SHORT TERM FINANCING OF COMMODITY PRODUCTION IN ISLAMIC PERSPECTIVE

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SHORT TERM FINANCING OF COMMODITY PRODUCTION IN ISLAMIC PERSPECTIVE

INTRODUCTION

All *Shari'ah* compatible modes of financing could be utilized in financing commodity production. These include *sharikah, mudarabah, murabahah*, instalment sale, etc. In spite of their differences, all these modes may be used for short-term as well as for long-term financing.

However, we wish to make three restrictions on the scope of the present paper in order to avoid a common habit of generalism and not going into specific characteristics of the issue on hand.

The first restriction is that this paper will only discuss those Islamic modes most suited for short-term financing. Hence, Islamic modes covered in this study are only those which have actual and/or potential use in short-term financing. Obviously, this excludes long-term leasing of plants and equipments as well as instalment sale.

Additionally, our analysis is further confined to the short-term peculiarities of the modes covered i.e. we will not write an essay on the general features of these modes nor indulge in reiterating their advantages and proclaiming their superiority over interest-based financing as this is mentioned in many other papers.

The second restriction is excluding both financing of services and purchaser financing. After taking a full account of the modes of financing industrial and agricultural production, financing of services may become an exercise of mere extension of the application of some of these modes to the services sector.

On the other hand, financing of commodity user, whether importer, trader or consumer is usually done by means of Murabahah, instalment sale and Ijarah and these are subject of many researches published during the last one and a half decades.

The third restriction excludes the whole block of pure financing and the worries of financial intermediaries with regard to utilization of funds available. Thus overnight utilization of liquidity falls outside the limits of this paper as it is not a concern of financing commodity production. Obviously, this and the previous two restrictions are all imposed by the title we selected for our paper, i.e. financing of the supply side.

Consequently, this paper is limited to the analysis of financing commodity production in the short-run in both industry and agriculture. This means financing working capital for periods which do not usually exceed one year.

We have divided this paper in three sections. Section one deals with financing of industrial production. It will look into non-debt based and debt based modes of financing respectively. It will also discuss the role of commodity markets in enhancing the application of debt based Islamic modes of financing.

Section two will be devoted to financing agricultural production. This covers *mudarabah* and *sharikah* in farming, *salam*, machinery provision on the basis of crop sharing, and short term equipment leasing.

Finally, section three summarizes our conclusions.

SECTION I
SHORT TERM FINANCING OF INDUSTRIAL PRODUCTION

One of the essential characteristics of Islamic financing is that it is always tightly related to the real market of production, distribution and consumption.[1] Hence, financing commodity production falls in the heart of Islamic financing, especially that consumers are always advised not to stretch their purchases beyond their own means.

Short term financing enhance industrial production in supplying them with funds needed to pay for raw materials, labor compensation, cost of other inputs such water, electricity, storage, marketing, etc. Producers very often prefer to use outside sources to finance these need so that they can devote their internal of self financing ability for long term growth.

Financing may be provided on the basis of sharing in which a partnership relationship is

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[1] Except for the *qard* [loan] all modes of financing in Islam require that funds can only be given to finance certain real operation e.g. commodity production or commodity trading. This means that financing is done to an economic activity not simply to a person. *Qard* does not entitle the lender to any return. It is therefore excluded from our analysis.

established between the producer and the financier or on the basis of debt where financing creates a debtor\creditor relationship.[2]

A- Sharing based financing

From Islamic point of view, industrial production financing may be done on the basis of sharing ventures undertaken by the producer which requires sharing also the outcome of these ventures. In the context of financing commodity production of already existing producers, sharing based financing demands that financier becomes a partner of the producer in property ownership as well as in risks involved.

Theoretically, sharing based financing may take one of the following three forms: *sharikah,*[3] *mudarabah* and output sharing. however, output sharing is mainly applied in agriculture in the form of *muzara'ah* and only the hanbalites extend its application to some other practices, e.g., giving one's mule to somebody to use it for transporting other people's goods and they share the return. Therefore, we will exclude it from this section and we will focus on *sharikah* and *mudarabah.*

***Sharikah* with variable capital**

From the point of view of financing, the main features of *sharikah* in Islamic jurisprudence are:[4]

[2] *Ijarah* may be added since, although it is essentially a long-term mode, it may be used for short-term financing. However we will not include it in this section as it is covered in financing agricultural production.

[3] *Sharikah* means partnership. In the Islamic jurisprudence literature there are four kinds of *sharikah*: *mufawadah* in which partners equally share every thing, *wujuh* which has no capital and works on credit obtained from outside, *a'mal* (or *sana'i'*) which is between craftsmen (or professionals) who sell there services and has either little or no capital, and lastly *'anan* in which partners may have variant shares in capital, labor and profit provided that losses are distributed in proportion to capital, (see al Khafif). Throughout this paper we use *sharikah* for *sharikah al 'anan*.

[4] These features are taken mainly from al Khafif and al Marzuqi, see also Siddiqi. It should be

1- all parties contribute to capital so they share the ownership of the properties of the *sharikah*;

2- they also share in providing their own work. However, any of them may choose to leave all the work to other partners and remains silent or sleeping but he always reserves the right to revoke this authorization and exercise his right in participating in the decision making of the partnership;

3- profit is distributed in accordance with agreed upon shares which may or may not be the same as the shares in capital;

4- distribution of losses can only be done in accordance with the shares of capital since losses are strictly defined in *Shari'ah* as a decrease of capital.

These features give the financier the right to interfere in management which, though may be a burden, offers a protection that may be resorted to when needed. More important is that *sharikah* offers a short term financing mode suitable for industrial production which demands gradual financing whose timing is synchronized with the dates of payments for labor and other industrial inputs. This convenience is obtained through the concept of variable capital in the *fiqh* of *sharikah.*

In general the *fiqh* of *sharikah* requires that the principal of each partner should be cash, known and paid at the time of contract, (al Khafif: 546-547).

The Shafi'ites, however, mention that partners' shares of capital need not be known and determined in advance as long as it is possible to have these shares unequivocally determined and known by an accounting method or any other means before the date of distribution of profit\loss. (See <u>Nihayat al Muhtaj</u>, V. 5, p.8). The author of this Shafi'i book continues that the reason for the

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mentioned that since our intention is to argue the special case which is related to the purpose of this paper, many details are disregarded because they do not affect our argument.

relaxation of the condition which requires knowledge of capital shares at the time of contract is that "the right is only between them." But if there is no way for knowing the distribution of shares of capital before distribution of profit and loss, then the contract of partnership is void, (Ibid.).

This rule of the Shafi'ites permits forming a partnership with variable capital. At the time of contract, only the partnership clauses are agreed upon which should include a clear cut method for determining the respective shares in capital of the financier and the industrialist although the amount of these shares need not be determined at the time of the contract. This also allows the financier to apply the concept of the line of credit, i. e., fixing a maximum amount of financing and leaving actual utilization of fund to determine the amount actually contributing to the *sharikah.*

One way of determining these shares could be the known method of "amount times number of days." This method requires that from the beginning of the partnership, say on january one, the amount furnished by the industrialist is known from the balance sheet. This will be multiplied by 365 until the end of the year. any amount added or withdrawn by the industrialist will be treated the same way. On the other hand, funds supplied by the financier will also be treated by applying the same rule. At the end of the partnership, say end of the year, the percentage of total numbers of the financier to the grand total of numbers of both partners represent the share of the financier to total capital of the *sharikah*.

Another way of determining the shares of capital could be by fixing the multiplication factors as months or quarters instead of days in the same method of calculation. This is applied in many Islamic banks with regard to the pool of investment deposits. In fact, the determination of these intervals depends to a large extent on the sophistication of accounting methods and the nature of business which decides the cycle of turn over of mobile capital.

It should be noted that the variation of capital in *sharikah* is facilitated by an other principle borrowed from the Hanafites. According to al Mabsut, it is not necessary to have the capital of a *sharikah* available at the time of contract nor to mix it (al Mabsut, V. 11, p. 152). this implies that it permissible to establish a *sharikah* without paying the capital at the time of contract as long as it is paid at the time of purchase (ibid.), i. e., when the new partnership needs funds to make payment for goods and services it acquires from others.

Advantages of *sharikah* with variable capital:

This type of *sharikah* offers the financier the following advantages:

i- flexibility in the amount, date and mode of payment of share in capital. Financier may pay contribution on date such amounts are due to outsiders for services and goods purchased. Payment may also be made directly to the sellers.

ii- accessibility to management and control over the company being financed. Financier need not use this authority unless in case of necessity in order to prevent or minimize losses and moral hazards. This way,financier has accessibility to means of minimizing commercial and non commercial risks. This is of course at the cost of time and effort consumed in management.

iii- The general advantages of sharing financing which are basically higher expected rate of return associated with higher risk exposure.

On the other hand, this form of financing offers the producer the advantage of not having to carry the burden of the financier for more than what is necessary, hence he\she would be able to minimize the cost of capital. This is of course in addition to the general advantages of sharing principle of not having to carry the risk of production alone.

Short term *mudarabah* certificates

Like *sharikah, mudarabah* is also based on the principle of sharing. Its characteristics are similar to those of *sharikah* with only one exception related to management.[5] Called *rabb al mal* [owner of fund], the financier forsakes all managerial decision making to the working party who is called *mudarib*.

In the simple form of *mudarabah rabb al mal* provides all funds and the *mudarib* puts all the work. But in order to use this mode of financing for short term commodity financing we have to resort to an adaptable version which suits financing working capital for an already existing firm.

Two known characteristics of *mudarabah* will be used in formulating this adaptable version, namely: funds of several financiers may be mixed together and used in the same *mudarabah*, and funds of financiers may also be mixed with funds of the *mudarib.*

With the help of these two characteristics, *mudarabah* becomes amenable to short term industrial production financing. Shari'ah specialists will be able to formulate certificates for public offering to finance working capital for certain period of time which depends on the production cycle of concerned industry.

Since *mudarabah* certificates represents real assets invested in industry, there should be no problem about their negotiability. However, because they have short durability they would require an efficient finance market with information available at short intervals.

Mudarabah certificates relieve the financier of the managerial burden at the expense of

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5 Many classical *fiqh* writings would argue that *mudarabah* can only be used in trade without any industrial work. But there are a few hints that it can be used in agriculture and in industry as the latter involves buying materials, manufacturing and selling them. Therefore, the Hanafites, malikites and hanbalites, one way or another allow *mudarabah* in agriculture and industry. Moreover, this restriction of *mudarabah* to trade alone is not supported by any text of verses or sayings. See for discussion of this issue Monzer Kahf, *Mafhum al Tamwil fi al Iqtisad al Islami* [Concept of Finance in Islamic Economics], IRTI 1412, pp 24 - 31; Ibn Qudamah, *al Mughni*, Dar al Kitab al 'Arabi, beirut 1972, V. 5, p. 188 and *al Sharh al Kabir*, printed with al Mughni, V. 5, p. 193 ; and al Kasani, *Bada'i' al sana'i'*, Dar al Kitab al 'Arabi, 1394 H, V. 6, pp. 91-92.

keeping him\her away of authority and control. This means that the risk related to moral hazards is obviously higher in *mudarabah* than in *sharikah*. Therefore, *mudarabah* suits risk takers and venturers and it offers them higher expected return at equilibrium.

lastly, it may be noted that variability of capital of may be applied with respect to *rabb al mal* in *mudarabah* on one hand and *sharikah* may be formed by issuance of short term certificates which are tuned to financing working capital if we have a sophisticated finance market.

B- **<u>Trade based financing</u>**

While sharing financing makes the financier a co-owner of the assets of the firm and establishes a partnership kind of relation, debt financing creates a creditor\debtor relationship and does not give room for financier's interference in the decision making of the firm. Thus, it offers advantages for risk takers, independent minded producers.

On the other hand, debt financing is a heaven for risk averting financiers because some of its forms provides them with minimum amount of risk below which *Shari'ah* does not permit any earning on financing.

The most famous form of debt based financing in undoubtedly *murabahah li al 'amir bi al shira'* [sale on mark up for the person who ordered the purchase]. it certainly fits short term commodity production financing because it is capable of financing the purchase of raw materials, small tools and supplies used in industrial production. However, *murabahah* cannot be used for financing certain services such as labor compensation, electricity and telephone. Therefore, other modes of financing are needed.

Additionally, since *murabahah* is discussed in details in many contemporary writings, we devote the rest of this sub-section to analyzing two other modes for short term commodity financing which are *'istisna'* and *salam*.

<u>'Istisna'</u>

'Istisna' is a version of sale contract on providing a manufactured product whose specifications are determined at the time of contract, (Dunia, p. 29). This contract may be used as a financing mode if the financier pays the price at the time of contract, the thing which enables the producer of having sufficient funds to pay for inputs of production. Payment of price may be made on installments as production progresses. *'istisna'* creates a debt in kind, i. e., in terms of manufactured goods which will be delivered at a future date.

For the firm, *'istisna'* financing secures funding and sale of output at the same time whereas the financier is assured of supply of commodities he\she needs. Accordingly, *'istisna'* is convenient for users of manufactured goods a lot more than it is for financial intermediaries.

<u>*salam*</u>

Salam is similar to *'istisna'* in that it is a version of sale contract in which goods sold on the basis of clear and detailed specification without being necessarily existing at the time of the contract. It is also similar to *'istisna'* in creating an in-kind debt on the part of producer which is represented by an obligation to deliver certain quantity of his\her output at a certain future date. In *salam,* however, payment of the price must be immediate, i. e., at the time of contract, ('Abdallah, pp. 129 - 138).

Salam offers the same financing characteristics and advantages to the financier and the industrial firm as *'istisna'*.[6] It is more suitable to users of manufactured goods who need a flow of future supply than financial intermediaries.

However, in order to make these two modes of financing attractive to financial intermediaries we have to fulfill two conditions. Firstly, banks have to be able to rid themselves of

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[6] It should be noted that *salam* may be used for agricultural products while *'istisna'* requires manufacturing ingredients in the goods sold, (see Dunia and 'Abdallah).

the goods purchased ; and secondly, this arrangement has to be done in a manner acceptable to *Shari'ah*.

Sale of goods purchased by *salam* and *'istisna'*

The ability of the financier to sell goods is usually week because of several factors: First, the financier will have to compete with the producers themselves; second, he\she are usually less skilled and experienced in the commodity market than specialized traders and producers; third, only very few manufactured commodities and a small number of minerals and agricultural products are standardized to the extend that they have wide market; and fourth, organized commodity markets is a very limited or absent phenomenon in most Muslim countries.

Part of the suggested solution lies undoubtedly in the establishment of organized commodity markets and the expansion of the existing ones since these market enable the financier to sell contracts similar in quantity and date of delivery to those purchased through *salam* and *'istisna'* financing techniques. Additionally, more standardization of agricultural and manufactured products would enhance introducing these products into the organized markets. Also, establishment of permanent exhibitions would strengthen the ability of the financier to sell goods purchased by means of financing.

However, a stumbling difficulty remains because on one hand, what is suggested above would only work in the long run and would not apply to most manufactured goods and to many agricultural products. Hence, an immediate solution need to be sought through modifying the financing operation -within the limits of *Shari'ah*- in such a way which keeps the financing institution out of the fear of ending up with having goods that it cannot sell.

Multi *salam* \ *'istisna'* contracts

The financier may enter in a *salam ('istisna')* as a seller at the same time that he\she enters into the financing relationship with the producer. Although these two contracts of the financier are totally separate from, and not dependent on each other, quantities and delivery date are made the same so that financier would assure minimum involvement in marketing and physical handling of goods purchased on the basis of *'istisna'* or *salam.*

Exactly as in the well established case of *murabahah li al 'amir be al shira'* where the user of funds may act as an agent of the financier in handling goods purchased by the financier (on order from the user) through a separate contract, here also the producer firm (user of financing) may act as an agent of the financier in handling the sale and delivery of goods produced and owned by the financier.

In other word, the case may very often be that we have a manufacturer of goods and a buyer but neither of them has necessary finance to start production. The financier may step in with two *'istisna'* contracts, as a purchaser for cash with the producer, and as a seller for deferred payment with the user of goods.

According to the Hanafites, *'istisna'* does not require that price be paid at the time of contract and may be delayed to any agreed upon date in the future, (Dunia, p.35 and his references). Therefore, the sale contract (between the financier and the final user of goods) may take the form of *'istisna'* with payment on delivery, while the purchase contract (between financier and producer) would take the form of *'istisna'* with immediate or installment payment as the need may be.

On the other hand, *Salam* requires that payment of price should be done at the time of contract which works perfect for the financing contract. But fulfillment of this condition makes sale contract difficult if the form of *salam* is desired. This problem may be solved by suggesting that this contract takes the form of a promise to make a contract in the future.[7]

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[7] It must be noted that according to some scholars it may be permissible to conclude a sale contract on the basis of complete and described specifications with the delay of both delivery and payment of price. See, for instance, Abdallah, pp. 238-250. The issue, however, calls for deliberation by *Shari'ah* specialists and may require fresh thinking and conclusive agreed upon opinion.

Finally, a combination of *'istisna'\salam* for the purchase contract with a *murabahah* for the sale contract is also possible as pointed out by dunia, (p. 45).

SECTION II

SHORT TERM FINANCING - AGRICULTURE PRODUCTION

Almost all Islamic modes of financing that are available for short term financing in industrial section can be utilized for agriculture financing as well. This section discusses the short term financing of agriculture under the following 3 principles :

1) Principle of Bay Salam Based Finance
2) Principle of Participatory Finance
3) Principle of Leasing Based Finance

A. Principle of Bay Salam

The principle of Bay Salam is primarily a mode of financing commodity production particularly in agriculture sector. The principle is to make advance cash purchases of products at a predetermined price when, during the process of production, the producer feels a financial constraint on part of his working capital needs. This principle is probably the easiest to implement in case of agriculture. The principle can be applied in the form of several variants to meet the contemporary needs of financing commodity production in agriculture sector. The financing based on this principle can enter into the production plans any time starting from the stage of planning of production.

Within the Shari'a restrictions on Bay-Salam, there remains multiplicity of possibilities to utilize this mode for contemporary commodity financing. The following are some examples:

1) Working Capital needs in Agricultural Sector

This may not merely be for production of crops but also for various other productive activities within agricultural sector such as poultry farming, dairy production, cattle breeding, fishery, forestry etc. The only problem that a financial institutions will face in providing such a financing would be disposal of the commodities that the Bank will be receiving.

The bank will need to have an agriculture marketing department which most of the contemporary Islamic banks do not have. Though it is possible that the bank may line up the prospective buyers of the commodities, there will always remain a possibility for the banks to get involved in the actual marketing of the goods.

Furthermore financial laws of some of the countries may not allow the banks to enter into commodity trading. Some special legal provisions will be required for the Islamic banks to meet their needs.

2) Hypothetication of Commodities

The contemporary practice of interest based financing through hypothetication of commodities can probably be replaced by financing through Bay Salam. The farmer or agricultural producer can get his product sold to the Bank and the Bank can promise to resell the good (on a mark up) to the farmer as soon as they are produced or become available.

The bank will probably not be allowed to do a simultaneous contract of resale, yet they can probably make promise to do so. Hypothecation-cum-resale procedure can also be used to provide a line of credit to the farmer or producer of agricultural products provided it is carefully scrutinized from Shari'ah point of view.

3) Financing Government Procurement

Most of the Governments of developing countries have to undertake various commodity operations. This includes procuring certain agricultural commodities at a certain support price. Govt. of course needs financing for such operations. Banks can use the principle of Bay Salam (in conjunction with the principle of Bai Murabaha) for this purpose. Bank pays to the farmers the procurement price even before the crop is ready. When the crop is ready, the bank resells the commodity to the Govt on a certain mark-up. No storing or marketing problems arise in this case for the bank, since the storage houses of the government are used for storage and since resale to government is already committed (even without a written contract). This probably would not pose any Shari'ah problems, nor would it create any marketing or other special problem for the bank.

B. **Principle of Participatory Finance**

The principle of participatory finance is based on the principle of either;

i) Output Sharing or

ii) Profit-Loss Sharing

In agriculture, it is mostly the out-put sharing modes of financing that are referred to. These modes are known are Muzarah and Musaqah. The profit-Loss Sharing based modes of financing known as Mudarabah and Musharakah have also been introduced in the contemporary application of Islamic methods of financing in agriculture. Another method of finance is based on two tier leasing.

The three modes of financing are briefly described below with respect to their application in agricultural commodity financing.

B.1. Output-Sharing Based Financing

a) Muzara'ah - Muzara'ah is considered to be one of the very useful modes for the supply of short-term financial needs in the agriculture sector and hence quite suitable for the banking sector to utilize. A bank can use this mode if it has somehow obtained authorization to occupy or use any piece of agricultural land. (A bank might have acquired such authorization as a result of another financing deal where the land might have been hypotheticated or might have been acquired on mortgage).

Alternatively, financing of agricultural production can be obtained from a bank on Muzara'ah principle on following basis :

i) The owner of a piece of land interested to cultivate it, approaches the bank for necessary funds to finance production of certain commodities.

ii) The bank may purchase the piece of land with an implicit understanding to resell it to the client (at the same price) after Muzara'ah contract expires. This may take the form of bay' al wafa' known in the Hanafi School.

iii) A Muzara'ah contract to cultivate the land can be signed between the bank as landowner and the client as working partner with the provision to share the output of the land either in physical term before it is marketed or in financial terms after it is marketed.

b) Musaqah - The operation of Musaqah contract is same as of Muzarah except that it will have "trees" in addition to land as the basis for financing. Musaqah can prove as one of the facilities whose proper exploitation can play an important role in financing agriculture production.

B.2. Profit-Loss Sharing Principle

It is possible particularly to finance commodity in agricultural sector on the basis of profit-sharing. Marketing of agriculture output is usually the stage where producer is in urgent need of financing. This need often leads him to be exploited by the middleman. Also his inability to bear the costs of storage, transportation etc. required for marketing compels the producer to sell his output to middleman at cheaper prices. When the crop is ready the bank may enter into a Musharakah contract with the producer. The bank will buy a proportion of the output at farm gate corresponding to the needed amount of financing and a sharikat will be formed on the basis of sharing the ownership of output at farm gate. Transportation, storage and marketing expenses will be either shared by the two parties or paid by one of them and the profit sharing formula will be determined accordingly. The practice of this mode of financial operations by some of the contemporary Islamic banks has already proved its efficiency in agriculture financing.

B.3 **Short Term Leasing**

Short term leasing of equipment can also meet the needs of agriculture financing. In order not to put a bank into actual leasing business by owning the equipment, the bank, here too can do a two tier leasing. Leasing the equipment on cash basis from a leasing company and giving it on lease to the producer on agriculture sector on deferred payment basis. The rent charged to the producer, of course, would be higher then the rent paid to the leasing company and hence generating income for the bank.

SECTION III

CONCLUSION

Commodity financing will be quite suitable for Islamic commercial banks particularly because of the short term nature of financing involved.

Islamic financial system provides a whole spectrum of modes of financing that are applicable for commodity financing which gives a wide flexibility to the Islamic banks to select the mode that suits them best with respect to any particularly demand for financing.

With the exception of a couple of modes, all other modes will generally require the banks to enter into actually handling the stock of output or machinery. The concept of two tier contracts, however, makes possible for the banks to provide financing through any of the modes described above without actually handling the stocks or equipment.

The above discussion refers to situations where individual Islamic banks are looking for opportunities in agriculture financing in a society which is otherwise interest-based. Council of Islamic Ideology Pakistan while presenting its report on how to eliminate interest from the economy made elaborate suggestions with respect to short term financing. It will be instructive to see their recommendations. A copy of the relevant part of the report is attached as annexure to this paper.

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