

A Proposed Capital Structure for Islamic Microfinance Institutions to Alleviate Poverty via Agriculture Financing

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ABSTRACT

Islamic Microfinance can be a solution to alleviate poverty amongst the rural farmers but there is a need of proper capital structure for Islamic MFIs by means of which they can finance the agriculture sector. Hence, the objectives were set to find out the Islamic contracts that can be used for agriculture financing and to implement more feasible contracts in the capital structure of Islamic MFIs to obtain a best solution to agriculture financing. A pure qualitative approach based on secondary data has been used throughout the study in order to answer the issues and to come up with a workable mechanism. Findings of the study suggest that IMFIs can obtain funds from Zakat and Waqf organizations that can be used for extremely poor farmers who cannot repay in case of loss. The funds that are obtained from the government, saving of clients would be based on Mudarabah principle. On the other hand muzara'a contract would be used by the farmer and IMFI as a mean of financing the farmer. In conclusion Islamic MFIs can provide best solution for the problems of farmers who are not able to meet the cost of farming by introducing Mudarabah contract on supply side and muzara'a on demand side.

INTRODUCTION

Agriculture has been a very fundamental source of food production for the mankind since the early times. But unfortunately this sector in the less developed countries is wrought with many problems because of the fact that the governments in such countries have always neglected this sector and being put in low priority rating as compare to those for industry and other urban-based (Gulaid, 1995). As agriculture is linked to the earning of rural population hence due to negligence from the government, rural people are pushed to extreme poverty. Hence the poverty ratio rises in such scenario.

In an economy two main types of poor can be found i.e. extremely poor and economically active poor. Extremely poor are those people who are unemployed or extremely underemployed, as well as those whose work is compensated so poorly that even they are not able to meet their caloric intake required per day. Whereas, economically active poor are those people who have some sort of employment and are not severely food deficit. These types of poor mostly reside in rural areas of developing countries (Robinson, 2006).

As most of the rural population is linked with agriculture hence in order to promote agriculture sector and to alleviate poverty amongst the rural farmers, the European governments, in 1960s and 1970s, tried to finance the agriculture sector via government owned development banks and donors from the credit markets. But this idea was failed due to lack of experience and coordination amongst the donors and the development bank itself. The failure opened the ways for innovation in credit financing so that poor farmers can take advantage of it. Microfinance was the result of such innovation in which micro credits were provided to the poor in order to establish their business.

In 1980s, microfinance became popular due to the success of Grameen bank's microcredit concept. Dr. Muhammad Yunus, the founder of Grameen bank, introduced the concept of group lending that was later followed by many of the microfinance institutes throughout the world. The

failure of government gave a new direction to microfinance institutions to finance the rural agriculture sector (Meyer, 2007). This led the closing of development banks and the evolvement of microfinance institutions.

Although microfinance has provided an opportunity to the rural farmers to promote their living standard but the loan that is provided to them is based on interest. It means that a farmer have to pay interest on each of his installments whereas Islam has totally prohibited interest (*riba*). This factor led the foundation of Islamic Microfinance Institutions (IMFIs). The financing in IMFIs are based on shariah compliant contracts where the factor of interest is eliminated from the transactions. The success of Islamic Banking in Muslim community shows a strong potential for IMFIs to penetrate the microfinance market and provide micro financing to the poor.

The farmers in rural areas are poor and they need working capital for day to day expenses of crop and non-crop activities such as purchase of seeds, fertilizers, pesticides, water and electricity etc. There are certain contracts in Islamic jurisprudence that are best fit for agriculture financing. Islamic banks use different contracts for agriculture such as Salam, Ijarah, Murabahah, Musawamah and Muzara'a (Hassan, 2012). In Salam contract, the seller undertakes to supply specific goods to the buyer in future in exchange of an advance price fully paid in advance. In this contract the price is in cash but the supply is deferred (Usmani, 2002). In Salam, the farmer has a choice to either to get single or multiple Salam. In single Salam, the farmer is paid at once which is a lump sum amount whereas in multiple Salam, the payment is made when the farmer needs it (Hasnain & Ahmed, 2011). Murabahah is a sale contract in which the seller mentions the costs that are incurred by him to avail the commodity for the buyer and then sell it to the buyer by adding profit on which both parties agree (Hassan, 2012). Musawamah contract is similar to Murabahah; the only difference is that the buyer doesn't know about the costs that are incurred by the seller on the commodity. The other type of contract which is called as Muzara'a that is similar to sharecropping contract. It's a contract between the landlord and the farmer stipulating the final output will be shared among both the parties as a reward for the managerial labour supplied by the tenant and the land capital provided by the landlord (Shafiai, 2011).

Hence there are certain types of Islamic contracts which can be used by Islamic financial institutions such as Islamic banks and Islamic microfinance institutions to finance the agriculture sector. Salam is the mostly widely accepted contract for agriculture sector whereas; Muzara'a has the potential to be the preeminent contract for agriculture sector.

Hence in this paper we are going to find out the suitable Islamic contracts for agriculture and to propose a potential capital structure for Islamic MFIs by means of which agriculture financing can be provided with ease. A pure qualitative approach based on secondary data has been used throughout the study in order to answer the issues and to come up with a workable mechanism.

LITERATURE REVIEW

'Islamic Sharecropping' Contract in Islamic Jurisprudence

In Islamic Jurisprudence there are some contracts that are related with the concept of sharecropping, namely *al-muzāra'a* and *al-musāqāt*. Although, a lot of arguments have been seen on its validity from different scholars but the later scholars do approved its validity based on their arguments. Basically these are the contracts between the landlord and the tenants according to which the output from the land will be shared between the landlord and the tenant based on the managerial skills provided by the tenant and the land and seeds provided by the landlord.

There is no proof in the Quran which the primary source of law for all the Muslims. Neither any proof can be found in the Sunnah, the secondary source of law, has given a clear idea about whether or not sharecropping is permissible for the Muslims. There is only one Hadith on which the *al-muzāra'a* and *al-musāqāt* are based. According to that Hadith, the Prophet Muhammad S.A.W. said to the Jews on the day of conquest of Khaybar that "I keep you on the land on which the God has kept you, on the condition that the fruit will be equally shared between you and us". To deal with the problems regarding *al-muzāra'a* and *al-musāqāt*, the jurists put some conditions and restriction to make the contract valid (Muslim 2000: no. 3939).

The theory of *al-muzāra'a* has prompted more criticism amongst the legal school as compare to *al-musāqāt*. *Al-muzāra'a* (derived from the word *zar'* which means sowing or cultivation though not necessarily with grain) is a sharecropping contract between two parties i.e. the landowner and the tenant whereby the landowner provide the land and the tenant or farmer cultivates the land against the specified ratio of the output share (Donaldson, 2000).

Imam Abu Hanifah acknowledged the contract of *al-ijara* but invalidate the contract of *al-muzāra'a* and *al-musāqāt*. According to him, the land cannot be the basis of the entitlement of the profit and it is not liable for loss too, whereas partnership is founded on the notion of profit and loss sharing. Imam Mālik and Imam Shāfi'ī validate the contract of *al-musāqāt* while they rejected the *al-muzāra'a* contract. According to their argument this contract involves uncertainty regarding the sale of commodity at yet unknown future values (Imam Malik).

A major element of *gharar* (uncertainty) can be found in *al-muzāra'a* contract because such contracts is frequently regarded as *ijārah* contract and ultimately the contract of *al-muzāra'a* contract will be consider as either *fāsid* (defective) or *bātil* (invalid) due to the strict interpretation of the rules for *ijārah* contract. According to *ijārah* contract, the date of payment cannot be specified since the time and date of the harvest cannot be exactly known. Secondly, the exact value of the rent cannot be determined as the output (harvested crop) is not available at the time of contract is made (Donaldson, 2000).

Imam Abu Yusuf and Muhammad al-Shaybani were the followers of Imam Abu Ḥanīfā. But their views regarding *al-muzāra'a* and *al-musāqāt* were opposed to Imam Abu Ḥanīfā. Based on their view, these contracts are considered to be the partnership between property and work, which is permissible under analogy of *Mudarabah*. According to them, the seed contributed by the landowner can be considered as capital whereas the land is to be considered as real estate because of which the profit will be generated with the help of labour input (Nyazee, 2002). The view of these two has been accepted by the later Hanafite jurists and declared *al-muzāra'a* as a valid contract.

The contract of *al-muzāra'a* and *al-musāqāt* are validated by the scholars as a legal contract of financing operations. The input sharing in *al-muzāra'a* can be in many forms such as the land and other physical factors of production will be provided by one party whereas, the labour will be provided by the other party. Alternatively, the land will be provided by one party while the other factors of production and labour will be provided by the second party. According to the third alternative for input sharing the land is provided by one party whereas the other factors may be provided by all the other parties in the contract (Kāsānī, 1968).

For *al-musāqāt* all the forms that have been applied for the *al-muzāra'a* contract will apply for this contract as well. The farmer is obliged to provide the labour whereas the landlord is responsible for providing a full access to the trees or orchards.

The primary responsibilities such as sowing, cultivating falls upon the tenant while the other works such as harvesting and transportation is a joint liability of both the parties. In case, if the land does not produce the output, then neither party is entitled for the profits. The landlord cannot claim the rent and the labour is not entitled for the wages for his work (Aziz & Jamali, 2008).

Furthermore, the responsibility of farmer regarding the crops is like a trustee, he is not responsible for the damage or loss to the crops except in case of excessive authority provided to farmer, default or violation of *al-muzāra'a* contract conditions (Shafiai, 2011).

On the other hand, in case of *al-musāqāt*, full authority should be given to the farmer regarding all major decisions about maintenance, watering and protection of the trees etc. whereas, the landlord has the authority to force the farmer to perform in case he is delaying or avoiding to work (Kāsānī, 1968).

It is an obvious condition for *al-muzāra'a* that the output should be share in percentage e.g. one third, one fourth of the output etc. None of the party can be paid with the money instead of output share, otherwise the contract will be considered as void (Aziz & Jamali, 2008). The same ruling goes for *al-musāqāt*.

Bay' al Salam Contract:

Bay' al-salam contract is a sale of an object, which is not in the existence at the time of the contract, but will be delivered to the buyer in the future date. The price of the object is however to be paid in advance during the session of contract (Muhammad & Chong, 2007). Bay' al-salam can also be defined as sale for an agreed price with immediate payment for a determinate thing, to be delivered in the future on a fixed date (Nawawi, 1999).

The Maliki school, in defined bay' al-salam as a sale in which the capital-sum is paid in advance and the object of sale is deferred to a specific term. Whereas, Shafi'i and Hanbali School defined the forward contract as the contract over described merchandise sold as a deferred liability on party, in exchange for a price that is received during the contract session (Muhammad & Chong, 2007).

Bay al-salam was allowed by the Prophet Muhammad S.A.W subject to certain conditions. The main purpose of this contract was to meet the needs of small farmers who requires financing to grow their crops and feed their families till the time of harvest. After the prohibition of *riba*, they could

not take usurious loans. Hence, it was allowed for the to sell their agriculture products before it is sown (Usmani, n.d.).

Conditions of Bay' al-salam

- Bay' al-salam cannot be applied on a certain commodity or on a product of particular field or farm. For example if the seller undertakes to supply barely of a particular field or fruit of particular tree, the contract of bay' al-salam would be valid. This is because the fruit or crops of that particular field might be destroyed before delivery; hence the possibility of delivery remains uncertain (Usmani, n.d.).
- It is necessary that the quality of the object of sale is thoroughly specified and should leave no ambiguity which may lead to a dispute between the contracting parties (Nawawi, 1999).
- Bay' al-salam contract cannot be affected on those commodities the quality and quantity of which cannot be specified such as precious stones because they differ in quality, shape and size etc.
- It is compulsory for the buyer to pay the amount of the commodity in advance at the time of contract because in the absence of the payment it will be a tantamount to sale of debt which is prohibited by Shariah (Muhammad & Chong, 2007).
- It is necessary that the quantity of the object of sale is agreed upon in unequivocal terms. If the object of sale is quantifiable then its exact measures should be given but what is normally weighted cannot be quantified in measures.(Nawawi, 1999).

2.3 The Role of Microfinance in Agriculture sector:

Access to the finance for the agriculture farmers is decisive. Without having access to the finances, it would be difficult for them to produce efficient amount of output in time. But yet majority of farmers in developing countries are excluded from the banking system. The interest rates charged by the banks are not affordable by the framers. In 1960s and 70s the rural finances were based on public authorities. The objective was to develop the agriculture industry by modernizing it. This kind of financing was provided by government development banks and the donors from the credit markets with the flexible interest rates. (Morvant-Roux, 2007)

However this system was costly and unsustainable and ultimately led to failure. When to problem was perceived it become known that a generous amount of fund was provided by the government and the donors to subsidize the interest rate and to cover the defaults that can arise because of unhealthy dependence on subsidies. The information regarding the borrower was first sent to the government and donors rather than informing the managers about institutional performance (Meyer, 2007).

In 1980s when microfinance became popular, the government failure gave a new direction to the microfinance institutions to finance the rural agriculture development. State owned development banks closed and microfinance was evolved. But due to lack of experience and lack of professionalism, the MFIs were failed to deliver what was expected from them (Morvant-Roux, 2007).

Although the MFIs were failed in delivering to the agriculture sector but they showed a sign for improvements. Hence, the possible opportunity for the Islamic MFIs do exists to penetrate this sector and channel the financing to the rural farmers. It is also cleared that the failure of MFIs was due to lack of expertise. Thus, it is not difficult to overcome such issues by having strategic alliances with the government owned departments who have specialties in agriculture. Department of Agriculture is responsible for policy making and consultation regarding agriculture.

Although microcredit provides opportunity for the poor to start own business by paying back the installments with simple interest rates but in Shariah, interest is not allowed and considered as haram. Hence, Islamic MFIs, the interest or riba is haram and they cannot charge it on their financing schemes. The Pakistan council of ideology clearly stated in its report on the elimination of riba from the Pakistan economy that "The term *riba* encompasses interest in all its manifestation irrespective of whether it relates to loans for consumption purposes or for productive purposes, whether the loans are of a personal nature or of a commercial type, whether the borrower is a government, a private individual or a concern, and whether the rate of interest is high or low" (Chapra, 2006).

Hence from this comprehensive statement from Pakistan shariah council regarding riba, it can be clearly observed that riba in any kind of transaction is haram. The prohibition of riba appears in the Holy Qur'an in the following verses.

And for their taking interest even though it was forbidden for them, and their wrongful appropriation of other peoples' property, We have prepared for those among them who reject faith a grievous punishment. (4: 161)

O believers, take not doubled and redoubled interest, and fear God so that you may prosper. Fear the fire which has been prepared for those who reject faith, and obey God and the Prophet so that you may receive mercy. (3: 130-2)

In Muslims populated countries, the trend is now changing from rabawi based financing to non rabawi. People in these countries prefer to get financing from Islamic Institutions rather than conventional interest based financial institutions. Hence an opportunity exists for Islamic financial institutions to penetrate the agriculture market. Now question arises that which Islamic contracts would be better to provide financing to the farmers so that the effect of loss on both parties would be minimum.

Supply & Demand in Islamic Microfinance:

The Demand:

Amongst the economically active poor of the developing countries, there is a strong need for small scale financial services. Hence a strong demand for microcredit do exists in such regions. Such kind of microcredit can help the poor to improve household and enterprise management, increase the productivity, smooth income flow and consumption costs.

The supply for Islamic MFIs:

In order to finance the poor, Islamic MFIs do need the supply of funds to be channeled to the poor. For MFIs the sources of funds are external funds such as multilateral and national agencies as well as saving of the clients but Islamic MFIs cannot afford interest based transactions hence they are more careful about selecting the source of funds. The government agencies and Islamic financial institutions can be the external source of funds whereas saving of the clients is the internal source of fund for the Islamic MFIs (Ahmad, 2002). Due to forbiddance from riba, the sources of funds for Islamic microfinance also shrink hence the inclusion of charity funds such waqf and zakat can fulfil the need of Islamic microfinance(Rahman, 2007).

FINDINGS AND DISCUSSION

The Islamic contracts for agriculture that have been discussed in the paper include Salam, Ijarah, Murabahah, Musawamah and Muzara'a. However all the contracts that are discussed do have their own specialties but the problem that do exist in such contracts except Muzara'a. The essence of sharing is missing in such contracts which mean that in case of loss, all the cost would be borne by the farmer. The probability of damage do exists in farming due to unforeseen disasters. In such case, whether it is Salam contract, Murabahah, Ijarah or Musawamah, the loss would be borne by the farmer. Hence the objective of alleviating poverty in such respect would not be satisfied. The beauty of Muzara'a contract is that, whether its profit or loss, it would be shared between both the parties. Hence the burden of loss on famers would be minimized. Secondly, with the involvement of Islamic Microfinance Institutes in the farming would help to produce better outputs. On the supply side for Islamic MFIs, Mudarabah contract would be suitable.

Figure 1 shows the supply and demand aspect of microfinance. As we have already discussed the fund provider for Islamic MFIs can be waqf, zakat, external funds, govt. funds saving of clients. Zakat and Waqf are not for profit organizations so the capital that is raised from these two organizations can be used as *qard ul hassanin* case where farmer is extremely poor and not in position to repay in case of losses. Waqf can be either in the land or cash. The IMFI can act as a landlord if the land is provided to the farmer and as a financier if waqf cash is provided to the farmer. Whereas, the capital that is raised from the external funds, govt. funds saving of clients, they would be provided with the profit based on Mudarabah. In other words the Islamic contract that would be used between Islamic MFIs and the mentioned parties would be based on Mudarabah principle. Whereas, the contract between the farmer and the Islamic MFI would be Muzara'a contract in which both the parties have to enter the contract first. After that each party has to provide specific input based on the contract in order

to achieve the required output. The output will be shared between both the parties based on the pre-specified ratio. The profit that will be obtained by Islamic MFI would be shared with the fund providers based on Mudarabah contract.

CONCLUSION

Poverty is the major concern of today's economies. Two type of poor are observed mostly, which includes extreme poor and economically active poor. Both types of poor do exist in the rural regions of the developing countries. The earnings of such people are mostly linked with agriculture. The government in past had tried to alleviate such poverty via financing the poor in agriculture sector. The development banks and other donors from the credit market were elected to channel the funds to the rural farmers but they failed to deliver. Hence this government failure led the microfinance institution to penetrate this market by financing the rural poor. The success of Grameen banks formula led the foundation for the other microfinance institution to contribute to the rural people. In the developing countries, sharecropping is the most frequently used contract under agriculture but still the farmers can't extract the right amount of profit out of this contract.

Hence, the first objective of this paper was to study the main Islamic contracts that are used or can be used for agriculture financing. We found that there are many Islamic contracts such as Salam, Ijarah, Murabahah, Musawamah and Muzara'a that can be used for agriculture financing. We also found that Muzara'a can be the best fit for agriculture financing because of its sharing nature.

The second objective of this paper was to provide a capital structure for Islamic MFIs by means of which agriculture financing can be available with ease to the poor farmers. Hence we provided a solution by introducing Mudarabah on supply side of Islamic MFIs and Muzara'a on demand side.

Hence it can be concluded that Islamic MFIs can provide best solution for the problems of farmers who are not able to meet the cost of farming. With the help of sharecropping the loss will be shared between both parties which will reduce the burden on poor farmers. After selling the share of output that is attained by the Islamic MFI, the profit will be shared between fund provider and IMFI based on Mudarabah principle.

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FIGURE 1: Proposed Capital Structure of Islamic MFIs to Finance the Agriculture sector.

