

The State Bank of Pakistan's Guidelines on Islamic Financing for Agriculture: An Analysis from the Prospective of Islamic Law

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Abstract

The agricultural sector plays a central role in the economic growth and stability of any agricultural country. It is, therefore, a benchmark through which the development of a country is determined. Being a Muslim country that relies on agriculture, various guidelines/prudential regulations have been issued by the State Bank of Pakistan (SBP) in order to facilitate and encourage financial institutions to pursue agriculture financing—both for crop and non-crop activities. Over the last few years, the SBP has started linking the expansion of agricultural activities with the implementation of sharī'ah-based financing products. However, it is argued that while framing these guidelines and prudential regulations, the SBP overlooked some basic principles of the sharī'ah. For instance, these guidelines ignore the lower class of farmers who have poor economic conditions and are not able to meet their basic agricultural needs for both crop and non-crop activities, do not take strict action against provision of loan on interest, allow unjustifiable collateral and securities, and recommend rigid procedure for the issuance of loan. This research aims to critically analyze the above-mentioned guidelines and prudential regulations of the SBP and suggest how to make them sharī'ah based or at least sharī'ah compliant.

Keywords

State Bank of Pakistan, guidelines, Islamic finance, agricultural finance, Islamic law, *sharī'ah*.

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Introduction

In modern times, agriculture has a substantial prominence for every country. Each country focuses on agricultural financing in order to augment the rate of agricultural production per acre. In Pakistan, such agricultural financing is provided by formal¹ and informal² sources. However, both types of sources have failed to achieve the desired results for many reasons. The most important among them is the provision of agricultural credit on interest basis—a commercial concept that is strictly prohibited by the *sharīah* (Islamic law).³ Being Muslims, the farmers in Pakistan prefer to avoid interest-based loans and, therefore, remain financially instable. This leads them to a situation in which they are not able to meet their basic agricultural needs, for both crop and non-crop activities. This unfortunate phenomenon may decrease the rate of production and consequently cause food shortage. Having the same in mind, the government of Pakistan has taken some initiatives to meet farmers' financial needs. For this purpose, the State Bank of Pakistan (SBP) has issued some prudential regulations and guidelines regarding the agricultural financing.

In the 1970s, major steps were taken by the government of Pakistan to expand Islamic banking and finance.⁴ These steps, in return, exerted a

¹ Formal financial institutions mean those institutions, which are registered, licensed, and regulated by a national authority. They include public and private banks, insurance companies, macro finance institutions (MFIs), government-funded bodies, formal money-transfer-service providers, NGOs etc. These institutions are called formal in the sense as they follow certain rules and regulations prescribed by the concerned country in which they function. "Study on Informal and Non-Formal Rural Financial Services Concern Universal," Final Report, June 2012, 8–9, [http:// www.concernuniversal.org /.../_universal_malawi_study_on_inform](http://www.concernuniversal.org/.../_universal_malawi_study_on_inform).

² Informal sources include lone and gifts from relatives, merchants, friends, local moneylenders, etc. These sources are usually non-governmental. Farmers generally prefer informal sources of finance to formal sources, as the former are more flexible in terms of procedure and repayment structure.

³ The *sharīah* strictly prohibits interest-based loan. Many Qur'ānic verses and Prophetic traditions confirm this prohibition. For instance, Allah says, "O Ye who believe! Fear Allah, and give up what remains of your demand for usury, if ye are indeed believers (2:278–79). According to a Prophetic tradition, "The Messenger of Allah cursed the one who charges *ribā*, the one who gives it, the one who records it, and the two witnesses, and he said, 'They are equal.'" Muslim b. al-Ḥajjāj, *Ṣaḥīḥ*, Kitābal-Musāqāh, Bāb la'n ākil al-ribā wa mu'kilih.

⁴ In the 1970s, some sober efforts were made for the growth of Islamic banking and finance, but no mentionable results were secured. However, in the 1980s, some proper legislation had been made for interest-free banking and many existing laws were reviewed like Companies Ordinance, 1984, Negotiable Instrument Act, 1882, State Bank Act, Recovery of Loans Laws etc. The main rationale was to mold all these earlier

noticeable impact on the growth of Islamic banking in the country. In order to assist the Islamic banks/conventional banks, the Agricultural Credit Department of the SBP issued separate guidelines on various kinds of agricultural financing, such as Islamic financing for agriculture, horticulture financing, poultry financing, fisheries financing, livestock financing, and finance scheme for small formers.⁵

However, it is pertinent to note that the SBP has used techniques for Islamic agricultural finance, which are similar to those of conventional financing. For instance, the ratio of profit has been based on the rate of KIBOR (Karachi Interbank Offered Rate), a benchmark that is used in conventional finance for the determination of the rate of interest. Additionally, procedure for the recovery of loans is analogous to that for the recovery of conventional loans. These and other issues make the guidelines of the SBP on the Islamic agricultural finance contradict the basic teachings of the *sharī'ah*.

The objectives of the present work are manifold. First, it points out some objectionable aspects of the SBP's Guidelines on Islamic Financing for Agriculture in the light of the *sharī'ah*. Second, it critically analyzes each issue in the Guidelines on Islamic Financing for Agriculture, applying basic principles of Islamic commercial law. Third, it puts forward recommendations in order to make the Guidelines on Islamic Financing for Agriculture *sharī'ah* based or at least *sharī'ah* compliant. Fourth, it explores new dimensions of Islamic banking in order to finance agriculture particularly crop farming.

The present work has some limitations. For instance, it addresses the guidelines and prudential regulations issued by the SBP for financing agriculture, but does not discuss the agricultural financing guidelines of the financial institutions themselves, owing to the fact that only the former is the regulatory authority. Moreover, it more focuses on the crop farming compared to other sectors of agriculture like livestock,

legislations according to the principles of the *sharī'ah*. Some other steps were also taken in the same era. For instance, issuance of interest-free instruments like PTC (Participation Term Certificates, which were later on replaced with TFC) and NIB (Non-Interest-Based Instruments), opening of interest-free counters in all conventional banks, and introduction of the contract of *mushārah* (Islamic law of partnership) in its various applicable forms. In the 1990s, a noteworthy and historical decision was made by the Federal Shariat Court on December 23, 1999, declaring all commercial dealings containing interest null and void abinitio with effect from June 30, 2001. For more details, see Khawaja Amjad Saeed, "Islamic Banking in Pakistan: A Review of Conventional and Islamic Banking," *Proceedings of 2nd International Conference on Business Management*, 7-8, umt.edu.pk/icobm2012/pdf/2C-95P.pdf.

⁵ All these guidelines can be accessed from the official website of the State Bank of Pakistan, www.sbp.pk).

poultry farming, fish farming, and horticulture. For, Pakistani agriculture is predominantly rural⁶ and the majority of farmers live in rural parts of the country and take up crop farming.⁷

***Shari'ah* Issues in the Guidelines on Islamic Financing for Agriculture**

The present work is primarily concerned with some basic questions, which are as follows: Are the Guidelines on Islamic Financing for Agriculture purely based on the principles of *shari'ah*? Are they enough and adequate to cover the vast spectrum of Islamic agricultural finance? Can they be used for the development of such models, which are feasible and practicable for the development of the agricultural sector? Are they helpful in realizing objectives projected by the Islamic financial system? Do the Islamic and conventional financial institutions follow these guidelines in their true spirit? The present work attempts to answer these questions.

The Issue of Interest

Although the Guidelines on Islamic Financing for Agriculture issued by the SBP do not explicitly allow the Islamic financial institutions (IFIs) to charge interest. However, they do not strictly prohibit them from involving in interest-based transactions either. For instance, the Guidelines on Islamic Financing for Agriculture state,

Under Islamic Modes of financing IBIs are prohibited to charge any *riba* or interest on their financing. However, it can share the profit/loss being an investor in the business or can charge rentals and other service charges at pre agreed rates on case to case basis.⁸

This statement attributes the prohibition of *ribā* to Islamic modes of financing, but the SBP itself does not bar IFIs from charging *ribā*. Being a regulatory authority, the SBP should have stringently barred the IFIs

⁶ Sohail Jehangir Malik and Hina Nazli, "Rural Poverty and Credit Use: Evidence from Pakistan," *Pakistan Development Review*, 38, no. 4 (1999): 699–716.

⁷ Majority of the farmers in developing countries live in rural areas. For instance, 62 per cent of the entire Pakistani population live in the rural areas and directly or indirectly depend on agriculture as their livelihood. Omer Farooq, "Pakistan Economic Survey 2009–10," Government of Pakistan, Ministry of Finance, ch. 2, p.13, http://www.finance.gov.pk/survey/chapter_10/02_Agriculture.pdf.

⁸ "Guidelines on Islamic Financing for Agriculture," Agricultural Credit Department, Islamic Banking Department, State Bank of Pakistan, 13, <http://www.sbp.org.pk/acd/2009/C1-IBD-ACD-Guidlines-03-Feb-09.pdf>.

from charging interest in any form. In case of violation, serious actions should have been taken against them. Such actions may range from pecuniary punishment to the cancellation of registration. The advisory type of guidelines may not be an effective strategy to prevent the IFIs from indulging in interest-based transactions directly or indirectly.

The SBP directs the banks to determine their mark-up on the basis of KIBOR, a benchmark used by the conventional financial institutions for the determination of interest rates. The IFIs also use KIBOR as a benchmark to determine their profit. The use of KIBOR (originally devised to determine the interest rate) as a benchmark to determine *ḥalāl* profit (earned through transactions of *murābaḥah* and *ijārah*), in the present authors' view, is not appropriate from the perspective of the *sharī'ah*, as the benchmark of KIBOR does not reflect the basic philosophy of Islamic economy, i.e., just and equitable system of distribution. Pakistani jurist Muhammad Taqi Usmani (b. 1943) argues that the use of LIBOR (London Interbank Offered Rate) as a benchmark for the determination of profit certainly makes the transaction resemble an interest-based financing, at least in appearance, and keeping in view the severity of prohibition of interest, even this apparent resemblance should be avoided. He emphasizes that the Islamic banks and other financial institutions should discard this practice, as it takes the rate of interest as an ideal for a *ḥalāl* business, which is not desirable. He urges them to develop their own benchmark for the determination of profit.⁹ Moreover, the use of KIBOR as a benchmark is unjust to the customer/depositor, as the Islamic banks do not share with them the actual profit, which is in most cases greater than the normal KIBOR rate. Taking of others' property—in this case depositors' share in the actual profit—unjustly is prohibited by the Qur'ān.¹⁰

The Issue of Recovery Procedure

The key issue for a financial institution is the recovery of its advanced liquidity along with profit. The proper recovery system ensures the development of financing portfolios and, consequently, the financial institutions opt for the provision of more financing facilities. In case of agriculture, the need for proper recovery system increases, owing to the fact that this sector is prone to many natural risks like droughts, floods, hail storms, earthquakes, mudslides, and a plethora of other mishaps. Due to these risks, the financial institutions are often reluctant to

⁹ Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Karachi: Maktabah Ma'ariful Qur'an, 2008), 118–120.

¹⁰ Qur'ān 2:188.

finance it.¹¹ Besides the natural risks, there are other risks that make the situation worse. These risks include economic risks, operational risks, social risks, political risks, etc.¹² The economic risks include price fluctuations, fall in demand, interest rates, exchange rate etc. These risks can be controlled only if the governments play their due role and bring economic stability. The operational risks relate, on the other hand, to land (e.g. soil contamination), capital (e.g., depreciation), labour (e.g., illness) etc. These risks can also be controlled by the governments through institutional efforts and exertion. The social risks ensue from social behaviours including strikes, theft, riots, warfare, etc. All these risks can be controlled or, at least, curtailed through strong economic, political, and social policies.

Owing to all these risks, the SBP has recommended very rigorous rules and regulations for monitoring the recovery system. According to the guideline on Islamic financing for agriculture, the IFIs are guided to follow some measures in order to develop a proper and rigid recovery mechanism. These include: 1) following up their customers and having frequent interactions/communication with them; 2) following the traditional correspondence and letter/notice-based recovery mechanism by issuing notices and letters for reminding and warning respectively, before and after the laps of time of repayment mentioned in the contract; 3) trailing the guarantors through personal contacts in order to pressurize the farmers to pay the amount due within the given time; 4) making recovery through the intervention of *Tahşıldār* if farmer fails to pay the amount due; 5) filing recovery suit in the concerned Banking Courts, having competent jurisdiction; 6) recovering the amount due from a farmer according to the procedure mentioned in Financial Institution (Recovery of Finance) Ordinance, 2001; 7) making recovery of its liquidity through any other legal remedy available to an IFI.¹³

The above-mentioned procedure is not in line with the rules and regulations described by the *sharīah* for the recovery of any financial liability. Islamic commercial law grants a recovery procedure, which is based on the principle of justice, ease, and human respect. Therefore, the *sharīah* advises the creditor to give relaxation to the debtor until the

¹¹ Mahmoud A. Gulaid, *Financing Agriculture through Islamic Modes and Instruments: Practical Scenario and Applicability* (Jeddah: Islamic Research and Training Institute, Islamic Development Bank, 1995), 44.

¹² Matthias Bickel and Martin Klein, "Rethinking Rural and Agricultural Finance: The African Case," *Rural 21: The International Journal of Rural Development* 44, no. 1 (2010): 32-35, https://www.rural21.com/fileadmin/_migrated/content_uploads/R21_Rethinking_rural_and_agricultural_finance_0110.pdf.

¹³ "Guidelines on Islamic Financing for Agriculture," 13-14.

latter is in a position to make the payment easily. If the debtor is unable to repay the amount at the given time, it is advised in special cases to remit the amount as a charity. The Qur'ān says, "If the debtor is in a difficulty, grant him time till it is easy for him to repay. But if you remit it by way of charity, that is best for you if ye only knew."¹⁴

The Guidelines on Islamic Financing for Agriculture, on the other hand, do not provide any provision related to the relaxation in terms of respite from payment or omission of the entire debt. It rather advises the financial institutions to use forceful methods for the recovery of debt. The advices mentioned (in the above lines) under category Nos. 4, 5, and 6 are various ways of such forceful recovery of debt.

Moreover, the contract of guarantee in Islamic commercial law is a charitable contract (*'aqd al-tabarru'*), and therefore, the guarantor is not allowed to take any charges. He has to pay the amount where a creditor fails to fulfill his financial liability. However, the advice mentioned under category No. 3 of the guidelines requires continuous follow-up of the guarantor from the very inception of the contract. This may be a suitable way in a conventional financial system where the guarantor charges both debtor and creditor for suretyship. However, as the same is not possible in Islamic commercial law, the persistent follow-up may irritate the guarantor and, consequently, he may refuse to continue the guarantee contract.

In order to put the recovery procedure in line with the dictates of the *sharī'ah*, the rules and regulations mentioned in the AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) Shari'ah Standards must be followed for the recovery of debt. However, the rules mentioned in the Guidelines for Islamic Agricultural Finance are contradictory in nature to those mentioned in AAOIFI Shari'ah Standards. For instance, according to the rule No. 2/6 of the standards, the default in payment is established when a normal notice for payment is given to a defaulter (who has not proved that he is insolvent) who fails to pay the debt on its due date.¹⁵ The statement plainly shows that the rule differentiates between the solvent and insolvent debtor. The Guidelines on Islamic Financing for Agriculture, on the other hand, do not classify the defaulters in such way and treat them equally.

Similarly, according to the rule No. 2/5(a), the financial institution is entitled to follow affairs of a debtor and his financial dealings after his default and not prior to that.¹⁶ It establishes that no follow-up is required

¹⁴ Qur'ān 2:280.

¹⁵ AAOIFI Shari'ah Standard No. 3, Rule No. 2/6, English version (2010), p. 33.

¹⁶ Ibid., Rule No. 2/5, p. 33.

before the stage of default. However, as per category Nos. 1 and 2 mentioned above, the Guidelines for Islamic Finance for Agriculture require the IFIs to follow up their customers and issue notices and letters for reminding and warning before and after the laps of time of repayment mentioned in the contract respectively.

In addition to the above, the other various guidelines issued by the SBP for financing agriculture do not answer certain questions; which are directly or indirectly related to the recovery of debt. These questions include, for instance: Do the IFIs stipulate any penalty clause in the contract by virtue of which they may demand any financial compensation from a farmer in case of default? In case of default, who will bear all legal and other expenses incurred for the recovery of debt? How a defaulting farmer will be blacklisted? If the farmer, entirely at his own discretion, pays an additional amount when setting up his debt, then what would be the legal status of such additional amount? In case of natural disaster, how much relaxation will be given to a farmer in terms of repayment's time? All these questions have been addressed by the Islamic commercial law with minute details and, therefore, should have been included in these guidelines.

The Issue of Eligibility Criteria

The IFIs do not provide loan to every individual who applies for financing facility. They apply strict eligibility criteria in order to minimize the risk of default. The scrutiny of these criteria shows that these eligibility standards are set in such a way that excludes the lower and lower-middle class of farmers from financing facilities and makes only the upper class of farmers eligible for the same. In the same way, at times, financing facilities are earmarked for corporate clients, and individual farmers are disregarded at all. Greater funds are allocated by the financial institutions to other sectors of agriculture, such as, livestock, poultry farming, fish farming, horticulture, and livestock compared to crop farming. All these sectors require a great amount of resources and hence cannot be ventured into by a small farmer for whom agriculture is a source of life, not business.¹⁷ The special treatment

¹⁷ According to a report related to the feasibility of poultry Breeder farm, issued by the Small and Medium Enterprise Development Authority (Government of Pakistan), the minimum cost (capital cost and working capital) required for the commencement of such project is RS. 2,397,292. This huge amount cannot be provided by a small farmer or even by a farmer who belongs to lower middle class. "Pre-Feasibility Study: Poultry Breeder Farm," Small and Medium Enterprise Development Authority, Government of

given by the financial institutions to these sectors is due to many reasons. For instance, investment in these sectors appears well protected as the owners are financially strong and, at the same time, have the ability to repay loans. Similarly, they have the mandatory collaterals and securities, required by the financial institutions for the release of loan. The following statement, given in the guideline for Islamic agricultural finance by the SBP, is self-explanatory:

Individuals/partnership concerns and all types of legal entities engaged in agriculture related activities, having sufficient knowledge and relevant experience are eligible to get financing under the Islamic financing scheme.¹⁸

It is clear from the above criterion that the small farmer is excluded from making use of this financing facility. It defeats the basic purpose of equitable distribution of resources and consequently fails to achieve the intended results from launching Islamic agriculture finance. According to another guideline, known as Financing Scheme for Small Farmers, issued by the SBP, a farmer applying for financing must “have sufficient knowledge of the business/activity being carried out.”¹⁹ This condition gives discretionary power to the financial institutions, which tend, naturally, to avoid financing the lower class of farmers. The Guidelines on Islamic Financing for Agriculture almost put the same condition for the borrower.²⁰

The eligibility criterion mentioned in the above guidelines is not sound as per the *sharī'ah* perspective. Islamic commercial law does not encourage strict eligibility criteria for a borrower; rather, it asks the believers to help others at the time of need. In this regard, the Qur'ān says, “If ye loan to Allah a beautiful loan, He will double it to your (credit), and He will grant you Forgiveness.”²¹ In another Qur'ānic verse, the same direction is given, “And establish regular Prayer and give regular Charity; and loan to Allah a beautiful loan.”²² The same directions

Pakistan, [http://amis.pk/pdf/Feasibilities/SMEDA%20 %20Poultry%20Breeder%20Farm .pdf](http://amis.pk/pdf/Feasibilities/SMEDA%20%20Poultry%20Breeder%20Farm.pdf).

¹⁸ “Guidelines on Islamic Financing for Agriculture,” 12.

¹⁹ “Financing Scheme for Small Farmers,” Agricultural Credit Department, State Bank of Pakistan, 4, <http://221.120.204.42/acd/FinancingSchemeSmallFarmers.pdf>.

²⁰ “Guidelines on Islamic Financing for Agriculture,” 12.

²¹ Qur'ān 64:17.

²² Ibid., 73:20.

are given to the believers by the *sunnah*, “Anyone who gives *al-qarḍ al-ḥassan* two times, is just like he advances *ṣadaqah* one time.”²³

The above-mentioned Qur’ānic verses and the Prophetic tradition actually relate to the concept of *al-qarḍ al-ḥassan* and do not relate to other modes of Islamic finance like *murābahah*, *musāwamah*, *salam*, *istiṣnā’*, *mushārahah*, *diminishing mushārahah* or *shirkah mutanāqishah* (a typical type of *shirkah* in which one partner purchases the other partner’s share gradually and becomes the sole owner at the end), *musāqāh*, *muzāra’ah*, and *ijārah*. However, being a financing mode, the basic philosophy of *al-qarḍ al-ḥassan* (which is to help poor segments of the society) can also be extended through analogy to other modes of Islamic finance. In addition, all modes of Islamic finance are structured in such a way that helps a less fortunate person (in terms of wealth). For instance, *muḍārabah* is a famous mode of Islamic finance in which wealth flows from the hand of a rich person to that of the poor. In the same way, the contract of *salam* is recognized in order to help poor farmers in buying the basic agricultural needs. Usmani explains this as follows:

Salam was allowed by the Holy Prophet ﷺ subject to certain conditions. The basic purpose of this sale was to meet the needs of the small farmers who needed money to grow their crops and to feed their family upto the time of harvest.²⁴

Mushārahah also has the same philosophy where two or more individuals combine their little investments (as they are poor and cannot invest huge amount) in order to accumulate a larger amount and then invest the same in some profitable business. These individuals, on their own, do not have adequate amount in their personal capacity to start some business. Therefore, they conclude the contract of *mushārahah*.

The above discussion shows that the policy of strict eligibility criteria set by the financial institutions is in contradiction to the philosophy and ethics of Islamic financial system. Such philosophy and ethics must be translated into practice by the IFIs through helping poor farmers in fulfilling their agricultural requirements, both for crop and non-crop activities. It is suggested that the eligibility and creditworthiness criteria should be relaxed substantially to enable poor farmers to benefit from all financing schemes offered by the IFIs.

²³ Muḥammad b. ‘Alī b. Muḥammad al-Shwkānī, *Nayl al-Awṭār* (Beirut: Dār Iḥyā’ al-Turāth al-‘Arabī, 2001), 5:259–337.

²⁴ Usmani, *Introduction to Islamic Finance*, 186.

The Issue of Collaterals and Securities

Collaterals and securities are the most significant requirements of the financial institutions for the provision of financing facility. The credit worthiness of a client is determined on the basis of securities that he provides.²⁵ The financial institutions use securities as a risk minimization tool in order to decrease the number of defaulters. The SBP, while realizing the importance of collateral, has advised the IFIs to secure their financing and investment by accepting securities and collaterals as per their financing policies, which may include the following:

1. Charge on agricultural land through passbook system;
2. mortgage of rural, urban or commercial property;
3. mortgage of assets;
4. lien on IBI deposit, IBI guarantee;
5. individual/group guarantee;
6. any other tangible collateral security acceptable to IBI.²⁶

However, since majority of farmers in the country are not in a position to provide the required securities, they are denied financing. In case of rural farmers, the situation becomes worse as majority of farmers do not have their own land. The report of Agricultural Census 2000 shows that only 37 per cent farmers of the rural areas have their own land while 61 per cent of these land-owning households owned fewer than five acres, or 15 per cent of total land.²⁷ Recognizing this fact, the SBP has taken some initiatives and allowed the financial institutions to provide unsecured loan to the extent of Rs. 1.0 million.²⁸

In the same way, the SBP recognizes the group-based lending mechanism in order to cope with the issue of collateral and securities. The SBP has “issued Financing Scheme for Small Farmers on group based

²⁵ Walter Schaefer-Kehnert and Jhon D. Von Pischke, “Agricultural Credit Policy in Developing Countries (Agrarkreditpolitik),” World Bank Reprint Series: Number 280, January, 1982, p. 10, <http://documents1.worldbank.org/curated/en/681211468739570289/pdf/multi0page.pdf>.

²⁶ “Guidelines on Islamic Financing for Agriculture,” 13.

²⁷ Mazhar Arif, “Agriculture and Food Security in Pakistan,” 13, https://www.sappk.org/wp-content/uploads/publications/eng_publications/Agriculture_and_Food_Security.pdf.

²⁸ “Prudential Regulations for Agriculture Financing,” Agricultural Credit & Microfinance Department State Bank of Pakistan, 8, <http://www.sbp.org.pk/publications/prudential/PRsAgriApproved.pdf>.

lending methodology whereby members of the group can borrow up to Rs 200,000/- without any collateral from financial institutions.”²⁹

However, in the Guidelines on Islamic Financing for Agricultural, none of these regulations is mentioned. Consequently, none of the IFIs provides financing without appropriate collaterals. The conventional financial institutions also follow the same practice despite of vibrant directions from the regulatory authority.

There are many *sharī'ah* issues in the existing structure of collateral and securities mentioned by the SBP in the Guidelines for Islamic Financing for agriculture. First, according to an established principle of the Islamic commercial law, guarantee in trust contracts is not permitted.³⁰ According to AAOIFI Shari'ah Standards, a contract of guarantee is permissible in contracts of exchange, such as contract of sale, contract of rights, and right of intellectual property.³¹ However, it is not permissible to stipulate any guarantee in trust contracts like agency contract and contract of deposits. Therefore, no guarantee can be taken in the contract of *mushārah* or *muḍārah*.³² Some scholars even do not allow guarantee in *salam* contract.³³ However, the Guidelines on Islamic Financing for Agriculture do not differentiate between the contracts of exchange and the contracts of trust as far as the application of guarantee is concerned.

Second, the *sharī'ah* prefers personal guarantee, as it is easier and more reliable compared to other types of guarantees like mortgage, pledge, etc. The Qur'ān and the *sunnah* of the Prophet (peace be on him) also refer to this. The Qur'ān records, “They said: We miss the great beaker of the king; for him who produces it, is (the reward of) a camel load; I will be bound by it.”³⁴ As for the *sunnah*, a *ḥadīth* is narrated by Salamah b. al-Akwa', who said, “We were with the Prophet (peace be on him). . . . Then a third funeral was brought. They said, ‘O Prophet, perform prayer on him.’ He asked, ‘Has he left anything?’ They replied, ‘No.’ He asked, ‘Is he in debt?’ They replied, ‘Three dinars.’ He said, ‘Perform prayer on your companion.’ Abū Qatādah said, ‘O Messenger of

²⁹ “Handbook on Best Practices in Agri/Rural Finance,” Agricultural Credit Department, State Bank of Pakistan, 7, <http://www.sbp.org.pk/acd/Handbook-Best-Practices-Agri-Rural-Finance.pdf>.

³⁰ ‘Abd Allāh b. Qudāmāh al-Maqdisī, *al-Kāfi fī Fiqh al-Imām Aḥmad b. Ḥanbal*, 5th ed. (Beirut: al-Maktab al-Islāmī, 1988), 2:230.

³¹ AAOIFI Shari'ah Standard No. 5, Rule No. 2/1/2, English version (2010), p. 57.

³² Ibid., Rule No. 2/2/1, p. 57.

³³ Al-Maqdisī, *al-Kāfi*, 2: 230.

³⁴ Qur'ān 12:72.

Allah, perform prayer on him, and I am responsible for his debt.' Then the Prophet performed prayer on him."³⁵

As far as the Guidelines for Islamic Financing for Agricultural is concerned, it seems as if they give more value to other types of securities compared to personal guarantees. For, they start the list of securities from "charge on agricultural land" through passbook system and "mortgage of rural, urban or commercial property," come to "mortgage of asset," "lien on IBI deposit," and "IBI guarantee," and end with individual or group guarantee.³⁶ Placing individual or group guarantee at the end of the list implies that they are not given preference.

Moreover, the guidelines recommend both the individual and group-based guarantees. The *sharī'ah* recognizes the same. However, empirical research shows that farmers always prefer individual guarantee and consider it difficult to find more than one individual as guarantors for securing loan.³⁷ Thus, the group-based guarantee is against the basic ethics of the *sharī'ah*, that is, *taysīr* (easiness). Therefore, it is suggested that the SBP should ask the IFIs to opt for individual guarantee rather than group based in financing agriculture, particularly crop farming.

Another *sharī'ah* problem is with the current mechanism of securities. The Islamic banks and financial institutions ask the customer to provide a security when the transaction has not yet created any liability or a debt. This is against the Islamic law, which says that the security is provided after the financial liability is established.³⁸ The proper way, therefore, in such transaction (particularly in *murābahah*) is that the financier should ask the customer to provide the security after the sale transaction is completed. The Guidelines on Islamic Financing for Agriculture, however, do not ask the financial institutions to avoid such practices.

The Issue of Agency in Agricultural Financing

According to the Guidelines on the Islamic Financing for Agriculture, the IFIs may not have the required experience to purchase the required

³⁵ Muḥammad b. Ismā'īl al-Bukhārī, *Ṣaḥīḥ*, Kitāb al-ḥawālāt, Bāb in aḥāla dayn al-mayyit 'alā rajul jāz.

³⁶ "Guidelines on Islamic Financing for Agriculture," 13.

³⁷ Lutfullah, "Application of Islamic Financing Modes to Agricultural Sector in Pakistan: An Analysis of *Sharī'ah* and Regulatory Issues," (PhD diss., Faculty of Sharī'ah and Law, International Islamic University, Islamabad, 2015), 285.

³⁸ Muḥammad b. Ḥusayn b. 'Alī al-Ṭūrī, [*Takmilat*] *al-Baḥr al-Rā'iq Sharḥ Kanz al-Daqā'iq* (Quetta: Maktabah-i Rashīdiyyah, n.d.), 8:428.

agricultural commodities from the local market due to the lack of trading experience, limited knowledge, wide range exposures, diversified demands, customer-specific needs etc. In such a situation, it is permissible for the IFIs to hire the services of an individual as an agent for purchasing the required commodity from the open market. The institutions are allowed to appoint the customers as their agents, in case of dire need, for the same purpose. In this latter case, all risks need to be borne by the Islamic bank.³⁹

The customer agency allowed by the Guidelines for Islamic Financing for Agriculture is repugnant to the injunctions of the *sharī'ah* from many aspects. For instance, the customer agency is allowed by the contemporary Muslim scholars only in a dire need and not at all times. However, in many cases a financial institution appoints its customer as an agent, while the third party agency-ship is almost ignored in every case. This excessive use is not only a violation of the guidelines issued by the SBP, but also breaches the rules and regulations mentioned in the AAOIFI Shari'ah Standard, which states,

The original principle is that the institution itself purchases the item directly from the supplier. However, it is permissible for it to carry out the purchase by authorizing an agent, other than the purchase order, to make the purchase, and the customer should not be appointed to act as an agent except in a situation of dire need.⁴⁰

Another problem with the agency structure given in the guidelines that relate to the remuneration of a farmer when he provides his services as an agent of the bank. In the Islamic law, the agency services may be performed with or without charges. However, in the latter case, free consent of the agent must be taken. According to the renowned contemporary Jurist Wahbah Muṣṭafā al-Zuḥaylī (d.2015), "It is permissible for an agent to take charges from his principal and he can also do the same (agency) without any consideration."⁴¹ However, the Islamic banks and other IFIs neither pay any remuneration to the customer for his agency nor take his free consent for waiving of the same. This whole procedure is against the basic ethics of the *sharī'ah*. Therefore, the SBP should include in its guidelines a provision related to the consideration of the farmer for his agency.

³⁹ "Guidelines on Islamic Financing for Agriculture," 2.

⁴⁰ AAOIFI Shari'ah Standard No. 8, Rule No. 3/1/23, English version (2010), p. 117.

⁴¹ Wahbah al-Zuḥaylī, *al-Fiqh al-Islāmī wa Adillatuh*, 3rd ed. (Tehran: Nashr-i Iḥsān, 2006) 5:4058.

The customer agency is a subterfuge for the provision of conventional finance. For instance, the Islamic banks and IFIs provide cash to the customer (just as the conventional banks provide interest-based loan to their customers), assuming that he is a customer of the bank and the cash is given to him in that capacity. To be realistic, this is nothing except the change of terminologies. Contemporary Muslim scholars noticed this situation and asked the IFIs not to pay this amount directly to the customer. Rather it should be directly paid to the original seller.⁴²

Keeping in mind the discouragement of the customer agency and other related issues mentioned above, it is suggested that the Islamic banks and other IFIs should appoint a farmer—other than the farmer who applied for securing financing facility—to purchase the commodity. Based on his agricultural experience, this farmer (the agent) will be able to identify the asset and negotiate an efficient price on behalf of the Islamic bank. The bank can also appoint such a person for a series of transactions. The appointment of such a farmer—other than the customer—is an ideal solution to the problem of agency in agricultural financing, as the bank will not have to buy the commodity directly nor will it involve the customer's agency, which is not advisable from the *sharī'ah* perspective.

Violation of *Maqāṣid al-Sharī'ah*

The Guidelines on Islamic Financing for Agriculture violates *maqāṣid al-sharī'ah* (objectives of Islamic law) from many aspects. First, they promote and more serve the interests of the rich farmers compared to the small farmers. For instance, more emphasis is given on poultry farming, fish farming, horticulture, and livestock in comparison to crop farming. All these sectors, by their nature, require a huge amount of money and are, therefore, not ventured into by the small farmers. Concentration on the interests of the rich goes against the objectives of the *sharī'ah* envisaged by the contemporary Muslim scholars i.e., social welfare and support.⁴³ Second, crop farming is a source of basic food for human beings. Food comes under the category of *ḍarūriyyāt* (necessities) while other agricultural products come under the category of *ḥājjiyyāt* (supporting needs) or *taḥṣīniyyāt* (complementary values). Principally,

⁴² AAOIFI Shari'ah Standard No. 8, Rule No. 3/1/5, English version (2010), p. 118.

⁴³ Yūsuf al-Qaraḍāwī (b. 1926) adds social welfare and support, freedom, human dignity, and human fraternity to the classical list of *maqāṣid al-sharī'ah*. See Mohammad Hashim Kamali, "Maqāṣid al-sharī'ah: The Objectives of Islamic Law," *Islamic Studies* 38, no. 2 (1999): 200.

the first category has precedence over the second and third categories. It is, therefore, need of the time to give priority to crop farming over other sectors of agriculture in the same way as *darūriyyāt* are given priority over *hājjiyyāt* and *taḥsīniyyāt*. However, the Guidelines on Islamic Financing for Agriculture oppose this basic approach of Islamic law towards human needs and wants. Third, the rules, regulations, and requirements related to the eligibility criteria, guarantee, recovery, procedure, etc. are designed in such a way that create difficulty for the lower class of farmers who consequently avoid getting financing facility. This also goes against an important purpose of the *sharīah*, i.e., *taysīr* (easiness).

No Assurance of Active Involvement of IFIs in Agribusiness

According to Islamic law, money has no intrinsic utility, hence not a source of profit. In commercial activities, like purchase and hiring, currency can be used only as a medium of exchange and no other character can be given to it under any stretch of explanation. Commodity, on the other hand, can be used as a source of profit for having intrinsic utility.⁴⁴ Following this basic philosophy, money cannot be a subject matter of trade in any form. Conventional financial system allows both money and commodity as sources of profit. Therefore, no legal restriction is put on trading in currencies therein. However, IFIs are bound to be involved in actual business activities and must not provide interest-based financing.

The Guidelines on Islamic Financing for Agriculture ignore the above principle and do not ask the financial institutions to actively participate in agribusiness. The term “financing agriculture” is frequently used in these guidelines. This also implies that active involvement in trade is not declared mandatory. The guidelines themselves state, “There are certain issues and problems in implementing the trade model of Islamic finance in Islamic banking industry, which can be addressed through adherence to the rules of Islamic financing.”⁴⁵ They further add that the IFIs should do physical inspection of the required agricultural goods and commodities and should take their possession, either actually or constructively. However, the guidelines then provide exceptions to this principle and allow the Islamic banks to resort to customer agency, indirect inspection of the property, indirect payment through the agent, etc. All these are various

⁴⁴ For details, See Usmani, *Introduction to Islamic Finance*.

⁴⁵ “Guidelines on Islamic Financing for Agriculture,” 2.

subterfuges that keep the IFIs away from actual trade in agribusiness. The inclusion of various concepts like securities, collateral, insurance, monitoring, and recovery system in the Guidelines on Islamic Financing for Agriculture implies that the SBP does not intend to introduce and develop true Islamic agricultural finance; rather, it encourages the Islamic banks to design their agricultural finance on lines similar to that of conventional agricultural finance.

Not Sufficient Discussion of *Muzāra'ah*, *Musāqāh*, and *Mughārasah*

There are some special contracts in Islamic commercial law designed for agricultural development and production. These contracts include *Muzāra'ah*, *Musāqāh*, and *Mughārasah*. *Muzāra'ah* is a contract for cultivation of land in return for part of the produce in accordance with the conditions stipulated by law.⁴⁶ According to Ibn Qudāmah (d. 620/1223), "It is a contract where a land is handed over by one party to another for cultivation in return for part of the produce."⁴⁷ *Musāqāh*, another important agricultural contract, is defined by the renowned Ḥanafī jurist al-Kāsānī (d. 587/1191) as "a contract of work for part of the produce along with the condition of validity."⁴⁸ A more comprehensive definition given by Ibn Qudāmah is as follow: "It is a contract for the caring of trees for part of their fruits."⁴⁹ *Mughārasah* is a contract in which one party provides a treeless piece of land to another to plant trees on it on the condition that they share the trees and fruits according to the agreed ratio.⁵⁰

Although the Guidelines on Islamic Financing for Agriculture discuss the basic principles, application, and procedure for all these transactions. However, they do not discuss them in terms of financing or working capital despite the fact that all these transactions have a great potential for the enhancement of agricultural production. For example, *muzāra'ah* is very useful, particularly, for large lands where two parties are interested in participating in the agricultural finance.⁵¹ Similarly, *Musāqāh* is a very useful transaction, especially, in the rural areas. Such an arrangement can greatly help reduce the menace of unemployment

⁴⁶ 'Alī b. Abī Bakr al-Marghīnānī, *al-Hidāyah*, 2nd ed. (Karachi: Maktabat al-Bushrā, 2008), 7:99.

⁴⁷ Al-Maqdisī, *al-Kāfī*, 2:298.

⁴⁸ 'Alā' al-Dīn al-Kāsānī, *Badā'ī' al-Ṣanā'ī' fī Tartīb al-Sharā'ī'* (Beirut: Dār al-Fikr, 1996), 6: 280.

⁴⁹ Al-Maqdisī, *al-Kāfī*, 2:289.

⁵⁰ "Guidelines on Islamic Financing for Agriculture," 12.

⁵¹ Lutfullah Saqib, *Financing Agriculture through Islamic Commercial Transactions: Theory and Practice* (Saarbrücken: Lambert, 2011), 70.

in these areas. For example, if there is a *Musāqāh* contract between an Islamic bank and the owner of the land then the former will provide labour and be responsible for the entire work on the land, while the latter will provide the land having fruit trees.⁵² In this scenario, it is possible for the Islamic bank to hire the services of other local farmers who will irrigate the trees and carry out other work related to their responsibilities. However, the SBP does not take concrete measures for implementing all these transactions in agricultural financing schemes. The reason is that all these contracts necessitate active involvement of the parties, which is against the basic nature of the business carried out by the financial institutions. Because of this reason, none of the financial institutions in the country has made these contracts yet. It is, therefore, suggested that the SBP should bound, above all, the IFIs, to enter into these transactions while financing agricultural activities.

Use of Conventional Insurance for Loan Disbursed

Another problem with the current Islamic agricultural finance is the insurance coverage used by the financial institutions to protect the amount disbursed for crop and non-crop activities. In addition to the amount financed, the life insurance of the borrower is also arranged in order to safeguard rights of both the bank and its borrower.⁵³ Sometime insurance policy is extended to agricultural yield for the purpose to protect the parties concerned from bearing loss in case of natural disaster like droughts, floods, hailstorms, earthquakes, mudslides, and a multitude of other mishaps.

Being a prohibited commercial deal in the *sharī'ah*, the IFIs are not allowed to opt for any type of insurance in their financing activities. However, as an alternate, the concept of *takāful* (Islamic insurance) can be used to serve all the required purposes. The Guidelines on Islamic Financing for Agriculture ironically advises the IFIs to cover their advanced amount through insurance. The word 'insurance' is more frequently used with the word "*takāful*," indirectly allowing the financial institutions to secure their financing through conventional insurance. The following statement of the guideline can be cited as evidence in this regard:

⁵² See Saqib et al., "*Mushārahah*—A Realistic Approach to the Concept in Islamic Finance and Its Application to the Agricultural Sector in Pakistan," *Arab Law Quarterly* 28, no. 1 (2014): 1–39.

⁵³ "Financing Scheme for Small Farmers," 6.

Further insurance/Takaful cover should be obtained for the asset to safeguard the interest of IBI and the customer from risks of losses due to circumstances beyond the control of the customer.⁵⁴

Similar words have been used in other guidelines issued by the SBP for the conventional agricultural finance.

Banks are advised to arrange insurance of the amount of loan disbursed for crop and non-crop activities and life insurance of the borrower to safeguard the interest of the borrower and the bank, in cases of losses due to natural calamity or event beyond the control of the borrower.⁵⁵

Being a regulatory authority, the SBP is supposed to bind the IFIs to follow the *takāful* in Islamic agricultural finance. Strict actions should be taken against the financial institutions that violate the regulations and use conventional insurance.

Conclusion and Recommendations

The *sharīah* prohibits Muslims from securing any interest-based loan whether from formal or informal sources. Muslim farmers are required to meet their agricultural needs from the financial sources that are acceptable to and endorsed by the *sharīah*. Islam presents a comprehensive and easy way for farmers, Islamic banks, and IFIs to enter into various commercial transactions, which are viable for all stakeholders and indispensable for the development of the agricultural sector. The Islamic banks and other IFIs have been financing agricultural activities based on Islamic modes of financing for the last few decades. However, the desired results have not yet been achieved. There are many reasons, in the view of the present authors, for this poor state of affairs.

First, being a regulatory authority, the SBP has asked all the financial institutions to determine their mark-up on the basis of KIBOR, a benchmark that is used by the conventional financial institutions for the determination of interest rates. The IFIs also determine their profit margin according to the same benchmark.

Second, in the Guidelines on Islamic Financing for Agriculture, the SBP has recommended stringent rules and regulations for monitoring and recovery system. This procedure is not in line with Islamic ethics for the recovery of any financial liability. The Islamic law, on the other

⁵⁴ "Guidelines on Islamic Financing for Agriculture," 13.

⁵⁵ "Financing Scheme for Small Farmers," 6.

hand, presents a recovery procedure, which draws upon the principles of justice, ease, and human respect.

Third, scrutiny of the Guidelines on Islamic Financing for Agriculture reveals that the small farmers cannot fulfil the eligibility standards mentioned in it. Similarly, at times, the financing activities are shifted to corporate clients and the individual farmers are hence ignored. The eligibility criterion, on the same way, is not based on Islamic ethics, which do not recognize the strict eligibility criterion for a borrower rather encourage the believers to help the needy.

Fourth, the Guidelines on Islamic Financing for Agriculture prefer pledge and mortgage to personal guarantees. The *sharī'ah*, on the other hand, prefers the personal guarantee, as it is more reliable and easier compared to other types of guarantees like mortgage, pledge, etc.

Fifth, the customer agency recommended by the Guidelines on Islamic Financing for Agriculture is repugnant to the injunctions of the *sharī'ah*. In many cases, a financial institution appoints its customer as an agent and ignores the third-party agency-ship. This not only violates the guidelines issued by the SBP, but also breaches the rules and regulations mentioned in the AAOIFI Shari'ah Standards.

Sixth, the Guidelines on Islamic Financing for Agriculture also violate *maqāsid al-sharī'ah* from many aspects. 1) They promote and serve the interest of the rich farmers rather than that of the small farmers. For instance, more importance is given to poultry farming, fish farming, horticulture, and livestock compared to the crop farming. Poultry farming, fish farming, horticulture, and livestock require a large amount of money and are, therefore, not ventured into by small farmers. 2) Crop farming is a source of basic food for human beings. Therefore, priority must be given to it over other sectors of agriculture in the same way as *darūriyyāt* have precedence over *hājīyyāt* and *taḥsīniyyāt*. However, the Guidelines on the Islamic Financing for Agriculture oppose this approach of the Islamic law towards human needs and wants.

Seventh, the Guidelines on Islamic Financing for Agriculture do not ask the financial institutions to actively participate in agribusiness. The Islamic commercial law, on the other hand, requires active involvement of all partners in the business.

The intended results from all modes of Islamic finance can be achieved only if certain alterations are made in the existing operational structure of IFIs. First, the existing procedure adopted by the IFIs is complex. It should be replaced with a simpler procedure understandable to the farmers who need financing but may not avail it due to the complexity of the procedure. Second, these institutions should earn less profit from small farmers compared to other customers in line with the

basic ethics of cooperation and welfare of society aimed by the Islamic financial system. Third, the crop farming may be concentrated more in terms of financing than other sectors of agriculture like livestock, dairy farming, fish farming, horticulture, poultry farming, etc. Fourth, since majority of farmers belong to the lower class and consequently are not in a position to provide securities and other forms of collaterals, the financial institutions should adopt other techniques for the protection of their liquidity. The best possible solution to this problem may be the provision of personal or group-based securities. Fifth, the financial institutions should follow a simple and accurate procedure for the provision of financing facilities and make best possible efforts for the reduction of transactional costs. Sixth, a possible solution to the problem of the customer's agency—which is not advisable from the *shari'ah* perspective—is that the financial institute may appoint any farmer—other than the customer—of the same locality as its agent. Seventh, the SBP should strictly bar the IFIs from charging interest in any form and take serious actions against them in case of violation. Such actions may start from pecuniary punishment to the cancellation of registration. The advisory type of guidelines are not a successful strategy to prevent IFIs from entering into interest-based transactions. They may simply change the term “interest” with “profit” and the term “rescheduling” with “penalty for the default of payment.” Last, the eligibility and creditworthiness criteria should be relaxed so that poor farmers may get more benefit from financing schemes offered by the IFIs.

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