# DINIMISHING MUSHARAKAH CONTRACT AS AN ALTERNATIVE FINANCING FOR SMALL AND MEDIUM-SIZED ENTERPRISES

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**Abstract**

Given the fact that the utilization of Islamic financial contract based on the PLS principle is relatively low, it is important to propose new insight of using Islamic financial instrument under PLS principles. Therefore, this paper aims to provide insight of using diminishing musharaka contract as an alternative financing for Small and Medium-sized Enterprises (SMEs), which operate under PLS principles. Descriptive analytical method is used to describe the use of diminishing musharaka contract. Using simple calculation, this paper shows how to apply this type of contract to finance investment for SMEs particularly in fixed assets. Based on the diminishing musharaka contract, the profit which is shared to Islamic banks decrease gradually in response to the amount of decreasing banks' capital involve in partnership. Conversely, the proportion of profit for SMEs increases gradually as a consequence of the increasing amount of partnership with Islamic banks. Thus, diminishing Musharaka contract enables SMEs to release the contract without undergoing financial distress because they make repayment of the principle in installment together with the profit sharing.

**Keywords: Islamic Banks, Riba, PLS principles, Diminishing Musharakah, SMEs.**

## A. Introduction

Bank is a financial institution that has a very important role in supporting business activities and ultimately economic development of a country. The role of the banks is generally as an intermediary institution between those who need funds and those who have excess funds. For companies, especially small and medium enterprises, banks are the main source of financing from outside the company (Berger *et al.*, 2001). This is because SMEs generally cannot access fund from the capital markets, either by issuing shares or issuing bonds, as was done by large companies.

Although banks are the main source of external capital for SMEs, but not all SMEs can meet all the needs of their funds from banks. This is because SMEs are often not considered creditworthy, mainly due to constrained to pledge collateral that must be provided. The collateral requested is intended to anticipate the risk of default of the customer. This situation raises the problem of the financing gap (OECD, 2006) in the SME sector.

The presence of Islamic banking is expected to reduce this gap by offering financing based on profit and loss sharing (PLS) principle. Under this principle, Islamic banks must be willing to bear the risk of loss that may be incurred from financed project. Thus, in theory, when assessing the worthiness of the customers, Islamic banks not solely based on the ability of a borrower to provide collateral but on the soundness of the project (Dusuki, 2007).

The establishment of Islamic banking in Indonesia is regulated formally since the enactment of law No. 7 of 1992, which was then converted into law No. 10 of 1998 about banking system. In terms of functionality, Islamic banking is no different from conventional banking. According to Law No. 10 of 1998 on banking, the definition of banks are business entities that raise funds from the public in the form of savings and channel them to the public in the form of credit or other forms in order to improve the living standards of the people. However, in its operations, Islamic banking should be based on the *sharia* principles. The main feature of Islamic banking is that the fact that it serves as banking institution that operates without charging interest on customers.

This paper offers a form of Islamic banking financing scheme based on the PLS principle that is considered appropriate to finance investments, particularly in fixed assets, which generally requires a fairly large amount of funds. Generally, especially in Indonesia, financing based on PLS principles only recognizes two types; *mudaraba* and *musharakah* contracts, this paper proposes the variant of *musharakah* contract namely *musharakah mutanaqisah* (diminishing *musharakah*), which is familiar in other country such as Malaysia. Furthermore, this paper explains the implementation of the concept of the diminishing *musharakah* financing.

The remainder of this paper is organized into four sections. Section one considers the prohibition of *riba*. Section two presents the methodology used. Section three explains the application of diminishing *musharakah* contract. The final section or section four is the conclusion.

## B. The Prohibiton of *Riba*

The holy Quran as a way of live for Muslim governs all Muslims' affairs, including *muamalah* issues. A financial transaction is one form *muamalah* that cannot be separated from the rules of *sharia*. The main features of the financial transactions that are prohibited in Islam are transactions involving *riba*. *Riba* is usually translated into English as usury or interest, but in Islam, it has a broader meaning. The literal meaning of the Arabic word *riba* is increase, excess, growth or addition (Algaoud and Lewis, 2007). There are some verses in Quran that explicitly prohibit *riba*, such as:

And whatever you lay out as usury, so that it may increase in the property of men, it shall not increase with Allah; and whatever you give in charity, desiring Allah´s pleasure-- it is these (persons) that shall get manifold *(Quran, Chapter 30 verse 39).*

*Allah does not bless usury, and He causes charitable deeds to prosper, and Allah do not love any ungrateful sinner (Quran, Chapter 2 verse 276).*

Nevertheless, Allah strictly forbid Muslim to involve in *riba* by threatening them if they do not avoid *riba,* Allah and his messenger will fight against them (Quran, chapter 2; verse 278 & 279):

*O you who believe! Be careful of (your duty to) Allah and relinquish what remains (due) from usury, if you are believers (Quran, chapter 2 verse 278).*

*But if you do (it) not, then be apprised of war from Allah and His Messenger; and if you repent, then you shall have your capital; neither shall you make (the debtor) suffer loss, nor shall you be made to suffer loss (Quran, chapter 2 verse 279).*

From the verses above, it is obvious that *riba* is prohibited in Islam. However, the reason behind the prohibition of *riba* remains ambiguous, because Quran itself does not explain the specific reasons for such prohibition. In reality, it is the poor and the needy who often borrow money, while the rich have surplus money to save. Implicitly, therefore, interest penalizes the poor and rewards the rich (Naser and Moutinho, 1997). Furthermore, charging interest is considered as unjust because it is determined in advance without considering the borrower to get profit or loss from the borrowed fund.

Although the Quran does not give explicit reasons behind the prohibition of *riba*, some scholars try to explain why usury is prohibited in Islam. Razi (1938, cited in Algaoud and Lewis, 2007) summarizes the reason of the prohibition of *riba*. Firstly, that is but the exacting usury of another's property without any counter value while according to the saying of the Prophet, a man's property is unlawful to the other as his blood. Secondly, *riba* is forbidden because it prevents men from taking part in active professions. Thirdly, the contract of usury leads to a strained relationship between man and man.

Fourthly, the contract of usury is a contrivance to enable the rich to take in excess of the principal, which is unlawful and against justice and equity. As a consequence of it, the rich grow richer and the poor remains poorer. Fifthly, the illegality of usury is proved by the text of the Holy Quran and it is not necessary that men should know the reason for it.

## C. Methodology

To explain the use of diminishing contract, this study uses descriptive analytical method. Simple calculation is used to describe how Islamic bank and the client get advantage in using this type of contract. Based on the analytic example calculation of diminishing *musharaka*, a histogram is built to give a clear picture of the proportion of profit share for both borrowers and the Islamic banks. In addition, total payment conducted by entrepreneurs to Islamic bank and share buyback is also depicted.

## D. Diminishing musharakah contract

Due to their inability to provide acceptable collateral and various other reasons, SMEs typically fail to fulfill the stringent credit criteria of conventional bank, and rarely qualify for creditworthiness. Conventional bank consider the viability of potential client mainly for accessing the credit risk by looking at the collateral they have. Conversely, equity participation as a medium of project financing, whereby the financier might make capital recovery along with gaining a return, is intrinsically related to the success of the venture. The requirement of collateral basically relevant if the entrepreneur is liable for losses.

Thus, the lack of collateral should not hamper Islamic bank to extend financing for SMEs on the basis of equity partnership, mainly due to the fact that the bank involves in a portion of asset ownership. It appears that equal participation such as *musharakah* could be adopted. However, medium and long term financing, termination of equity partnership cannot be done abruptly and a gradual withdrawal may become necessary. Therefore, diminishing *musharakah* is considered as an ideal tool for SMEs financing (Sadique, 2008).

Diminishing *musharakah* is a variant of *musharakah* contract. Diminishing *musharakah* or sometimes is called *musharakah mutanaqisah* is a type of partnership contract between two parties where one partner gradually buys the whole part of the property (Osmani and Abdullah, 2010). In a diminishing *Musharakah* contract, the repurchasing agreement is part of the contract. The buyers in this contract will gradually own a larger share of the joint venture and, as a result, they share the capital increases. With this increase in capital, the buyers will be liable for a larger proportion of any loss over time. Profit ratios will be revised either with each purchase or on a periodic basis as agreed between the partners.

According to Maybank (cited in Osmani and Abdullah, 2010), the operational of diminishing *musharakah* can be done as follows:

- The client and the bank make partnership to acquire the capital to buy the assets.
- The client and the bank become the owner of the property based on the ratio of payment in purchasing the assets.
- The bank leases its share to the client and collect rentals monthly based for a predetermined period. The client buys the bank's share gradually.
- Finally, the bank's share come to the end and the client get full ownership of the assets.

Thus, *musharakah mutanaqisah* intrinsically consists of three contracts; namely *musharakah, ijara,* and *bay'*. Firstly, the customer enters into a partnership (*musharakah)* under the concept of '*Shirkat-al-Milk*' (joint ownership) agreement with the bank to co-own the asset being financed. Secondly, the bank leases its share of asset ownership to the customer under the concept of *ijara* during the period of contract. Thirdly, *bay'* concept is adopted when the customer gradually buys the bank's share at an agreed portion periodically until the asset is fully owned by the customer (Meera and Razak, 2009).

*Musharakah mutanaqishah* is widely used by Islamic bank in home financing in some countries (Osmani and Abdullah, 2010; Meera and Razak, 2009; Hanif and Hijazi, 2010). *Musharakah mutanaqisah* is also best suited for procuring assets needed by the enterprise. Thus, factories, buildings, machinery, equipment, tractors, boats, vehicles, and so on are necessary for MMEs to be financed under this concept. However, decreasing partnership structures presently adopted could require further refinement and enhancement the procedure to ensure that many SMEs would use this instrument (Sadique, 2008).

This type of contract is not limited to acquire fixed assets, but it can be adopted to finance other projects. SMEs that need capital to finance their project can use this contract. For example, a staple food trader needs funds 8,000 to undertake their business, assuming that the SME has its own funds as much as 4,000 and needs another 4,000. The SME decides to enter to *musharakah* contract with Islamic bank to get the 4,000 and will be repaid in 10 months. Under this contract, bank receives 20% of profit while the entrepreneur will receive 80%. Every month, the entrepreneur can make profit 1,000. Since bank initially places it funds as much as 50% of total funds needed, then only 50% of the monthly profit (500 in the first month) must be share to both bank and entrepreneur based on the predetermined profit ratio. Therefore, in the first month, bank obtains 100 of the profit (20% x 500), while the entrepreneur receives 900 or (80% x 500) plus 500. Then, the entrepreneur uses this 500 of 900 profits to buyback bank's share. This process continues for 10 month payments. Implicitly, the share shifts from the bank to the entrepreneur gradually, which in turn decreases the profit of the bank. This process is similar to *mudaraba* model. The only different is that in *musharakah*, the profit is entitled to entrepreneur's capital proportion in initial project, which should be considered and must not be shared to the financier. The concept of diminishing *musharaka* calculation is shown in table 1 and repayment schedule in table 2.

Table 1. Example of Bank and Entrepreneur Profit under diminishing *musharakah* contract

*Musharakah* project = 8,000
Bank :50% = 4,000
Entrepreneur 50% = 4,000

Profit ratio
Bank receives = 20%
Entrepreneur receives = 80%

| **Month** | **Bank share** | **Profit to be shared** | **Bank income** | **Entrepreneur income** |
|---|---|---|---|---|
| 1 | 50% | 50% x 1,000 = 500 | 500 x 20% = 100 | 500 x 80% + 500 = 900 |
| 2 | 45% | 45% x 1,000 = 450 | 450 x 20% = 90 | 450 x 80% + 550 = 910 |
| 3 | 40% | 40% x 1,000 = 400 | 400 x 20% = 80 | 400 x 80% + 600 = 920 |
| 4 | 35% | 35% x 1,000 = 350 | 350 x 20% = 70 | 350 x 80% + 650 = 930 |
| 5 | 30% | 30% x 1,000 = 300 | 300 x 20% = 60 | 300 x 80% + 700 = 940 |
| 6 | 25% | 25% x 1,000 = 250 | 250 x 20% = 50 | 250 x 80% + 750 = 950 |
| 7 | 20% | 20% x 1,000 = 200 | 200 x 20% = 40 | 200 x 80% + 800 = 960 |
| 8 | 15% | 15% x 1,000 = 150 | 150 x 20% = 30 | 150 x 80% +850 = 970 |
| 9 | 10% | 10% x 1,000 = 100 | 100 x 20% = 20 | 100 x 80% +900 = 980 |
| 10 | 5% | 5% x 1,000 = 50 | 50 x 20% = 10 | 50 x 80% + 950 = 990 |
| | | **Total** | **550** | **9,450** |

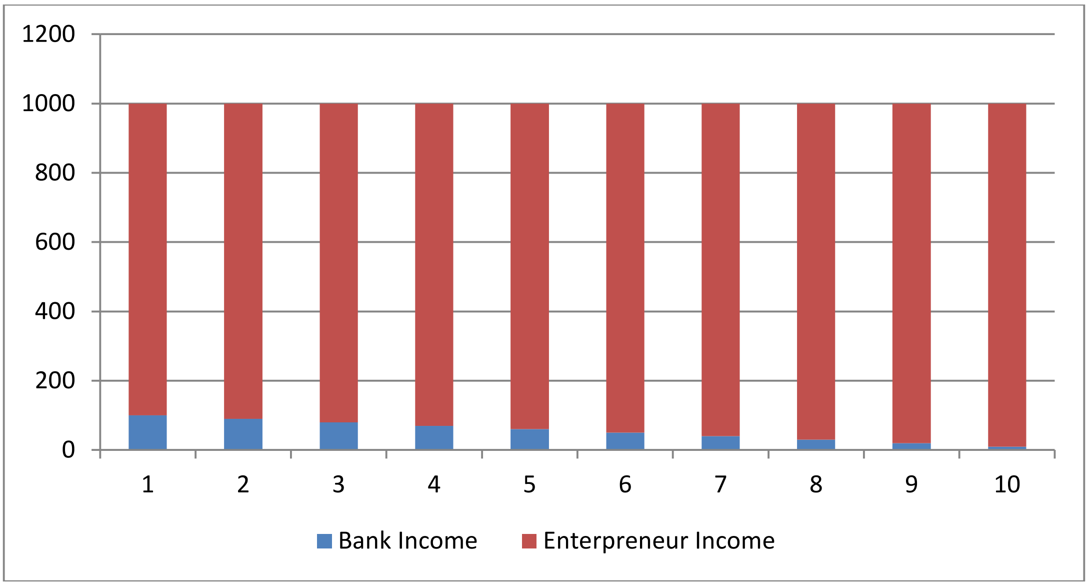


Figure 1. The Distribution of income under diminishing *musharaka* contract

Figure 1 shows that the income of Islamic bank decreases gradually. Conversely, the proportion of income of entrepreneurs gradually increases as well. This happen as a consequence of the decrease of the amount of Islamic bank fund invested in the project. This scheme gives advantage for the entrepreneurs since they can repay the principle gradually without disturbing their business activities. Thus, diminishing *musharakah* contract gives the opportunity for entrepreneur to release the fund borrowed from Islamic bank smoothly.

Table 2 Repayment schedule of diminishing *musharakah* contract

| Month | Share buy back | Profit distribution | Total payment |
|---|---|---|---|
| 1 | 400 | 100 | 500 |
| 2 | 400 | 90 | 490 |
| 3 | 400 | 80 | 480 |
| 4 | 400 | 70 | 470 |
| 5 | 400 | 60 | 460 |
| 6 | 400 | 50 | 450 |
| 7 | 400 | 40 | 440 |
| 8 | 400 | 30 | 430 |
| 9 | 400 | 20 | 420 |
| 10 | 400 | 10 | 410 |

Table 2 depicts that by utilizing diminishing *musharaka* contract, the entrepreneur buy back the share in the same amount every year. Consequently, the share of Islamic bank in the project decrease gradually. As a result, the Islamic banks receive the profit distribution from the entrepreneur is also going down gradually. Similarly, the entrepreneur repay to the Islamic banks in gradual total payment that consist of principle and profit distribution.

## E. Conclusion

The presence of Islamic banks is an alternative source of external capital for SMEs. By applying the concept of PLS principles, Islamic banks should be willing to bear the risks. Therefore, the assessment of the worthiness of the customers should be based on the soundness of the project rather than the availability of the collateral. One of the contract under PLS principles is diminishing *musharkah*. This type of contract gives advantage for SMEs in financing their business. The primary benefit of the diminishing *musharakah* is that the entrepreneurs can release the money borrowed from the Islamic bank without disturbing the activity of their business. Rather than repaying principles in the end of the contract, the entrepreneurs can reduce the loan by repaying the loan gradually. On the other hand, Islamic banks are also benefited from this type of contract because they can avoid default risk by receiving the repayment of the principle plus the profit in installment.

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