This can be done by initiating some form of internal rating system, specifically, risk weighting of their assets. According to the authors, this could evolve into more sophisticated systems in the medium and long run, which could assist in filling the gap in risk management system between the two.

Concluding Remarks: Islamic banking started as an alternative to the conventional banking system in some Muslim countries and communities in the last three decades. Theoretically, the main point of departure between Islamic and conventional banking is joint liability and risk sharing. While the former focuses on equity financing, which promotes profit and loss sharing, the latter distributes risk and return unevenly in favour of the rich against the poor. However, practically, Islamic banks tend to avoid the risk sharing and, thereby, apply debt-like contracts with minimal partnership based contracts. In view of this, this paper develops a model of Islamic Micro-Investment (IMIM) that promotes partnership based financial contracts that are applicable to the Islamic banking system in Malaysia. The model incorporates *Ijara*, *Mudaraba* and *Musharaka* with a special fund to train micro-entrepreneurs without charge, for corporate social responsibilities on the side of the banks and for skills as well as business development on the side of micro-entrepreneurs. The model is expected to promote equitable distribution among members of society.

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