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### **Qardhul Hasan Principles Applied to Micro Finance Facilities**

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#### **Abstract**

*During the last ten years, several developing Muslim countries experienced an interesting phenomenon. Where they are able to build his country's economy through the economic empowerment of small communities. The role of microfinance institutions cannot be denied. Through microfinance programs, the country can further improve the welfare of the poor and reducing poverty. Accordingly, Muslim countries have to combat it by using religious institution and culture. In this case, the role of Qardh al Hasan, as traditional Islamic financing in tackling of poverty is very relevant and important. Qardh al Hasan is supposed to be an important to investigate and provide much needed social service to the poor effectively. The Qardh al-hasan is one of financing-product provided by microfinance institutions. Unlike other financing products, the qardhul-hasan has some unique characteristics, including to entertaint a very specific customers who might be categorized as the dhuafa' group. The purpose of this paper is to show how microfinance programmes based on Qardh al Hasan financing principles can be established.*

*Keywords: Qardh al Hasan, Micro Finance*

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## 1. Introduction

Microfinance grew out of experiments in Latin America and South Asia, but the best known start was in Bangladesh in 1976, following the wide-spread famine in 1974. Many experts argue that the microfinance movement has helped to reduce poverty, improved schooling levels, and generated or expanded millions of small businesses. The idea of microfinance has now spread globally, with replications in Africa, Latin America, Asia, and Eastern Europe, as well as richer economies like Norway, the USA, and England.<sup>3</sup> Among the features of microfinance is disbursement of small size loan to the recipients that are normally micro-entrepreneurs and the poor. The loan is given for the purpose of new income generating project or business expansion. The terms and conditions of the loan are normally easy to understand and flexible. It is provided for short term financing and repayments can be made on a weekly or longer basis. The procedures and processes of loan disbursements are normally fast and easy. Additional capital can also be given after the full settlement of the previous loan. Microfinance is an alternative for micro-entrepreneurs, which are normally not eligible or bankable to receive loans from mainstream financial institutions.

The emerging of Islamic financial institutions in 1970s also led to the establishment of Islamic microfinance institutions in several Muslim countries. Therefore, Islamic microfinance institutions seem to be an institutional economics surrounded by a “fashionable aura” in Muslim countries: where Islamic banking institutions, conventional bank, MFIs, and Islamic MFIs NGOs are very interested in their fighting to solve the poverty issue. They works very intensely when it comes to fighting poverty.

While models of microfinance vary in terms of exact features, they are invariably characterized by an overwhelming concern for the welfare of their members and clients. Profit seeking is seen as a means to ensure sustainability and not as end in itself. While Shariah distinguishes between commercial and benevolent transactions and provides an elaborate framework for both kind of transactions that would ensure their freedom from *riba*, *gharar* and other prohibitions, some activities of microfinance institutions may not even involve contractual arrangements and stipulations and would call for a benevolence-driven framework rather than a prohibition-driven framework.

Where contracts form the basis of activities of microfinance institutions, the distinction between microfinance and commercial banking should be clearly recognized in product development efforts. Many of classical Shariah-nominate contracts have been modified by contemporary Islamic jurists to suit the needs of mainstream commercial banks. Arguably, these commercial banking products may not be appropriate for microfinance, given the points of difference between the two. Islamic microfinance product development would be a natural response to the unique needs of this sector, even while this remains a major challenge for this sector (Obaidullah and Khan 2008). A recent study by CGAP (Karim et al 2008) indicates that the industry lacks a profound degree of product diversification and most firms offer only one or two *Sharia*-compliant products. Another recent study (Obaidullah 2008) on microfinance in three IDB member countries, Turkey, Bangladesh and Indonesia notes that while there may be a multitude of Shariah-compliant modes of microfinance, it is important to take note of their

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<sup>3</sup> Abdul Rahim Abdul Rahman, *Islamic Microfinance: An Ethical Alternative to Poverty Alleviation*, Humanomics Vol. 26 No. 4, 2010, p.284

comparative features to identify the ones that are practically and operationally more suitable than others. This paper aims to focus on different issues, how to maximize the potential of microfinance institution from *Qardh Al Hasan* as one of their products in alleviating poverty and improve people's welfare.

## 2. Principle and Legality of Qardh Al Hasan (Benevolent Loans)

Islam allows loan as a form of social service among the rich to help the poor and those who are in need of financial assistance. Loan in Islam may be obtained in two ways: (i) Loan with condition of repayment, and (ii) gratuitous loan without any compensation or gift. However, Islam does not recognize any loan with interest for the benefit of the debtor. It only recognizes gratuitous loan or better known as *al-Qard al-Hasan*. *Al Qardh Al Hasan* transaction is mentioned and encouraged in many places of the *Qur'an* and the *Sunnah*

*“Who is he that will lend to Allah a goodly loan so that He may multiply it to him many times, And it is Allah that decreases or increases (your provisions), and unto Him you shall return on the Day of Resurrection”*<sup>4</sup>

In this verse Allah equate good deeds and charity gift with loan property, and equate the gain with debt payment because the people doing good or something to get replacement so as resemble to those who lend something to get return.<sup>5</sup>

*“.....and lend to Allah a good loan...”*<sup>6</sup>

There are several meaning for word of *al qardh al hasan* in this ayah. First, it means Zakah. The second is Shadaqah.<sup>7</sup>

*“Verily, those who give Sadaqat, men and women, and lend Allah handsome loan, it shall be increased manifold (to their credit), and theirs shall be an honorable good reward”*<sup>8</sup>

Al Qurtuby said about this verse, *Shadaqah* and giving *fi Sabilillah*. Al Hasan said that every word of *al qardh al Hasan* in Al Qur'an mean *Tathawwu'*, or recommended not compulsory.<sup>9</sup>

*“...and perform Salah and give Zakah and lend to Allah a handsome loan.....”*<sup>10</sup>

Umar ibn Khattab said giving in charity.<sup>11</sup> Ibn katsir said, charitable donations. For verily, Allah will reward for this the best and most abundant of rewards<sup>12</sup>

<sup>4</sup> Qur'an,2:245, 11:57

<sup>5</sup> Abdullah Muhammad At Thayyar et.al, *Al Fiqh Al Muyassar*, 2004, Madar al Wathan Li An Nasyr, Riyadh, KSA,p.154

<sup>6</sup> Qur'an, 5:12

<sup>7</sup> Ibnu Al Jauzy, *Zaad al Maysir fi 'Ilmi at Tafsir*,1964, Maktabah al Islamy li at thiba'ah Wa an Nasyr, Damasqus, 2/312

<sup>8</sup> Qur'an, 57:18

<sup>9</sup> Al Qurtuby, *al Jaami' li Ahkam al Qur'an*,1976, Wizaarah at tsaqaafah, al Qahirah,17/252

<sup>10</sup> Qur'an, 73:20

<sup>11</sup> Al Mawardy, *an Nukat wa al Uyun Tafsir al Mawardy*, 1982, Wizaarah al Auqaf wa As syu'un al Islamiyah,4/339

Loans are permissible on Sunnah tradition, as well as consensus of the muslim community<sup>13</sup>

In this regard a few of Hadits strengthen the legality of *al Qardh al Hasan* including hadiths narrated from Imam Moslem from Abu Rafi' Radhiyallahu 'Anhu, that Rasulullah borrowed a young camel, and then received a charity of camels and ordered Rafi' to repay the man an other young camel. Rafi' said that the closest he could find was a six year old camel (which is more valuable ). Then Rasulullah ordered him to give it to the man, and added "*the best among you is the one who is best in repaying his debts*"<sup>14</sup>.

Narrated on the authority of Ibn Mas'ud that Rasulullah (pbuh) said, "*Every two loans extended by a muslim to another count as one charitable payment*"<sup>15</sup> In another hadith reported by Abu Hurairah Radhiyallahu 'Anhu, Rasulullah Shalla Allahu Alaihi said, "whoever relieves a believer from a difficulty in this world, Allah will relieve him from his difficulty and Allah will facilitate him in this world and world hereafter."<sup>16</sup>

The above Qur'anic verses and *Ahadith* directly and indirectly encourage the Muslims to give *Qardh al-hasan* and which will increase their credits in manifold and bring forgiveness for them.

### Definition of Qardh Al Hasan (Loans)

Literally, *Al Qardh Al Hasan* consists of two syllables. *Al Qardh* and *Al Hasan*. First, the word "*qard*" etymologically is derived from Arabic "*qirad*" or *qaradha asy syai – yaqridhuhu* which means 'to cut'<sup>17</sup> It is called qard, as it cuts certain part of the lender's property by giving loan to the borrower or signifying that the person extending the loan is giving the borrower part of his property.<sup>18</sup> *Hasan* is also an Arabic word, which originates from '*ihsan*'. *Al Hasan* etymologically means good or beauty opposed from bad or ugly.<sup>19</sup>

Ihsan means kindness to others. So, hasan is an act which benefits persons other than those from whom the act proceeds without any obligation. The term *al-qard al-hasan* means beneficial loan or benevolent loan, gratuitous loan, interest free loan, beautiful loan, etc.

Terminologically, Qardh is giving property to someone who will take advantage and repayment at a later time<sup>20</sup>. Thus, etymogically, *Al Qardh Al Hasan* means someone cut the right of others with kindness.<sup>21</sup>

The Hanafis define the contract legally as one in which a fungible property is paid from one party to another, in exchange for a later payment of an equivalent amount.<sup>22</sup> The Malikis interpret Qardh is property issued to *taqarrub* to Allah, then used by someone else and returned

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<sup>12</sup> Ibn Katsir, *Tafsir al Qur'an al Adhim*, 2000, Maktabah auladi asy Syekh li at Turats, 14/173

<sup>13</sup> Ibnu Qudamah, *Al Mughni*, Dar al Kutub al 'Ilmiyah, Beirut, 4/313

<sup>14</sup> Narrated by Muslim

<sup>15</sup> Narrated by Ibnu majah, Ibn Hibban in His Shahih, asa well as Al Bayhaqi

<sup>16</sup> Narrated By Muslim

<sup>17</sup> Fairuz Abaadi, *Al Qamus al Muhith*, 1993, Muassasah ar Risalah, Beirut, p.840, Ibnu Mandzhur, *Lisan al Arab*, undate, Dar Lisan al Arab, Beirut, 3/60

<sup>18</sup> DR. Wahbah Az Zuhaily, *Al fiqh wa adilatuhu*, 2003, Dar al Fikr, Libanon, 4/370

<sup>19</sup> Al Azhary, *Tahdzibu Al Lughah*, undate, 8/341, see Muhammad Nuruddin Urduniyah, *al Qardh al Hasan Wa Ahkamuhu Fi al Fiqh al Islami*, 2010, Jamiah an Najah al Wathoniyah, Nablus, Palestine, p.8

<sup>20</sup> Muhammad Amin ibn Abidin, *Hasyiyah Ibnu Abidin*, II/1386 H, Matbaah Musthafa al Halabi, Mesir, IV/171

<sup>21</sup> Muhammad Nuruddin Urduniyah, *al Qardh al Hasan Wa Ahkamuhu Fi al Fiqh al Islami*, 2010, Jamiah an Najah al Wathoniyah, Nablus, Palestine, p.12

<sup>22</sup> Ad Dasuqy, *Hasyiyah ad Dasuqy*, Dar Al Fikr, Beirut, 3/22

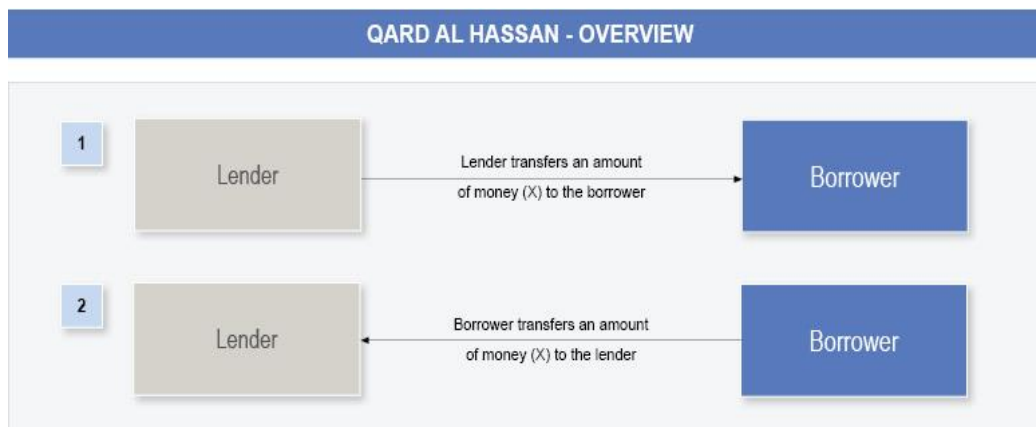
as the origin of such property<sup>23</sup>. Meanwhile, Syafi'i's define qardh as ownership of property that will be returned in the future. Such as, because the borrower cut off a part of debtor property.<sup>24</sup>

From some meaning *al-Hasan al Qardh* as mentioned by the fuqaha, it can be concluded that Al Qardh Hasan in fiqhiah is a contract that gives the property and obligation to one and return those assets and liabilities, as a form of tabarru 'and approach to Allah .<sup>25</sup>

However, in modern economic terminology, *al-Qardu al-Hasan (benevolent loan)* is a loan granted on the basis of mere social obligation, in this case the borrower is not required to return anything except loans (Perwataatmadja dan Antonio, 1999). The nature of the *al- qard al- hasan* is not financial benefits (Antonio, 2001). M. Umer Chapra has given the definition of *Qard al Hasan* as: "*Qard al-hasan is a loan which is returned at the end of the agreed period without any interest or share in the profit or loss of the business.*" *Qard al-Hasan* is "An interest-free loan given mainly for welfare purposes. The borrower is only required to pay back the amount borrowed."<sup>26</sup>

Therefore, qard al-hasan is a kind of gratuitous loan given to the needy people for a fixed period without requiring the payment of interest or profit. The receiver of qard al-hasan is only required to repay the original amount of the loan.<sup>27</sup> In practice, the *qard al hassan* is used for short-term bridging financing and social welfare.

Figure 1



### Objectives of Qardh al-Hasan

<sup>23</sup> Al Qarwany, *Kifayah ath Tholib Ar Rabbani*, Maktabah ats Tsaqafah al Diniyah, al Qahirah, 2/455

<sup>24</sup> Asy Syarbiny, *Mughni al Muhtaj ila Ma'rifah Ma'ani al Alfadz al Minhaj*, Mathba'ah al Baby al Halabi, Egypt, 2/117

<sup>25</sup> ibid

<sup>26</sup> A Glossary of Islamic Economic Terms, see Dr. Mohammad Omar Farooq, *Qard al-Hasan Applications and Misapplications of Some Concepts in Islamic Banking*, paper was presented at Harvard Islamic Finance Forum, April 19-20, 2008

<sup>27</sup> M. Umer Chapra, *Towards a Just Monetary System*, 1995, The Islamic Foundation, UK, p-68

Islam emphasizes to make brotherhood among the Muslims. The main principle of brotherhood is to care and share each other. *Qardh al-hasan* being a gratuitous loan can help the fellow Muslim brothers who need money but they do not have. Thus, qard al-hasan enhances brotherhood among the Muslims. The main objectives of *qardh al-hasan* are:

- a. To help the needy fellow people.
- b. To establish better relationship among poor and the rich.
- c. The mobilization of wealth among all people in the society.
- d. To perform a good deed that is encouraged and appreciated by the Almighty Allah and His messenger.
- e. To strengthen the national economy.
- f. To facilitate the poor to create new jobs market and business ventures by using their merits, skills and expertise.
- g. To establish a caring society.
- h. To eradicate poverty and unemployment problem from the society.
- i. It can be also a missionary work for da'wah activities by giving qardh al-hasan to the non-Muslims, who might be attracted by knowing the beauty of Islam.
- j. It can remove social and economical discrimination from the society, and
- k. Finally, obviously there is a great reward in the Hereafter for giving *qardh al-hasan*

### **Qardh al Hasan Framework**

*Qardh al Hasan* is a virtue/ soft loans without compensation, usually for the purchase of fungible goods that can be estimated and replaced according to weight, size, and amount. In the classical fiqh literature, qardh categorized in *aqd tathawwu'* or contract help each other rather than commercial transactions. *Qardh al Hasan* on Islamic banking is one of the instruments of the contract *Tabarru'*. *Tabarru'* contract are all sorts of agreements relating to non-profit transaction. So in essence, *Qardh al Hasan* is not intended for commercial profit for banks or institutions that use this product. (Adiwarman Karim, 2003).

The object of qardh, usually is money or other currency which is a pure loan transaction without interest when the borrower get cash from MIF and is only obligated to return the principal debt at a certain time in the future. Borrowing on its own initiative to restore greater as gratitude. This contract is primarily used by the IDB. When providing soft loans to the government. This service costs are generally not more than 2.5%, and so far range between 1-2%.(Ascarya, 2007)

As the work patterns of *Qardh al Hasan* instruments in effect on the general Islamic Finance Institution, at least there are some things that need to be highlighted as a background problem of this product Non Performing Loans (NPL) are: The absence of collateral the borrower, the lack of focus on coaching and monitoring intense from the Islamic banking, and products considered as unproductive product.

From identifying the problem, of course the banks will be psychologically companies do not pay more attention to this product. This is because, in principle this product is not a highly profitable product. However, when reviewed according to the background of this issue, precisely

achievements generated if this product can be used in empowering the poor in productive activities, then the banks or institutions concerned to assess the prospective entrepreneur from the beginning that can be funded from other commercial products such as contract sale and purchase as well as cooperation in Islamic banking. Therefore, it is necessary to formulate new strategies to optimize the function of this product and minimize the risk of its NPL.

### 3. Few Example of Qardh ul Hassan in Micro-finance Facilities

#### a. Indonesia

Bait at Tamwil Muhammadiyah ( BTM ) Pekalongan, Middle Java

BTM operates Qardh al Hasan's fund from membership funds twigs and mosques Muhammadiyah. In 2009, funds collected amounted to Rp.52 billion. Of that amount 95% is channeled to these types of commercial financing and a number of 5% or Rp.2, 5 billion is channeled through financing qardh al Hasan. Technically, the distribution system with the systems group, with a mechanism of joint responsibility, if there is failure to return within a group becomes a shared responsibility. The target of program are Muhammadiyah members who have the KTA, then the community, and sympathizers who have small businesses. Funds are disbursed as working capital or purchase of working equipment. The use of working capital and working equipment a priority, and return no more than is acceptable. Besides Business, Qordh al Hasan Financing facilities by BTM is for education and health also.

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- Baitul Mal Wa at Tamwil (BMT ) Beringharjo, East Java

BMT Beringharjo operationalize Qardh al Hasan through empowerment of the poor with Partisipatory Rural Appraisal (PRA) approach:

#### 1. SIM (Sahabat Ikhtiar Mandiri) approach.

This method adopted from AIM (Amanah Ikhtiar Malaysia) for strengthening of capital business productive. The object is mustahiq eligible orphans with the designation of priority development needs of business and life .The location of the program and target beneficiaries are the poor/ orphans in the city of Yogyakarta and surrounding areas this program been in effect since 1995 and until now has helped ± 2000 people poor. Until now Baitul Maal Beringharjo BMT has conducted mentoring 4 groups, namely SIM Argodadi, Jlagran, SIM Kota Gedhe and SIM Prawirodirjan. Each SIM group consisted of 10 members. Development carried out in accordance with the agreement of at least 2 weeks.

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#### 2. SIMASPUNG (Sahabat Ikhtiar Mandiri Masuk Kampung) Approach.

Through SIMASPUNG Program, Qardul Hasan funds was given Rp. 300.000, to each grup. The highlight of this program is the economic empowerment of orphans who are the group with responsibility renteng system. Each groups between 15-12 people. The groups that have accompanied the group Purbayan, Pilahan, Prenggan, Karangasari, Balirejo, barking, Sewon, Brontokusuman, Dipowinatan, Patehan, Mangkuyudan, Ngadinegaran, and Sorogenen Nitikan.

The program is the product of *Qordh al Hasan*. Until now people who have felt the benefits of about 2131 people with money loaned to reach ± Rp. 502.021.700,- Empowerment is accompanied by a coaching group with the spiritual treatment, management treatment, and technology treatment.

### 3. Syariah Microfinance Community Based (Misykat ) LAZIS Darut Tauhid West Java.

Syariah Microfinance Community Based (Misykat) is one of empowerment Zakat productive from Lazis DPU-DT. This program adopted from the Grameen Bank in Bangladesh who coined by Nobel laureates Muhammad Yunus. Economic empowerment given to small entrepreneurs (who are qualified, among them a month to have incomes of less than 500 thousand Rupiah and could read the Qur'an) in the form of venture capital, which is given in the group. One group consisted of 5 people who then subdivided into 2 people, 2 people and 1 person as the head of the group. Venture capital given to 2 people first, then later take turns in accordance with the installment agreement. So this system is also often known as a revolving fund 2-2-1. DPU-DT Misykat program takes approximately 3 years to produce independent villages and timeless money from the *Qardh al Hasan*'s fund; divided into six semesters. Each semester all groups has right to bring the desired loan business capital. And every week all group members must pay in installments and the training materials provided.

#### b. Malaysia

##### AIM Loan Schemes

When it was first started, AIM offers the following loans:

##### i. Ikhtiar Loan Scheme 1 (Skim Pembiayaan Ikhtiar 1 – SPI 1)

SPI 1 provides loans to poor households with average monthly income of not more than RM340 (1998-2002) or two third of poverty line income. Initial loans are up for a maximum of RM1,000, increasing to RM2,000, RM3,000, RM4,000 and RM4,900. The loan repayment period is between 50 weeks to 100 weeks.

##### ii. Ikhtiar Loan Scheme 2 (Skim Pembiayaan Ikhtiar 2 – SPI 2)

SPI 2 loan scheme provides loans between RM5,000 to RM9,900 to borrowers who have made good repayment from the previous two loans and having a monthly income exceeding RM600 (2003) The repayment period of the loan is between 50 to 150 weeks.

##### iii. Ikhtiar Loan Scheme 3 (Skim Pembiayaan Ikhtiar 3 – SPI 3)

SPI 3 provides loans up to RM10,000 to borrowers with good track record with perfect repayment for at least 2 loans (SPI 1) or SPI 2 and having a monthly income exceeding RM1,000. The loan could be repaid up to a maximum period of 150 weeks.

##### iv. Single Mother Loan Scheme (Skim Ibu Tunggal - SKIT) and Fisherman Loan Scheme (Skim Nelayan – SKIM)

SKIT provides loans to single mothers living in town areas. The aims of the scheme are to increase the living standard of single mothers and motivate them to undertake stable economic activities to support the family. Eligibility for the loans depends on the household earnings and varies within states. Household earnings for those living in Kuala Lumpur and Johore must not exceed RM1,200; Selangor, Malacca and Negeri Sembilan RM800 per month; Kelantan, Terengganu and Kedah RM425 per month; and Perak RM600 per month. As for SKIN, source of



fund came from Fisherman Development Authority of Malaysia (LKIM). These loan schemes actively disbursed for eight years, from 1998 (RM 597,987) until 2005 (RM 4,193,248).

iv. Special Loans – Emergency, Education Loan and Housing Loan

In addition, special Education loan Scheme up to RM1,000 with maximum loan period up to 50 weeks, since 1990 (RM 13,997) until today (total amount approved until 2008 was RM 8,816,050). As for Housing Loan Scheme (since 1991 until today), the amount approve will be up to RM5,000 with maximum repayment period up to 100 weeks are available to borrowers with good repayment record. Until 2008, total amount of loan approved was RM 3,708,194. Compare to these two special loans, Emergency Loan Scheme only last until 2000 (RM 10,349).

AIM has an overall good repayment rate of about 95 percent from its loan programmes, while its portfolio at risk (PAR) stood at 5.39 percent (AIM, 2008). In 2001, 2002, and 2003 its repayment rates were at 96.5 percent, 95.5 percent and 95.3 percent respectively. The set-back was due to the Single Mother Loan Scheme (SKIT) which contributes to its poor performance of collection of about 36% and also from Fisherman Loan Scheme.

AIM has introduced new schemes (Skim Pembiayaan Ikhtiar-SPI), grouped into economic, social and rehabilitation. The economic loan consists of I-MESRA, I-SRIKANDI and I-WIBAWA. In I-MESRA scheme maximum loan up to RM20,000 but the starting loan for the new borrower is RM2,000 and the repayment period of the loan is between 25 to 150 weeks. Similarly, in I-SRIKANDI scheme minimum loan is RM2000 and maximum loan is RM20,000 and the loan repayment period between 25 to 150 weeks and the I-WIBAWA scheme provides loans up to RM5,000 and the loan could be repaid up to a maximum period of 6 months. In contrast, the social loans consist of I-BISTARI and I-SEJAHTERA. The I-BISTARI scheme provides loan of RM5,000 and the loan repayment period between 50-100 weeks. On the other hand, the I-SEJAHTERA provides loan up to RM10,000 and the loan repayment period between 50 to 150 weeks. Lastly, the rehabilitation loan, known as I-PENYAYANG, offers minimum loan is RM1,000 and maximum loan is RM5,000 and the loan repayment period between 12 to 50 weeks( Table 1.1).

Table 1; AIM Loan Schemes, Maximum Limit and Repayment

Loan Schemes	Maximum Limit	Repayment period
Ikhtiar Rezeki (Economic Loan)		
i) I-Mesra	2,000 - 20,000	25-150 weeks (weekly)
ii) I-Srikandi	2,000 - 20,000	25-150 weeks (weekly)
iii) I-Wibawa	5,000	6 month (weekly/ monthly)
iv) I-Wawasan	20,000 - 50,000	25-250 weeks (Not exceeding 5 years) (weekly)
(Non-economic Loans)		
Ikhtiar Penyayang	5,000	25 - 150 weeks (weekly)

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ii) Ikhtiar Bestari	5,000	25 (weekly)	-	150	weeks
iii) Ikhtiar Sejahtera	10,000	25 (weekly)	-	150	weeks

Source: Communication with AIM (2009)

### c. Sri Lanka

After the Asian Tsunami swept across the Indian Ocean in 2004 it killed more than 200,000 people and washed away the livelihoods of hundreds of thousands of people in the region. Muslim Aid (MA) used a multi-stage model for provision of finance and other inputs to the farmers. The first stage involves a creative variant of the classical *bai-salam* or "deferred delivery" transaction. Under this mechanism, a farmer was provided funds in advance against a forward sale of his produce at the time of harvest. The funds were used by the farmer to finance purchase of the necessary inputs to start paddy cultivation. Unlike bank financings, no collateral was required from the farmer. Instead, a farmer needed to obtain a set of recommendations from the local mosque and community leaders who acted as guarantors.

The second stage began at harvest time once the agricultural produce was delivered to MA. It involved a partnership between MA and local miller(s) to take possession of the harvested paddy from the farmers, process it and sell the final product at the market with the profit being shared between MA and the miller(s) on the basis of a *mudharabah* partnership. It was expected that the profit share of MA would cover the administration cost of the financing. In order to ensure that the over-all model was a not-for-profit one and that it was also sustainable one, any surplus of profit share over administrative cost was to be used to create a Revolving Fund for the farmers (See Figure 2). Farmers enjoying incremental income were also expected to make *zakah* contributions to this Fund and therefore, adding to its size and ability to provide financing to greater numbers. This was the third stage of the model.

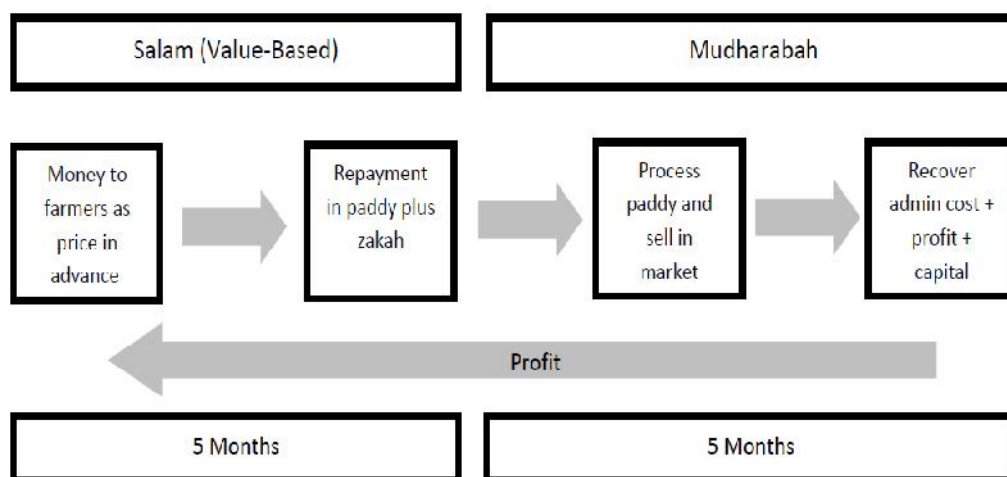


Figure 2. MA Model

The second stage of this project entailed an arrangement between a miller and MA on the basis of a *mudharabah* partnership. The mill owner was recommended from the community and a legal agreement was entered into whereby he would proceed to mill the paddy (that MA had received) and sell the processed paddy at a higher rate (as the price had now increased since harvest time). The financial contribution of MA to the *mudharabah* enterprise was in the form of paddy as *mudharabah* capital plus the processing costs as a *qard* loan. Profits from the business (after repayment of *qard*) were to be shared between both MA as *rabb-al-maal* and the miller as the *mudharib* on an equal basis. Finally in the third stage, after taking back the equivalent of their financing and part of the operational costs, MA then voluntarily proceeded to donate its share of profits to the farmers' associations. All of this was done in a ten month cycle. This can be explained further with a simple working example as follows,

1. Farmer X wants to cultivate 3 acres of paddy.
2. He needs money to prepare and till the land.
3. He intends to take a loan for tilling, fertilizer and seed paddy.
4. Likewise if there are other farmers within his association who would like to take a similar loan, the association will itself apply for the loan on behalf of the farmers.
5. The association can approach banks or in this case it will apply to MA for financing.
6. Assessing the capacity and need, MA will come to an agreement with the farmers association. The amount of financing is agreed so as to pay for tractor charges, seed paddy and fertilizer whilst the farmer provides the labor costs. Some of the tractor charges are kept for expenses related to machine use during harvesting.
7. MA gives the money to the association and the goods and services are procured by the association and disbursed in kind to the individual members.
8. Hence farmer X will get his share of Rs 8470 worth seed paddy, Rs 10,100 worth tractor charges and another Rs 10,100 worth fertilizer in kind as a loan from the association based on his need. Hence his loan from MA is Rs 28,670
9. If the harvest is successful, a minimum of 40-60 bags of rice will be the output per acre. Therefore, a 3 acre land should yield a minimum of 120 bags (40 x3). If the value of each bag is Rs. 900 (approximately \$9), the total value of the yield (120 bags) will be Rs 108,000 (\$1080).
10. However with mutual agreement with the farmers, MA will receive as a loan repayment in kind, paddy at a value of Rs 1000 (\$10) per bag. Hence for farmer X, he will need to repay his loan of Rs 28, 670 which is the equivalent of 28.67 bags.
11. This paddy is now given to the miller on a 50/50 profit sharing basis.
12. Normally the milling cost will be about Rs 100 (approximately) per bag with the miller normally taking a loan (with interest) to purchase and process the paddy into rice, which he then proceeds to pay back after selling the rice. Hence for 28.67 bags it would cost approximately Rs 2867 to process.
13. Processing / milling 28.67 bags of paddy will give on average 1260 kg of rice. If it is sold at Rs 32 (price as in May, 2007 against the current market price of Rs 65 per kg) the total turnover will be Rs 40,320.
14. The cost of production (investment from MA + processing costs) is Rs 31,527. Therefore the profit (turnover – cost of production) is Rs 8800 (approx). MA and the miller will

share a profit of Rs 4400 each. This is sufficient for MA to cover the operation cost of the project.

15. If all farmers have paid back the loan, a percentage of profit may go to them when MA passes on the surplus to the farmers' association to strengthen its funds position and which can be subsequently used to meet basic needs of its members

d. **Iran**

*Qardh al Hasan* Funds are operating in the Iranian informal financial sector for the past two to three decades. It is estimated that currently more than 3000 funds of these types operate in urban and rural areas of the country. *Qardh al Hasan* Funds can be divided into at least four categories: Family *Qard Hasan* Funds, Workplace *Qard al Hasan* Funds, Community or Village *Qardh al Hasan* Funds and large *Qardh Hasan* Funds. In principle, all forms of *Qardh al Hasan* Funds are non-profit institutions in which members of a community set up a savings and loans society. Members deposit their savings with the fund in order that other members who need some loan for a short period could be helped from this fund.

This is a mutual support fund — a depositor at one time may become a borrower at another time and vice versa. Members are free to withdraw some or all of their deposits if and when they want (or at short notice). No depositor demands or receives any amount in addition to his/her capital. As the members are known to each other and trustworthy, there is no room for default on loans. The operations of the society are run by volunteers, using some free office space. Other overheads, such as, costs for stamps, stationery, transport, communication and so on are covered, in some *Qardh al Hasan* Funds, through engagement of funds in business activities. In most of the others, the borrowers have to pay the costs.

Therefore, even though the capital is cost-free the loan is not. It is *riba*-free but not cost-free. Most of *Qardh al Hasan* Funds only accept current and saving deposits. Similar to banks, the current deposits can be withdrawn at any time. The checks issued by *Qardh al Hasan* Funds, however, are not official and legally viable and only some other Funds accept these types of checks. Saving deposits are deposited by individuals or companies. These are the most common type of deposits in *Qardh al Hasan* Funds. Studies show that the average amount of saving deposits in *Qardh Hasan* Funds is larger than those of banks. Loan applicants of *Qardh al Hasan* usually request loans for needs like marriage, health, or housing. Depending on the size of the loan and borrowers' ability to pay, borrowers have between 1 to 2 years to repay the *Qardh al Hasan* loans. To be eligible for a *Qardh al Hasan* loan, a borrower must be in urgent need, have at least one referee or guarantor, and demonstrate sufficient evidence to repay the loan. The total amount of loans provided by *Qardh al Hasan* Funds have been estimated to be much more than those provided by the commercial banks in Iran.

#### **4. The Sharia Issues in Qardh al Hassan Micro-financing**

The different Islamic financing methodologies are applicable according to the nature of commodity/business and the period for which the project will be financed. Before detailing the principal Islamic financing practices, however, we should remember that such methodologies are founded on the core belief that money is not an earning asset in and of itself. There are some general principles that are of particular importance for Islamic, or perhaps more precisely termed “*shariah* compliant”, finance and these include:

- There must be some risk, whether funds are used in a commercial or productive venture.
- A financial transaction needs to have a “material finality”, that is, it should be directly or indirectly linked to a real, tangible economic activity as opposed to financial speculation.
- The product or service that is bought or sold must be clear to both parties.
- There should be no funding of *haram* or sinful activities such as the production of alcoholic beverages or gambling, and funds should preferably finance socially productive activity. In broad terms, Islam forbids all forms of economic activity, which are morally or socially harmful.
- Financial risk must lie solely with the lenders of the capital and not with the manager or agents who work with the capital. Furthermore, a financial transaction should not lead to the exploitation of any party in the transaction.
- Interest is forbidden in that it is a predetermined, fixed sum owed to the lender irrespective of the outcome of the business venture in which the fund is used. This does not imply in any way that capital is free of charge or that it should be made available without any cost or that there should be absolutely no return on capital. Rather, a return on capital is allowed, provided that capital participates in the productive process and is exposed to business risk.
- It is not permitted to sell what one does not own – therefore “short-selling” (selling something that one does not own in the hope that it can be bought cheaper at a later date) is impermissible

In such loans the borrower should only repay the principal, although certain scholars allow the lender to cover the administrative costs incurred in disbursing the loan as well. The service charges are not profit, they are actual costs in respect of such items as office rent, salaries, stationary, etc. Islamic law allows a lender to recover from the borrower the costs of the operation over and above the principal. However, an important condition attached to such charges to prevent them becoming equivalent to interest is that the commission or charge cannot be made proportional to the amount or to the term of the loan. In practice, such service fees are frequently in the range of 2-4% of the loan amount (for example the Islamic Development Bank Jeddah in Saudi Arabia charges 2-3% Hossain 2002). Importantly, this figure is arrived at after due calculation of administrative costs actually incurred rather than an assumed percentage. Banks in Pakistan are authorised to provide loans on the basis of service charges that are considered permissible under *shariah* provided they are not related to the amount of the loan and are related to actual administrative expenses. In Pakistan, the maximum service charge on loans for a given period is calculated using the following formula (from Ahmad 1993):

Service charge:  $(E/A) \times 100$

Where

E: administrative expenses during the year

A: average assets during the year

MFI provides funds for covering the processing cost through a *qardh* loan that is recovered before profits are calculated and distributed between both parties as per pre-agreed ratio. Thus there is creation of additional value or wealth and its equitable sharing among both the parties. A for-profit mechanism is combined with non-profit financing to provide sustainability to the overall model. In the final stage MFI donates the surplus if any, back to the customer cooperative to create a Revolving Fund to cater to basic needs and provide a safety net

to members. The costumers themselves contribute *zakah* to the Fund from their augmented income. The Fund is expected to mature into a Takaful Fund that can provide micro-*takaful* to its members against unforeseen adversities on an on-going basis.

In a composite model as above the first and foremost requirement for Shariah compliance is that the terms of the contracts must be clearly and objectively stated and understood by the parties and there must not be any element of interdependence between the contracts. It is important to move from verbal arrangements (that is quite common in a rural setting of a microeconomy) to written contracts. Each contract must be independent of the other in terms of rights and obligations of the parties. For example, if the MFI dons two hats - of a *rabb-al-maal* (capital provider) in the *mudharabah* partnership - and of a lender to the *mudharabah*, the rights of MFI being repaid the *qard* loan amount in full is independent of its share in profits or losses.

There are also several sharia issue in Qardh al Hasan Micro financing as fallow :

### ***Use of Qardh Financing***

The use of *qardh hasan* in a correct manner and acceptable by the *Shari'ah*, would definitely benefit contracting parties. However, if it is inappropriately used, it would potentially create problems, which may tarnish the image of the Islamic financial system. Among the issues that may arise are:

1. Whether *qardh hasan*, in its true meaning, implies the need to be repaid or otherwise;and
2. Since Islamic micro finance institutions offer financing by utilizing customers' deposits who expect returns, the use of *qardh hasan* as a mode of financing is deemed to be inappropriate. This is because *qardh hasan* is not meant to generate profit, rather it is benevolent or *tabarru at* by nature. (Resolution Shariah Advisory Council, Central Bank of Malaysia. The Council, in its 51st meeting, held on 28th July 2005 / 21st Jamadil Akhir 1426, resolved that the word 'hasan' should be taken out after the word 'qardh', implying that qardh is an obligation for borrowers to repay their loan to lenders.)

### ***Borrower can pay an extra if not stipulated by the contract***

A loan contract between two parties for social welfare or for short-term bridging finance. Repayment is for the same amount as the amount borrowed. The borrower can pay more than the amount borrowed so long as it is not stated by contract. Most Islamic banks provide interest-free loans to customers who are in need. The Islamic view of loans (*qard*) is that there is a moral duty to give them to borrowers free of charge, as a person seeks a loan only if he is in need of it. Some Islamic banks give interest-free loans only to the holders of investment accounts with them; some extend them to all bank clients; some restrict them to needy students and other economically weaker sections of society; and some provide interest-free loans to small producers, farmers and entrepreneurs who cannot get finance from other sources.<sup>28</sup>

***Only one type of loan, qardh al hasan, is permissible, which must not accrue any direct or indirect benefit to the lender***

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<sup>28</sup> The Board of Advisors of Islamic Finance Institut includes, among others, Dr. Monzer Kahf, Dr. M. Nejatullah Siddiqi, Abdulkader Thomas, and so on. <http://www.islamicfinancetraining.com/glossary.php>

According to Islamic principles, only one type of loan, *Qardh al Hasan* (lit. good or benevolent loan) is allowable. Under the concept of *Qardh al Hasan*, the lender may not charge interest or any premium above the actual loan amount. Some Muslim jurists state that this restriction includes directly or indirectly any benefits associated with the loan: ‘...this prohibition applies to any advantage or benefits that a lender might secure out of the *qardh* (loan), such as riding the borrower’s mule, eating at his table, or even taking advantage of the shade of his wall.’<sup>29</sup>

***The lender can charge some service fee to cover the administrative and transaction costs***

*Qardh al-Hasan* are loans with zero return that the Koran encourages Muslims to make to ‘those who need them.’ IFIs are allowed to charge a service fee to cover the administrative and transactions costs of these loans so long as such costs are not related to the maturity or amount of the loan. And may make interest-free loans (*qardh al hasan*) either as a charitable activity or as a favor to customers, lawfully charging for the actual costs of its services in providing such loans, but not for the opportunity cost of the money.<sup>30</sup>

***The Qardh must be paid back on demand by the creditor***

A Qard is a loan, free of profit. We use this arrangement for our Current Accounts. In essence, it means that your Current Account is a loan to the bank, which is used by the institution for investment and other purposes. Obviously it has to be paid back to you, in full, on demand.<sup>31</sup>

## **5. Remodelling Qardh al Hasan Realization Form for Micro Finance Institution**

*Qardh al Hasan* generally categorized as loan without compensation that allows borrowers to use these funds for a certain period and return in the same amount at the end of the agreed period. If the borrower suffered a loss not due to negligence, the loss may reduce the amount of the loan. Source of *Qardh al Hasan* funds comes from external and internal. External comes from donations and charity, internal sources come from Institution as well as halal income.

This product allows the disbursement of fresh funds to the poor (orphans) and included in *mustahiq* or are eligible to receive zakat as the capital for productive businesses with loan amounts are also adjusted to the capacity of its business. Usually Islamic Finance Institution (IFI) provide restriction on the amount and duration, it is meant as a process to revolving *Qardh al Hasan* Fund, so can be rotated back to other *mustahiq*.

Micro business as targeted disbursement of funds through product *qardh al Hasan*. Many positive effects that will be received by the Micro Finance in conducting this virtue, but also there is little negative.

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<sup>29</sup>based on fatwa of the Shariah advisory board of al-Rajhi Bank, dated April 2001 (<http://www.takaful.com.sa/m1sub2.asp>)

<sup>30</sup> referring to Cf. decision 1, third session (1986), Fiqh Academy Journal (fatwa specifically for the Islamic Development Bank)

<sup>31</sup> The Supervisory Board of the Islamic Bank Of Britain included Sheikh Muhammad Taqi Usmani (retired from the Board in 2002), Sheikh Dr Abdul Sattar Abu Ghuddah Sheikh Nizam Muhammad Seleh Yaqubi. (<http://www.islamicbank.com/islamicbanklive/islamicTerms/1/Home/1/Home.jsp>)

Some of the positive effects that may result from use of these instruments by the MFI or institutions, such as the first the imaging community and customers to the performance of the MFI as an institution that can provide assistance in improving the economic wealth for the poor. Second, MFIs from scratch can forge the candidates of potential customers who could be assisted through commercial financing products owned, having been tested at the moment customers are enjoying the product *qardh al Hasan*. Generally, our loyal customers will show a good collectability that MFIs can help from a small initial amount (Qardh al Hasan) to the number of large (commercial financing). Third, if *qardh* fund management is done properly, this will encourage the desire of others to entrust *Muzakki* to be managed by MFIs. Fourth, the trust of stakeholders will further increase as MFIs can do business in a good afterlife and can provide benefits to the region. Fifth, indirectly, the promotion of products MIF will be helped by customer *qardh al Hasan*.

However, these products can be categorized as a product that has less attention because does not provide profit as other products in the concept of profit and usually on the application often leads to bad credit showing inability to pay back these products to the MFI. Therefore, it needs refreshed model that can trigger improvements in the application of this product so that the least able to present a positive effect as the above expectations.

Remodelling in this case is not intended to reconstruct *qard al hasan* definition that already exists, but the pattern *qardh al Hasan* realization that can be identified with the financing pattern of MIF in order to empower people and maximize *qard al hasan* function in IFI.

In MIF framework that studied, was found as general effective pattern in the development of micro businesses with methods of optimizing the economic function of MIF, which use a coaching model specifically for beginners and micro businesses as a basis for beginning to introduce industrial systems that can be developed later through capital of commercial funds. The model is when converted to MIF lending system can be described in the following stages.

First, The MIF provides funds of *qardh al Hasan* on submitting the loan with the identification; the funds as needed and for productive enterprise (if the proposed beginning to the business consumer). The Second, MIF provides fund management guidelines for consumer business. The third step is to provide specific guidance for the management of productive funds of the *qard al hasan* product. The next, evaluate the results of operations and governance of the effort. And the last step is MIF provides the trading house facilities for productive fund administrators.

The steps mentioned above, need to be supported with the creation of a committee or separate division for this *qardh al Hasan* fund management or can be integrated in the MIF financing division that has now been started and more popping up in some islamic countries.

With these measures and the factors supporting this particular division, it will open new opportunities for the creation of micro entrepreneurs which will be financed by commercial funds islamic banking course at the end result can increase the capacity of the market share of Islamic banking in the next few years.



## 6. Conclusion:

Islam attempts to establish justice and eliminate exploitation in the society and prevents the accumulation of wealth in the hands of few people. Islam, therefore, absolutely prohibits *riba* as it is the root of all injustice in the human society. *Al-Qard al-Hasan*, on the contrary, being an interest free loan for humanitarian and welfare purpose may ensure the proper movement of wealth amongst all classes of people in the society. That is why, the Qur'an and the Sunnah have much appreciated and encouraged for the implementation of *al-Qard al-Hasan* in the Muslims society. The paper argues that Islam has the potential to provide various schemes and instruments that can be advanced and adapted for the purpose of microfinance. Comparatively, *qardh al hasan*, *murabahah*, and *ijarah* schemes are relatively easy to manage and will ensure the capital needs (*qardh al hasan*), equipments (*murabahah*), and leased equipments (*ijarah*) for potential micro-entrepreneurs and the poor. The study also highlights the need to move beyond the "popular" Microfinancing instruments such as, *Qardh al Hasan* and to search for innovative and appropriate solutions. Of course, the framework remains free from Shariah prohibitions relating to *riba* and *gharar*. The study also highlights the need to develop the institutions of *zakah* and perhaps cash *waqf* and integrate them with microfinance. The people perception still consider that *Qardh al Hasan* is a product of social issues such as the assistance given by government to the community is one factor that makes *Qardh al Hasan* become fluent. The pattern of training and guidance to change business style life of recipient's *Qardh al Hasan* in the use of capital loan is more important from given addition.

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