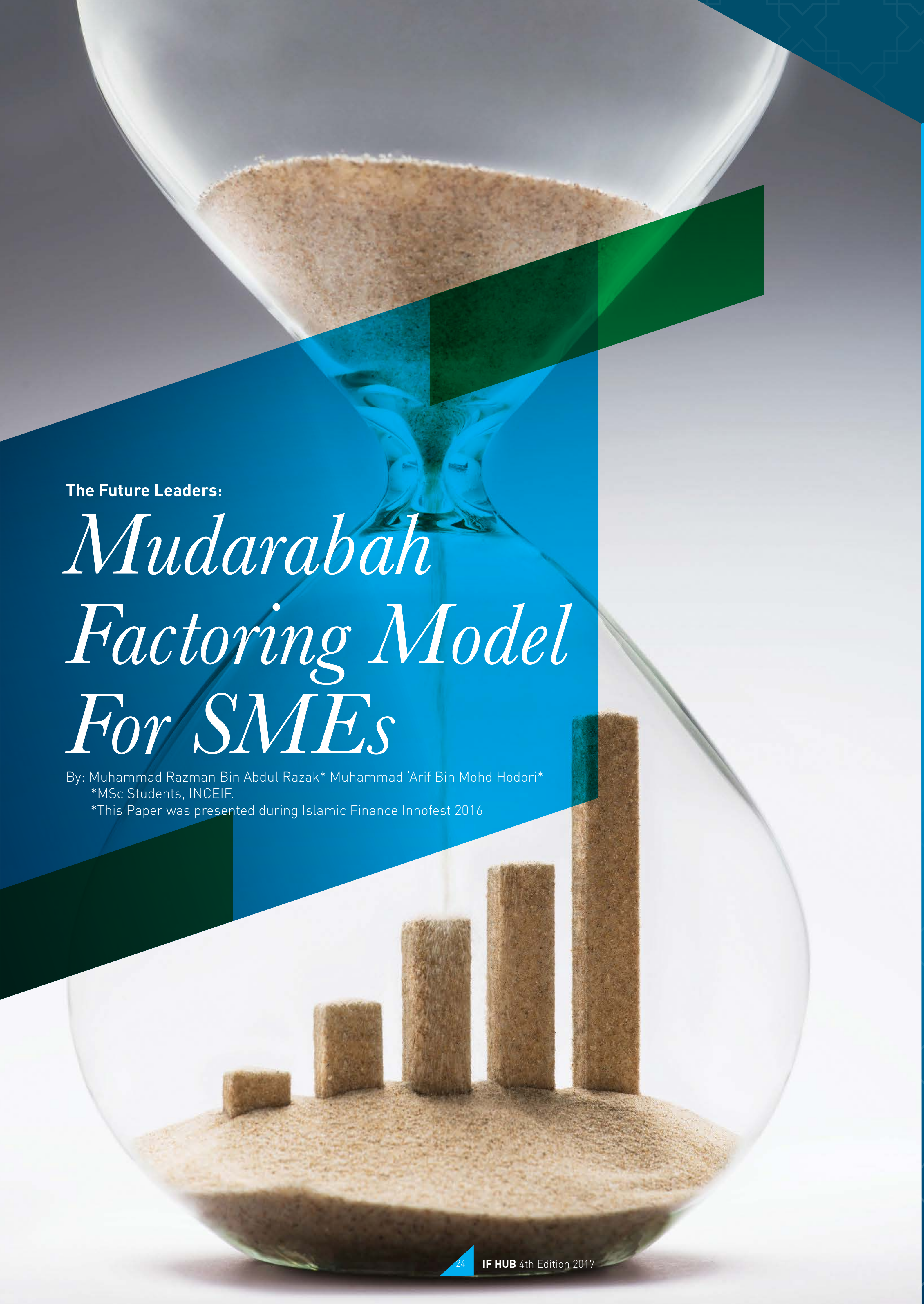

The Future Leaders:

Mudarabah Factoring Model For SMEs

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"SMEs have the potential to contribute substantially to the economy"

The small and medium-sized enterprises (SMEs) is an interesting sector to talk about – defining them may generate dispute as everyone sees "small" and "medium" differently, however, their importance to the economy are unanimously agreed upon. SMEs represent an essential source for economic growth, dynamics, and flexibility for both the developed countries and the developing and emerging economies. Although individually small in size, SMEs justify their crucial presence on the economy through sheer volume alone; in the Malaysian context, the SME Corp Malaysia's annual report stated that SMEs in Malaysia contribute up to 36.3% of its GDP. From that, we can see that SMEs have the potential to contribute substantially to the economy as it is able to not only strengthen existing industries but also lead to the rise of new ones.

Having justified the importance and potential of SMEs to the economy, it is crucial that we understand the current status quo facing these SMEs, particularly in the financing aspect. Through various reports and studies, a major theme of problem recurring among the SMEs falls under the aspect of funding and cashflow management – looking specifically at one study, Beck and Demirguc-Kunt finds that smaller firms have limited access to external financing (2006). This situation hinders the growth of SMEs and their contribution to economic development. Furthermore, the lack of financing will pose problem involving prompt payments by their customers, leading to illiquidity and inefficiency. This is where we believe a financing tool like factoring, especially Islamic factoring, can play a pivotal role.

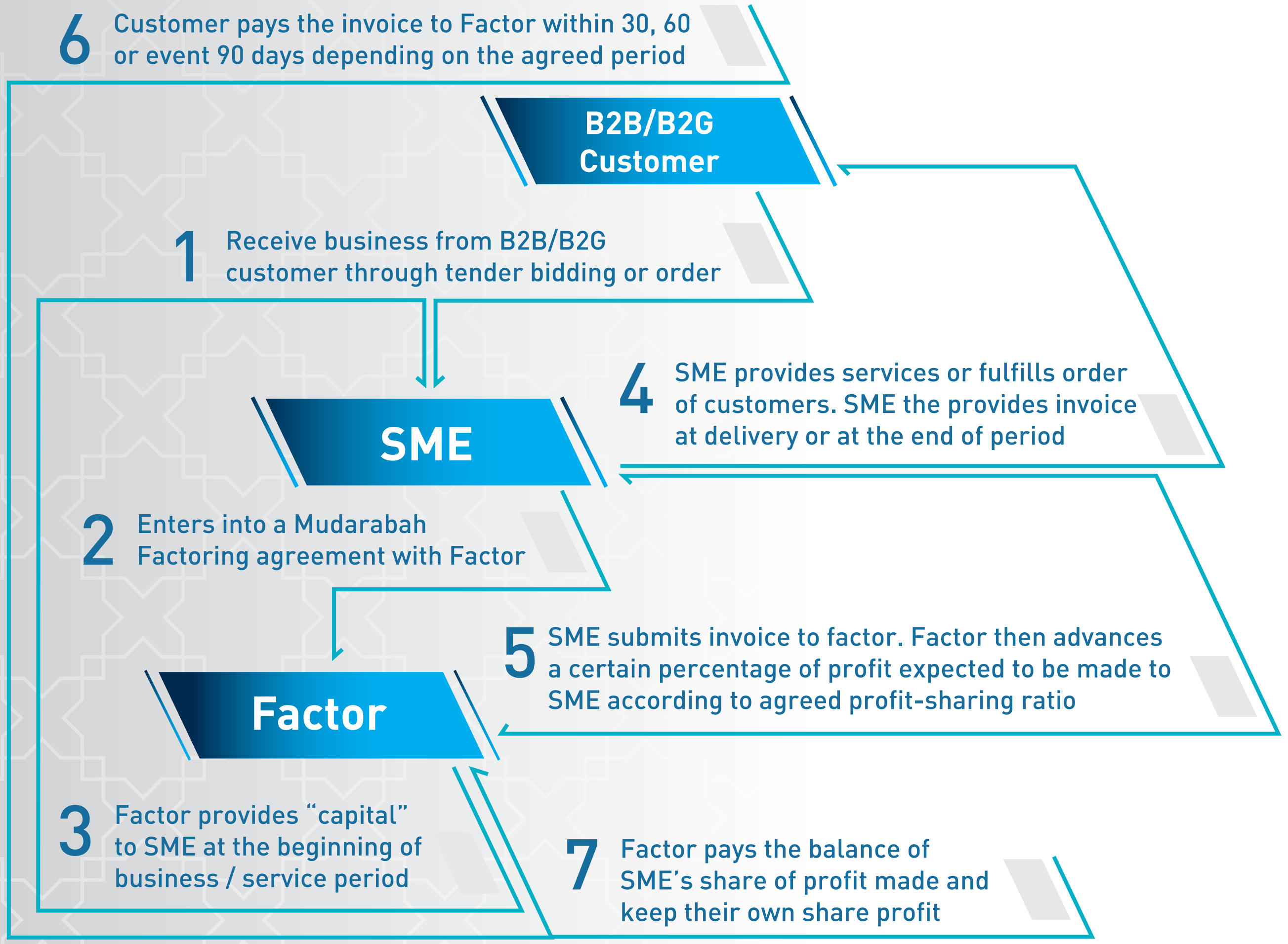
Factoring is a type of financial transaction whereby a business sells its account receivables or invoices for cash at a discounted price to a third party known as the "Factor". It involves three parties where the "Factor" (purchases the receivables), the "Seller" (sells the receivables), and lastly, the "Debtor" (holds financial liability and is required to make payment to the owner of the invoice). The receivables in question are often associated with an invoice for services provided or goods sold that provides the owner of the receivables the legal right to collect money from the debtor.

In addition, factoring is often practiced by some firms to obtain cash as well as to manage their cash flows, more so when these firms lack available cash balance to meet their current obligations and other cash needs. This is especially important for SMEs because factoring allows businesses to obtain payment sooner and determine the exact period of receiving the said payment (rather than waiting for 30, 60 or even 90 days). In the management point of view, SMEs will gain access to better cash flow and liquidity management through factoring. Besides that, factoring is essentially not a loan; businesses engaging in factoring would be able to avoid the acquisition of debt and the need for collateral in instances of financing – this is particularly crucial when we consider the small nature of SMEs. Hence, factoring is a necessary tool that enables these firms to cover their short-term cash needs without adding debt stress and risking their already limited collateral (or lack thereof).

Unfortunately, the mechanism used in conventional factoring allows the "Factor" to receive payments beyond the cost of purchasing the debt; this is tantamount to Riba and is not permissible in Islam. As an alternative to that, the practice of Islamic factoring or i-factoring is introduced and is practiced in countries like Malaysia. One model adopted in Malaysia is Bai al Dayn (the sale of debt). This model refers to the sale of debt, in which a firm would sell their receivables at a discount to a factor, essentially reflecting the practice of conventional factoring. Although it is allowed based on views of some Islamic jurists, this model is rare in Gulf countries because the mechanism of this model is considered impermissible.

Furthermore, an article written by Ahmad Mukarrami Ab Mumin and Aizul Aiman Musa from RHB Islamic Bank has also aptly described other models adopted for factoring, which includes Islamic Factoring via commodity Murabahah and Hawalah as well as Islamic Factoring via Bai Dayn Bil Al Sila (BDBS). These models are more common as they are globally accepted by Shariah scholars. However, both models involve the sale and purchase of commodities through a commodity trading platform. This will incur additional charges that will be borne by either the Seller or the Factor. Hence, there is definitely a need for a factoring agreement with a harmonized mechanism that can be accepted by all major schools of thought in Islam as well as one that can also circumvent the utilisation or need of commodities. For the objective of filling the said gap, we propose a Mudarabah Factoring Model.

Mudarabah refers to a contract whereby one party provides capital (rabbul mal) and the other party brings in personal effort (mudarib). An important characteristic of the mudarabah contract is where the profit sharing arrangement can be shared in any proportion agreed by the two parties beforehand and in case of a loss, the rabbul mal bears monetary loss while the mudarib loses the rewards for his efforts. Losses caused by negligence or any violation of the terms of the contract on the other hand is borne by the mudarib. Moreover, the rabbul mal has no say in the management of the business by the entrepreneur but they do have the right to stipulate certain conditions to ensure proper and better management of their money. The structure of the Mudarabah Factoring Model is as described below.



1. SME receives business dealings from its customer (B2B/B2G) via tender biddings or via purchase order.
2. SME then enters into a Mudarabah Factoring agreement with the Factor. Before entering the agreement, Factor will carry out a screening process to evaluate SME's business wellbeing i.e. creditworthiness, track record, paid-up capital, etc. If the SME passes the evaluation, both parties can proceed with the agreement. In the agreement, both parties must specify the amount of capital to be given at the beginning of SME's business/service period, the profit sharing ratio between SME and Factor, and the percentage of SME's share of profit that is going to be advanced by Factor to SME upon submission of invoice and lay out other relevant terms and conditions of the contract if needed (such as pledging of an asset owned by SME to Factor as security for Factor's capital in the case of loss in the arrangement that is due to SME's negligence).
3. Factor provides capital to SME on the beginning of the business on a certain percentage of the expected amount of invoice to be billed that has been agreed.
4. SME then provides the services or fulfils and deliver the orders to their customers. SME then provides the customer with an invoice for the orders/services that is to be paid within a specified period.
5. SME then submit the invoice to Factor. The Factor will then advance a certain percentage of SME's share of profit that is expected to be made according to the agreed percentage in the agreement.
6. The customer then pays the amount of the invoice to Factor within the period specified in the invoice.
7. Factor will then pay the balance of the remaining share of SME's profit after receiving the payment from customer and keep their own share of profit from the dealings.

It is foreseeable that undesirable outcomes may arise.

For that, we have considered possible alternative scenarios that can occur in regards to the arrangement of the proposed factoring model. These scenarios also highlight the unique features of the model, particularly inherent due to the nature of the Mudarabah contract. Firstly, we consider the scenario where the billed invoice is cut due to underperformance (negligence) of the SME. In this case, if profit is still made (after the bank or factor house recovers their capital) from the arrangement, then, the profit distribution will have to be recalculated based on the amount of invoice realized according to the agreed profit-sharing ratio. On the contrary, should the bank or factor house fail to recover their capital as a result of loss due to the underperformance of the SME, the losses will be borne by the SME, which in this case, is converted into a Qard. The last scenario would be the case in which the client (debtor) fails to pay the invoice after it has been billed. In this scenario, based on the principle of Mudarabah, it is a loss, but one that is not caused by the negligence of SME (Mudarib), thus, the loss is to be borne by the bank or factor house (Rabbul Mal).

To summarize, the idea of a Mudarabah Factoring Model for SMEs will surely pave way for a more harmonized practice of factoring in Islamic Finance. Additionally, the incorporation of the Mudarabah structure enables the risk-sharing element that is propagated in Islamic Finance to be embedded within the product. Surely, one might say, it is riskier for the banks or factor house to engage in this particular structure, but the fact is, since this model consists of both ex-ante and ex-post arrangements, it is less risky for the banks or factor house because they would have access to necessary information before the invoice is billed, including but not limited to, the nature of the business, the arrangement of the business, and supplementary information regarding the invoice that is to be factored. Through this, more information would be at the banks or factor houses' disposal; this would aid in their decision making processes while also lowering any uncertainties and risks.

As for the businesses, this structure would be a much fairer agreement for both parties compared to a normal factoring arrangement. Since losses due to the negligence of the SMEs would be borne by the SMEs themselves, the banks or factor house will be protected from losing their entire capital. From an SME's point of view, rather than being accountable for the failures of their clients in making invoice payments, it would instead fall on the shoulder of the Factors, as the Rabbul Mal, to bear the losses. Nevertheless, it is quite obvious that this model is fundamentally different from a factoring model. The term factoring however is retained mainly due to its familiarity by consumers as well as the similar end goal that both models aim to achieve, i.e. provide liquidity to SMEs. To put it simply, it is just a different mean towards a common end.

All in all, factoring is definitely important for the SMEs, particularly as a liquidity management tool. Ergo, it is with great hope that our humble attempt towards the proposal of this Mudarabah Factoring Model structure would provide an improved and desirable alternative to conventional factoring, especially one that can be received with open arms by both scholars and practitioners alike.

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