

Micro Credit Through 'Bai-Muajjal' Mode of Islamic Banking Financing System

(A unique means of institutionalization and development of saving habits among rural-based small and cottage industry owners and mobilizing rural savings towards productive sources)

By

Dr. Mohammed N Alam

Coordinator

'Fresh Start' Program

Small Business Training Program for Women
In the Region of Peel,
Ontario, Canada.

Contact Address:

7170 Darcel Avenue
Apt # 241, Mississauga, ON.
L4T 3T5, Canada

Email: mna5@rogers.com

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ABSTRACT

The rural-based industrial sector in developing nations contributes greatly towards economic development by generating employment opportunities and mobilizing rural savings towards productive sectors. Micro-credit given by Islamic banks through the Bai-Muajjal mode of financing is a unique means of developing saving habits among rural entrepreneurs. The article includes the outcome of the author's research process developed to discover how the Bai-Muajjal mode of Islamic banking finance serves to institutionalize the saving habits of rural-based small industry owners and to what extent this lending technique successfully mobilize rural savings towards productive and profitable projects.

The article consists of three different sections. Firstly, it highlights the methodological and theoretical aspects used for the research. The second section includes a brief description of different financing modes of Islamic banks and an empirical, study-based discussion as to how different Islamic banks lend funds to the rural-based small industry owners in Bangladesh. The final section of the article represents an analysis of the research result showing to what extent the Bai-muajjal mode of Islamic banking finance contributes to developing savings habits among rural entrepreneurs and mobilizing the savings towards productive projects.

INTRODUCTION

The rural-based small and cottage industry (SCI) sector in developing nations contributes greatly towards economic development by generating employment opportunities and mobilizing rural savings towards productive sectors. It is revealed from many researches that this SCI sector is one of the most neglected sectors of economy in almost all least developed and developing nations of the world. Among others rural-based small entrepreneurs suffers from lack in working capital, institutional credit facilities and poor management. Due to the shortage of capital they are compelled to borrow funds from local moneylenders at a high rate of interest. This practice brings endless miseries to the rural-based small industry owners. With regards to the burden of debts of the rural poor there is a proverb in developing nations, which says, 'The rural poor are born in debt, lives on debts and die in debts'.

It is observed from the study that most of the rural people are savings minded and they try to save from whatever little earnings they have. Unfortunately, the efforts of these people remain unattended. Formal as well as informal lending organizations seldom consider the issue of rural savings as an important factor for generating working capital for rural SCI owners. Institutionalization of saving habits through lending procedures might contribute to a greater extent in developing saving mentality among rural-based SCI owners and also to mobilize these savings towards productive sectors.

In recent years different Islamic banks in Bangladesh started giving micro-credit towards grass-root level SCI projects in rural areas¹. Some of the lending procedures of this financing system are designed in such a way that in order to obtain a micro-credit, a client must show minimum personal savings in order to be qualified for a loan. Islamic banks normally use the Bai-Muajjal mode of financing while lends funds to the grass-root level small and cottage industries in rural areas of the country. In this article, I tried to highlight on how Islamic banks micro-credit policy through the Bai-Muajjal mode of financing contributes towards developing and institutionalizing saving habits of their clients.

The study was carried out in Bangladesh and used a theoretical model; '**Institutional-Network Approach**' (Alam 2003). The theoretical frame of references was developed during the tenure of my research on the subject, 'Islamic Banking Finance to Small and Cottage Industries' at the Lund University, Lund, Sweden. While conducting the empirical study, I interviewed 125 rural-based small industry owners who were clients to different Islamic banks in the country. These clientele of Islamic banks were running grass-root type (poultry/dairy firms and handloom industries) of small and cottage industries. Among others, the Social Investment Bank Limited (SIBL) is one of the Islamic banks that give micro-credit to grass-root level SCI owners under Bai-Muajjal mode of financing. Based on the said theoretical perspective, empirical data are analyzed, in order to see as to what extent the Bai-Muajjal mode of financing of Islamic bank contributes towards developing saving habits and the way the bank institutionalized this habit of the rural SCI owner. The article also highlights on the extent to which this particular lending procedure of the bank assists clients in making proper utilization of their borrowed funds and also in developing lender-borrower network

¹ The Social Investment Bank Limited (SIBL) is one of the few Islamic banks that render financial services in the money market of Bangladesh. Besides other sectors of economy the bank gives micro-credit to the grass-root level small and cottage industry owners under its Bai-Muajjal financing mode. The loans are given in kind and ranges from minimum US \$ 100 and maximum US \$ 500.

relationships. In order to understand the lender-borrower relationships in depth, a qualitative nature of research methodology was used in the study. Since, case studies reveal various facts about a particular phenomenon and allow a researcher to get very close to his or her informants, I used a case study method while collecting data from the field.

The article is designed in a few major sections. Firstly, it includes a brief description of the theoretical and methodological approaches that was used in the study. The discussion in the second section highlights on Islamic banks and its different investment techniques. The third section includes a detailed description of the Bai-Muajjal lending procedures that the Social Investment Bank Limited uses, while lending micro-credit to the grass-root level SCI owners. The final section of the article represents an analysis of the results obtained from the study.

THEORETICAL AND METHODOLOGICAL APPROACHES

Based on Whitley's (1992a) 'Business System' institutional approach, an analytical frame of references is developed to study the lender-borrower relationships between different financing organizations and rural-based small and cottage industries. The theoretical model is designed in such a way that different small and cottage industries as well as financing organizations of similar nature are grouped and institutionalized into different 'SCI systems' and 'Financing Systems'. The theoretical model is also used to carry out a comparative study as to how financing organizations under different financing systems differ from each other, while lending micro-credit to small and cottage industry owners under different SCI systems.

In order to achieve the said objectives, I developed the concept of four components of different SCI systems and financing systems. These components for example, are nature of organization, market organization, employment systems and authority and control systems. Accordingly to Whitley (1992b) a comparative analysis of the 'business system' is the systematic study of these configurations and as to how they become established in markets. Like Whitley's (1992b) 'Business Systems', the Islamic Financing System is seen as a, 'financing business system of its own, with a foundation based on religion, having its own rules governed by the Islamic laws'. These rules differ from those of other financial systems. Like Whitley's (1992a, 1992b) Business System, financing organizations of similar nature are grouped into different financing systems. Thus, the concept of different financing systems for example; the Market-Based Financing System (MBFS), the Islamic Financing System (IFS), the Cooperative Financing System (CFS), and the Traditional Money Lending System (TMLS), is developed in the theoretical framework and these are viewed as particular arrangements of hierarchy-market relations that become institutionalized and relatively successful in a particular context. A similar arrangement is also done to institutionalize different rural-based small and cottage industries. The rural-based small and cottage industries of similar nature are thus, grouped into three different SCI Systems, such as the Grass-root level (GL), the Season-based (SB) and the Semi-mechanized (SM) SCI Systems. Similar nature of financing organizations under different Financing Systems and small and cottage industries under different SCI Systems are regarded as economic actors acting within these organizational fields.

Since, the concept of network as part of the hierarchy-market relationships is poorly developed in Whitley's (1992b) 'Business Systems' approach, Jansson's (2002) network institutional model was also taken into consideration for developing the network aspects in the theoretical frame of references. In his network institutional model, Jansson (2002) highlights network relationships

between the multinational corporations (MNC) in India and major external parties in the product/services market like customers, intermediaries, competitors and suppliers. It also gives some examples of external institutional factors that affect the networks. Like the network relations between the MNC and major external parties' financial organizations in the present study influence and are influenced by various commercial actors in the financial market and other markets in Bangladesh. Since one of the main objects of the research was to study the network relations between financial organizations and other major external parties in the financial market, especially the small and cottage industries, regarding the use of the network approach among many others (for example, Rasmussen, 1988; Kuklinski & Knoke, 1988; Anderson and Carlos, 1976; Easton & Araujo, 1991; Elg & Johansson, 1992; Easton, 1992; Håkansson, 1993; Aldrich & Whetten, 1981; Emerson & Cook, 1984, Jansson, Saqib & Sharma, 1995.), I found the concept of Jansson's (2002) model appropriate for the present study. Thus, based on the existing theoretical models as mentioned above, the 'Institutional-Network' theoretical frame of references (Alam, 2003) was developed for studying the lender-borrower relationships between economic actors in different Financing Systems and SCI Systems, especially with regards to financing towards small and cottage Industry (SCI) sector. The theoretical model also includes various background societal institutions like country culture, legal systems, religion, family/clan, government etc., that have direct as well as indirect influences on the lending and borrowing activities between different financing organizations and the rural-based SCI owners. The article is designed to highlight the empirical finding with regards to lender-borrower relationships between small and cottage industries under the grass-root level (GL) SCI system and Islamic banks under the Islamic Financing System (IFS).

Methodological approach

In order to develop the 'Institutional Network' theoretical model, a combination of both **deductive and inductive** methodological approach (Glaser 1978, Strauss & Corbin 1990, Jansson et.al. 1995) was used in the study. In the deductive approach, one tests the hypothesis or the validity of a theory. It is a method by which one may study an individual case using a general law – that is, a logical analysis of what the general theory says about a specific event. Initially, the research design was based mainly on Whitley's institutional theory (1987, 1990, 1992a, 1992b), and the network institutional theory of Jansson (2002), and the network theories of Kuklinski & Knoke (1988), Johannisson et al (1992), and Håkansson (1993). The inductive approach principle implies a journey made by a researcher from the empirical point to the stage of a theory development. At one point in the theory development process, based on the data collected from the field, the originally defined theories were modified and developed an Institutional-Network theoretical frame of references, based on which data collected from the field are analyzed.

The research methodology applied in the study is of a **qualitative nature** (Jick 1979, Merriam 1998, Sherman and Webb1988, Patton 1985). A qualitative type of research is characterized by collection of data directly from respondents in the field. This is because the entire research program is based on facts acquired from the material world, that is, the practical field of study. The study of lender-borrower network relationships between rural-based small and cottage industry owners and Islamic banks was conducted through '**in-depth**' interviews with respondents under review.

A **case study** (Yin 1994) method was adopted as a research strategy in order to focus on contemporary phenomenon within the real life context of different rural-based small and cottage

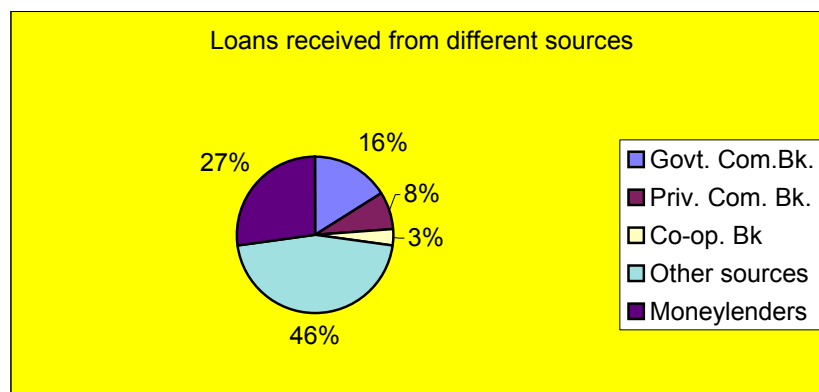
industry owners under various SCI Systems and their relationships with financing organizations within the Islamic Financing Systems (IFS).

SOURCES OF FUNDS FOR SMALL AND COTTAGE INDUSTRY OWNERS IN BANGLADESH

There are many formal as well as informal financing organizations that are functioning in the money market of Bangladesh. Formal financing institutions like government and privately owned commercial banks normally give loans to large and medium scale industries. Cooperative banks in the country although gives loans to the rural-based small and cottage industry owners, they confine their credit giving activities mainly to the members of the bank. One of the specialized banks in Bangladesh called 'Grameen bank' (Yunus, 1993, Nabi, 1996) also gives loans to the rural-based poor people. But due to the limitation of amount of credit to customers, high risks and administrative costs, the bank has not initiated any loans to small and cottage industry owners in the country. Moneylenders in rural Bangladesh are also an important source funds to the small and cottage industry owners. Since last two decades a few Islamic banks started financing different industrial and business sectors. Some of these banks extended their loan giving activities towards rural-based SCI owners.

During the field studies, I interviewed 125 different rural-based SCI owners who are customers of different Islamic banks in the country. While conducting interviews, it was tried to acquire knowledge from these respondents about different sources that they used to get funds before taking loans from the Islamic banks. The result shows that 30 of 125 clients received loans from conventional banks of which 20 from government commercial banks and 10 from private commercial banks. Among remaining clients 57 obtained their funds from friends and personal savings, 4 from cooperative banks and 34 from moneylenders. The following figure demonstrates respondents' position in percentage based on different sources of funds.

Figure 1. Sources of funds of rural-based SCI owners



(Source: Field study on SCI in Bangladesh 1997)

It is noted from the above figure that more than 70% SCI owners interviewed raised their funds from informal sources of credit. Only 27% owners received loans from formal credit giving institutions.

It is mentioned in the earlier section that like other conventional banks financing organizations within the Islamic Financing System render financial services towards different industrial sectors in the money market of Bangladesh. For reader's knowledge, before introducing Islamic banks and its relationships with lenders especially, the grass-root level small and cottage industry owners, a brief description of an Islamic bank and its investment modes is given in the following section.

AN ISLAMIC BANK: A BANK WITHOUT INTEREST

An Islamic bank may be defined as a financial intermediary whose objectives and operations as well as principles and practices must conform to the principles of Islamic Law (Shariah); and, consequently, is conditioned to operate all its activities without interest (Alam, 2001). The aim of Islamic economics as observed by Ahmad (1984), and Molla et.al. (1988), is not only the elimination of interest-based transactions but also the establishment of a just and balanced social order free from all kinds of exploitation. An Islamic bank is not only a financier but also a partner in business. The system essentially involves sharing of risk between the owner of capital and the entrepreneurs, as well as sharing the result of the collective efforts. Thus, it differs from an interest-based system in which the risk is mainly borne by the entrepreneur or by the user of capital. In other way we can call Islamic banking as participatory banking.

Islamic banks around the world

Nassief (1989), Ahsan (1989), and Kazarian (1991) observed that more than 70 Islamic banks and Insurance houses are rendering interest-free services in Asia, the Middle East, the Far East, Africa and Europe and North American countries. The Islamic Society of North America Canada (ISNA, 2000), has initiated Islamic banking activities in recent years and started lending interest-free funds to their customers especially for housing and other projects. The interest-free housing loans are given through the ISNA controlled organization called "Islamic Co-operative Housing Corporation Limited (IHC). A few Western banks such as, the Kleinwort Benson, Citibank and ANZ Grindlays also started to adopt the pattern of Islamic banking in cost-plus financing, leasing and equity financing for their clients in the Middle East, Southeast Asia and a few international corporations in Europe and Latin America (Gathura; 1996, Roula; 1995, Ken; 1994, Parker; 1993, Heffernan, 1999)

INVESTMENT MODES USED BY ISLAMIC BANKS

An Islamic bank renders similar services to their customers as other conventional banks but due to the differences in the principles of Islamic banking systems the modes or techniques of accepting deposits and lending funds to customers differ from conventional banks. The investment modes that an Islamic bank uses while investing funds are discussed below.

Mudaraba or Capital Financing

Under the Capital Trust Financing or Mudaraba mode of financing Islamic banks supplies the entire capital of the business and the customer gives his time and expertise, which form a relationship between the supplier of capital and the user of capital. Thus the bank and the customer work together and share profits and losses.

Musharaka or partnership financing

The word 'Musharaka' means a profit sharing joint venture, designed to limited production or commercial activities of long duration. In this case the bank and the customer contribute capital

jointly. They also contribute managerial expertise and other essential services at agreed proportions. Profit or losses are shared according to the contract agreed upon. An individual partner does not become liable for the losses caused by others. Due to this joint venture this technique is also known as Equity Participation mode of investment. Profits or losses are distributed according to a predetermined profit and loss sharing agreement. Both the bank and the customer take part in the management and control of the entrepreneurial activities.

Murabaha (Mark-up or Costs-Plus- Profit based financing)

The word 'Murabaha' means a cost plus profit based financing. As Khoja & Ghuddah (1997, chap. 1, p.2), states: "The mode of Murabaha sale connected to a promise is used by the Islamic banks which undertake the purchaser of commodities according to the specification requested by the customer and then resells them on Murabaha to the one who promised to buy for its cost price plus a margin of profit agreed upon previously by the two parties". Under the Murabaha mode of investment the bank agrees to purchase for a client who will then reimburse the bank in a stated time period at an agreed upon profit margin. The mark-up price that the bank and the buyer agree to is mainly based on the market price of the commodity. Thus the bank earns a profit without bearing any risk.

Bai-Muajjal or cost plus sale under deferred payment

The Bai-Muajjal mode of investment is as like as a Murabaha mode of investment with an exception that the sale under this cost-plus sale modes investment is made on a credit basis rather than cash. The main feature of this technique consists in procurement of goods at the request of the client and selling it to him/her on credit. This mode follows the same conditions as Murabaha mode of investment except the following:

- The bank transfers the possession of goods to the client before payment.
- In order to cover the sale price of the goods the bank obtains collateral securities from the client.
- The bank normally takes property of Municipal area as mortgage. In case the client fails to repay the sale price the bank realize the amount by selling the mortgage property.

Bai-Salam or advance purchase

Under Bai-Salam mode of investment the bank purchases industrial and agricultural products in advance from their customers. The main features of this mode are:

- The price is normally paid with the execution of an agreement.
- According to the terms of agreement the bank receives the goods in due time.

Hire-Purchase investment under Shirkatul Meelk

Islamic banks in Bangladesh also invest funds under Hire-Purchase mode. Under this investment technique the bank sells building, transport and other valuable items to the client. The value of hire-purchase amount is payable in instalments. When the client pays back the value of the goods including rent, the ownership is transferred to him. The features of hire purchase are:

- Before the purchase of the item the bank determines its accrual price, monthly rent, schedule of payment, cash security, additional security, etc.
- The ownership of the item remains with the bank till the client pays the entire amount of instalment.

- The rent is received on the basis of accrual income.

Ijara or Leasing

The word 'Ijara' indicates leasing. The leasing purchase is another technique followed by Islamic banks in financing customers. This system is almost similar to the leasing activity provided in traditional banking. Leasing is a contract between the bank and the customer to use particular assets. In this case the bank is called lessor and the customer is called lessee who wants to use the assets and pays rent. Zineldin (1990), in this regard argued that the leasing agreement is based on profit sharing in which the bank buys the movable or immovable property and lease it to one of its client for an agreed sum by instalments and for a limited period of time into a saving account held with the same bank. These instalments are invested in Mudaraba investment (Venture) for the customer's account. The accumulated profit generated from the payments, and the payments themselves are invested in the bank's investment ventures over the time period of lease, contributing to eventual purchase of the leased assets

Ijara-wa-iqtina (Leasing purchase)

According to the Western leasing system the lessee pays specific rentals and a fixed rate of interest over a given period for the use of specific assets. But in the Islamic banking system of leasing the risk related to leasing has to be shared between the bank and the lessee, in case of any damage to the leased assets. The contract is called '*ijara-wa-iqtina*' i.e. *leasing purchase*, when the ownership of the assets is transferred to the clients after the completion of the leasing contract.

Quard E Hasan

Quard E Hasan means an interest-free loan given by the Islamic bank to the needy people in a society. The practice of dealing with this sort of investment differs from bank to bank. Quard E Hasan is normally given to needy students, small producers, farmers, entrepreneurs and economically weaker sections of the society, who are not in a position to obtain loan or any financial assistance from any other institutional sources. The main aim of this loan is to help needy people in a society in order to, make them self-sufficient and to raise their income and standards of living.

ISLAMIC BANKING FINANCE TOWARDS SCI SECTOR

One of the major aims of Islamic banks under the Islamic Financing System is to render financial services to the rural-based small and cottage industry sector. In many ways, Islamic banks are similar to other privately- owned formal financial intermediaries. The main difference is that an Islamic bank neither accepts deposits nor invests funds to its customers on interest. Instead, the bank shares profit or loss. Nienhaus (1993) in this regards observes that the rural based small and cottage industry owners are not being benefited much either by the state-owned or the privately owned financial organizations. One might therefore find it interesting to observe how an Islamic bank acts as 'bank for rural SCI owners'; for example, how far an Islamic bank, with its motive of investing funds on a 'profit and loss sharing' basis, may contribute towards financing and promoting rural-based small industry sector.

LENDING FUNDS THROUGH BAI-MUAJJAL MODE: AN EMPIRICAL REVIEW

As mentioned earlier, one of the Islamic banks called Social Investment Bank Limited (SIBL) gives loans to the small and cottage industry owners in rural Bangladesh. These clients of the bank are involved in poultry/diary firms, handloom industries etc. These sorts of industries are grouped and institutionalized as the Grass-root level (GL) SCI System in the study. An in-depth interview was conducted with 40 small and cottage industry owners belonging to the Grass-root level (GL) SCI Systems. Among these respondents 20 are poultry firm owners and 20 handloom industry owners. The bank gives loans to clientele under the Bai-Muajjal mode of Islamic banking finance. The lending procedures under this financing mode initiate in a different way than the normal loan giving process followed by other conventional banks. A brief description of lending policy of the Social Investment Bank Limited towards the rural base grass-root level SCI owners is discussed in the following section.

The bank initiates groups and teams among customers

This bank gives interest-free loans to its customers on the condition that they first create a **group** amongst themselves. Customers who intend to take loans are asked to form a group of five members before the request for a loan may be assessed. Each group requires a volunteer group leader to organize all aspects of the business and to assist the other group members in various activities. In such a group-wise loan, group members are jointly liable for the mistakes the other members might make. The bank then forms a **team**, which consists of five individual groups of poultry farmers. All the groups within a team are in turn also responsible for each other's activities and they relate every instance back to their designated *team leader*. The group leaders of five different groups work as members of a **team-executive-committee** and this committee selects one president, one cashier, and one secretary.

The bank's staffs are responsible for training the group leaders. The training consists of information sessions where everyone learns general ideas and techniques about their production activities. For example, in case of poultry firm, the team leaders of the poultry firms are taught how to care of chickens at every phase of the chickens' life; this includes how one ought to administer medicine and other nursing aids when the need arises.

Structure of the group organizing by the bank

Under the supervision of the Social Investment Bank Limited staff, grass-root level SCI owners (respondents) organized the different groups comprised of five farmers in each group who were interested in borrowing funds from the bank. An officer is usually assigned by the bank to organize meetings with each group on different days of the week. Thus, each group has the opportunity to contact the bank directly, through the representative officer of the bank. In case the clients feel the need to discuss about any business or personal issue they may discuss the same with the officer.

Opening of a savings account with the bank

In order to obtain a loan from the bank, every member in a group is required to open a savings account with the bank and deposit an agreed-upon amount of money every week. The savings accumulate gradually and steadily using this method, for up to ten weeks. The respondents opened savings accounts with the bank under their own names. These types of accounts are called 'Mudaraba Savings Accounts' (Profit & Loss Savings Accounts). After the account had been

opened, each member of a group was expected to begin depositing both a minimum amount of TK. 25 and a maximum of TK. 50² every week.

Collection procedure of the weekly deposits

It is the group leader's duty to collect money during the week from the members of his or her group and to record how much each person contributed in a ledger. At the end of every week, the leader submits the entire sum of cash, along with the record of names of the depositors, to the cashier of the team. The bank officer in charge of supervising the projects visits the project-site once in a week and collects these deposits from the cashier of team. The amount that is collected is then credited to the respondents' savings accounts.

Requirement of minimum deposits

The staffs of the bank responsible for collecting information about customers determines whether various project proposals submitted by different customers intended to initiate using the bank's money were feasible. The bank handles the weekly sum of savings quite carefully because a customer's deposit figure must exceed 5% of the loan he/she applied for or he/she will not be entitled to receive any loans from the bank. For this reason, the bank officer regularly gives business advice that will be necessary if his clients are to succeed. He encourages them to be punctual with the deposits of their weekly savings so as to avoid hassles. Apart from this regular advisement and encouragement, the bank officers in charge of the project also give the respondents training in their respective fields of expertise.

Bank officers' direct contacts

During the ten-week saving period, it is also the duty of the bank officer-in-charge to inquire about each borrower's working capability and the types of business they are interested in for the future. The bank officers meet every group at different times to educate them about the Islamic banking systems, and particularly about its techniques and its aims. At the same time, he also gives them information about how their new banks have developed.

After the saving period ends

When the ten weeks of the term of the savings with the bank came to an end, the group leaders arranged a meeting with all the individual members of each group. In this general meeting, a resolution is drafted and passed regarding the amount of loan each member intended to borrow from the bank. A copy of this resolution was then prepared for the bank officer when he came to visit the site. After considering this resolution, the visiting bank officer fixed a date with each individual member of the various groups and asked them to come to the bank with their group leaders to sign the contract for the loans.

Payment of loans

When the above-mentioned processes ended the bank-sanctioned loans to the clients on a *Bai-Muajjal* (Credit plus profit) mode of financing. As mentioned earlier, under this mode of financing, the bank does not issue the agreed-upon loan amount to the customer in cash, as is the custom of most conventional banks. When they signed their loan agreement with the bank, the respondents under review were asked by the bank to select a raw material supplier and to bring a pro-forma

² 1,00 USD is equal to 57.4000 BDT, Live Rates as of 2001.06.24 (<http://www.xe.net/ucc/convert.cgi>)

invoice for the price of the raw materials that they required for their industry. The respondents promptly complied and immediately sought suppliers and collected invoices from them. Another bank officer was in charge of supervising this aspect of the project and giving any professional assistance that was required of the clientele. Once the bank authorities were satisfied with the invoice prices, the quantity of materials etc., made necessary arrangement to pay the money directly to the suppliers. Soon after the payment was made to the suppliers of raw materials, the bank officer responsible follow up the matter in order to be sure that the customer received the raw materials. The bank then debits the same amount from each customer's savings account, in accordance to the amount each had stated was necessary for his/her specific needs. In this way, the bank ensures that the fund borrowed by small and cottage industry owners will be directed efficiently and that the customer will be successful in achieving his or her goal.

Direct supervision of borrowed funds

The SIBL allows its customers free access to their entire borrowed fund, with an important stipulation; before one is able to get unlimited access, one must prove to the bank that the amount being lent will only be spent to buy raw materials or other accessories for the development of the farm. In order to do this; the customer must produce new invoices from the vendors of the raw materials each time he visits the bank. They may then utilize the whole amount all at once, or however else they may see fit. This is allowed to takes place only after the loan has been sanctioned and credited to the individual's Profit and Loss Savings Account.

Profits charged by the bank

A further condition within the SIBL's lending policies under Bai-Muajjal mode that deal with the clients in the Grass-root level SCI System is that the bank officials who deal with them calculate a percentage of profit on top of the invoice price after the customers present their invoices for the materials they intend to buy. The principle of the Bai-Muajjal mode of financing is that the bank first buys goods for customers and then sells these goods back to them at a profit. The bank realizes the principal amount of loans plus the profits from customers in separate, equal instalments. In this particular case, the SIBL charged the small and cottage industry owners 14% of their net profits made on the goods bought by the bank for the customer. Soon after the purchase was made, the respondents became the owners of the goods and were responsible for its proper use.

Security

As a security measure, the bank asks the respondents to produce their land property title documents as well as a letter of recommendation either from a person notarized by the bank or from an influential customer of the bank in the locality.

Repayment of loans

The repayment of loans, including profits, was divided into a number of equal instalments. The SIBL fixed the instalment rate of repayment of the loan. This repayment time starts two weeks after the customer receives the loan or soon after the product is ready for sale in the market.

BAI-MUAJJAL MODE OF FINANCING AND ITS EFFECTS ON SMALL AND COTTAGE INDUSTRY OWNERS: A CRITICAL ANALYSIS

The study reveals that the mobilization of the rural savings is one of the prime aims of the organizations in the IFS, where their lending techniques develop the saving mentalities among the customers, especially the rural-based SCI units. It is noted from the above discussions that the

financing organizations within the Islamic Financing System while lending funds to firms in the Grass-root level SCI System demands deposits from their customers. The clients in this SCI System accumulate these deposits through individual savings. Financing organizations in the IFS supervise and monitor the customers' savings activities through certain established rules. In this section a detailed analysis is done to see how changed saving habits are regulated and savings are mobilized towards productive projects by the financing organizations in the Islamic Financing System through Bai-Muajjal lending mode of financing.

It is noted from the empirical record that the Social Investment Bank Limited through its Bai-Muajjal lending technique develops new ways to save i.e. how saving is institutionalized to become new or behavioural rule of these organizations. It is also found that the development of new saving habits among the SCI owners promotes network ties with different actors within and outside the SCI units. Since the Islamic Financing System introduced its special lending policy in the Grass-root level SCI System, the saving of the SCI owners is governed by the new rules creating another saving habit. In order to borrow funds, the Grass-root level small and cottage industry owners are required to abide by these saving rules. Thus, through the lending process new saving habits of the rural people have been institutionalized.

Habits viewed as an institution

Habits originate as serial repetition of behaviour within the complex interaction of human beings. Habits are either hereditary in nature or grows through imitation, but in both cases based on replication of a precedent. Every society considers social habit to be a significant factor in determining social law and customs, and vice versa. According to Veblen (1919, p.239), institutions themselves are comprised of 'settled habits of thought common to generality of men.' Man is socialized by societal agents and forces, thus habits are an outcome of social behaviour, customs, traditions and law. Habits influence economic as well as non-economic activities of human beings in their everyday life.

Habit play out in human life in various ways. Some habits are natural, essential for living such as physical necessities of eating and sleeping, whilst other habits are acquired from the social environment. Habit, as mentioned, is also established in human life through imitation of others. Regardless of the mode of entrenchment, habits have a great impact on the economic and social activities of a society. Good habits reduce the social burden and, arguably, vice versa. Hodgson (1988,p.127), observes as "*We acquire habit in various ways. Sometime it is through the imitation of others. This does not always result from full conscious choice, as all animal species are born with some capacity to imitate. The development of the intellectual and political skills of young children is based largely on imitation, and we retain this faculty in later life, other without conscious thought about what we are doing*".

While discussing on the subject rural savings and saving habit of Grass-root level small and cottage industry owners, I think it is needed to highlight on traditional saving habits that play an important role in rural economy of Bangladesh. In order to have an overview on that the first part of the next section includes a brief discussion on the overall position of the traditional saving habits and sources of rural savings. Then, it discusses the extent to which the organizations in the Islamic Financing System contribute to mobilizing the rural savings towards the productive sectors.

Traditional habits of savings

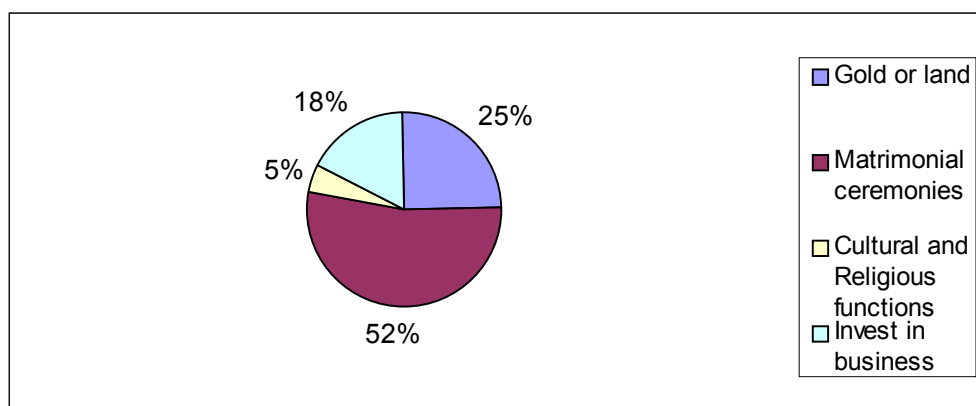
Veblen (1919) views habits as either hereditary in nature or that they grow through imitation. The author further argues that institutions themselves are comprised of settled habits of thought common to the general public. Saving habits influence economic as well as non-economic activities in almost all societies. Ashe and Cosslett (1989, p. 94) reports that the household savings in the informal sector is an essential element in the growth of developing economies, partly because the informal sector is larger than the formal enterprise or public sectors.

It is observed from the study that the rural-based SCI owners are usually habituated to save funds. Saving tendencies are a hereditary part of these people's nature. The majority of respondents in the SCI units in rural areas informed that, although they used to save money on their own initiative, they could hardly use these funds in a profitable way. It was also known from the study that the rural-based SCI owners are used to saving money for different purposes. Some of these are discussed below.

Motives behind the traditional savings

Saving is found to be a very common habit among the majority of the rural-based small and cottage industry owners. But the motive behind creating saving differs from person to person and from family to family. While interviewing the Grass-root level small and cottage industry owners it was found that almost all respondents were trying to save a little from what they had. But the motive behind the savings was different. 21 respondents among 40 SCI owners interviewed expressed the motive of savings was to accumulate funds for the matrimonial ceremonies of their children. Ten clients intended to use savings for buying gold or land. Three of them intended to spend for religious and cultural functions and seven invest in business. These figures are demonstrated in percentage by the following figure.

Figure 2. Utilization of savings



(Source: Field study on SCI in Bangladesh 1997)

The above figure shows that more than 50% respondent having children were worried for the marriage of their daughter and they start saving a little of what they have for their matrimonial ceremonies. Only 18% showed their interest in utilizing their savings for the business or productive purposes. They were afraid of using their savings funds for business purposes because of their lack of entrepreneurial mentality, the risk involved, and the lack of experience in business.

Therefore, large amounts of rural savings are not being utilized in any productive activities, instead being locked in unproductive sources.

CHANGING SAVING HABITS: THE ROLE OF THE ISLAMIC FINANCING SYSTEM.

The lending policy of the financing organizations in the IFS gives prime priority to the saving habits of people. As one of their lending principles, owners of the grass-root level SCI owners are required to deposit a certain percentage of the borrowed funds with the bank. They are required to make these deposits from their weekly savings. The following section includes a discussion about various reasons as to why the Social Investment Bank Limited give preference to their clients accumulate weekly deposit, thereby creating new habits of saving for these organizations and in that way institutionalizing new ways of saving.

Developing a saving mentality

The SCI owners in the grass-root level SCI system are poor rural people, who have very little educational qualifications and professional skills. They are therefore, unable to understand how to save in a proper way for example using savings in productive ways. In order to develop the saving mentality among rural SCI owners the financing organizations within the Islamic Financing System arrange their lending activities in such a way that the borrowers initiate group savings before they apply for loans. It takes a few weeks for the SCI owner in the grass-root level SCI system to obtain a loan. During this period, the Islamic banks contact their customers from time to time, to discuss various issues concerning their projects, and to monitor the progress of the group savings in order to develop the proper savings mentality. Thus, the organizations within the Islamic Financing System establish close contacts with the SCI owners in the grass-root level SCI system and encourage them to save and plan how and in which way to spend their savings. In developing the saving mentality of the clientele the bank assists and encourages them to accumulate their idle funds and to use the same for productive purposes.

Educating about saving habits

As noted above, although the SCI owners in the grass-root level SCI system are poor, many of them spend whatever they have saved in unproductive ways, for example, on dowries at marriage ceremonies. Since the organizations within the Islamic Financing System do not start lending before the groups savings are initiated, the lending rules themselves educate the clients about the advantage of savings. Moreover, bank officials, through personal contact, discuss various issues regarding the drawbacks of the old saving habits. Thus, it is concluded that the rural SCI owners are educated about how to make proper utilization of their savings in productive ways. New saving habits are thereby being institutionalized. By giving them a proper understanding of the value of their savings, the lending organizations within the IFS encourage poor SCI units to start saving from the little they have in their hands.

Uniting customers' efforts

The bank also had the idea of developing the saving habits to establish unity among people from different walks of social life. The lending activities initiated through the group savings established unity among rural people of different social categories, since it encourages different individual SCI owners to work together in harmony. Thus, new saving habits not only unite the rural SCI owners but also their skills and efforts. This ultimately results in the investment of funds towards productive activities. The rule to collect individual savings encourages customers to fulfill the group

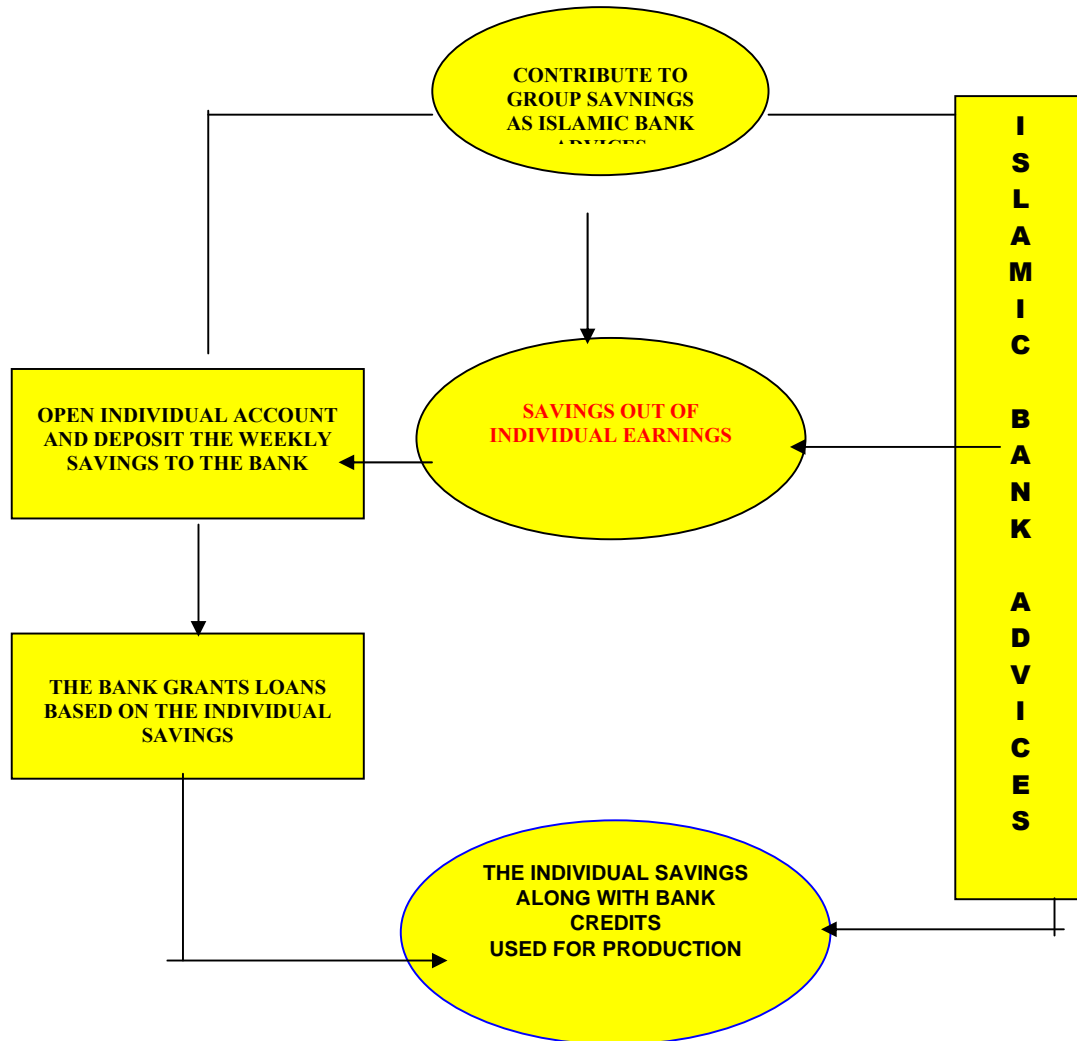
obligations. Thus, the savings of the individuals are mobilized from unproductive uses towards productive fields.

INSTITUTIONALIZATION OF SAVING HABITS

In his discussion of social life and group behaviour, Hughes (1939) observed that anything socially established can be called an institution. It is mentioned earlier sections that the rural people in Bangladesh try to save from whatever income they have, but this habit is neither taken care of nor guided by any lending organization. Human habits do not change without a change in catalytic circumstances. For example, if one is inclined to believe that a change of habits or a development of a new habit in everyday life is like to be of benefit, materially or financially, one may not hesitate to transform habits as a conscious act of volition. Within the societal domain, however, it may require an institutional process or policies adopted by either by the government or the individual institution. By way of example, let us refer to the case of saving habits among people in a society. Needless to remind, that every spending that is incurred by people may not be productive. This, no doubt, happened due to certain behaviour or routine activity, which people are customized into over the years. A proper motivation and guide for people to save money may end up with a good result if, in return, they are shown a profit oriented and productive project in which to invest their savings.

Bai-Muajjal mode of savings as observed in the earlier section, changes socially established saving habits of rural-based SCI owners. The traditional habit is changed to a newly developed saving habit. The entire lending procure of the Islamic bank is consists of certain rules, procedures which in a way was used in organizing the behaviour of the bank's clientele. Thus it may rightly be said that, through the Bai-Muajjal lending process saving habits of the rural SCI clientele are institutionalized. Regarding institution Jansson (2002) observed that, an institution usually means rules, procedures, and conventions typical for a more specific way of organizing human behaviour- a (legitimized) social grouping of some kind- for example family, clan organization, nation, market game or ceremony. Within these institutions are found rules and conventions typical of specific organization, which led to habitual and routinized behaviour or action. The critical analysis of the Bai-Muajjal mode of Islamic banking finance indicates that the entire process of savings and its uses contribute towards developing other new habits. For example, the people of the different SCI units start to think along the lines of productive activities. The savings activities are organized and arranged in such a way that they develop lender-borrower relationships and establish close ties with co-workers within the locality. Furthermore, the newly developed, saving habits direct them to think in advance regarding a particular project in which they might invest their savings. The traditional, saving habits of SCI owners discontinue with the gradual development of new habits. This mobilization of the savings takes place through institutionalization of new saving habits. Institutionalization of saving habits is a process of changing spending behaviour of the rural poor and promoting a goal oriented saving habits among these people. The following figure demonstrates the processes by which the entire credit giving process of the Social Investment bank Limited regulate and institutionalized the saving habits of the rural-based grass-root level SCI owners.

Figure 3: Process of developing saving habit by Bai-Muajjal financing



Institutionalization of saving habits through lending process

It is noted from the above figure that the entire lending procedures used by the Social Investment Bank to give loans to the owners of the grass-root level SCI system contribute to the de-institutionalization of old saving habits and institutionalization of new saving habits. The saving habits of the clients are established through certain rules. The process used by the bank is a unique means of organizing human efforts and behaviour. It is thus concluded that an important part of the lending policy of this bank is aimed at institutionalizing saving habits of the rural-based SCI owners and organizing savings towards productive activities.

Characteristics of the institutionalized saving habits

- The new institutionalized saving habits of the SCI owners in the grass-root level SCI system are characterized by the following factors.
- Savings are generated from self-earning
- Savings are initiated and supervised by the financing organizations in the Islamic Financing System
- Savings are deposited with the financing organization
- Customers know about the purposes of their savings
- Savings are returned back to customers as capital for production
- Capital formation is done through depositing savings with the financing organizations
- Savings are utilized in productive sectors
- Savings are utilized in a proper way to create job facilities
- Saving habits develop network relations within the co-workers and with financing organizations.

CONTRIBUTION OF INSTITUTIONALIZED SAVING HABITS

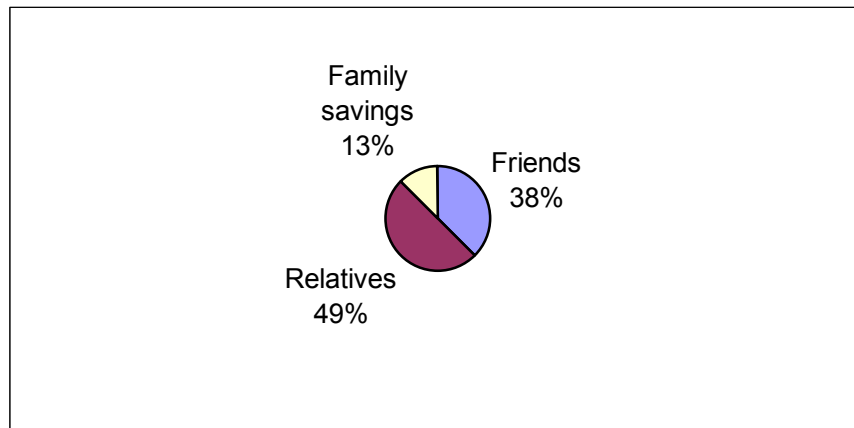
The following section includes a brief description regarding the contribution of the institutionalized saving habits.

Generates working capital

It was observed from the study that working capital is a major hindrance for rural-based small and cottage industry owners, lack of which often compels them to use their borrowed funds to overcome their capital shortage rather than investing it for production. In this regard Ashe & Cosslett (1989), observes that the lack of working capital often leaves owner little resources other than to buy from certain suppliers on credit and at very high prices, thus exacerbating the common problem of chronic indebtedness.

A lion's share of working capital may be generated from the private savings of the rural people. To a certain extent the inadequacy of working capital can be overcome by inculcating the habit of savings in the business nature of the small and cottage industry owners. Apart from that, the lack of entrustment among the rural based small industry owners is also another major hindrance that makes financial intermediaries fail to realize their expected benefit from their investment. It is found from the study that major portion of working capital of the grass-root level SCI owners interviewed comes from other sources than personal savings. Among 40 respondents, to raise funds for working capital, 15 borrowed funds from friends, 20 from relatives and 5 used their family savings. This figure is shown in percentage by the following figure.

Figure 4. Sources of working capital



Source: Empirical studies on grass-root level SCI in Bangladesh (1997)

It is noted from the above figure that only 13% of SCI owners raise their working capital from personal or family savings. This indicates that rural-based SCI owners use other sources than personal savings. In case they fail to raise funds from friends and relatives they are bound to use borrowed funds as working capital, which ultimately hampers production activities and results in the deficiencies of cash flow.

When the Islamic banks give loans to the grass-root level SCI units, they want to make sure that they have sufficient funds for their working capital. Since SCI units in many cases used their funds for other purposes than they were originally borrowed for, the savings give the financing organizations an assurance that the borrowed funds would be used for the right purpose.

Proves credit worthiness and adds security

The study reveals that as a rule, in order to obtain a loan the SCI owners in the grass-root level SCI system must deposit a certain amount of their savings with the bank. This stipulation not only ensures saving but also allows Islamic banks to judge the credit worthiness of rural-based small and cottage industry owners. Islamic banks, like other conventional banks, also take freehold properties as a security from customers. In many cases there is no problem even for rural-based SCI units to give such securities. Due to economic hardship, it is tough to give any cash amount as security. As part of their lending policies, financing organizations in the Islamic Financing System encourages borrowers to save. This ultimately makes financing organizations sure that borrowers are really worthy of giving credit to. A saving attitude also makes customers mentally strong and encourages them to work hard to prove their worthiness to the lending organizations.

Creates mutual obligations between the parties

The lending of funds by Islamic financing organizations to grass-root level SCI units may be termed as '*giving and taking policy.*' By this term, I want to mean that the lending policy of the financing organization in the IFS is arranged in such a way that, borrowers first of all must deposit in order to be qualified for a loan. It creates a mutual obligation between the lenders and borrowers. The SCI

owners are bound to fulfill their obligation by depositing savings with the bank. Once customers comply with this condition, as rule the bank gives loans to them. This system makes the SCI owners conscious of making proper use of their borrowed funds. It also develops initiative among SCI owners to work hard and to be sincere in dealing with bank loans and encourages them to save more as they need to repay the loans after a certain period of time. The amounts of loans are of course higher than the savings that SCI owners deposited with the bank. The obligation of the bank is looked from the standpoint that they become more vigilant to observing that the loans are being properly utilized, failure of which might cause a great financial loss to them. Thus, it is concluded that the Bai-Muajjal lending policy of the Islamic Financing System through developing saving habits creates mutual obligations between the lenders and borrowers.

CONCLUSION

In conclusion it may be said that as seen above the spending habits of the people in rural Bangladesh are habits influenced by *societal institutions* (Alam 2000, 2002) such as family/clan, religion, country culture etc. Since a major portion of rural savings is not used in productive purposes, it brings economic misery in a society and contributes towards intense poverty among rural people. A least developed country like Bangladesh is in need of an organization-based guide to safeguard the rural savings and to make use of these idle funds. Since many rural poor are not aware of the proper utilization of their savings, the institutionalization of saving habits through the Bai-Muajjal mode of lending procedure, educate them to spend their savings towards productive venues. It is thus, apparent from the above discussions that the Bai-Muajjal mode of Islamic banking finance is a unique means of institutionalizing and developing saving mentality among the rural-based small and cottage industry owners and mobilizing their savings towards productive purposes.

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