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SARF-BASED ISLAMIC MICROCREDIT FACILITY

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Objectives

(1) To examine commercial features of the current structure.

(2) To examine Shari'ah issues embedded in the current structure.

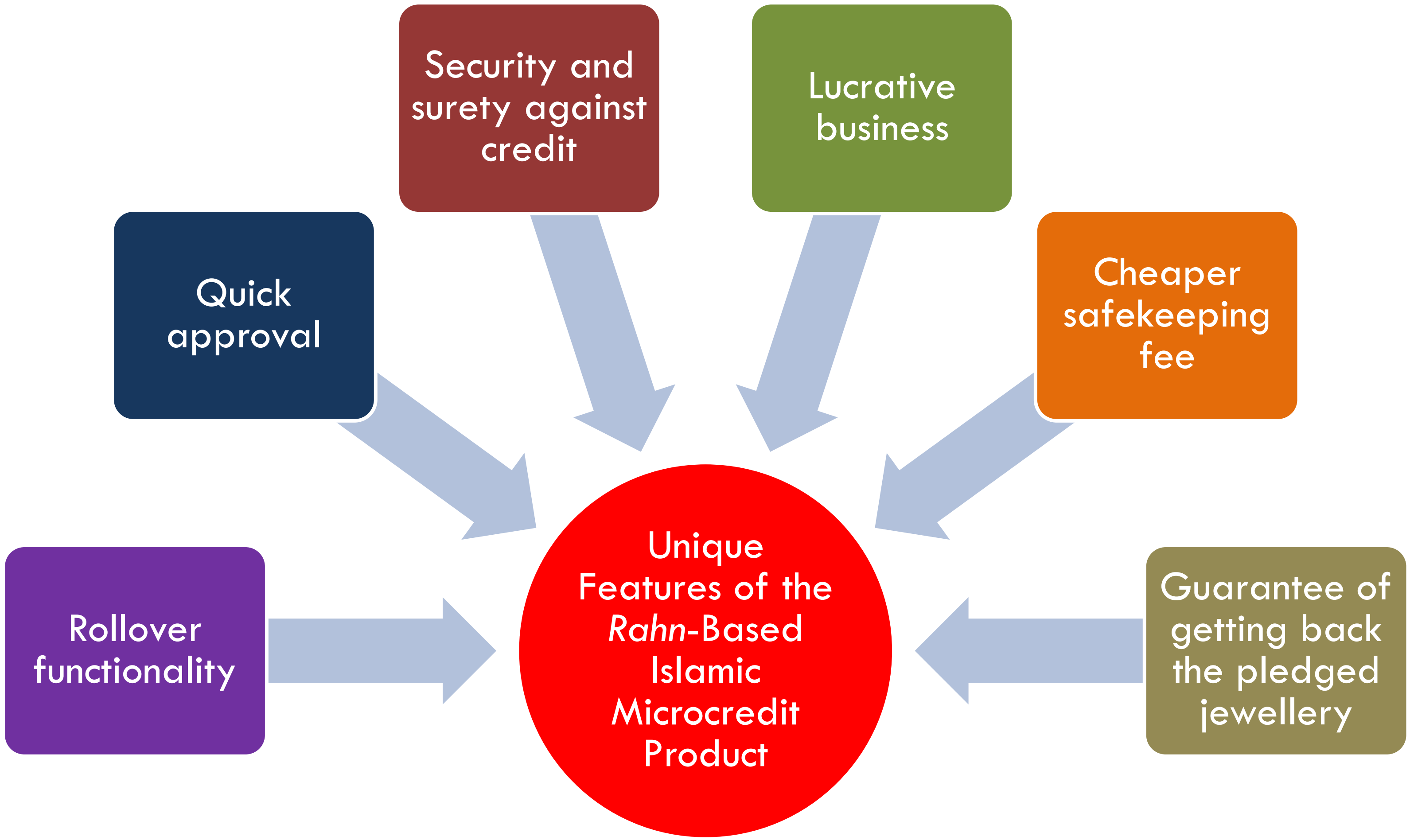
(3) To propose an alternative Shariah compliant-structure.

INTRODUCTION

- *Rahn*-based microcredit facility is an increasingly popular financing option among (1) lower income groups and (2) gold traders.
- However, its structure has been criticised by Islamic scholars on account of some Shariah issues.
- This study is an attempt to propose a new structure of Islamic microcredit facility based on *sarf* contract (contract of currency exchange).

RESEARCH METHODOLOGY

- This research is generally of a qualitative nature, relying on both primary and secondary sources of data.
- Secondary sources of data include the relevant documents available at the two banks, notably their (1) product manuals and (2) product concept documents (PCD).
- The interview method was also adopted as a primary source of data to gather additional information relating to the current operation of the Islamic microcredit facility that was not spelled out in the product manuals and PCD.


Security and surety against credit
Lucrative business
Quick approval
Cheaper safekeeping fee
Unique Features of the *Rahn*-Based Islamic Microcredit Product
Rollover functionality
Guarantee of getting back the pledged jewellery

Operation of the Current Islamic Microcredit Facility

1. The customer keeps his/her gold with the bank under the principle of *wadīʿah yad ḍamānah* and pays *ujrah*

2. In return, the bank provides custody service with a risk-protection guarantee

4. The customer pledges the gold under the principle of *rahn al-wadīʿah*

3. The bank grants *qarḍ* (loan) to the customer

The Safekeeping Fee and Margin of Financing

- The margin of financing granted varies from 50% to 70% of the *marhun* (collateral) value.
- For instance, a customer who pledges gold worth RM10,000 is eligible for a *qard* (loan) up to RM7,000.
- Subsequently, the bank charges the customer for the safekeeping service, based on the principle of *wadi'ah yad damanah*.
- The safekeeping fee is calculated on the amount of the *marhun* and not the amount of the loan.
- the service charge does not reflect the actual cost of safekeeping but, rather, creates an accrued profit.

Institutions	Safekeeping Fee for Every RM100 *Marhūn* Value	Financing Margin of *Marhūn* Value
Bank Rakyat	RM0.65-0.75	65%-70%
RHB Islamic Bank	RM0.70-0.80	70%-75%
Agro Bank	RM0.50-0.75	50%-70%

Daily Basis

Margin of Financing	Safekeeping Fee on a Daily Basis
< RM1000	RM0.65 per RM100 of *marhūn* value
> RM1000	RM0.75 per RM100 of *marhūn* value

Monthly Basis

Margin of Financing	Safekeeping Fee on Monthly Basis
0% (No financing)	RM0.10 per RM100 of *marhūn* value
50% and below	RM0.50 per RM100 of *marhūn* value
>51% up to 60%	RM0.60 per RM100 of *marhūn* value
>60 up to 70%	RM0.75 per RM100 of *marhūn* value

Calculation of the Safekeeping Fee on a Monthly Basis

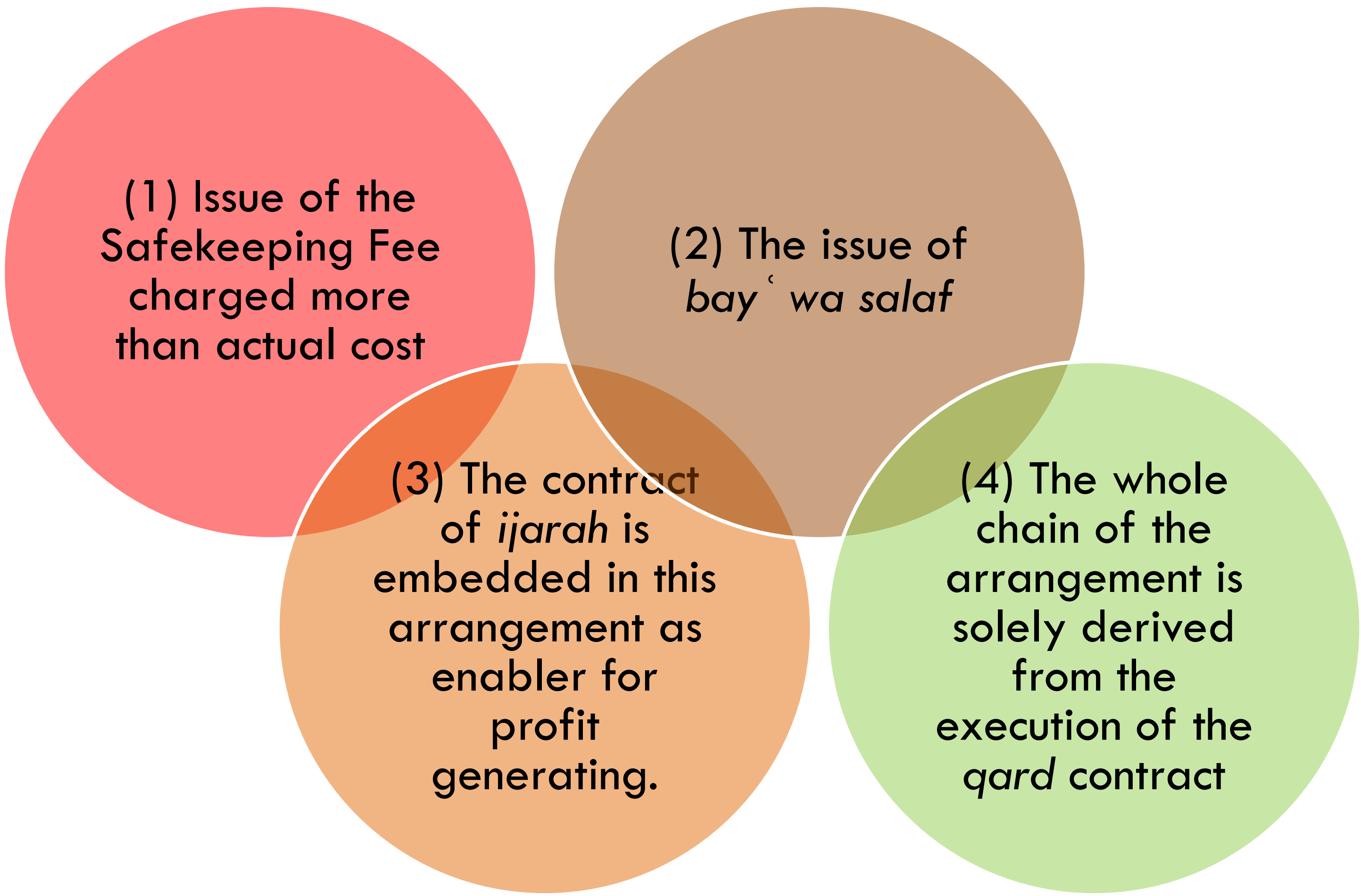
Quantity of *marhun*	:	50 gm
Market price	:	RM200 per gram
Value of *marhun*	:	RM10, 000
Margin of loan	:	70%
Total loan amount	:	RM7,000 (70% of the *marhūn* value)
Safekeeping fee	:	**RM0.70/100 monthly**
Charge date	:	Jan 1st, 2012
Maturity period	:	6 months
The maturity date	:	July 1st, 2012

- Assuming that a customer pledges 50 gm jewelery (24 carat/999 grade) for the current price of RM200/gram, the *marhun* value is RM10,000.
- Therefore, he/she is eligible for 70% financing margin, which is equivalent to RM7,000.
- Given that RM0.70 is charged for every RM100 *marhun* value, the safekeeping fee charged to the customer is RM70 per month.

- Hence, the total charge for the 6-month period from Jan 1st to July 1st, 2012 is RM420 as computed in the following formula:
- Safekeeping fee = $\frac{\text{RM0.70 x RM10,000 x 6 months}}{\text{RM100}}$

  = RM420 @ RM70 per month
- In substance, the bank indirectly charges RM70/month for RM7000 loan given, which is equivalent to 1% per month or 12% per year of the loan amount.
- On the maturity date of July 1st, 2012, the customer should redeem the pledged gold. To exercise this, he/she has to repay the full amount of the loan and subsequently pay the safekeeping fee, i.e., a total amount of RM7420:
- Total redemption = Total amount of loan + Safekeeping fee

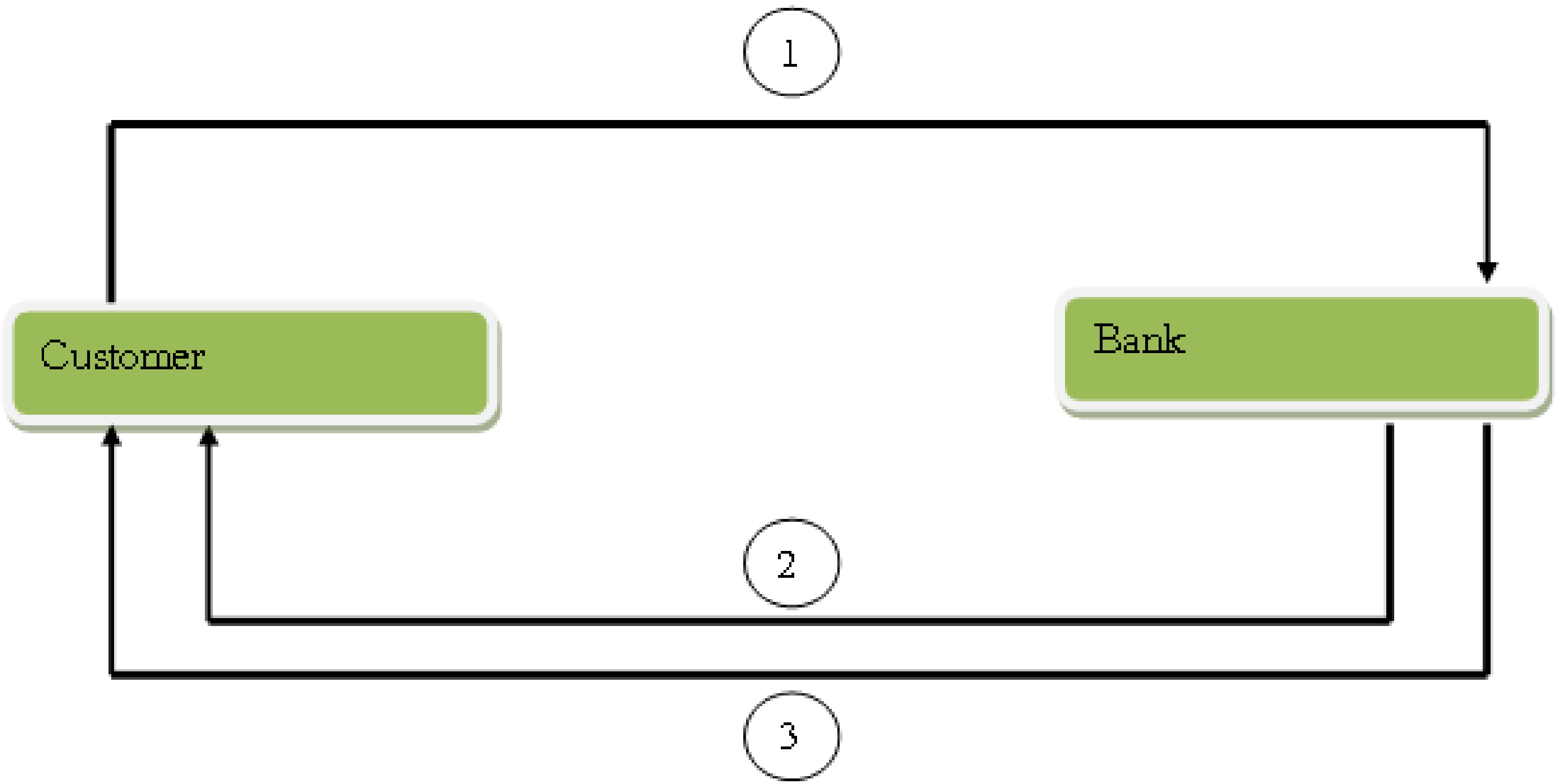
Shari’ah Issues Associated with the Current Islamic Microcredit Facility



The Proposed *sarf*-based Islamic Microcredit Facility

- This structure is proposed by taking into account the Shariʿah issues arising from the current structure, particularly the issue of the safekeeping charge.
- As this structure is primarily intended to resolve Shariʿah issues in the current structure, it may not be able to accommodate all the unique features of the current structure.
- The proposed structure involves the use of *bayʿ al-sarf* (contract of currency exchange) as the underlying Sharīʿah contract for the facility.

Sarf Contract 1

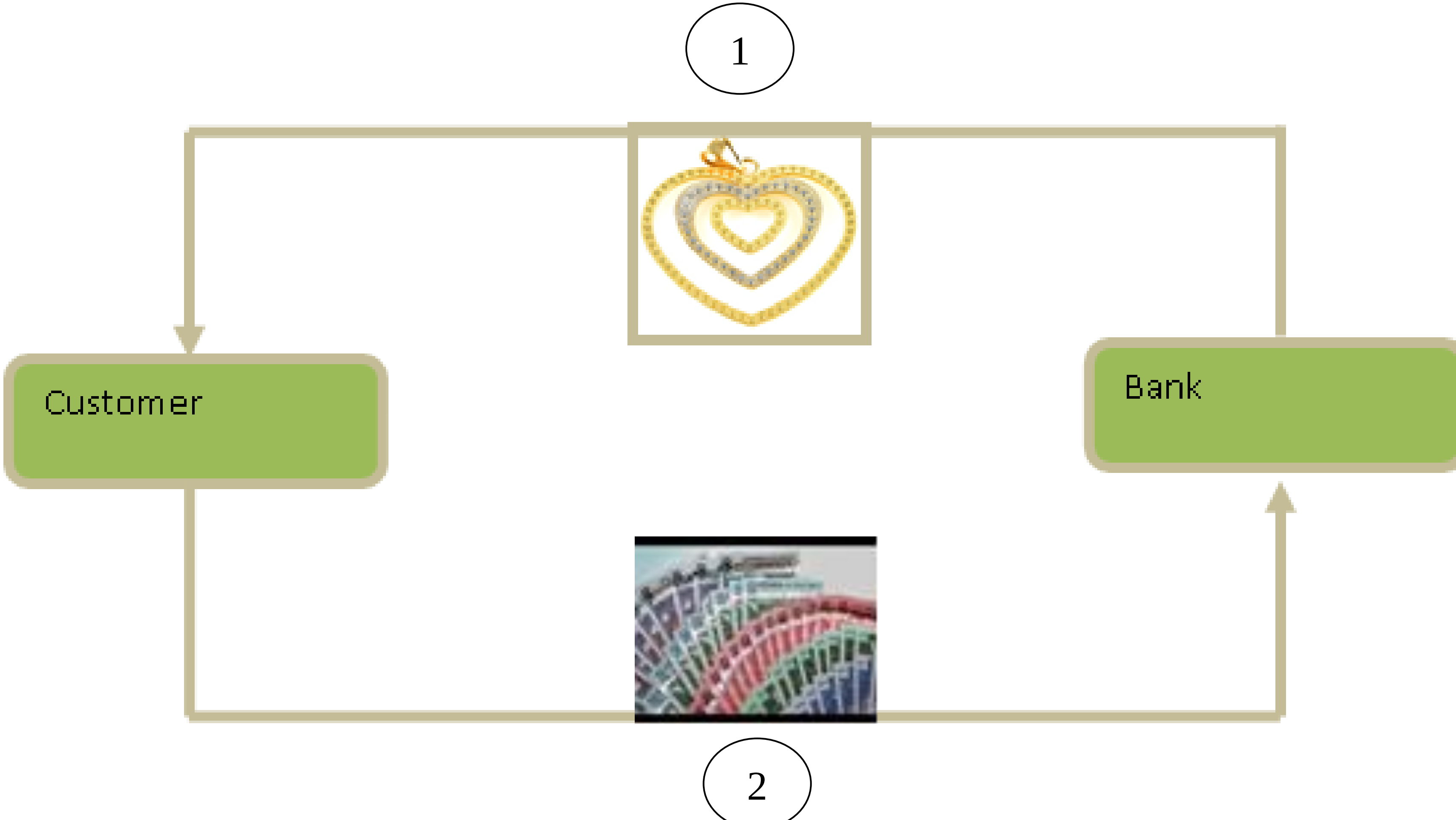


- The customer enters into a *sarf* contract with the bank whereby he/she sells 50 gm (RM200/1gm) of gold bar/jewellery worth RM 10,000 at RM 7,000 to the bank on a spot basis.
- Both parties take possession of the transacted subject matter in the contract session before leaving each other.
- In this structure, both counter-values 1) the gold bar/jewellery and 2) the money—are treated as currency and, hence, the rules of currency sale shall take effect accordingly.
- The purpose for which the bank purchases the gold bar/jewellery at RM7,000, which is 30% lower than its market price, is to mitigate the risk of gold price fluctuation, particularly when the gold price decreases.

- Furthermore, assuming that there is no significant change in the gold's market price, the bank can still sell the gold to a jewellery shop at RM8,000, which is still higher than the purchase price.
- This is because it is a common practice of most jewellery shops in Malaysia to buy gold/jewellery from customers at 15-25% lower than the market price of the gold.
- The bank pays RM7,000 to the customer in cash during the execution of the *Ṣarf* contract and takes possession of the purchased gold bar/jewellery.

- The bank, based on the principle of a binding unilateral promise (*waʿd mulzim min taraf wahid*), undertakes:
- (a) to sell the same weight of gold/jewellery (up to a maximum of 50 gm) to the customer during a period starting from the sixth (6) month until the end of the eighth (8) month.
- However, the bank is **not** obliged to sell the **same physical** gold/jewellery bought in the first *sarf* contract. As the gold/jewellery is completely owned by the bank, the bank assumes free disposal of the gold/jewellery.
- (b) to sell the gold/jewellery at 75% of the current market price (25% discount) at the time of the sale. To realize this, the bank will enter into another *sarf* contract with the customer that is totally separate and independent from the first *sarf* contract executed earlier.

Sarf Contract 2



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- The Bank sells the gold bar to the customer between the sixth (6) month and the eighth (8) month at 75% of the market price.
- Assuming, for purposes of calculation, that there is no change in gold's current market price (RM200/1gm), the bank sells 50 gm of gold to the customer at RM7,500.
- In this case, the bank generates RM500 (7.14%) profit in 6 to 8 months, as demonstrated in the following calculation:

Bank's selling price (x) = 75% x current gold price x gold weight

x = 75% x RM200 x 50 gm = RM7,500

Bank's profit(y) = Selling price – purchase price

y = RM7,500 – RM7000 = RM500

- The customer pays the price of the gold bar/jewellery (RM7,500) on a spot basis in the contract session.
- However, the price concluded in the contract could be lower than RM7,500, which is subject to the agreement of both parties.
- If the period of 8 months has elapsed and the customer does not undertake the purchase of the gold bar within that period, the bank may offer the gold bar/jewellery for purchase to other customers at the market price.
- In a situation where the value of the 50 gm gold increases to RM10,500 (RM205/1gm), the highest selling price at which the bank can sell the gold to the customer is RM7,875. However, the bank at its sole discretion may sell it at lower price. This can be calculated as follows:

- x = 75% x RM205 x 50 gm
- = RM 7,875
- y = RM 7,875-RM 7000
- = RM 875
- These scenarios seem to give an advantage to the bank by easily generating profit out of the transaction. However, in actual fact, the profit is not guaranteed because the gold price fluctuates, thus the bank is inevitably exposed to currency risk.

- Assuming that the gold price decreases to RM180/1gm during the sixth (6) month to the eighth (8) month, the new current market value of 50 gm gold would be RM9,000, the highest price that the bank can sell to the customer is RM6,750. Instead of generating profit, the bank suffers a loss of RM250 while the customer gains the surplus.

  x = 75% x RM185 x 50 gm

  = RM 6,750

  y = RM 6,750 – RM 7000

  = –RM 250

Important Features of the Structure

- The underlying principle used in this structure is the contract of currency exchange (*bay ʿ al-Ṣarf*).
- Both gold bars and jewellery are treated as currency. Hence, both are subject to the rules of currency exchange.
- The bank undertakes to sell the gold/jewellery at 75% of the market price during a period starting from the sixth (6) month until the end of the eighth (8) month.

- The bank is only liable to sell the amount of gold of the same weight and quality. In other words, the bank is not obligated to sell the exact same physical gold/jewellery.
- Despite that, the bank may sell back the same physical gold/jewellery at its sole discretion.
- The bank has full right and freedom to use the gold/jewellery.
- The customer is not bound to purchase the gold/jewellery from the bank.
- This model is free from the *qarḍ* concept because it is a straightforward *Ṣarf* contract.
- There is no issue regarding the *waʿd* as it is a unilateral binding promise, which is allowed by the majority of scholars.

CONCLUSION

- This study resolves that the proposed structure for the Islamic microcredit scheme should have two essential features namely; (1) Shariʿah compliance and (2) commercial viability.
- The proposed structure based on a *sarf* contract meets most, though not all, of the unique features of the current microcredit facility. Thus, it is recommended as a viable alternative to the existing structure.
- However, it is undeniable that the proposed structure needs to be further evaluated by Shariʿah scholars and practitioners to ensure that it does not violate any Shariʿah principle in both its forms and substance and that it is marketable and commercially viable.