SAHULAT

A Journal of Interest Free Microfinance

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Guidelines for Authors

A Journal of Interest Free Microfinance is a research based refereed journal. To begin with, it is published twice a year – in January and June. It is brought out by the Sahulat Microfinance Society, New Delhi, India. Sahulat welcomes contributions from all interested scholars all over the world. The areas of special interest for the journal are: Economic Development of Minorities; Poor People and Economically Weaker Sections of the Society; Financial Sector; Co-operative Effort and Co-operative Movement; Commercial Banking; Interest Free Finance; Microfinance and Interest Free Microfinance. The sole purpose of the journal is to encourage free and frank discussion on the issues of concern in these areas so as to develop them as scientific disciplines.

The manuscripts submitted for publication should be typed double spaced. The manuscripts may be submitted in duplicate or through email. If submitted by mail, soft copy may also be sent on a compact disc. No bibliographical reference should be inserted within the text. Instead, all references must be cited at the end of the text as end notes, which should be consecutively numbered. The style of citation in the end notes should be as follows:

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Mummidi, T. (2009). Women and Income Generating Activities: Understanding Motivations by prioritizing Skill, Knowledge and Capabilities. RUME working paper series. Marseiiie, 1, 6-29.

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Editorial

I start writing this editorial with pain and grief at the loss of Dr. Ausaf Ahmad, the founder editor, of this pioneer journal on interest-free microfinance. Dr. Ahmad was a legendary figure in Islamic Economics and Finance who was ready to support any activity that would disseminate the knowledge of this discipline. His presence was a great strength to the votaries of this idea of financial system and he discharged his duties in the best possible manner as a veteran. I, on behalf of the team of Sahulat Journal, pray that Allah forgives all his sins and bestow him with an elevated status in paradise.

This issue of the journal contains diverse contributions by people from various specializations. This indeed is the strength of this journal. All the articles submitted for publication were checked for plagiarism and then forwarded for blind peer-review. Finally, four articles and one book review were selected for this issue. Each of them is expected to add significant value to the existing knowledge on interest-free microfinance. We invite your feedbacks and comments.

The first article of this issue deals with the working capital requirement of the non-farm unorganized sector. The issue has been discussed more at a conceptual level and several recommendations have been suggested to fill the existing gaps. It basically highlights a significant fact that the traditional banks are not designed to meet the credit needs of this sector. Therefore, there is a need to depend on an alternative mechanism, possibly microfinance.

The second article brings forth the relevance of Islamic finance to Corporate Finance. The author intends to basically touch upon the financing of businesses that has been blurred by the lack of distinction between production and consumption. The article discusses the practical applications and the accounting perspective of the Islamic finance in corporate lending. Several critical issues such as the nature of short and long term financing, partnerships, losses, sharing of profits and accounting have been described.

The theme of the third article is *Murabaha* in Indian legal context. The authors present empirical assessment of the Indian tax laws and the effect on this Islamic finance instrument. The authors propose solutions to make the instrument feasible and viable in the Indian legal and financial environment. The authors also recommend amendments in the tax laws based on the rationale discussed in the article.

The fourth article covers the social and financial aspects of the issues of migrant labourers. The authors have conducted an empirical investigation to determine the socio-economic condition of the migrant labourers. The research mainly focuses on the recessionary periods in the economy. The findings of the study confirm that migrant labourers are the most affected in times of recession. Based on the findings, the researchers have recommended remedial measures.

The fifth article is a review of a book by Jonathan Ledgerwood. This is an updated version of her earlier work. The earlier work focused on institutions and this one has been written with client in the center of discussion. The review provides a good understanding of the existing outreach, impact and future actions for the microfinance dealt in the book.

Najmul Hoda
Editor

ARTICLES

Bottlenecks in the Present Institutional Credit Delivery System with respect to Non-farm Unorganized Sector: Potential Role of Microfinance Institutions

Dr. D K Yadav[1]

Abstract

Unavailability of working capital has been identified as one of the biggest problems faced by non-farm unorganized sector. In spite of consistent effort of government to cater to the credit requirement of this sector, it is still facing huge shortage of institutional credit. This paper is an effort to understand the nature of credit issues faced by the non-farm unorganized sector. It critically analyzes the present institutional structure of credit delivery and its underlying problems. The main cause that has been identified in this paper is the mismatch between demand and supply of product portfolio of traditional institutions (like banks) and it thus recommends the role of Microfinance Institutions (MFIs) for filling the gap. It also assesses the problems in development of MFI sector in India and recommends for separate independent regulatory body to ensure the healthy competition and enabling environment.

1. Introduction

Presently, India is following multi-agency system to extend the credit to non-farm unorganized sector, where SIDBI (Small Industries Development Bank of India) is playing the leading role. In addition to that, the Commercial Banks, Co-operative Banks, Regional Rural Banks (RRBs) and Micro Finance Institutions (MFIs) are other major institutions involved in providing credit to non-farm enterprises. Credit advances to micro, small and medium enterprises are being considered as priority sector lending. Along with SIDBI, role of NABARD as a refinance agency, monitoring

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the overall rural credit (farm and non-farm), has increased sharply in the post reform period. NABARD has focused on SHGs (Self Help Groups) as a channel to extend the credit for unorganized non-farm sector. It is noteworthy that in spite of crediting many institutions in non-farm unorganized sector, NABARD's share in the institutional credit is very low and is declining with time, particularly in the post reform period. Share of non-farm unorganized sector in total institutional credit declined from 15% in 1991 to 6% in 2006. Declining share of institutional credit for the non-farm unorganized sector demands a relook into present institutional structure of financial system, more so because of its contribution in Indian economy in terms of employment creation, poverty alleviation and transformation of rural economy. Nearly 20% jobs of unorganized sector in rural areas are contributed by non-farm activities. Looking at the stagnant growth and underproductive employment in agriculture; non-farm unorganized sector is being considered as an alternative and potential sector for gainful employment in rural areas. In this context the relevant questions that arise are given below:

- Why formal financial institutions failed to provide the credit to this sector?
- Was it because of mismatch in demand and supply of product portfolio?
- If yes, what is the structure of demand and what is the structure of supply of product portfolio and how are both different from each other?
- If the above mentioned difference exists, what kind of change and reform should be made to address it? What may be the role of MFIs in this concern?
- What are the special characteristics of MFIs that address the needs of the poor as well as their economic activities?
- What went wrong in the development process of MFI sector in India and how it can be corrected for inclusive and holistic development of the sector?

Rest of the paper is organized into six sections. Second section discusses the present structure of financial institutions and causes of their reluctance to extend the credit to rural non-farm unorganized activities. Characteristics of MFIs and their suitability to micro-enterprises are discussed in the third section. Fourth section presents the experiences of microfinance movement in Bangladesh. Evolution process of MFIs in India is discussed in the fifth section. Sixth section is the analysis of what went wrong in development processes of MFIs in India and lastly the seventh section includes the conclusions and policy prescriptions.

2. The Flow of Credit to Rural Non Farm Sector: An Overview of the 3rd SSI and 68th NSS Survey Reports

As it has been said earlier, India is following multi-agency structure to extend the credit to non-farm sector. Since independence, different kind of experiments through different kind of institutions have been made to increase the credit flow to the non-farm unorganized sector. Initially, co-operative banks were assigned major responsibility to extend the credit to non-farm sector, along with its prime responsibility of financing agriculture and other related primary sector. Primary co-operative banks had started lending to handloom; power looms; village small, micro and tiny enterprises along with similar other kinds of unorganized rural non-farm activities. But this process weakened with deteriorating financial health of co-operative banks, due to government's increasing intervention in their activities and internal decision making. Vested interest of politicians, which was because of channelizing funds of government welfare policies through the co-operative banks, damaged the efficiency and autonomy of co-operative banks. It was reflecting in the form of high NPA of co-operative banks.

It is due to the increasing disappointment with co-operative banks to provide the credit and advances to rural farm and non-farm unorganized sector, that the government tried the commercial banks model to extend the credit to the sector. 14 major commercial banks, in 1969 and 6 more banks in 1980 were nationalised towards this objective. Credit extended for this sector was considered as priority-sector lending and interest rate subsidy was provided on it. Rural penetration of commercial banks in terms of branches increased rapidly, which helped in mobilization of savings and to some extent in meeting the credit requirement of rural unorganized activities, particularly of agriculture. Though, the credit provided for rural non-farm unorganized activities was also considered as priority-sector lending, but very limited and small part of total credit was given by banks to this sector. The third census data of SSI units revealed that only 20.1% of registered and 5.48% of unregistered units had reported outstanding loans and out of that only 14.26% of the units in the registered sector availed the bank finance, while only 3.09% of the unregistered units had access to bank finance. Since most of the unorganized non-farm units are unregistered, it might well be assumed that only 3% to 4% of the unorganized units avail bank finance and the same has been confirmed from the NSS 55th survey data, which shows that a similar percent of un-organized enterprises have access to institutional finance.

Low credit advancement to SSI units is mainly because of wrong policy formulation of priority-sector lending. Under priority-sector lending policy, 40% of Net Bank Credit (NBC) is earmarked for the priority sector, viz., agriculture and small scale industries. Out of 32% allocation by the foreign bank, 10% has been earmarked for the SSI sector. Any shortfall in such lending by the foreign banks has to be deposited by the Small Industries Development Bank of India (SIDBI). However, the domestic bank has been given the liberty in such cases. Unlike foreign banks, there is no such provision of sub-target to SSI sector for the Indian public and private banks. The Indian banks are not required to deposit the shortfall in lending to SSI sector like SIDBI. In case of the Indian banks, 18% is earmarked for agriculture and 10% for weaker sections of the society as sub-targets within priority-sector lending. In order to fulfill the priority-sector target, soft target provision in the form of subscription of the bonds of SFCs, NABARD, National Housing Banks, Rural Electrification Corporation, Housing and Urban Development Corporation etc. have been made, instead of lending to SSI sector by domestic banks. Now even retail credit provided in the form of car loan, housing loan, education loan etc. are being considered as priority-sector lending. Dilution of definition of priority-sector lending is affecting the credit allocated for SSI and other real priority-sectors. Flow of credit from commercial banks to SSI sector has decelerated in the post-reform period. Share of SSI sector in total net bank credit was 15.17% in 1994-95 declined to 6.66% in 2005-06.

Not only do the private or foreign banks ignore the SSI sector, even Public Sector Banks (PSBs) tend to do the same. Credit flow to SSI sector from PSBs has declined from 17.5% (of NBC) as in 1998 to 8.5% in 2006. More alarming problem is declining share of tiny units within the credit allocated for the SSI sector. As per the guideline of RBI, 60% of credit allocated or disbursed for the SSI sector should be given to tiny industries, but commercial banks have never achieved this target and situation worsened with time.

Reasons for Low Credit to SSI Sector

Policy ignorance (both in terms of policy formulation and policy implementation) with respect to SSI sector is the major reason behind the declining share of institutional credit to this sector. In spite of very strategic importance of this sector, the government has given more importance to the agriculture sector in terms of allocating the credit under priority-sector lending policy. In 1969 the share of agriculture and SSI sector were 5.4% and 8.5% respectively. But in subsequent years the comparative position of sectors has changed drastically.

While share of agriculture in NBC increased nearly 3 times from 5.4% to 15.7% in 2005, SSI sector has registered very minimal growth from 8.5% to 9.4%. If we further divide the whole period into sub periods; situation worsened mainly in the post reform period. Up to 1991 both sectors registered growth in their respective shares in total NBC; however the rate of growth for agriculture was greater than the SSI sector. In the post reform period situation became worst. Share of SSI sector which increased from 8.5% to 16.1% in 1991, declined to 9.4% in 2005 and further 8.5% in 2006. Though the share of agriculture remained almost constant with neither decrease nor incremental increase in the post reform period, the shares clearly indicated that under the priority-sector lending policy, the government was more keen to support agriculture with negligence towards the SSI sector.

Second reason for less credit allocation for the SSI sector is its high Non-Performing Assets (NPA) in comparison to other priority and non-priority sectors. NPA of SSI sector in 2001 was 22.4%, which is higher than the 16.9% NPA in Agriculture and 15.3% in large scale industries and non-priority-sector in the same year. However, there is a decline in NPA ratio of each sector but relative position remains unchanged in succeeding years as well. In the year 2004, NPA ratio of SSI sector was almost double (15.1%) to NPA ratios of other sectors (8% for agriculture & 8.3% for large scale industries). Because of high default ratio, commercial banks hesitate to lend to the SSI sector. It is the peak time to understand why the NPA ratio is higher in this sector than other sectors. The National Commission for Enterprises in the Unorganized Sector (NCEUS) set up a Task Force on Access to Finance, Raw Material and Marketing in 2012 which identified some of the important factors behind the high NPA of SSI sector. Their report said, "One of the main factors leading to the high NPAs in the SSI sector is the problem of delayed payments of dues from buyers particularly the large units and public sector undertakings. Another reason is the problem faced in the marketing of the products due to increased competitions - given the high cost and poor quality of goods". Reasons identified by the task force are related to product quality and payment processes for the sold products. But both the factors are not directly related with credit system, they are external factors and could be solved by appropriate regulatory, marketing and production initiatives. Before zooming into external and advanced staged problems it is important to see whether there is any role of internal and more fundamental factors in increasing the NPA in SSI sector or not?

Institutional structure and governance, lending methodology, product portfolio, credit delivery mechanism and the basic principles of functioning of the Indian banking system, are also some factors that need to be considered and analysed. Traditional banking system believes in typical collateralized commercial and consumer lending. It restricts to individuals and organizations which have physical or non-physical qualitative collaterals to borrow from banks or the qualitative collaterals in terms of efficient organizational structure and future prospectus to satisfy the banks. This is one of the important factors which restricts credit flow towards SSI sector.

Institutional structure and governance of commercial banks working in rural areas is also responsible for low credit flow to SSI sector. Commercial banks follow the centralized top-down management processes. Ground workers, employees and branches have very less liberty to change the rule or processes to meet the credit requirement of borrowers. Rural society which is very heterogeneous in nature, due to socio-cultural & economic factors, does not fit in the set rules of commercial banks for borrowing and other financial services. Decentralization and contextualized formulation of policies is very important for extending credit to the SSI sector.

Commercial banks have very few financial products which are designed according to the needs of rural micro-enterprises. Commercial banks tried to sell the products designed for large scale industries or agriculture to the SSI sector. This further restricts micro-enterprises to purchase these products, and/or return the amount purchased through these products. Small and micro-enterprises need small amount for borrowing, ranging from INR 3000 to 15000 and flexibility in return policies like small, frequent and in short period of time, weekly instalments etc. Most of the branches of commercial banks are concentrated in urban or semi urban localities like Tehsil, Thana (Police Station), Blocks etc. and the opportunity cost of coming to these branches is very high for the people involved in rural micro-enterprises. Financial services should be made available at their door step. It is only possible when bank employees themselves reach villages and the people who are involved in these small venture activities. While real situation is just reverse; banks insist that the people should come to the bank. Reaching to the rural enterprise at their door step is not only important to provide the financial services but also to help them in their non-financial problem, which is equally important. Due to their socio-economic problems, static and underdeveloped business environment and the rural entrepreneurs cannot understand the future prospectus and business viability of activities in which they are involved. Without helping on these aspects, which are non-financial in nature, financial services may not be commercially viable.

Another very important factor related to high NPA, which is also reported by NCEUS task force, is the high cost of credit. Prime interest rate charged by commercial banks to SSI sector is close to 15%, which is just double the interest charged to large scale industries, i.e. 7 to 8%, on the pretext of credit worthiness. If we include the other costs like processing cost and bribes offered to the bank employees and management because of unwelcome attitude from banks, actual cost will be much higher than the prescribed interest rate. This cost differential, ultimately leads to the high cost of SSI products resulting in the increase of NPA for commercial banks.

Factors discussed altogether show western-styled traditional finance approach of commercial banks, which do not fit in the Indian rural society and the micro-enterprises in it. It needs to be shifted towards Asian/Indian approach of trust and confidence.

Census of Small Scale Industries (SSI sector) 2001-02 shows that among 4,445,868 SSI units, 99.5% (4,425, 587) units are tiny units, which require more attention, monitoring and supervision than the large or medium size industries. Ross and Savanti (2005), in their primary survey study of micro enterprises in Tamil Nadu and Uttar Pradesh, found that 69% people involved in traditional micro enterprises were not willing to change the nature of their enterprise even after receiving the training to set up some other enterprise. 31% people, who showed interest to change the economic activity they were involved in, did not have any idea about the kind of training they required. In other words, they demonstrated no business idea or strategy, but desired something other than their current activity. Similar responses were found when they were offered money instead of only trainings. Nearly 43% said they would change activity, while 57% said they would not. Out of those wanting to change their activity, 22% said they had no idea of activity they would move into and 37% said they would move into some form of trading such as grocery, tea, paan or kirana shop. Findings of the survey indicated orthodox approach and low level of awareness and information of the people involved in micro-enterprises in rural areas. In this given situation providing fund alone does not help in the development of micro-enterprise, unless active involvement and interest is shown by financial institutions; which commercial banks are not able and willing to do. Now the question arises as to what may be the probable ways for commercial banks to not only provide credit for micro-enterprises but also take active interest in providing external support services (for eg. training and facilitating them to access market for their products)? Changing scenario, evolving financial market, and experiences of our own and other developing countries provide evidence that Micro-Finance Institutions (MFIs) may do this challenging task and substitute the commercial banks. But the recent happenings, particularly development of Andhra Pradesh (regulatory action to control activities of micro-finance Institutions) and their limited capacity to extend the credit because of infancy phase of development, raise serious doubt about their role as substitute of commercial banks in the rural credit market. Given the penetration and work profile, which is contextualized according to the demands of rural credit market, co-operative banks may substantiate and compensate to the under-developed stage of micro-finance institutions. To understand this further the next section analyses the role of micro-finance institutions in providing credit to the SSI sector.

3. Micro-Finance Institutions (MFIs) and SSI sector

Success of micro-finance institutions in Bangladesh, particularly Muhammad Yunus's Grameen Bank, has attracted worldwide attention as potential mode of poverty reduction and substitute of formal financial institutions viz. commercial banks. Most of the developing countries including India are implementing this model for poverty reduction and employment generation. But experiences and results in terms of above mentioned objectives are varying from country to country. In India, while southern states are doing very well, it is not so good in case of north and north eastern states. Moreover, recent emerging issues like high interest charged by MFIs and limited outreach to very poor and vulnerable sections of society, raise serious doubts about their effectiveness and sustainability. Recently State government of Andhra Pradesh has banned some of the activities of top MFIs working in India, and termed them equal to money lenders who are exploiting the poor people and small farmers. In this context it will be interesting to analyze what are the special characteristics of MFIs which suit the need of poor including the need to sustain and enhance their economic activities. And at last what went wrong in development process of MFIs that they got the image of exploiter rather than institutions for the poor?

3.1 Characteristics of MFIs and their Suitability to Micro-Enterprises

MFIs differ from traditional financial institutions in terms of their lending methodology, client base, administrative cost, portfolio composition, and institutional structure & governance. Actually, the evolution of Micro-finance institutions took place to fill the gap generated by the traditional financial institutions and informal sources of credit. While on one hand, lack of physical collateral restrict the poor from accessing the formal sources of finance, usurious interest rate of informal sources block poor micro-entrepreneur to access credit from informal market. Poor micro-entrepreneur also require broader package of services viz. skill training, technical assistance, and marketing services along with credit, which neither traditional financial institutions are willing to offer nor informal sector is in a position to provide because of their limited capacity. Micro-finance institutions fill these gaps by their special characteristics, which is pro-poor. It is interesting to study how MFIs overcome these problems and fill this gap. MFIs are hybrid of traditional financial institutions and informal lenders. These are more organized structures like formal institutions than informal lenders and more flexible in their operation like informal lenders than formal financial institutions. Unlike commercial banks, MFIs do not believe in physical collateral based lending. In place of physical security, MFIs use social security for lending. They do not lend directly to individuals but group of individuals, which ensure the collective responsibility of group to monitor the fund borrowed from the MFIs and ensure its repayment. Groups have freedom to select their members and decide the rules to disburse the borrowed amount among the members. Next instalment of borrowed fund is issued only in case of repayment of the previous instalment. It generates peer pressure on the member of a group, who has utilized the previous instalment to repay the loan. Group based lending, while reduces the monitoring cost on one hand, it also solves the problem of asymmetric information on the other.

Low potential profitability is another problem which restricts banks to lend poor entrepreneurs. Banks consider them commercially unviable because of high costs, high risk, low income and profit opportunity in micro-enterprises. At the individual level, such borrowers generally do not have steady or adequate income or any asset to seize, and they face great economic and cultural barrier to earn income. MFIs solve this problem by active involvement in micro-enterprises. Providing credit is part of a broader package which includes training & skill development of individuals andtechnological support & marketing of products. It helps poor entrepreneurs in their consistent growth of income and also solves the problems generated by social, economic and cultural constraints. Regular savings is another very important characteristic of group based lending which helps in minimizing and managing the risks involved in lending to rural non-farm sector. The policies related to insurance products and emergency funds also help to overcome the problem of portfolio diversification and risk containment.

Moreover, fundamental philosophy and business approach in which MFIs believe, also helps to overcome the problems linked to the rural non-farm sector. Sound banking principles, basic economic premise, theory of price and poverty are some fundamental business approaches of MFIs. It is believed that timely and hassle free availability of credit is more important for the poor in comparison to credit on subsidized rate of interest; which generates vested interests, lengthy processing and documentation affairs. MFIs provide credit at the door step of poor entrepreneurs in very less time, low documentation and processing cost and at market rate of interest. They intuitively believe that the poor are basically honest in repaying their loans irrespective of collaterals. Among the poor they target the women on the basic premise that women are more responsible than men in making payments. Implicitly they also believe that poor work hard to maximize their income and repay the loan in addition to improving their poverty situation. Over 98% repayment rate in case of Bangladesh's Grameen Banks, which is an MFI, is strong evidence in favour of above arguments.

Fundamental philosophy of MFIs is derived from an old Chinese proverb which states - "To a hungry man don't give your fish, give a fishing rod". They believe that subsidies given in the form of lower prices or income transfers, rarely reduces poverty; rather they sustain and perpetuate it. Instead of augmenting income-generating capacities, subsidies put the recipients on clutches and generate dependency. Number of evidences, both from within the country and outside are available that show that providing fish has not solved the problem of starvation and poverty. MFIs are potential institutions to experiment with this model of development.

4. Experience of Bangladesh's Microfinance Movement

Bangladesh has been considered as a role model for South Asian countries as well as for other developing countries vis-a-vis microfinance activity and its role in poverty alleviation. Muhammad Yunus's Grameen Bank (GB) has been propagated as the best suited model for providing credit to poor and marginalized sections of society. Confirmation of Nobel prize for Grameen Bank and its founder Muhammad Yunus, further recognized their contribution in this area. Looking at Grameen Bank and other MFIs working in Bangladesh together with their policies, procedures and impact on poverty alleviation, may be helpful in designing the policies for the development of the sector in our country.

Empirical studies show that GB has significantly contributed in income enhancement, poverty alleviation and improving the social and economic conditions of the poor in Bangladesh. Impact study done by Tazul Islam shows that income earned by GB members from different economic activities, is significantly higher than by non-members of project village and control villages. Impact on income is more obvious in non-farm activities. Another very important result which the study shows is that GB members have least dependence upon wage labour in comparison to other two groups. Table.1 indicates that non-members of project village and control village are earning more wages than GB members. From this it may be concluded that GB credit is helping its members in becoming self-dependent.

Table.1
Impact on income after joining GB

Income Component	GB Members (Group 1)	Non - participants		Difference	
		Project Villages (Group2)	Control Villages (Group 3)	Group 1 over Group 2	Group 1 over Group 3
1 Agriculture	**11,230**	**10,506**	**13, 469**	**6.9**	**-16.6**
1.1 Crop cultivation	5392	4125	5013	30.7	7.6
1.2 Homestead Garden	1143	756	999	51.2	14.4
1.3 Livestock and fisheries	2083	1683	1700	23.8	18.4
1.4 Agricultural wage labour	2612	3942	5757	-33.8	-54.6
2. Non Agriculture	**26888**	**20262**	**14315**	**32.7**	**87.8**
2.1 Processing & Manufacturing	9453	5936	2988	59.2	216.4
2.2 Trade	7977	5736	3134	39.1	154.5
2.3 Transport	2795	1335	1300	109.4	115.0
2.4 Non Agriculture wage labour	1461	1683	1528	-13.2	-4.4
2.5 Other non-agricultural	5202	5572	5365	-6.6	-3.0
Household income	**38118**	**30768**	**27784**	**23.9**	**37.2**
Per capita income	**6930**	**6032**	**5292**	**14.9**	**30.9**

Source: Household survey of GB Project and control villages (1998) and Tazul Islam (2007)

More clear and strong impact on income from non-farm sector activities is also reflecting as changing occupations of borrowers, from farm to non-farm activities, after joining the Grameen Bank.

It is particularly true in case of female borrowers. Before joining the GB there was 49.4% unemployment in female category which has significantly reduced to 17.0% at the time of survey. Major chunk of this population was employed in processing and manufacturing, trading and shop keeping and other similar non-farm activities.

Table.2 Changes in occupation of borrowers after joining GB, 1998						
Principle Occupation	**Before joining GB**			**At the time of survey**		
	Male (N =144)	**Female (N = 156)**	**All (N = 300)**	**Male (N =144)**	**Female (N = 156)**	**All (N = 300)**
Cultivation	8.2	0.6	4.2	6.8	0.6	3.6
Wage Laborer	18.6	1.8	9.9	1.8	0.1	0.9
Livestock and Poultry raising	0.4	0.8	0.6	4.5	9.1	6.9
Processing and Manufacturing	15.2	38.8	27.5	13.5	55.4	35.3
Trading and shop keeping	34.2	6.2	19.6	48.3	13.5	30.2
Transport operation	3.2	0.1	1.6	11.0	0.2	5.4
Construction and other services	11.2	2.3	6.6	14.1	4.1	8.9
Unemployed	9.0	49.4	30.0	0.0	17.0	8.8
Total	**100**	**100**	**100**	**100**	**100**	**100**
Source: ibid						

Question may be raised that increasing income and changing occupational pattern may be due to development process rather than GB credit. But available evidence provides sufficient support to believe that GB credit has played significant role in increasing income and changing occupational pattern of its members (Table.2). Borrowers who borrowed in progressive ways are benefited accordingly. Those who have completed higher number of loan cycles, their respective size of income was also high (Table.3).

Table.4 shows that the role of credit in increasing the income of GB borrowers also reflects an increased use of working capital by them in their micro-enterprises. It is true across different groups of borrowers and occupations. Absolute amount of working capital increased three fold after joining the GB credit plan by members.

Table.3 Number of loans taken, average size of loans & household income for GB members				
Number of loans taken	**Number of borrowers (N = 300)**	**Share of borrowers (%)**	**Average size of loans (in taka)**	**Average size of household income (in taka)**
First time	88	29.3	3867	32893
Second time	66	22.0	5612	38239
Third time	54	18.0	6668	35908
Fourth time	54	18.0	6668	35908
Fifth time and more	30	10.0	7018	49180
Total	**300**	**100**	**5576**	**38118**
Source: ibid				

Increased income of GB members has also helped in alleviating their poverty. The Ginni concentration ratio is comparatively lower among the GB members than the other groups of non-members. Proportion of moderately poor population was standing at 64.1% among the GB members than 78.6% and 74.2% of non members of project village and control village respectively. Similar situation was in the case of those living in extreme poverty. It was 46.1% in case of GB Members, and 63.8% and 60.4% in non members of project villages and control villages respectively (Table.5).

Table.4

Changes in working capital, type of borrower and occupation after joining GB, 1998

Type of borrowers	Number of borrowers	Borrowers reporting working capital		Amount of working capital per borrower	
		Before Membership (%)	At time of survey (%)	Before Membership (Taka)	At time of survey (Taka)
1. Gender					
1.1 Male	144	50.1	72.5	1268	3788
1.2 Female	156	46.2	66.9	1170	3468
2. Occupation					
2.1 Processing and Marketing	104	65.2	83.2	1347	4182
2.2 Trading and Shopkeeping	93	42.1	74.5	1452	4322
2.3 Others	103	36.3	51.5	875	2380
Total	**300**	**48.1**	**69.6**	**1217**	**3607**

Source: ibid

Table.5

Proportion of poor population among participants and comparable non–participants

Variable	**Grameen Bank Members**	**Target group non participants**		**All Households**	
		Project Villages	**Control Villages**	**Project Villages**	**Control Villages**
Gini concentration ratio of income	0.263	0.269	0.289	0.287	0.286
Proportion of moderately poor population	64.1	78.6	74.2	62.8	71.6
Proportion of extremely poor population	46.1	63.8	60.4	53.4	55.2

Source: ibid

Increasing income and reducing poverty is also helping to improve the social welfare indicators of GB members (Table.6). Activity ratio, expenditure on education for children, expenditure on family nutrition and expenditure on health services of GB members are comparatively better than the target group non-members in control villages.

Table.6
Welfare indicators of GB female borrowers

Welfare Indicators	GB Members	Non-members in project villages	Non-members in control villages
Activity ratio	0.50	0.35	0.31
Expenditure on education for children	0.18	0.08	0.06
Expenditure on family nutrition	0.14	0.09	0.09
Expenditure on health services	0.11	0.07	0.09

Source: ibid

Grameen Bank's contribution in reducing poverty and improving welfare indicators through its credit programme and related services for its members, is well documented. But several applied studies have raised questions on its success in terms of reaching to poorest of the poor. Wright (2000), remarks that certainly none of the larger MFIs including the GB, operating in Bangladesh, are serving the poorest of the poor through their mainstream saving and credit activities. However, Grameen Bank has improved a lot in its second phase of development (started in 2000) but its minimalist credit strategy in first phase as well as later, has hampered the effort of alleviating overall poverty. Microcredit, though a very necessary resource, but not sufficient for promotion of micro-enterprises, other resources, like business and production training, establishing market linkages for inputs and outputs, sub-sectoral analysis and policy reform are also required. Integrated approach of credit policy should be given preference over minimalist approach, which fortunately GB has recognized in its second phase of development.

5. Evolution of MFIs in the Context of India and its Regional Differences

Evolution of micro-finance in India is very much different from the evolution of micro-finance in Bangladesh. In Bangladesh, NGOs and MFIs have played leading role in micro-finance movement, while in India role of these institutions are limited. Role of NABARD was pivotal in development of India's micro finance sector. NABARD has tried to link all the existing financial institutions that provide credit to unorganized sector and to self-help groups (SHGs). SHG-Bank linkage model was the most successful programme launched by NABARD with co-operation of government. Though no definite statistics are available, it is estimated that about 90% of micro-credit comes from SHG-Bank linkage programme and only rest 10% from MFI-SHG model or from other sources. However sustainability of SHG-Bank linkage programme in the long run is a big potential question, for further research.

Micro-finance movement (SHG-Bank linkage programme) has registered significant success in southern states and states like Odisha, West Bengal to name a few. But it was not that successful in northern and north-eastern region. The share of southern region in total number of new SHG formed in the period of 2001-02 to 2003-04 was more than 60% while the share of northern, north-eastern and western regions were 5%, 1.2% and 5.3% respectively. Situation is worse when we see the figures of cumulative bank loan utilized by SHGs in different regions. While the share of southern region in cumulative bank loan was 78%, it was merely 3.4%, 0.5% and 3.9% for northern, north-eastern and western region respectively. Now question arises, what are the possible reasons of prevailing huge regional imbalances in SHG formation and their capacity of using the bank credit? Is it because of micro-finance model (SHG- Bank linkage) which India has chosen or because of credit history and culture prevailing in the region? Or is it somehow related to the concentration and intensity of poverty prevailing in the region? And if it is not because of economic factors and real reasons are inherent in social, political factors and value systems of these regions, then what is the possible interpretation of causality lying between non-economic factors and micro-finance movement?

Micro-finance model (SHG-Bank linkage) has been doubted as one of the factors of failure of the movement in northern, north-eastern and western part of the country. The way in which the concept of micro-finance has evolved in Bangladesh indicates that lending agency should have an active involvement in economic activities of the poor. Providing training, technical advice, technological support and help in marketing of products are part and parcel of the credit policy. In SHG-Bank linkage model, though we have chosen SHG channel for extending credit to the poor as an important characteristic of micro-finance, but other aspects mentioned above have been ignored. Access to credit is one part, but utilizing available credit for productive purposes is entirely a different aspect. It needs ancillary services which SHG-Bank linkage model does not provide. Further formation of SHGs depends a lot on performance and experiences of existing SHGs and because existing SHGs are not performing due to lack of ancillary services, their formation is not taking the momentum.

A further question arises, whether this is the reason for this model to be successful in southern region? Probable answer may be prevailing credit culture and credit history in southern region, which is lacking in northern region. It has been observed in northern region of the country that many SHGs exist only on paper. They are the source of drawing money, which is provided by the government in the form of subsidy by influential people of society. People who are socially or politically influential and dominating, form the group by including the people from socially marginalized and economically backward communities to maximize their vested interest. On behalf of the illiterate and ignorant people, they take all the benefits. Studying the socio-economic profile of leaders of the group along with group members might be an interesting topic for further research.

Another probable important reason for the failure of micro-finance movement in northern part may be the low intensity of poverty in comparison to southern part. Though the concentration of poverty in northern India is more than the poverty in southern India, but they are able to manage their basic needs. It also reflects in suicide cases, which are comparatively less in northern region than the southern region of the country. The low intensity of poverty might be a factor for people of northern India to show less interest in micro-finance movement.

Attitude and perception towards work, particularly low profile work which is considered as inferior, may be another reason for not taking interest in microfinance movement. This reason is linked to value system of society, which has deteriorated very rapidly in north India. People want to earn money without efforts and are attracted towards those activities which are shortcuts to good and easy money like politics, administration and other government jobs. They do not have any attraction towards traditional work and self-employment.

6. The Development Process of MFIs in India:Its Adverse Implications

MFIs movement which started with due social and economic objective to empower the weaker sections of the society lost its path of development in midway. Increasing commercialization of micro-finance institutions has affected their social and economic concerns for weaker sections of society. Flow of private equity funds and entry of other capital market institutions in this sector has further aggravated their concern for return and profit. For increasing the profit, MFIs have raised their rate of interest and focused on grabbing more and more customers. Increasing rate of interest and competition for potential borrowers has led to the result of multiple borrowing by the same customer which has deteriorated the quality of assets created by MFIs.

Another drawback of development process followed by MFIs is that it inhibits the transformation process of MFIs from non-profit making societies, trust and section 25 companies to profit making Non-Banking Financial Companies (NBFCs). Organisational Transformation was the need of the time for increasing the scale of their activity and reaching out to large section of poor population across the region and sectors. But the model followed was not sustainable because of increasing family and individual concern and their vested interest in MFIs. The managerial remuneration of the managing director of SML (Share Microfinance Limited) was around 2.29 crores in 2008-09 which shot up to INR 8.08 crores; by far not only the highest remuneration in the microfinance sector, but way above the remuneration obtained by the CEO of the largest private sector bank - ICICI Bank. Similarly in Asmitha Microfinance, the managing director who is the wife of the MD of SML was to obtain a salary of INR 34 lakhs in 2006-07, which was proposed to be hiked to approx. INR 60 Lakh in 2007-08 and in 2008-09 she was actually paid a salary of INR 1.58 crores and allotted a sweat equity of INR 1.94 crores taking the total remuneration to above 3.5 crores. It has also weakened the professional and corporate governance. Moreover, public funds have been transformed into private assets and wealth in this transformation processes. Rectification of institutional and organizational transformation is a must for ensuring the sustainability of the sector in the long run.

Disparities in regional spread have emerged as a challenging concern for the development process of MFI sector. Most of the MFIs are concentrated in southern region and very few MFIs are expanding their business in northern or north-eastern part of the country. Southern region alone had a share of 54% clients and account 58% of loans.

7. Conclusion and Policy Prescriptions

India's non-farm sector has strategic importance to solve the unemployment problem of rural India. Shortage of working capital has been identified as one of the biggest problems of this sector. Traditional financial institutions, such as banks, are not able to fill this gap. Institutional structure and governance, lending methodology, product portfolio, credit delivery and monitoring mechanism, and more importantly the basic philosophy in which Indian banking system believes, are some important factors behind this. Looking at the experiences of South Asian countries, particularly Bangladesh and within our own country, particularly southern states, MFIs may play a very important role in solving the problem and filling the gap. Hassel free and door step availability of credit, group based lending and active involvement in venture of their borrower, and their fundamental social and economic philosophy for lending to borrowers, are some unique features that suit the small entrepreneurs. Experience of Muhammad Yunus's Grameen Bank, which is an MFI, shows that the model has worked very well to develop the small enterprises in non-farm sectors, by creating employment and reducing poverty in Bangladesh. But India's experience of microfinance evolution is very different from Bangladesh and other South Asian countries. Whereas in other countries it was developed by NGOs and private sector and supported by market demand; in India it was propagated and launched by the government through the NABARD in the form of Bank-SHG linkage model, which was a supply push effort. Though, under this model banks have made group based lending, which is an important characteristics of MFIs, but other ancillary services for the micro enterprises were missing. Results and responses of this model are not very encouraging and have wide regional differences in their outreach and impact. Even the development of Microfinance Institutions (NGOs and NBFCs), which once had a very rapid growth and a conducive environment, is now in its darkest phase. Lack of proper regulatory structures and supervisory norms have given space to some individuals to abuse the public funds and maximize their vested interest at the cost of society. Flow of private capital fund further aggravated their interest for return, which pushes the lending interest rate towards the higher side. Very high interest charged by MFIs is generating social and political consciousness against them because of suicide cases that are taking place in some of the states by the MFI borrowers. It is the peak time for the policy makers to design proper supervisory norms and monitoring structures for the MFI sector to develop a healthy environment and competitive scenario.

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CORPORATE FINANCE IN ISLAMIC PERSPECTIVE

Dr. Waquar Anwar [1]

'Corporate Finance' may be understood as the management of finance for corporate bodies. Management of finance encompasses arrangement of funds, maintenance of funds and application of funds. In this article, we shall dwell only upon some aspects of the arrangement of finance.

At the outset, it is necessary to delineate the usage of the word 'Corporate Finance' in the article and in common parlance, so that its purpose and contour may be appreciated in proper perspectives.

Corporate bodies would mean organisations that are formed under a statute or those that attract legal obligations. Such an organisation may be a Sole Proprietorship, a Partnership, a Company, an Association of Persons (AOPs), a Body of Individuals (BOIs) or any other organisation with any other name under any legal system. The legal system may not require their prior registration under an act of law but such entities entail legal obligations like payment of tax on income. In other words, organisations which have distinct legal identity may be called corporate entities.

This paper is primarily focused on the finance of a business corporation. Literally, the word *'corporate'* would cover legal entities of both charitable and business-related establishments. But the connotation *'Corporate Finance'* relates only to business establishments concerned with production and service related activities.The term finance is a misnomer for the funds required for consumption or contingencies of humanitarian nature.

Another aspect which needs mention here is that in this article the subject is analysed more from the point of view of production/service units than from the aspect of fund providers like banks or other financial institutions. In the last four decades, the overwhelming majority, of literature and research work on Islamic finance, emphasises on the perspective of fund providers. That is why even the funding for consumption needs, like purchase of cars and houses, has been understood as 'financing'. Obviously, for fund providers this too is business as they earn profit therefrom. A basic reason for this lopsided understanding of

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Islamic finance is that, these so-called Islamic financing activities have developed within a rentier-economy instead of a production-based economy.

Islamic Perspective

Islam, as such, is not the author of business systems like *'shirkat'* or *'mudharabat'.* These systems of business were prevalent at the time of Prophet Muhammad (peace and blessings of Allah be to him). He either maintained silence about them *(taqreer)* or corrected the wrong practices *(e.g. naha and rasoolullah)*[2]. His silence on these practices and his suggestions for corrections in some practices are both part of his traditions *(sunnah)*. Silence was maintained on practices which were in order and corrections were done only where required. Further, the Qur'ān also provides certain specific and related commandments. So we find that business systems like *'shirkat'* and *'mudharabat'* were practiced in earlier times as well. The commandments of Qur'ān and the traditions of the Prophet *(Sunnah)* enabled these systems to continue with certain amendments by providing the bases on which corrections in practices can be done wherever required in any period, including present times.

Islamic scholars have opined that the purpose of the corrections done in prevalent business practices was to check the practice and propagation of any one or more of the following abhorring and harmful activities:[3]

1. *Riba* – Interest (Increase in debt)
2. *Maysir/Qimar* – Gambling
3. *Gharar* – Misleading the other party
4. *Dharar* – Causing harm or getting harmed
5. *Jihl mufdhi ilan-niza* – Lack of material information leading to dispute
6. *Tadlees* – Misrepresentation and causing wrong impression about the product
7. *Taghreer* – False description of goods
8. *Ghaban* – Check on excessive profiteering

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[2] traditions reporting that the Prophet forbade something

[3] [Waquar Anwar, Business Transactions in Islam, Markazi Maktaba Islami Publishers, New Delhi, pp. 47-48]

9. *Khulaba* – Impressing buyers by gestures and sales talk/art of deceit
10. *Ihtikar* – Hoarding of food grains and essential items
11. *Baiatain fil bai* – Two-in-one transaction/Conditional deal
12. *Kharaj without dhaman* – Earning profit without corresponding risk/ authority/possession.
13. *Bai madoom* – Dealing in non-existing product
14. *Malikil ghair* – Transaction in products that are in the possession of any other person
15. *La khilabah wa Khayarat (haqqo raddil bai)* – No fraud and the right (option) of revisiting transactions

Islam stands for the welfare of human beings and the corrections related to the above mentioned provisions are meant to ensure justice for all so that the desired prosperity in human society may be achieved. The ingrained principle of business transactions in Islam may be summed up as JUSTICE, EQUITY, GROWTH and WELFARE. Eradication of corruption is required to ensure achievement of these goals. This can be done by ensuring that the higher objectives of Islamic law are adhered to. Islamic scholars have described these higher objectives of Islamic law as Protection of Life, Religion, Reason, Progeny, Property and Preservation of dignity and freedom *(maslaha & maqasid al-shari'ah)*[4].

The Relevance of Islamic Perspective in Present Times

In the present times, the approach should be to study the prevalent business systems and either design new methods or carry on corrections based on the cardinal principle of ensuring Justice, Equity, Growth and Welfare. One has to keep in mind the relevant provisions of the Qur'ān and *Sunnah* and the valuable works done by Islamic scholars in finding and describing the principles emanating therefrom. That is the basis of further work on the subject.

The approach mentioned above can be elaborated with the help of an example. A joint-stock company is a recent development in the business sector and its issues cannot be based on old business practices. Different sources were referred

[4] [Mohammad Nijatullah Siddiqi, Riba, Bank Interest and the Rationale of Its Prohibition, Markazi Maktaba Islami Publishers, New Delhi, p. 20]

to understand the relationship between shareholders and a joint stock company and the following five responses were derived:

1. The concept of limited liability is a fraud on society. So the whole thing needs to be abolished and an entirely new system akin to those in the past are required to be recreated.
2. It is *shirkat* because all the shareholders are joint owners
3. It is *mudharabat* because individual shareholders simply provide funds and sit back and the business is done by the promoters of the company
4. It is *shirkat* because *mudharabat* is nothing but an extension of the former

The first mentioned opinion seems to be a complete rejection of a new idea. It appears simple to say that anything new is wrong *ab-initio* so we need to abolish it altogether and re-create the past. Life does not move like this. Also the development of Islamic thought too does not confirm or propagate such a renunciation.

The other three above mentioned positions taken by the scholars have one thing in common, that they tend to apply the principles delineated by the scholars of the past regarding *shirkat* and *mudharabat* to an entirely new situation. The concept of a joint stock company is an entirely new phenomenon so one need not apply an old parlance for this new system/concept. There is a need to analyse afresh this new system and take new positions in the light of the provisions of primary Islamic sources and the principles developed in their light by past scholars.

Further, one should look into the deliberations of contemporary scholars and the checks and balances developed to combat ill practices. For example, a worthwhile literature is available on the following issues which are concerned with, inter alia, checking monetary and other frauds being perpetuated by mighty few on the hapless majority of shareholders:

- Corporate governance
- Rights of minority shareholders
- Lifting corporate veil
- Discloser requirements with balance sheets.

Profit Sharing and Loss Bearing

Profit Sharing

There is a basic difference between *shirkat* and *mudharabat* that affects corporate finance. Scholars agree that the distribution of profit in both the above mentioned systems shall be done in the ratios agreed between the partners. Loss will, however, be borne by them in the ratios of their respective capital in the business. As in *a mudharabat,* capital is provided only by the passive partner, so the burden of the loss shall entirely be on the passive partner.[5]

This issue needs to be examined afresh in view of the contemporary situations. The case of an active partner with no capital is very unlikely. In the case of a passive partner joining a running business, some amount of capital is always invested. That capital might include goodwill of the business which may be accounted for on some agreed basis. The only possibility of nil capital of the active partner is in the case of a new business. That too is not common these days. Fund providers insist on margin money of the active partner and this makes the venture a *shirkat*. One may safely conclude that the contemporary corporate finance scenario is more akin to active partnership *(shirkat)*. Pure passive partnership *(mudharabat)* is an exceptional, if not far-fetched, situation. The Islamic scholars have interpreted the banking business as *mudharabat* between the depositors and the banks. Even this position can be challenged, as no financial institution can be allowed to begin business without seed money/initial capital. So the banks too, invest initial capital. Thus, the opinion that the losses in an Islamic banking business shall be borne only by the depositors, needs reconsideration.

Loss Bearing

Loss, according to Islamic scholars, is erosion of capital which shall be borne by the partners on the basis of their respective invested capital. This principle of distribution of loss on capital ratio has been recognised in the contemporary accountancy practice and referred to as Garner vs. Murray rule. However, that rule relates to insolvency stage of a partnership business. The contemporary business reality suggests that like profit-sharing, loss-bearings too require to be ascertained on periodical basis (most likely annually).

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[5] [Siddiqi, Shirkat-o-Mudharabat ke Sharaī Usool, Markazi Maktaba Islami Publishers, New Delhi, pp. 14-15]

Another issue is the quantum of capital of partners and the method of their accounting. These are basic requirements in financing under Islamic perspective because interim losses shall be borne according to these. Hence the prospective partners need to agree at least on following two issues:

1. Accounting or otherwise considering the goodwill of the older partner, where a new one is joining at a later stage.
2. Basis of accounting of capital - either on Fixed Capital or Fluctuating Capital systems.

For short term financial arrangements, either in the beginning of any venture or project financing in later periods, it is advisable to opt for Fixed Capital system. It is advisable to consider the initial share in finance as the basis on which losses would be borne.

An issue that needs resolution by Islamic scholars is the case of weightage for capital of an old partner. Goodwill is accounted for the purpose and with the reason that the capital being infused by a new partner in an old and flourishing business cannot be treated at par with that of the old partner. Similarly, opinion is required on the contemporary practice of issuing equity shares with premium, where face value of the share of a joint stock company is less than the amount paid for that.

Short Term Financing

The object of this paper is to initiate a discussion on corporate finance. One such aspect for discussion is the case of financing in following two situations:

1. Short term partnership in the initial period of business
2. Project financing in the interim period

As against the practice of business partnership for long periods, the practice of short term financial arrangement in the initial period of a business has a very good potential. This has resulted in enormous growth in the Silicon Valley in USA. This type of finance is provided by venture capitalists or angel financers on equity basis. Venture capitalists arrange their own fund on mutual fund basis and invest in prospective businesses. Angel financers, on the other hand, are individuals with surplus fund who enter into such arrangements. Such finance providers remain partners for few years and then take back their capital and accumulated profits and let the business continue as usual. So the issue that has to be resolved by Islamic scholars is that of ascertainment of profit or loss in the period of association and the accounting at the close of the venture without closing the business.

The margin required to be invested by the entrepreneur is his share of capital and by the venture/angel capitalist is his share. Thus if the funding is done on a margin of 15% the capital ratio between entrepreneur and financer is 15:85.

An ongoing business may need short term financial arrangement to finance a particular project. Given below is the case of a business, which was running before such an arrangement and which shall continue to run after the expiry of this arrangement. A method for profit sharing by the short term partners is proposed with the help of the following computation.

A Typical Profit and Loss Account

Particulars	Rs.	Rs.
Sales		200,000
Add: Closing Stock		20,000
		220,000
Less: Opening Stock	30,000	
Purchase	60,000	
Wages	15,000	
Other Direct manufacturing expenses	10,000	(115,000)
Gross Profit (GP)		105,000
Less: Salaries	15,000	
Other Overheads	25,000	(40,000)
Profit before tax and depreciation (PBDT)		65,000
Less: Depreciation		(12,000)
Profit before tax (PBT)		53,000
Less: Tax		(17,200)
Net Profit (NP)		35,800

The parties may agree to share profitability on the basis of Gross Profit (GP), Profit Before Depreciation and Tax (PBDT), Profit Before Tax (PBT) or on Net Profit (NP).

This system is advantageous to the entrepreneur because he need not share his total business accounting and trade secrets with the project financer. Sharing information up to the stage agreed for profit sharing, shall suffice. However, this system has a disadvantage that the entrepreneur may actually suffer loss after complete accounting, although he might have provided share of 'profit' to the project financer earlier.

The advantage described in the above paragraph may be ensured while the disadvantage may be avoided by adopting marginal costing method - bifurcating expenses into fixed and variable. In that case profitability may be shared as 'contribution' which is computed by deducting variable expenses from gross income/sales. This system is justified where fixed expenses are recovered by the business. So the marginal increase in profit on account of the new project may be shared between the entrepreneur and the project financer. Computations in the following table have been done in order to elaborate this.

A Typical Profit and Loss Account Prepared on Marginal Costing

Particulars	Rs.
Gross Income	900,000
less: Variable expenses	(550,000)
Contribution	350,000
Less: Fixed expenses	(100,000)
Profit before tax and depreciation	250,000
Depreciation	(30,000)
Profit before tax	148,700
Tax	(71,300)
Net Profit	217,900

The data as above has been used from the final account of a software professional. He has negotiated for a software development job which will yield an additional income of Rs.500,000. The additional direct expense estimated by him is Rs. 225,000. It is the cost of engaging a professional for completing the job.

He envisages no further fixed expenses like office rent and other office establishment expenses, as it will be covered by his existing business. Contribution from this project is Rs.500,000 minus Rs.225,000 = Rs.275,000.

However, he will require one computer with proper systems to execute the job, which will further cost him Rs.100,000. As this new asset will remain with him even after the project period it will not be justified to charge this cost in total on the project. He can at best charge depreciation on this asset for the period of the project. Considering the project period to be 9 months and the rate of depreciation on computer and its software as 60% the share of chargeable depreciation on the project shall be 60% of Rs. 100,000*9/12 = Rs. 45,000.

Thus, the profit may finally be shared on the differential gain as under

= Contribution minus depreciation
= Rs.275,000 – Rs.45,000
= Rs.230,000

The entrepreneur needs fund for executing this and a friend agrees to finance him up to Rs.250,000. So, based on this real time data, he wants to know the basis of sharing profit with this friend without sharing his existing business details.

"Total additional fund required by the entrepreneur for executing the job is Rs. 325,000 comprising Rs. 225,000 direct expenses and Rs. 100,000 for the computer system. However, the particular job will utilise the depreciation of the additional computer system only to the tune of Rs. 45,000. So the fund outlay justified for the job is Rs. 270,000 (i.e 225.000+45,000). Thus the capital ratio between the entrepreneur and his financer friend is 20:250."

"The profit from the venture can be shared by them on any agreed ratio. However, ratio for sharing loss between the entrepreneur and the financer shall be 20:250."

The final account of the entrepreneur after executing this arrangement may be as under:

Particulars	**Rs.**
Gross Income	1400,000
less: Variable expenses	(775,000)
Contribution	625,000
Less: Fixed expenses	(100,000)
Profit before tax and depreciation	525,000
Depreciation	(90,000)
Profit before tax	435,000
Tax	(141,000)
Net Profit	294,000

Thus we may conclude that issues relating to corporate finance in Islamic perspective may be resolved on a case to case basis.

Murabaha Contract: Its Application and Tax Implications in India

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Abstract

The success of any alternative mode of finance relies on how much 'extra profit' it offers to the customers or 'how cost effective' it is in comparison to the other existing modes. The more a financial product is profitable and cost effective, the more it is technically feasible to be adopted in a market. Therefore, this paper attempts to study the technical feasibility of one of the major Islamic Finance contracts - *Murabaha* in comparison to the prevailing modes of conventional finance. This paper explores the impacts of Indian taxation laws and provisions on *Murabaha*. Further, it proposes possible solutions to make *Murabaha* technically feasible and viable for adoption in the Indian market.

1. Introduction

It is evident that within the prevailing economic system there are a number of serious market failures that need external interventions to be resolved. One such failure is the inability of the present credit system to meet the loan demands from the sections of population that cannot access formal credit channels or do not have sufficient collateral against which they can borrow. These 'non-banked' or 'non-bankable' groups include not just the poor, but also would-be entrepreneurs with projects or ideas with potentially high rates of return (Iqbal and Mirakhor, 2011). One of the solutions to this market failure came in the form of Microfinance in the mid 1970s.

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The Raghuram Rajan Committee states that microfinance institutions can be utilized as effective channels for financial inclusion in India. Similarly the Rangarajan Committee also suggests opening specialized microfinance branches or cells (Rangarajan Committee Report, 2008).

Through their carefully designed products and processes, the Microfinance Institutions (MFIs) help these non-bankable people to avail banking services such as savings, credit and insurance. Unfortunately, along with their positive contributions to financial inclusion in India, there have also been some bitter experiences with MFIs over the last decade. The combination of minimal regulation and rapid sector growth, eventually led to an environment where customers became increasingly dissatisfied with the microfinance services, resulting in the Andhra Pradesh Microfinance crisis in 2010.

Among various issues related to the microfinance operations and practices, three major issues have been identified for immediate attention.

First is with regards to the high rates of interest charged by the MFIs. MFIs justify these rates of interest by citing the high operational costs involved in dealing with small deposits and credits. Nevertheless, an average annual rate of interest of 30% and above is considered unjustifiably high. The gap is so much higher than the acceptable levels that the MFIs have been alleged of profiteering and eventually becoming modern moneylenders *(sahukars)*.

The second issue is related to the competition among MFIs resulting in multiple lending to the borrowers, which is chiefly responsible for their indebtedness.

The third issue is the indulgence of MFIs in coercive and undignified practices while recovering their loans.

Experts have already proposed many possible solutions and reforms to address the above mentioned issues. In addition to them, another potential solution could be alternative modes of finance delivery services, specifically, Islamic Microfinance.

Islamic Microfinance works on the principles of *Shariah* (Islamic law) which ordains the strict prohibition of receipt and payment of *Riba* (usury/interest) in loan and exchange transactions. The Islamic financial system is also premised on the general principle of providing services for the welfare of the people by prohibiting practices considered unfair or exploitative (Karim, Nimrah, Tarazi & Reille, 2008). Thus, Islamic finance has an important role to play in furthering the socio-economic development of the poor and small (micro) entrepreneurs. Its various ethical schemes and instruments can be advanced and adapted for the purpose of microfinance. For *e.g. Qardh-ul-hasan* (the benevolent loan), *Murabaha* (cost plus/mark up), and *Ijarah* (leasing/hire purchase) schemes are relatively easy to manage. They can cater to the needs of potential micro-entrepreneurs and the poor for capital, working capital and equipments etc. Participatory schemes such as *Mudaraba* (profit sharing) and *Musharakah* (joint venture/equity participation), on the other hand, have great potentials for microfinance. They uphold moral and ethical attributes which can effectively motivate micro-entrepreneurs to flourish. However, specialized skills are required in managing risks inherent in the structure of the contracts related to these schemes.

Contemporary Islamic Microfinance Institutions (IMFIs) across the world are using a variety of Islamic modes of financing such as *Musharakah, Mudaraba, Murabaha, Ijarah, Salam and Istisna* (form of forward sales contract/manufacturing finance). Among all the Islamic finance contracts (products) *Murabaha* financing is one of the most widely used and preferred financing methods.

The concept and practice of Islamic Microfinance is very old in India. The Islamic Finance Institutions have been operating in India since the beginning of the 19th century (Nisar, 2004). Presently, a good number of Islamic Finance institutions (organised and unorganised as well) registered under Non-Banking Financial Companies (NBFCs) or Trusts/Co-operatives are operating in different states such as Kerala, Andhra Pradesh, Uttar Pradesh, Bihar, Karnataka, Maharashtra, Tamil Nadu and Jammu &Kashmir etc.

The objective of this paper is limited to review *Murabaha* in the Indian context. This paper discusses issues and theories at the conceptual level. It does not aim to empirically examine them. However, it is expected that this paper shall be useful to develop hypotheses for future research, especially in the relatively new area of Islamic microfinance.

2. Islamic Microfinance in India: Some Notable Thoughts

It is important to understand the reasons for financial exclusion and marginalisation of people, especially, Muslims in India and across the world. This would help in building a better understanding on the application and tax implications of

Murabaha in the Indian context. There could be various reasons contributing to this exclusion. Two of the most important ones are given below.

Usually Islamic IMFIs use two types of financing instruments viz. Debt financing and Investment financing in addition to *al-Qard al-Hasan i.e.* the loan with zero return. The former includes *Murabaha, Ijarah, Salam* and *Istisna*. Whereas the latter based on profit and loss sharing covers *Mudaraba, Musharakah, Musaqat* (Orchard Financing), *Muzar'ah* (Share of Harvest) and Direct Investment.

So far, the focus of Islamic Microfinance practitioners has been on debt financing instruments, especially *Murabaha.* It is an asset-based sale transaction which is used by clients to get their working capital financed. In the process, the client requests the financier to procure a specific commodity. The financier procures it directly from the market and resells it to the client at a higher price including a fixed 'mark-up' as profit.

Critics of *Murabaha* financing product argue, that its pricing (with cost mark-up or administration fee) closely equals (or even exceeds) the pricing of conventional products. The cost seems to involve more than simply giving the money to a borrower who can purchase the required materials/items. The cost involved is high compared to conventional lending. This is due to additional staffing expenses, expenses for procurement of goods/equipment, expenses for execution of *Murabaha* financing procedure and taxation involved to buy goods. Furthermore, *Murabaha* does not allow a late payment fee unlike some IMFIs which consider it while pricing their products.

In addition, a few other important factors should also be taken into account to understand *Murabaha*.

Firstly, IMFIs in India greatly lack funds both from the individual investors as well as the government, unlike the conventional MFIs (including cooperatives/NGOs). It goes without saying that fund providers, investors, donors and government play the most important role to strengthen the Microfinance sector. IMFIs stay deprived from such support. Some leading institutions like Islamic Development Bank (IDB) or parent organization, Islamic Banks, Sovereigns etc. provide such funding support to the IMFIs.

Secondly, the regulations in India restrict the IMFIs to take deposits because of which they are unable to offer saving and equity products such as *Musharakah* and *Mudaraba*. In addition, they are required to pay a fixed percentage of interest to the depositors. The cancellation of licence of Alternative Investments and Credits Limited (AICL) by the Reserve Bank of India (RBI) on this ground is a recent example illustrating this point [4].

Thirdly, there is hardly any Research & Development (R&D) work carried out in India to critically analyze the prevailing conventional microfinance products, from the *Shariah* perspective to make them *Shariah* compliant. In this case the IMFIs lack financial and human resources required to conduct such R&D activities.

Fourthly, equity financing and risk sharing products are ignored due to moral hazard and agency issues. The reliance on *Murabaha* (Mark-up) financing does not serve the purpose as it cannot be extended in cash for meeting running expenses like salary and other utilities. Furthermore the existing fixed-return financing instruments like *Murabaha, Ijarah, Salam & Istisna* lack effective marketing to increase their outreach and acceptability.

These factors would enable better understanding of the technical analysis of *Murabaha* from the perspective of taxation.

3. *Murabaha* – A Brief Introduction

According to Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), "*Murabaha* is selling a commodity as per the purchasing price with a defined and agreed profit mark-up. This mark-up may be a percentage of the selling price or a lump sum. This transaction may be concluded either without a prior promise to buy i.e. an ordinary *Murabaha*; or with a prior promise to buy, submitted by the person interested in acquiring goods through the institution i.e. *Murabaha* to purchase order (the customer)" (AAOIFI, *Shariah* Standards, 2012). *Murabaha* is a sale contract based on trust under which the seller explicitly discloses the actual cost/price and added profit to the buyer.

It is to be noted that the practice of *Murabaha* usually involves two sales. First sale is between the supplier/manufacturer and the institution (including microfinance Institution) where the institution purchases the goods from the supplier. The second sale is between the institution and the customer where the institution sells the same goods to the customer on *Murabaha*. This paper further discusses the structure and mechanisms of *Murabaha* contract.

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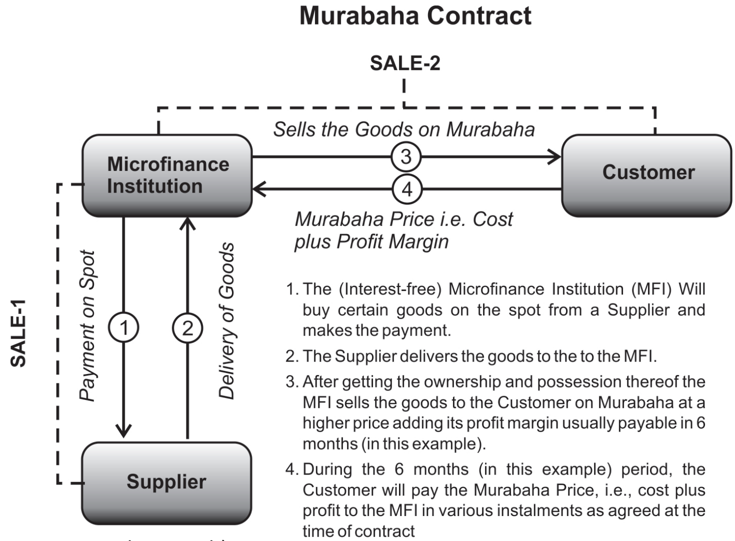
[9] AICL is a Kerala based asset financing NBFC established in the year 2000, operating on Islamic Finance principles. At present its licence has been cancelled by RBI and it has been challenged in the Mumbai High Court.

3.1 Structure and Mechanism of a Murabaha Contract



1. The (Interest-free) Microfinance Institution (MFI) Will buy certain goods on the spot from a Supplier and makes the payment.
2. The Supplier delivers the goods to the to the MFI.
3. After getting the ownership and possession thereof the MFI sells the goods to the Customer on Murabaha at a higher price adding its profit margin usually payable in 6 months (in this example).
4. During the 6 months (in this example) period, the Customer will pay the Murabaha Price, i.e., cost plus profit to the MFI in various instalments as agreed at the time of contract

(Source:Personal Research)

3.2 *Murabaha* Calculations

A few examples are given below to illustrate the calculations involved in *Murabaha*.

Table.1
Calculations involved in *Murabaha* Financing

***MURABAHA* FINANCING**			
Basic Assumptions			Equations and Formulas
Particulars	Unit	Value	
Cost of the Asset	INR	50,000	C
Down Payment	INR	0	D
Amount Financed (100%)	INR	50,000	F=C-D
Profit Margin (Fixed Rate) % p.a.	%	10%	R
Term of Financing	Months	24	T
Total Profit Amount	INR	10,000	P=F*R*(T/12)
Total Murabaha Sale Price	INR	60,000	SP = F+P
Monthly Installment	INR	2,500	I=SP/T
Cost portion of Installment	INR	2,083	IC=F/T
Profit portion of Installment	INR	417	IP=P/T

(Source: Personal Research)

- The table shows an example of *Murabaha* goods finance transaction. The total cost of the goods is INR 50,000.
- The customer makes zero down-payment and requires 100% financing.
- The bank agrees to finance 100% cost of the goods which is INR 50,000.
- The bank purchases the goods and sells it to the customer on *Murabaha* (deferred sale) basis repayable in 2 years i.e. 24 months.
- The total *Murabaha* sale price will be INR 60,000. This is the amount financed by the bank which is INR 50,000 and the bank's total profit margin which is INR 10,000.
- The profit amount of INR 10,000 is calculated as below:

  Profit= [Amount Financed (F) * Profit Rate(R) * Term of Financing]

  Profit= [50,000*10%*24/12] = 10,000
- The monthly Installment of INR 2,083 is calculated as below:

  Monthly Installment = [(Amount Financed (F) + Profit Amount (P))]/Term of Financing

  Installment= (50,000+10,000)/24 = 2,083.
- The customer would pay the total amount of INR 60,000 (i.e. 2,083*24) in 24 installments.

4. *Murabaha* and Tax Treatment

Tax is a financial liability imposed by the Central government, State governments and Local authorities such as the Municipality etc. There are various types of taxes and duties levied on the business and financial transactions in India. Purchase of raw materials, import of goods, purchase and resale of goods, export of goods etc. are the tax events where a specific percentage on the cost of goods is collected as Tax. On every tax event when the tax is levied, the cost of goods increases. This phenomenon goes on till the goods reach the end user.

The next few examples analyses *Murabaha* financing from the perspective of Value Added Tax (VAT), Income Tax/Corporation Tax and Stamp Duty.

4.1 *Murabaha* and VAT

Value Added Tax (VAT) is the indirect tax on the consumption of goods, paid by their original producers upon the change in goods or transfer of goods to their ultimate consumers. It is based on the value added to the goods by the transferor. It is the tax in relation to the difference of the value added by the transferors, and not just a profit.

There are two methods for collection of VAT in India. In the first method, tax is charged separately based on the tax paid on purchase, and the tax payable on sale is shown separately in the invoice. Therefore, the difference between the tax paid on purchase and the tax payable on sale, as per the invoice, is the VAT.

In the second method, tax is collected and charged on the aggregate value of the tax payable on sale and purchase, by applying the rate of tax applicable to the goods. Therefore, the difference between the sale price and purchase price would be VAT. It means VAT is the tax collected at each stage before it reaches the final consumer, ultimately paid by the consumer.[5]

The example given below shows how VAT applies in a *Murabaha* transaction.

In Table.2 below, we have discussed the impact of taxation when goods are financed through *Murabaha*. As stated above, *Murabaha* usually involves two sales; the first sale takes place when the Islamic Finance Institutions purchases goods from the supplier on cash and the second sale takes place when the Islamic Finance Institutions sell the goods to the customers on *Murabaha* basis.

In Table.2, the basic cost of goods is INR 100 and the tax rate is 14.5% (taken on the basis of information provided on the government's website.[6]

Therefore, as per the calculations, the **Selling Price-1** for first sale comes to be INR 114.5 which includes the tax amount of INR 14.5.

Table.2
Taxation in *Murabaha* due to two sale events

Particulars	Unit	Value
Cost of Asset	INR	100
VAT @ 14.5% (a)	INR	14.5
Selling Price-1	INR	114.5
Paper Work and other Costs @ 4%	INR	4.5
Profit Margin @ 20%	INR	22.9
Offered Price	INR	141.9
VAT @ 14.5% (b)	INR	20.5
Selling Price-2	INR	162.5
Extra Tax Payable (b-a)	INR	6.0

[5] www.archive.india.gov.in
[6] www.tnvat.gov.in

At the second sale, the Islamic Finance Institution after adding its expenses (INR 4.5 in this example) and profit margin (INR 22.9 in this example) resells the goods to the customer on Murabaha at the **Selling Price-2** of INR 162.5 which includes the tax amount of INR 20.5.

It is seen in the example that the total extra tax payable/collected is INR 6.0 (i.e. 20.5-14.5 = 6.0) which is around 41% more than the tax amount paid in the case of a conventional mode of finance.

Due to the high **Selling Price-2** resulting from the additional tax paid, the customer may prefer the conventional finance where the same goods are available at a lower price. Therefore, there is some tax disadvantage (INR 6.0, in this case) for *Murabaha*.

The solution to this problem could be seeking the relaxation in taxation. The tax should be levied not on the basis of mechanisms in the contract but on the objectives of the contract. This adjustment in Tax laws has been done in United Kingdom (UK), Hong Kong, Singapore, France and Japan (Lovells, 2009).

4.2 Cost of Finance in *Murabaha* and Tax Treatment

It is important to understand that the higher taxation in case of *Murabaha* is not only due to the involvement of two sale events. The other reason is that, in *Murabaha* the financing charge gets added to the basic cost and so the indirect tax gets charged not only on the basic cost but also the cost of financing. In a conventional debt financing on the other hand, the cost of finance (i.e. interest) gets paid separately without being subjected to any such tax element. Thus, even if the first level of tax is exempted in *Murabaha* finance, as it happens with VAT, still a *Murabaha* purchase turns out to be more expensive. An example given below illustrates this point.

Table.3
Taxation in *Murabaha* due to inclusion of cost of finance in the basic cost of goods

Particulars	Unit	Conventional	Murabaha
Cost of Goods	INR	100.0	100.0
Cost of Finance (Interest@5% p.a.)	INR	5.0	5.0
Finance Period	Year	1.0	1.0
Offered Price	INR	105.0	105.0
VAT (@ 14.5%)	INR	14.5	15.2
Sale Price		**119.5**	**120.2**
Additional VAT Amount in Murabaha	**INR**	**0.7**	
Difference in terms of %	**%**	**5**	

Table.3 shows the basic cost of goods as INR 100, the cost of financing as 5% of the basic cost, the financing period as 1 year and the tax rate as 14.5%. As per the calculations, the **Offered Price** in both the cases (Conventional and *Murabaha*) is same i.e. INR 105.0 which includes the basic cost (INR 100) and the cost of financing (INR 5). However, there is a variation of INR 0.7 (15.2-14.5) in the tax amounts. In the case of a conventional mode it is INR 14.5. (i.e.100*14.5%) and in the case of Murabaha it is INR 15.2 (i.e. 105*14.5%).

It is due to this reason that in *Murabaha*, the financing charge (INR 5) gets added to the basic cost and so the indirect tax gets charged not only on the basic cost but also the cost of financing. In conventional debt financing on the other hand, only the basic cost (INR 100) is subjected to taxation whereas the charge for the finance (interest, INR 5) gets paid separately without being subjected to any such tax elements. It is seen in the example that the total additional tax payable/ collected is INR 0.7 (i.e. 15.2-14.5 = 0.7), which is around 5% more than the tax amount paid in the case of a conventional mode of finance.

Due to the high **Selling Price** resulting from the additional tax payment in *Murabaha*, the customer may prefer the conventional finance where the same goods are available at a lower price. Therefore, due to the inclusion of financing cost in the basic cost of goods, there is some tax disadvantage (INR 0.7 or 5, in this case) for *Murabaha*.

The possible solution to this aspect of the issue is still a matter of discussion among the experts and researchers.

4.3 *Murabaha* and Income Tax/Corporate Tax

Income tax/Corporate tax is the tax liability imposed by the Government of India (GOI) on the taxable income of all persons including individuals, Hindu Undivided Families (HUFs), companies, firms, association of persons, body of individuals, local authority and any other artificial judicial person. It is governed under the Indian Income Tax Act, 1961 by the Central Board of Direct Taxes (CBDT). It is to be noted that the corporate tax is levied as a percentage i.e. 30%, excluding surcharges of the profit, and is deducted from the profit before it is distributed or retained.[7]

As per the current provisions of Indian taxation system, the sources of funds (capital structure) play a key role in the applicability of corporate tax. The phrase 'sources of funds' means the 'Debt' (usually known as 'borrowed funds')

[7] http://www.incometaxindiapr.gov.in

and 'Equity' (usually known as the 'shareholder's funds') in the total capital employed. There can be two different capital structures based on the nature of fund mobilisation. First is the fully equity based structure in which 100% of the capital employed is mobilised only from the shareholders or owners of the business. Second is the debt based structure in which a portion of the capital required is mobilised through borrowings, in addition to the equity. An example given below explains this.

In Table.4 below, the columns *Murabaha* and Conventional mode of financing is represented. In *Murabaha* the debt to equity ratio is 0:100 whereas in Conventional mode it is 100:0. For both modes of finance we have assumed the Profit Before Interest and Tax (PBIT) as 20%, the rate of interest on borrowings as 12% p.a. (assumed on the basis of the recent trends of Prime Lending Rate (PLR) which is around 12% p.a.) and Corporate Tax rate as 30%. It is to be noted that all the basic assumptions except the capital structure are the same in both the cases.

In this table the Profit Before Tax (PBT) in the case of *Murabaha* is INR 20.0 whereas in the case of **Conventional** mode is INR 8.0. The difference in PBT between the two modes of finance is due to the interest factor. In **Conventional** mode INR 12.0 is deducted from PBIT as interest on the 100% debt financing. And since *Murabaha* is considered as the sale transaction involving zero debt, so no interest is deducted from PBIT. Hence, PBT is higher in this case. Moreover, the same effect of interest payment is carried over to tax calculations. Table.4 shows that in *Murabaha* the tax amount is INR 6 whereas in **Conventional** mode it is INR 2.4. It means the IMFI opting *Murabaha* for financing shall end up paying 105% more tax than its counterpart.

Table.4
The variation in tax amount between *Murabaha* and conventional finance

Particulars	Murabaha	Conventional
Debt	0.0	100.0
Equity	100.0	0.0
Total Capital	100.0	100.0
PBIT	20.0	20.0
Interest @ 12% p.a.	0.0	12.0
PBT	20.0	8.0
Corporate Tax @ 30%	6.0	2.4
Net Profit	14.0	5.6

Source: Personal Research

Thus, we can conclude that the sources of funds (capital structure) shall have a great impact on the tax payments. In the books of account of the customer who opts for conventional mode, interest on borrowed funds is deducted from PBIT.Hence, the tax levied on the PBT amount is lower. Whereas, in the case where the customer opts for *Murabaha* mode (which is a credit sale transaction), there is no interest deducted from PBIT. Hence, the tax charged on PBT is higher.

The possible solution to this issue could be advocating for a similar tax treatment for *Murabaha* as it is for the conventional mode.

4.4 *Murabaha* and Stamp Duty

Stamp Duty is a tax, similar to income tax, collected by the government. It is payable under Section 3 of the Indian Stamp Act, 1899. It must be paid in full and on time. A delayed payment attracts penalty. A stamp duty paid instrument/ document is considered a proper and legal instrument/document, has evidentiary value and can be admitted as evidence in the court. Document not properly stamped, is not accepted as evidence by the court. It is payable before execution of adocument or on the day of its execution or on the next working day from the day of its execution.[8]

An example explains this further. In Table.5, the basic value of property is INR 100 and the Stamp Duty is 8%. [9]

Therefore, as per the calculations, the **Selling Price-1** for first sale comes to be INR 108.0 which includes the Stamp Duty of INR 8.0. At the second sale the IMFI, after adding its profit margin (INR 21.6 in this example), sells the property to the customer on *Murabaha* at the Selling **Price-2** i.e. INR 139.9 which includes the Stamp Duty of INR 10.3.

It is seen from the above analysis that the total extra duty payable/ collected is INR 2.3 (i.e. 10.3-8.0 = 2.3) which is around 29.6% more than the normal duty payable in case of conventional mode of finance.

Table.5
Stamp Duty in *Murabaha* due to two sale events

Particulars	Unit	Value
Cost of Property	INR	100
Stamp Duty@ 8% (a)	INR	8.0
Selling Price-1	INR	108.0
Profit Margin @ 20%	INR	21.6
Offered Price	INR	129.6
Stamp Duty@ 8% (b)	INR	10.3
Selling Price-2	INR	139.9
Extra Duty Payable (b-a)	INR	2.3

[8] Execution of the document means putting signature on the instrument by the person's party to the document (www.indiainfoline.com).
[9] www.indiaproperties.com

Due to the high **Selling Price-2** resulting from the additional duty payable, the customer may prefer the conventional finance where the same property is available at a lower price. Therefore, in this case also there is some tax disadvantage (INR 2.3, in this case) for *Murabaha*.

One of the possible solutions to this problem could be seeking relaxation in the Stamp Duty on one of the tax events in *Murabaha* transaction. This solution is on similar lines to the one proposed earlier in case of VAT treatment in *Murabaha*.

5. *Murabaha* Instalments and Multiple Financing

In addition to the tax related issues discussed in above paragraphs, another issue that needs to be discussed, is the issue of *Murahaba* instalments and multiple financing. The previous example shows that in a *Murabaha* mode of finance, a customer pays the *Murabaha* sale price in various instalments (not necessarily in all the cases) linked to a specific due date.

The problem arises when the customer needs some more goods to be financed through another *Murabaha* transaction while the instalments for the previous *Murabaha* purchases are still due. In such circumstances what could be the possible line of actions for the institution? Whether it should provide finance to the customer despite the existing liability on the customer or should it reject the application on the grounds of the due instalments?

In the first case the institution shall be at risk as the instalment for the earlier transactions remain unpaid. This may also result in multiple financing and adding to the burden of the customer. In the second case, the institution may end up depriving the customer from availing the required financial services that further could affect the growth and development of the concerned project.

Hence, there is a need to evaluate this problem from both *Shariah* and technical point of view to bring out the possible solutions and protect the interest of the institution and the customer.

6. Conclusion

The analysis of *Murabaha* in the Indian context, brings to the fore a few disadvantages pertaining to the practice of *Murabaha* in India. Since the objectives of *Murabaha* are similar to the objectives of the conventional transactions, it is noteworthy that the tax treatment for both of them should also be the same. The first step towards this problem could be to initiate amendments in the existing tax laws and relax the taxes levied at various stages of a *Murabaha* transaction, on the basis of its objectives rather than its mechanisms.

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Socio-Economic Status of Migrants, their Issues and Coping Mechanisms During Economic Crisis

Suresh Jungari[1]

Abstract

The economic crisis that began in 2008 has had a significant impact on the well-being of a certain segment of the population, and its disruptive effects can be expected to last for many years. Rapidly growing industrialization has attracted a large number of migrants from the rural areas to urban areas, who have been deployed as contract laborers in many manufacturing companies. This study attempts to investigate the socio-economic status of migrant labourers who work in these industries as contract laborers, and their coping mechanisms during the economic crisis.

The primary data for the study has been collected from interviewing 60 contract laborers,working in five industries of Pune industrial area; identified through snowball sampling method. Results of the study reveal that during an economic crisis, contract laborers are the first target for manpower reduction. Thus, they do not have any job security due to their temporary form of job descriptions. Most of these migrants are from the state of Uttar Pradesh and Bihar, and only a few of them are from within the state. A major problem that they face during recession is the financial crisis in their families. Therefore, they adopt several coping strategies. One of them is to undertake multiple job responsibilities and develop good relationship with their human resource managers and contractors.

Introduction

Several studies have been conducted on the relationship of economic recession with industrial production, growth rate, export and import and business affairs. One such example is a well documented piece on the economic recession and its impact on international migration by Khalid Koser (2009). Although the global

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estimates suggest that the number of internal migration is four times larger than that of international migration (Human Development Report 2009), the issue of economic recession and its impact on internal migrants is less explored. In this study, efforts have been made to explore the micro level realities of economic crisis and its impact on the migrant labourers in the manufacturing industries.

Migration is an important element of human civilization, it reflects human endeavour to survive in any condition. Several factors contribute to this phenomenon. Some of them are extreme poverty, increasing unemployment and failure of agriculture. Migrant labourers in India, especially the ones working in the manufacturing sector, face several problems including low wages and poor living and working conditions. In the past few years, the metro cities in India have witnessed a massive inflow of migrant labourers from different parts of the country. Their poor and underdeveloped conditions, force them to migrate to big cities and work on minimum wages in worse working conditions. Pune is one such city that houses migrant labourers from Uttar Pradesh, Bihar and Jharkhand.

Another important aspect of migration related issues is the entitlement of the migrants to safe and secure working conditions and labour rights. Many studies have found that economic recessions have strong adverse impacts on the labour. The World Council of Churches (WCC) opines that economic crises are not merely financial in nature. They also have moral and ethical dimensions that have already begun eroding our societies over a period of time. The economic crises are also influenced by migrants' attributes such as their place of origin and destination, their level of education, their occupation and length of stay in the destination city.

What is Recession or Economic Crisis?

The National Bureau of Economic Research (NBER) defines an economic recession as "A significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production and wholesale-retail sales." The economic crisis during 2007-10, which was considered to be similar to The Great Depression of 1930s, fascinated policymakers, academia and the general public alike. This economic depression contributed to slowdown market forces across the world (O'Rourke, 2010).

Causes of Recession

A recession occurs when there is a slowdown in economic growth for two consecutive quarters. The possible causes for recession could be several, but some of them that certainly contribute to recession are as follows:

- The decline of the rate of profit
- Strategies to restore the rate of profit
- Search for new borrowers — low-income for workers
- Structure of home mortgage market
- Government policies
- Lack of effective financial regulations

Impact of economic recession

- Unemployment
- Lower wages
- Taxation
- Decrease in government spending
- Budget deficit
- Lost output
- Adverse impact on workers

Global Economic /Crisis - Impact on India

The crisis may have originated in the developed countries but it is no longer confined to them. The heat is being felt by the developing countries too, including India. There were both direct and indirect impacts in India. The direct impacts stemmed from the exposure of Indian banks and other financial institutions to the 'toxic' or ‘distressed’ assets. (C. Rangarajan, 2009).

The global crisis affected the health of several sectors of Indian economy through distinct channels: financial markets, trade flows, export & import and exchange rates (Walia, 2012). During the recession, industrial growth faltered and the Indian industrial sector suffered from depressed demand conditions in its export market as well as from suppressed domestic demand, due to the slow generation of employment (Das, 2013). As per the Index of Industrial Production (IIP) data, released by the Central Statistics Office (CSO), the overall growth in 2008-09 was 3.2% compared to an increase of 8.7% in 2007-08. With the onset of the crisis, growing trade integration implied that one of the routes through which the real economy was affected was a deceleration in export of goods and services, which had contributed significantly to the earlier boom (Ghosh, & Chandrasekhar 2009).

Magnitude of Migration

In India the phenomenon of migration is dominated by short distance migration. The 2001 Census reported 309 million internal migrants. Among these migrants,70.7% were women. Two-thirds of the migrants (67.2%) were from rural area and only 32.8% were from urban area. Male migrants were relatively more in number in the urban stream (53.1% of male migrants were urban compared with only 24.4% of female migrants) and in more distant streams. The percentage of male migrants among intra-district, inter-district and inter-state migrants was 52.2%, 26.7% and 21.1% respectively; compared to 66.9%, 23% and 10.1% respectively for female migrants. Internal migration figures for India show that the phenomenon of migration is dominated by female migrants, mainly due to the widely prevalent social custom of exogamous marriages.

Legal Provisions for Contract Labour

The government of India enacted the Contract Labour (Regulation and Abolition) Act, 1970 to protect the interest of contract labourers and to ensure the welfare facilities for them. Under this Act, contract labourers are entitled to health and welfare facilities like restrooms, canteen, provident fund, latrines and urinals, washing facilities and first-aid facilities. But many industries that house a large number of contract labourers, do not abide by this act. A mutual understanding between the contractor and the management deprives the contract labourers from even the basic facilities. The migrant labourers are more vulnerable than the local labourers, as they do not have the right to demand their entitlements at the workplace.

In 1979, the government enacted the inter-state migrant workmen (regulation of employment and conditions of service) Act, 1979 to provide legal support and regulate the employment of inter-state migrant workmen, and to provide support for their conditions of services and related matters. The act says contractors must pay timely wages to workmen, provide suitable residential accommodation and prescribed medical facilities. The act also gives the labourers, the right to raise industrial disputes in the provincial jurisdiction where they work or where they come from. It is needless to mention here that the act and its provisions is unknown to most of the migrant labourers.

Objectives of the Study

1. To study the impact of economic recession on migrant workers working as contract laborers in manufacturing industries.
2. To understand the problems faced by the migrant workers and their coping mechanisms during recession.

Methodology and Tools

Data Collection

The primary data has been collected from the migrant workers of manufacturing industries, using interview schedules and observations. In addition, few key informant interviews have been conducted with the contractors, to find out their understanding of the problems and situations of migrant workers during the economic crisis. The time period for data collection has been from January 2010 to March 2010.

All the ethical concerns have been addressed and prior consent has been obtained from the respondents. The respondents have been assured of confidentiality of data and information. All the interviews have been conducted accprding to the convenience of the respondents.

Sampling Technique

Purposive sampling has been adopted to collect the data from the five manufacturing industrial sites in Pune industrial area, where large number of migrant workers resided. Since the list of migrant workers was not available, the data has been collected using snowball sampling tool in which one respondent referred to another respondent in the same area of study. Total 60 male migrant workers and six contractors have been interviewed as respondents and key informants respectively. The migrant workers in the manufacturing industries have been selected as respondents.

Findings of the study

Socio-Demographic Information

The demographic information has been collected from the respondents. Migrant labourers are mostly between the age group of 20 to 30 years. Table.1 shows the distribution of the age of respondents, with 66% of them falling in the category: 20-30 years.

Table.1
Age wise distribution of the respondents

Age	Frequency	Cases
20-30	66	40
30-40	33.33	20
Total	**100**	**60**

Table.2 shows that 55% of them were married and remaining 45% were unmarried, during the study. Table.3 informs about the level of their education. 53% respondents completed their high school, whereas only 2% graduated. This indicates that those who are less educated are more likely to migrate and get deployed in unskilled workforce.

Table.2
Marital status of the respondents

Marital status	Frequency	Cases
Married	55.33	32
Unmarried	41.66	25

Table.3 Problems faced by migrant contract labourer during economic recession		
Problems during recession	**Frequency**	**Cases**
Reduced salary	58.33	35
Reduced Facilities	23.33	14
Unemployment	16.66	10
Total	**100**	**60**

Problems and Coping Mechanism during Recession

During recession, these migrant contract labourers faced many problems within the work space as well as within their families. Table.4 shows that during recession, 58% of migrant labourers faced the problems of low wages or reduced wages and reduced health and welfare facilities. Some migrant labourers became unemployed due to less workload during the crisis.

Table.4 Problems faced by the families of migrant labourer		
Problems	**Frequency**	**Cases**
Financial problems	93.33	56
Children's education	1.6	1
No problems	5	3
Total	**100**	**60**

Table.5 lists the problems faced by the families of these workers. 93% of the respondents faced financial problems due to less salary and less workload, and some of them said that this affected their children's education. They could not

Table.5 First target during cost cutting during recession		
First target	**Frequency**	**Cases**
Contract labourers	93.66	56
Permanent employees	1.66	1
Causal workers	5	3
Total	**100**	**60**

send remittances to their native places. Therefore, the recession not only affected the industries but also the migrants' families and their children's education.

The migrant workers were asked, "Who is the first target during the recession?" In their response, 93% said that the migrant contract labourers are the first target because they do not have the job security they can be subjected to leave the workforce even without a prior notice. However, only 1% of permanent labourers face such issues. During this difficult time, migrant labourers strategize to work harder in the industries to save their jobs and secure their families' financial interests.

Many contract labourers reported about their struggle to keep themselves in the job market Table.6 shows that 51% of migrant contract labourers work hard to keep themselves in the workforce whereas 28% of labourers take more responsibilities for surviving in a recession.

Table.6
Strategies of migrant contract labourers to secure their job during the crisis

Strategies	**Frequency**	**Cases**
Hard work	51.66	31
Take more responsibilities	28.33	17
Give good productivity	10	6
Concentration on job	10	6
Total	**100**	**60**

Table.7 shows the coping mechanisms of migrant labour during recession, where 68% of them believe that having a good relationship with contractors is the best mechanism to save their jobs and 30% believe that having a good relationship with management and manager is the best mechanism during recession.

Table.7
Coping mechanisms of migrant contract labourers during recession

Coping mechanism	**Frequency**	**Cases**
Good relationship with contractor	68.33	41
Good relationship with management	30	18
No response	1.66	1
Total	100	60

Conclusion

The findings of the study point towards the fact that the migrant contract labourers are the most affected people during any economic recession. They become the first people to lose their jobs and their entitlements to health and welfare facilities.Most importantly their families are affected, including their children's education. They give their full potential to keep themselves in the workforce by maintaining a good relationship with the contractor and the management. Thus, it becomes crucial for the government to develop and implement laws which protect the interests of migrant labourers and enable them to overcome their problems.

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REVIEW REPORT

A Review of 'The New Microfinance Handbook: A Financial Market Perspective'

Usama Khan[1]

Abstract

Joanna Ledgerwood authored 'The New Microfinance Handbook', which discusses on the financial market system and the system of microfinance at length. It emphasizes on deeper understanding of the functioning of microfinance and how this system is going to serve the need of marginalized population. It critically analyses the financial needs of poor people, and discusses how a categorically developed financial system can mitigate these needs of poor with easy accessibility and benefits. This book emphasizes on larger admittance and usage of financial products and services that can holistically meet poor people's needs through sustainable mechanisms. It advocates for a wider financial system beyond the traditional microfinance with the aim of inclusive economic development. The approach of the book is unlike the earlier such writings.

The new handbook reveals the multidisciplinary functioning of modern microfinance systems. The juncture of finance, technology and development has increased its penetration. The embedded combination of network and technology operators, microfinance institutions and community network has made it possible. This book impressively reflects on the constantly changing dynamics of microfinance environment that is important in the formulation and implementation of strategies.

This handbook critically examines the demand and supply of microfinance industry, legal structures and legal obligations, delivery mechanisms, technical support systems and sources of funding available in the existing global market. The handbook considers these as basic components required for an effective microfinance system with maximum and hassle-free outreach.

The author of the book talks about a different approach from her earlier microfinance handbook,[2] published by the World Bank in the year 1998. This

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[2] Microfinance Handbook: An Institutional and Financial Perspective

was written with an institutional perspective and it advocated for a supply driven microfinance system. The central idea in this handbook was to develop a model of sustainable banking with the economically active poor, based on their needs.

On the contrary, 'The New Microfinance Handbook' considers the demand side of the market and advocates that the need for working capital cannot be considered as the only credit need of the poor. Their primary requirements are their consumption needs. So the microfinance institutions have to be more equipped with the products of consumption credit and emergency credit alongside working capital credit. Thus, the book emphasizes on the credit need emerging from the demand side and focuses on adopting a delivery system that will be capable of meeting these demands effectively.

It provides a strategic manuscript which can help in the assessment of financial requirements of the poor and of ways in which their demands could be met by the microfinance industry. The handbook presents a detailed observation of the current microfinance market, its components and its modus operandi. It focuses on the ways to improve the delivery mechanisms and emphasizes that the outreach, sustainability and impact are key factors for the success of any microfinance institution.

Since past few years the focus of microfinance institutions has shifted to the need of the client. The handbook analyses that the performance of these institutions is now directly related to the behavior of clients, their financial requirements and fulfillment. This shift is a result of learnings from experience, past data and research based on empirical examples. Presently, microfinance is not only an option of investment in micro-enterprises but it also provides a range of financial products and services to satisfy needs related to the poor. It has become a way to improve the quality of their lives.

It highlights the issues related to the expansion of such a model with variety of products, services and providers. It says that a formal regulatory body is needed to monitor and regulate the microfinance activity, as this model may also involve some informal sectors within the system. The regulatory body will be the co-ordination link between the industry and the government in order to maximize financial inclusion through its outreach.

Focusing on the financial market, the handbook says that there is a wide range of service providers and demand for services. A deeper understanding of the microfinance market system becomes important in order to determine the objectives and roles for a microfinance institution. An institution developed with a thorough understanding of the current financial market and with a clear vision for the future dynamics, can deliver the objective of financial inclusion with a sustainable approach. According to the book, this can lead to economic growth and upliftment of the poor.

The handbook also discusses the role of government in the financial inclusion, as it is the mandate of the government across the world to reduce income disparity and encourage economic development of the underprivileged. One of the agendas of the microfinance institutions is financial inclusion of the financially excluded, by providing source of finance to them. So the handbook emphasizes on the role of government through formation of policies, rules and regulations and a support system for the already established microfinance industry. The book suggests the government to develop standard guidelines for the microfinance industry to enable a friendly environment for the demand and supply of financial services. The role of the government will also be significant in developing strategies to increase the financial capabilities of the client as well as the microfinance industry. It also advocates for a provision to safeguard the rights of a client to protect him or her from harassment and malpractices.

Assessment of the impact and measurement of the outreach helps to record the effectiveness of the program, as also highlighted in the handbook. All the components related to the service providers viz. industrial players, development agencies and the government, have their own roles to play. In this process of assessment it becomes necessary to record the current status of demand and supply and the current situation of the needy segment of the society. Further, setting a goal for the future and calculating the difference between the present situation and the expected outcome will enable to estimate the impact of the efforts taken. This exercise will assist the policy makers ofthe industry and the government to review the policies from time to time.

The assessment data should also be recorded and stored for which a global data bank should be set up. Data from both the sides viz. supply and demand side, should be recorded and stored in that global bank. This data bank will help practitioners and policy makers to reach to the findings, based on the global empirical data. It will help to understand the impact of strategies implemented in different global scenarios. This handbook lists few other tools for the assessment of strategies e.g. (i) financial diaries (it is helpful for smaller groups), (ii) financial landscape studies and (iii) monitoring and evaluation.

The new handbook has critically analyzed the service providers in the microfinance industry and divided them in two categories (i) community based financial service providers (ii) institution based financial service providers.

Community based financial service providers are informal players with flexible terms of services. Though such services are convenient and hassle free in terms of operational and administrative costs, they have a very limited range of products and lack sustainability. The institution based service providers including NGOs, microfinance institutions, financial co-operatives and non-banking financial institutions are referred in the handbook as formal service providers. These players have different domains and different products due to their legal structure and regulations. These service providers are legal entities with structured governance and supervision that makes them less vulnerable to the market threats and uncertainties.

The demand for services related to savings is huge and diverse, reiterating the importance of financial services and delivery channels, specifically for the low income group. A regular institution with services related to savings can enable them to accumulate their small savings to create a pool from where they can meet their household requirements. The handbook further discusses the dynamics of saving services from an institutional perspective. The mobilization of small savings bears high operational cost as well as expanded operations, though it can be minimized with a good governance structure.

It further elaborates on the importance and mechanisms of credit system in details. It says that the credit products are the most consumed services in the financial industry and a crucial requirement for the poor. This requirement may be related to their consumption or investment need or for meeting their emergency needs. Thus it has to be ensured that the credit services should be designed from the perspective of the needy segment. The service provider has to look into the issues related to the requirement, market, delivery channel and market risk while designing a credit product. The handbook discusses in details about the conventional credit products and Islamic credit products (*Sharia* compliant). Discussing the credit needs of rural areas, the handbook highlights the agricultural finance as the most required credit service. This sector involves a lot of risks and uncertainties. So the practitioners, policy makers and regulators have to be very careful while understanding its complexities. From the perspective of agriculture, every area is geographically different and thus involves different risks. Assessment of a support system in agriculture is also an important factor while considering risks.

Insurance is yet another essential financial service for poor/low income group. They live in such a situation where diseases, inabilities, crimes and calamities are common. So insurance is an essential service for them to recover from all these crises. The challenge is that the poor is reluctant to pay the premium for an intangible service with future benefits, which may or may not be claimed. Another challenge according to this handbook is that the service providers have lost credibility among the low income group, due to slow remedial processes. These aspects need special attention in order to rebuild the trust and increase the outreach and awareness among the low income group.

The handbook advocates the use of technology for the delivery of financial services as well as for improved client services. The electronic payment system is an important supporting component for that. The handbook underlines the importance of providing the liberty of instant transaction to the client. These days the mobile phones are the most common devices that people have access to. Financial services on mobile handsets can give a very safe and accessible client experience. Though it gives independence, at the client's end it also involves liquidity commitments. Thus mobile based financial services need to be more effective with more efficient customer support. Especially, when the industry is concerned with the poor, this service should provide ease to carry out their microfinance activities. Financial health of an individual as well as a group can be monitored easily with the help of these services. As a delivery channel, mobile services are capable of increasing the outreach of microfinance services to the remotest areas.

It accentuates the important factors related to better management and upscaling of a financial institution. This is an important information for the funders, regulators and practitioners to develop a sustainable model with effective governance. Firstly, a strong information system is required to check the feasibility for scaling up and developing better management systems. Secondly, appropriate and effective data management is required to monitor risks and performance of a financial institution. Thirdly, planning, reporting and monitoring are important aspects of better management. Fourthly, financial management and business planning are two key components. Thus the reporting of financial activities has to be precise. Fifthly, risk management is an important component. Risk should be assessed while developing and deploying strategies for better management and scalability both. Sixthly, Social performance mix is another important factor for the analyses of objectivity of microfinance institutions. It also ensures transparency in the system.

Good governance is a very important component for delivery channels and is a key to better operations, as described by 'The New Microfinance Handbook'. It depends on firm policies, regulations and organizational and legal structure of the institution. A full-fledged organizational hierarchy should be defined and implemented. The governing system should be capable of visioning and strategic planning.

Human resource management is an essential part of it which is responsible to build an effective delivery channel in a financial institution. So it becomes necessary to have a detailed human resource department based on industrial standards. Human resource policy helps in creating an environment with less grievances and smooth functioning. Performance of a financial institution is directly related to its range of products. The institution must have a proficient department for product development and related researches. Innovations in product line and modification in the existing product line, in accordance with the market requirements, is necessary to sustain in the financial market.

The book also touches upon the risks related to the operations vis-à-vis scaling up. Thus an internal control framework and timely communication through proper reporting channel in the hierarchy is important for minimizing risks.

Internal or external support system is one of the basic requirements for financial inclusion. This handbook notes down few components required to support the microfinance system. Funding is one of them. Due to the commercialisation and professionalisation of the microfinance industry, the scope of funding has also extended to the private sector, institutional investors, commercial banks, private equity funds and individuals. The handbook elaborates on the types of funding, types of funding agencies and their importance in microfinance. It also gives information on regulations and policies related to fundraising.

It discusses regulations as a support system for microfinance. It describes the rationale and objectives of a regulatory system and evaluates it with an international perspective. The regulatory system shall be developed according to the market situation. Regular assessment of this system is also an important task to put a check on the delivery system vis-a-vis the market demand. The regulation for microfinance shall be specific and it shall not get mixed up with the regulations of conventional finance industry. Infrastructure viz. physical infrastructure, financial infrastructure, communication infrastructure and technological support system, is an important part of the support system for microfinance. The handbook quotes that some part of the support system must be outsourced to the expert industry like auditing and accounting, training and advisory, software and security of transactions.

'The New Microfinance Handbook' discusses many aspects of financial inclusion. The approach is to build an inclusive financial environment which is suitable for the poor. Therefore it becomes crucial to understand the market. Nature of the market, nature of demand and the development within and outside the market. To make the idea of 'a financial market that works for poor' successful, the behavioral observation of the market and the client is important in developing strategies and timely interventions. It is also important to monitor and evaluate the progress on a regular basis.

Lastly this handbook discusses that both quantitative and qualitative research has to be carried out regularly for getting good understanding of the fluctuations in the market.

Conclusion

The handbook underlines the progress that has been made in the area of financial inclusion and projects microfinance as the hope for bringing poor in mainstream economic activities and in mainstream financial industries. In the coming years the industry would be developed as a financial system that works for the poor. With this vision the handbook is a tool for envisaging the scope of microfinance industry as it tries to envisage a significant path for the ultimate objective.

It gives a potential idea of viable financial market development by the experiences learnt from microfinance practices till date. All these experiences will open gates for rebuilding regulatory and supervisory mechanisms. It will help in understanding and developing more user friendly business models and more purposeful products. Technological innovations will ensure flawless and effective services to the end users at their convenience.

'The New Microfinance Handbook' will surely enhance the understanding of merits and limitations of microfinance services as well as the proportional relation between demand and diversity of demography and economic conditions.

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