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Khattak, Naeem Ur Rehman Khattak and Hussain, Anwar Hussain

Pakistan Instittute of Development Economics Islamabad Pakistan

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A REVIEW OF THE PRINCIPLES OF ISLAMIC BANKING SYSTEM FOR AGRICULTURE CREDIT

Naeem-ur-Rehman Khattak* and Anwar Hussain**

ABSTRACT

An attempt has been made in this paper to highlight the basis and principles of Islamic banks in general and particularly the agriculture banks for agricultural credit. Islamic financial techniques and their nature have been discussed. Murabaha, Mudaraba, Musharaka, Ijara Wa Iktina, Muqarada and Salam were observed the major Islamic financial techniques. The basic rules regarding Islamic finance have been mentioned. It was observed that Islamic banking system believes in assets based transactions. The challenges facing the Muslim ummah regarding Islamic banking were highlighted. It was also concluded that Islamic banking system is more effective in the distribution of income, reducing monopolies and curbing inflation as compared to conventional banking system.

INTRODUCTION

Islam is a complete way of life. Allah, the Creator of humanity, has given us guidelines affecting many different aspects of our lives, including the economic aspect. There is a great deal of information in the Qur'an and Sunnah, which describes how Muslims are to engage in economic transactions. Just as Muslims are obligated to obey the rules of Islam regarding prayer, fasting, etc., they are also commanded to obey the injunctions regarding interest for example. "O you who believe! Do not devour your property among yourselves falsely, except that it be trading by your mutual consent, and do not kill yourselves. Surely Allah is Merciful to you." Qur'an [4:29]. The best-known feature of Islamic banking is the prohibition on interest. The Qur'an forbids the charging of Riba on money lent. It is important to understand certain principles of Islam that underpin Islamic finance. The Shari'ah consists of the Qur'anic commands as laid down in the Holy Qur'an and the words and deeds of the Prophet Muhammad (S.A.W.). The Qur'an is clear about the prohibition of Riba, which is sometimes defined as excessive interest. "O You who believe! Fear Allah and give up that remains of your demand for usury, if you are indeed believers."

* Professor, Department of Economics, University of Peshawar.
**M.Phil (Economics), University of Peshawar.

Muslim scholars have accepted the word Riba to mean any fixed or guaranteed interest payment on cash advances or on deposits. Several Qur'anic passages expressly admonish the faithful to shun interest. Using the various Islamic modes, e.g., Musharaka, Mudaraba, Murabaha, Salam, Istisna and Ijara, can finance all market activities.

There are numerous publications in Arabic and Urdu, which have made significant contributions to the theoretical discussion. The book by Qureshi on Islam and the Theory of Interest (Qureshi, l946) looked upon banking as a social service that should be sponsored by the government like public health and education. He also spoke of partnerships between banks and businessmen as a possible alternative, sharing losses if any. The principle of mudaraba based on Shariah was invoked systematically (Uzair, l955). His principal contribution lay in suggesting mudaraba as the main premise for 'interestless banking'. Al-Arabi, l966 envisaged a banking system with mudaraba as the main pivot. He was actually advancing the idea of a two-tier mudaraba which would enable the bank to mobilize savings on a mudaraba basis, allocating the funds so mobilized also on a mudaraba basis. Mohsin, l982, has presented a detailed and elaborate framework of Islamic banking in a modern setting. Chapra, l985, envisaged Islamic banks whose nature, outlook and operations could be distinctly different from those of conventional banks. Khan, l983, identified two types of investment accounts: one where the depositor authorized the banks to invest the money in any project and the other where the depositor had a say in the choice of project to be financed. On the asset side, the banks under investigation had been resorting to Mudaraba, Musharaka and Murabaha modes. Khan's study reported profit rates ranging from 9 to 20 per cent, which were competitive with conventional banks in the corresponding areas. Khan's study revealed that Islamic banks had a preference for trade finance and real estate investments. Nienhaus, 1988, suggested that the relative profitability of Islamic banks, especially in the Middle East in recent years, was to a large extent due to the property (real estate) boom. He has cited cases of heavy losses, which came with the crash of the property sector. Nien-haus , l988 concluded that Islamic banking was viable at the microeconomic level but dismisses the proponents' ideological claims for superiority of Islamic banking as 'unfounded'. It is neither private ownership nor the institution of market forces that is the basic cause of injustice in the capitalist system. The world, therefore, is badly in need of a Third Economic System. The present study will be proven as a guideline for Muslim economist to give special attention for Islamic agricultural banks.

MATERIALS AND METHODS

As the study aimed to review the Islamic principles regarding agricultural credit so materials have been collected from Islamic Fiqha. The basic Islamic financial techniques and rules regarding Islamic finance in general and particularly for agricultural credit have been reviewed in the light of Islamic philosophy. Assets based banking system and challenges for the Muslim umma have been discussed. A theoretical overview has been reviewed to highlight the basic principles for interest free agriculture banks.

RESULTS AND DISCUSSION

Islamic financial techniques for agriculture financing

Islamic banks around the world have devised many creative financial products based on the risk sharing, profit sharing principles of Islamic banking. For day to day banking activities, a number of financial instruments have been developed that satisfy the Islamic doctrine and provide acceptable financial returns for investors. Broadly speaking, the areas in which Islamic banks are most active are in trade and commodity finance property and leasing. Some of the basic financial techniques of Islamic banking are the following:

Murabaha: This is the sale of a commodity at a price, which includes a stated profit known to both the vendor and the purchaser. This can be called a cost plus profit contract. The price is usually paid back by the buyer in deferred payments. Under Murabaha, the Islamic bank purchases, in its own name, goods that an importer or a buyer wants, and then sells them to him at an agreed mark-up. This technique is usually used for financing trade, but because the bank takes title to the goods, and is therefore engaged in buying and selling, its profit derives from a real service that entails a certain risk, and is thus seen as legitimate. Simply advancing the money to the client at a fixed interest rate would not be legitimate. It is important to note that only a legitimate profit in addition to the actual price is considered lawful under Islamic law. Any excessive addition on account of deferred payments will be disallowed as it would amount to a payment based on the value of money over time i.e. interest.

Mudaraba: This implies a contract between two parties whereby one party, the *rabb al-mal* (beneficial owner or the sleeping partner), entrusts money to the other party called the *mudarib* (managing trustee or the labour partner). The mudarib is to utilise it in an agreed manner and then returns to the rabb al-mal the principal and the pre-agreed share of the profit. He keeps for himself what remains of such profits. The following characteristics of Mudaraba are of significance:

- The division of profits between the two parties must necessarily be on a proportional basis and cannot be a lump-sum or guaranteed return.
- The investor is not liable for losses beyond the capital he has contributed.
- The mudarib does not share in the losses except for the loss of his time and efforts.

Briefly, an Islamic bank lends money to a client - to finance a factory, for example - in return for which the bank will get a specified percentage of the factory's net profits every year for a designated period. This share of the profits provides for repayment of the principal and a profit for the bank to pass on to its depositors. Should the factory lose money, the bank, its depositors and the borrower all jointly absorb the losses, thereby putting into practice the pivotal Islamic principle that the providers and users of capital should share risks and rewards.

Musharaka: This is a partnership, normally of limited duration, formed to carry out a specific project. It is therefore similar to a western-style joint venture, and is also regarded by some as the purest form of Islamic financial instrument, since it conforms to the underlying partnership principles of sharing in, and benefiting from, risk. Participation in a musharaka can either be in a new project, or by providing additional funds for an existing one. Profits are divided on a pre-determined basis, and any losses shared in proportion to the capital contribution.

In this case, the bank enters into a partnership with a client in which both share the equity capital- and perhaps even the management - of a project or deal, and both share in the profits or losses according to their equity shareholding.

Ijara Wa Iktina: Equivalent to the leasing and installment-loan, hire-purchase, practices that put millions of drivers on the road each year. These techniques as applied by Islamic banks include the requirement that the leased items be used productively and in ways permitted by Islamic law.

Muqarada: This technique allows a bank to float what are effectively Islamic bonds to finance a specific project. Investors who buy muqaradah bonds take a share of the profits of the project being financed, but also share the risk of unexpectedly low profits, or even losses. They have no say in the management of the project, but act as non-voting shareholders.

Salam: A buyer pays in advance for a specified quantity and quality of a commodity, deliverable on a specific date, at an agreed price. This financing technique, similar to a futures or forward-purchase contract, is particularly applicable to seasonal agricultural purchases, but it can also be used to buy other goods in cases where the seller needs working capital before he can deliver.

Rules regarding Islamic finance

For millions of Muslims, banks are institutions to be avoided. Islam is a religion, which keep Believers from the teller's window. Their Islamic beliefs prevent them from dealings that involve usury or interest (Riba). Yet Muslims need banking services as much as anyone and for many purposes: to finance new business ventures, to buy a house, to buy a car, to facilitate capital investment, to undertake trading activities, and to offer a safe place for savings. For Muslims are not averse to legitimate profit as Islam encourages people to use money in Islamically legitimate ventures, not just to keep their funds idle. Following are the simplest rules regarding the Islamic finance.

- Any predetermined payment over and above the actual amount of principal is prohibited. Islam allows only one kind of loan and that is Qard-el-hassan (literally good loan) whereby the lender does not charge any interest or additional amount over the money lent. Traditional Muslim jurists have construed this principle so strictly that, according to one commentator "this prohibition applies to any advantage or benefits that the lender might secure out of the Qard (loan) such as riding the borrower's mule, eating at his table, or even taking advantage of the shade of his wall." The principle derived from the quotation emphasizes that associated or indirect benefits are prohibited.

- The lender must share in the profits or losses arising out of the enterprise for which the money was lent. Islam encourages Muslims to invest their money and to become partners in order to share profits and risks in the business instead of becoming creditors. As defined in the Shari'ah, or Islamic law, Islamic finance is based on the belief that the provider of capital and the user of capital should equally share the risk of business ventures, whether those are industries, farms, service companies or simple trade deals. Translated into banking terms, the depositor, the bank and the borrower should all share the risks and the rewards of financing business ventures. This is unlike the interest-based commercial banking system, where all the pressure is on the borrower: he must pay back his loan, with the agreed interest, regardless of the success or failure of his venture. The principle which thereby emerges is that Islam encourages investments in order that the community may benefit. However, it is not willing to allow a loophole to exist for those who do not wish to invest and take risks but rather content with hoarding money or depositing money in a bank in return for receiving an increase on these funds for no risk (other than the bank becoming insolvent). Accordingly, under Islam, either people invest with risk or suffer loss through devaluation by inflation by keeping their money idle. Islam encourages the notion of higher risks and higher returns and promotes it by leaving no other avenue available to investors. The objective is that high risk investments provide a stimulus to the economy and encourage entrepreneurs to maximise their efforts.
- Making money from money is not islamically acceptable. Money is only a medium of exchange, a way of defining the value of a thing; it has no value in

itself, and therefore should not be allowed to give rise to more money, via fixed interest payments, simply by being put in a bank or lent to someone else. The human effort, initiative, and risk involved in a productive venture are more important than the money used to finance it. Muslim jurists consider money as potential capital rather than capital, meaning that money becomes capital only when it is invested in business. Accordingly, money advanced to a business as a loan is regarded as a debt of the business and not capital and, as such, it is not entitled to any return (i.e. interest). Muslims are encouraged to purchase and are discouraged from keeping money idle so that, for instance, hoarding money is regarded as being unacceptable. In Islam, money represents purchasing power, which is considered to be the only proper use of money. This purchasing power (money) cannot be used to make more purchasing power (money) without undergoing the intermediate step of it being used for the purchase of goods and services.

- Gharar (Uncertainty, Risk or Speculation) is also prohibited. Under this prohibition any transaction entered into should be free from uncertainty, risk and speculation. Contracting parties should have perfect knowledge of the counter values intended to be exchanged as a result of their transactions. Also, parties cannot predetermine a guaranteed profit. This is based on the principle of 'uncertain gains' which, on a strict interpretation, does not even allow an undertaking from the customer to repay the borrowed principal plus an amount to take into account inflation. The rationale behind the prohibition is the wish to protect the weak from exploitation. Therefore, options and futures are considered as un-Islamic and so are forward foreign exchange transactions because rates are determined by interest differentials. A number of Islamic scholars disapprove the indexation of indebtedness to inflation and explain this prohibition within the framework of Qard-el-hassan. According to those scholars, the creditor advances the loan to win the blessings of Allah and expects to obtain the reward from Allah alone. A number of transactions are treated as exceptions to the principle of

Gharar: sales with advanced payment (Bai' Bithaman Ajil); contract to manufacture (Istisna); and hire contract (Ijara). However, there are legal requirements for the conclusion of these contracts to be organized in a way, which minimizes risk.

- Investments should only support practices or products that are not forbidden -or even discouraged- by Islam. Trade in alcohol, for example would not be financed by an Islamic bank; a real-estate loan could not be made for the construction of a casino; and the bank could not lend money to other banks at interest.

Assets based banking system

According to the Islamic banking system predetermined returns on investments are possible only when some real economic activity is involved. This shows that financial activity is the servant not the master of real economic activity. There have to be some goods and services to be objects of Murabaha, Salam, Istisna and Ijara as against non-Islamic banking system. In other words, Islamic banking structure is based on real assets in the economy. You exchange money either for goods and services, or for money or for debt. In the Islamic framework we have no problems with the first, the second, exchange of money for money is severely constrained, and the third is almost eliminated.

Challenges for the Muslim ummah

The system of interest favors the rich industrialists who benefit from the wealth of the common people who deposit their savings in the bank, and after making huge profits do not allow the common people to share these profits except to the extent of a fixed rate of interest that is again taken back by them as it is charged to the cost of production. At macro level, it means that these rich people always use the money of depositors for their own benefit and in reality pay nothing to them because the interest payments are always added to the cost of production. Similarly, gambling is a major instrument for concentrating the wealth of thousands of men in a few hands and for promoting the disastrous motive of greed for the unearned income. The speculative transactions are also a major source of disturbing the natural market operations and contribute to the inequities in the distribution of wealth. Islam not only allows the market forces but also provides mechanism to keep them operative with their natural force in the economy without their being hindered by monopolies. It also favors the equal distribution of income.

The Muslim world is looking toward the coming century with hope that it will bring for it independence in general and particularly in economic and political fields in the real sense so the Muslims may find their due place among the nations of the world and may be free to live according to the Quran and the Sunnah of the Prophet (Sall-Allahu alayhi wa sallam). The injunctions of Halal and Haram tend to prevent monopolies and curb the unjust and immoral earnings and commercial activities detrimental to the collective interest of the society. The institution of Zakat, Sadaqat, and certain other financial obligations provide that even the Halal income is again distributed to the persons who could not earn enough due to insufficient market opportunities. Through the twin controls, the wealth is kept under constant circulation and the chances of its concentration are almost eliminated. But our main tragedy is that the principles of Islamic economy are still in theoretical form for which no living example is available. The Muslim countries have not tried to structure their economy on Islamic basis. Unfortunately, despite having the clear cut Islamic injunctions, the inequities existing in Muslim countries are far more severe than in the Western world. But the Muslim economists still should seek the possible ways to solve the questions like:

- How the interest-free banking system can survive in the global challenging environment?
- How to attract the investors and businessmen to adopt Islamic banking system?
- Will the people accept to adopt the interest-free banking system against the prevailing banking system?
- Will the Islamic-based assets in the economy enough to satisfy the demand of the society?

CONCLUSION AND RECOMMENDATIONS

All types of Riba regarding agricultural credit are completely prohibited in Islam. Major techniques used for Islamic financing are Murabaha, Mudaraba, Musharaka, Ijara Wa Iktina, Muqarada and Salam. Any predetermined payment over and above the actual amount of principal is prohibited. The lender must share in the profits or losses arising out of the enterprise for which the money was lent. Making money from money is not allowed in Islam. It is based on assets based transitions, which will help in curbing inflation in the economy. Gharar (Uncertainty, Risk or Speculation) is also prohibited. Investments should only support practices or products that are not forbidden -or even discouraged- by Islam. The concepts of Halal and Haram discourage monopolies. Similarly, Zakat and Sadaqat favors equal distribution of income in the economy. In brief, the concepts of equity and morality are at the root of Islamic banking. In the capitalist countries the instruments of interest, gambling, speculative transactions and the tools of exploiting immoral desires of the consumers to secure huge profits were allowed, which tend to create monopolies and in turn paralyze the forces of demand and supply or at least obstruct their operation. The Muslim Ummah can work out this system based on the Islamic norms. The economic principles taught by the Quran and Sunnah of the Prophet (Sall-Allahu Alayhi Wa Sallam) are quite capable of solving the major economic problems faced by the world today. There is need for the Muslim Ummah in general and particularly the Pakistan to have independence in all the economic activities in general and particularly in the fields of politics, policies and banking system. To this end, we need a total revision of our strategy, a well-considered plan, a collective resolution, and a revolutionary approach. Islamic banking system should be given a great stress and push in the present challenging world through its exposure and support. They should arrange separate Islamic agricultural banks to assist the poor farmers. The poor farmers should be assisted through interest free loans.

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