Application of Islamic banking Instrument (Murābaha) for Sugarcane Industry in Developing Countries

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Abstract

Food is the basic need without which life cannot exist. It is estimated that world population will increase by 70 percent by 2050. This necessitates the need to increase the food production at an increasing rate to ensure the life existence at the present level. Sugar, being an important part of human nutrition, is a vital necessity. Therefore, increasing the production of sugar is as important as any other food item. This objective can only be achieved if small farmers and small business owners play their invaluable and effective role in this pursuit. However, they often face financial constraints which, in turn restrain them from realizing their full potential. *Murābaha* (cost plus profit sale) mode of financing, as offered by Islamic Banks offers a potential solution to this perpetual problem of small farmers and small business owners. This mode, if practiced properly, can be equally beneficial for sugar grower (small farmers), sugar mill owners (small business owners) as well as for the Islamic banks/financial institutions.

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Key Words: Murābaha, Sugarcane, Sugarcane, Industry, Financing, Islamic bank, Islamic financial institutions

1. Introduction

World population is expected to increase by 70 percent from 6 billion to 9 billion by 2050 (Lianto & Badiola, 2010). Unless a corresponding increase in food production is achieved, the future food scenario is likely to be quite bleak. The bulk of world population lives in Asia, Africa, and South America, where most of the countries are relatively poor and underdeveloped. One of the important methods of increasing the food production is to increase per acre yield. However, the farmers of these poor regions cannot afford the cost of mechanized farming, which is essential for increasing the per acre yield. The solution lies in the provision of financial support which may either be extended by the Governments or the financial institutions. This paper intends to make a case for the application of *Murābaha* (Sale with profit, one of the *Ribā* (interest) free modes as the main source of agricultural financing) as offered by Islamic banks and financial institutions.

A Muslim society stands on the pillars of religious and economic needs (Islamic Banking Sector Review, 2007), which are described as the fundamental needs. Islamic economic system, therefore, offers a frame work for the provision of these needs through different modalities of doing business and various modes of financing. One of the frequently used modes is *Murābaha*. Its essence lies in the concept of trade, which is encouraged by Islam (*Al Qurān, 2:276)*. This mode can be practiced in all types of businesses, whether small or large, as well as for farming, ~~or~~ trade and industrial ventures (Islamic Banking Sector Review, 2007). The small farmers can benefit from this mode to overcome their financial constraints.

Murābaha as a financing tool can be used for eliminating world poverty. The inherent characteristics of *Murābaha* can help reduce the chances of default as well (Goud, 2007).

Some of the Islamic scholars, particularly those who are conversant with Islamic financial system have focused their attention towards *Murābaha* and its procedure. The succeeding paragraphs elaborate the salient features of *Murābaha* and methods of its application to the sugarcane crop.

2. What does *Murābaha* mean?

2.1. Literal Meaning

The word *Murābaha* literally means "profit". A *Murābaha* transaction involves selling a commodity at a price more than its cost. It can also be described as the sale of a commodity on cost plus profit basis (Qud*ā*ma, 1988).

2.2. Technical Meaning

Different Muslim jurists define *Murābaha* differently based on their understanding of the term. Al-Qurtabī (2003) states that when the seller discloses price of goods being sold to the buyer, where profit finds its place as a conditional item, then such a sale is called *Murābaha*. *Kāsānī* (1996) defines *Murābaha* as selling of goods at the price which includes actual cost plus profit and both these elements are known to the buyer. It is important for the buyer to be aware of actual cost and profit otherwise the contract will be a void one. According to the well established principle of Islamic commercial law, in *Murābaha*, the price needs to be known to the parties. Mansoori (2006) explains that it is a contract of sale in which cost plus profit for selling commodity is mutually decided by both the parties. Nyazee (2005) views *Murābaha* as a contract where the cost plus profit is clearly determined for the knowledge of the buying party. Siddiqui (2008) states that it is a contract of sale where profit is decided on the basis of mutual agreement and only when the cost of selling good is reasonably known to the buyer. Gulaid (1995), an expert of Islamic economic system, gives a specific name "*Al-Murābaha Lil-amir Bil Shira Maa Bay Bi-thamani Aji*i" (*Murābaha* to the purchase order on deferred payment basis) to Murābaha transaction (p. 50) .Some of the scholars do not differentiate between the term *Murābaha* and bai' muajjal and considered both the same (Tahir, 2007).

Keeping in view the above definitions of classical and contemporary Muslim jurists, one may conclude that it is a form of contract between two parties where the element of reliability is present through which both parties discuss the cost, as well as profit, arising from the transaction. In other words, cost and profit is mutually decided between the parties on the basis of prior agreement (Guidelines on Islamic Finance for Agriculture, 2008). Where the Islamic banks adopt this mode, they must ensure that specific terms like nature and cost of the commodity, bank's profit, period of *Murābaha* are clearly known and acceptable to both the bank and that customer (Ahmed & Ghuddah, 2007)

2.3. *Murābaha* vs. interest

The Islamic commercial law prohibits *Ribā* (interest) as it is an excess demanded by the creditor over the principal amount, from the debtor, without any counter value or compensation (Ibn Hazm 1988; Qurān 2:278-279; Qurān 30:39) (). According to the basic philosophy of Islamic law an individual is entitled to profit because of the capital employed (along with risk) and the work carried out. In *Ribā* (interest) bearing loans, this condition is missing and hence the creditor is not entitled to any profit. On the other hand, contrary to *Ribā* (interest), Islam allows *Bai'*(sale) as it fulfills the requirement mentioned above and includes exchange of two, just, counter values.

Due to a misconception prevailing among a few writers, *Murābaha* is sometimes equated with the conventional loans where only the term "interest" is replaced with "profit". However, this analogy is not tenable as Usmani (2008) describes "The first and the most glaring mistake is to assume that *Murābaha* is a universal instrument which can be used for every type of financing offered by conventional interest based banks" (p.148). The differences between *Murābaha* and an interest based loan transaction may be briefly described as:

- *Murābaha* s essentially an investment based transaction involving sale and purchase of real commodities on profit (mark up) while interest, on the other hand, is related to loan transaction that is based on borrowing and repayment of counter value of borrowed amount.
- As a *Murābaha* transaction is exposed to the usual marketing risk, the risk of loss becomes an inherent characteristic of *Murābaha*. A conventional bank lending interest based loan runs no such risk.
- In case of a *Murābaha* transaction, there is an involvement of personal labor and production while the lender of an interest based loans becomes entitled to an excess (interest) over the loan amount without any personal effort/work.

2.4.Rules of Murābaha

As *Murābaha* is a sale contract, including all rules and regulations of a valid sale contract i.e. proposal, acceptance, consideration, capacity of the parties, lawful, objective, and legally enforceable. In addition, a *Murābaha* transaction must fulfill the following more conditions:

(a) Customer Awareness about Original Price Plus Profit

A seller must disclose and buyer must be made aware of the original purchase price of and the amount/ratio of profit being added to the cost. If this information is not revealed, in specific terms to the buyer while concluding the contract, the contract will become invalid despite the fact that it is duly conveyed at a later date (*Kāsānī,* 1996).

(b) Contents of Cost

The direct costs like, freight, customs duties, taxes and other levies etc. can be added to the product cost for the purposes of *Murābaha* transaction (Usmani, 2008). However, indirect costs like employees' expenses etc. are not permissible for inclusion in the cost (AAOIFI, 2003).

(c) First Contract and its Validity

The contract for purchase between an Islamic bank and the seller of sugarcane must be properly concluded prior to, and valid at the time of signing the Murābaha contract between an Islamic bank and the sugar mill *(Kāsānī 1996*).

3. Reasons for *Murābaha* Application to Sugar Industry

Generally Islamic finance is a new activity of Islamic commercial law and hence it is a dire need of the time to develop its application widely to the commercial markets by introducing new products and services. Some of the scholars suggest that such introduction of new products and services must be on continuous basis. (Foud Al saleem, 2009). Based on the same philosophy *Murābaha's* application should be extended to sugarcane industry. The following paragraphs will reveal more, those facts due to which it becomes indispensible to apply this commercial transaction to the sugar industry:

a) Deficit of Sugar

There is an increasing demand for sugar at international level and even some of the developing countries face deficit of sugar. Below is a table that contains information regarding world sugar data and reveals sugar import to exhibit an increasing trend in countries like South America, Western Europe, Africa, China and Indonesia during 2009 to 2011. Major countries have to import sugar to fulfill domestic needs which, provides a solid case to increase its production.

Table 1: World sugar production, supply and distribution

1,000 metric tons, raw value

Country	Year	Production	Imports	Total Supply	Exports	Domestic Consumption
South America	2009|10	44043	1849	46938	26381	19500
	2010|11	45538	1916	48511	27109	19779
	2011|12	47317	1715	50655	28895	20435
Western Europe	2009|10	16992	2970	22503	2651	18051
	2010|11	15331	3482	20614	1055	18141
	2011|12	15550	4082	21050	1060	18141
Africa	2009|10	8158	7478	18150	3352	12446
	2010|11	8302	8000	18654	3244	12814
	2011|12	8251	7885	18732	3076	13015
China	2009|10	11429	1535	16748	93	14300
	2010|11	11303	1820	15478	64	13900
	2011|12	12000	1850	15364	64	13600
Pakistan	2009|10	3420	1030	5000	70	4100
	2010|11	3920	250	5000	70	4250
	2011|12	3820	600	5100	70	4300
Indonesia	2009|10	1910	3200	5450	0	4700
	2010|11	1770	2995	5515	0	5000
	2011|12	2088	3010	5613	0	5200

Source: USDA, Foreign Agricultural Service, PSD database http:||www.fas.usda.gov|psdoline|psdQuerry.aspv)

Sugar and Sweeteners Outlook (SSS-M-274) Economic Research Service

The shortfall of supply against its demand in Asia and Africa may be attributed to the following reasons:

1. The small farmers in Asia and Africa are generally poor, with small land holdings, and cannot afford high quality agriculture inputs or mechanized farming. Thus per acre yield and total income of such farmers remain low. If the problem of finance is resolved, these poor farmers will be able to increase their crop production and earn more income to improve their living standards (Serunkuma & Kimera, 2002).
2. The sugarcane crop requires a lot of water for its cultivation. The additional cost of water, especially in water deficient areas, discourages the poor farmers to opt for this crop.
3. The cultivation cycle of sugarcane, from sowing to harvesting is very long, extending to almost a year. The other crops like wheat, cotton and paddy etc. only take six months to be ready for harvesting. The poor farmers would normally prefer to get two seasonal crops in a year and get early income rather than rely on one crop for the whole year.

b) Sharp Increase in Financing Needs of Sugar Industry

Financial institutes like those existing in Pakistan are consistently providing credit to both public and private corporate sectors. The demand for credit is increasing consistently with the passage of time. It has reached up to 1520.2 billion rupees in 2007 (Financial Stability Review, 2008).

As shown in table 2 below, due to increased sugar demand, the sugar industry has increased the use of the credit facility provided by the banks. 1.3 percent of the total bank credit to the private corporate sector in 2003 increased to1.9 percent in 2007. It reflects a steady increase in the demand for credit by the sugar industry. Islamic banks and financial institutions can meet this increased demand through *Murābaha* financing mode.

Table 2: Bank Credit to Corporate Sector (Billion Rupees), Share in Percent

	CY03	CY04	CY05	CY06	CY07
Total Credit to Corporate Sector	606.5	873.0	1076.2	1269.6	1520.2
Growth	15.6	43.9	23.3	18.0	19.7
Public Corporate Sector Share in Credit	4.8	5.4	4.5	4.2	4.9
Private Corporate Sector Share in Credit	47.9	48.6	49.3	48.3	48.9
Share of Sugar in Private Corporate Sector	1.3	1.4	1.7	1.9	1.9

Source: Statistics Department, State Bank of Pakistan

c) Focus of Islamic Banks

According to Islamic Banking Bulletin (2010), Islamic financial institutions are primarily focusing on chemical, pharmaceutical, and textile industries whereas the sugar industry, which fulfills the basic needs, is not given due attention. The share of this industry is only 2.3% of the total financing provided by Islamic banks in Pakistan.

Table: 3 Sector wise Financial Concentration in Percentage

	June-09	**Mar-10**	**June-10**	**Industry**
Chemical and Pharmaceuticals	7.1%	10.5%	9.1%	4.1%
Textile	20.5%	20.6%	18.3%	16.9%
Sugar	2.8%	6.0%	3.6%	2.3%

Source: Islamic Banking Bulletin, 2010

Murābaha (sale on cost plus profit basis) can be effectively applied by the Islamic banks to sugar industry. The sugar mills, that need sugarcane as the raw material may approach the Islamic banks for provision of this raw material. The Islamic banks, on receiving a firm requirement from a sugar mill may procure the sugarcane from the growers on *Murābaha* basis, directly or through an agent, and then sell the same to the sugar mill after adding its profit to the cost. Both the contracts will be independent of each other in accordance with the established principle of Islamic commercial law (Shawkānī 2001). Islamic bank may also agree to recover the sale price from the sugar mill on deferred payment basis, either in lump sum on sale of refined sugar, or in installments within an agreed period. This arrangement will meet the working capital requirements of a sugar mill through an Islamic mode of financing.

How *Murābaha* could be applied to the Sugar Industry through Islamic bank?

A *Murābaha* transaction by an Islamic bank will involve three parties, namely, sugar grower, an Islamic bank, and the sugar mill owner. The Islamic banks may attract the sugarcane growers and the sugar mills owner through the measures described below:

The Sugar mill owners need working capital to purchase sugarcane on seasonal basis. For this purpose, they may enter into a contract with an Islamic bank for the provision of raw material (sugarcane) on the basis of *Murābaha* Islamic bank, on the other hand may enter into another and independent contract with the sugarcane grower(s) to purchase the quantity of sugarcane which the bank has agreed to sell to the sugar mill. There are three parties involved within the structure of *Murābaha*, namely, the Islamic bank, the sugar mill owner and the original seller (the grower) from whom the Islamic bank purchases the commodity for onward sale to the sugar mill.

The sugar mill owner must provide a complete description of the transaction, e.g. price, quality, quantity, identification of the supplier, time of delivery, place of delivery etc. Since Sharī ‘ah does not allow a contract for a non-existent commodity (Qud*ā*ma, 1988), the agreement is entered into by and between an Islamic bank and the sugar mill, often referred to as Master *Murābaha* Agreement. However, such an agreement will become a contract only when the sugarcane is delivered to the Islamic bank, actually or constructively, by the sugarcane grower. The Islamic bank will, of course, evaluate each and every request received from the sugar mills in accordance with the established

criteria, such as market reputation, financial stability, solvency, etc, before agreeing to enter into an agreement with any of them.

Murābaha financing to sugar industry will, thus, entail two independent contractual relationships. The first such relationship is established between the Islamic bank and original seller i.e. the grower, while the second relationship is between the Islamic bank and the mill owner. Both these relations (contracts) should be independent of each other where rights and duties in the first contract should not be related to the rights and duties in the second. In other words the transaction of *Murābaha* is only between the financial institution and the mill owner which in no way is linked to the earlier contract between the same bank and the grower. In such a situation it is suitable for the Islamic bank to buy the sugarcane from the sugar cane grower on option basis so that in case the sugar mill owner refuses to buy the sugar cane, it may return the same without undergoing any loss (AAOIFI. 2003).

For concluding a valid *Murābaha* contract between the sugar mill owner and the Islamic bank, the following conditions must be fulfilled:

- The sugar mill owner must have knowledge regarding the price paid by the Islamic bank to the sugarcane grower (the original seller).
- The sugar mill owner must know the ratio of profit/mark-up being charged by the Islamic bank. The exact cost incurred on the sugarcane must be declared and assured.
- As a matter of principle, only the direct expenses of Islamic bank like freight, custom duty etc. can be included in the cost rather than the indirect expenses such as staff salaries, rent of the premises etc. (Usmani, 2008). Following this rule, insurance (Takaful) can be included in the cost, however, including the salary of the staff and opportunity cost is not permissible.

4. Can a Sugar Mill Become an Agent?

As a general rule of *Murābaha*, as described earlier, an Islamic bank must actively participate in the transaction and purchase the required quantity of sugarcane in its own name before selling it to a sugar mill owner under *Murābaha* arrangement. However,

most of the Islamic banks, in their present state of development are not well equipped to handle commodity transactions. In order to overcome this impediment, an Islamic bank may appoint an agent to handle the logistic and administrative aspects of the transaction (Siddiqui, 2004), which may result in an additional cost to the Islamic bank. Since, the cost of an agent, being an indirect cost, cannot be recovered from the sugar mill owner; it will have to be borne by the Islamic bank. Alternatively, an Islamic bank, in exceptional circumstances may appoint sugar mill owner (the second party to the *Murābaha* contract) as its agent for taking the requisite steps on behalf of the principal i.e. the Islamic bank. State Bank of Pakistan (2007) requires the following rules to be strictly complied with:

- Sugar mill owner, as an agent, must complete the transaction strictly in accordance with the instructions of the Islamic bank, i.e. the principal.
- Islamic bank must pay the price directly to the sugarcane grower (AAOIFI, 2003).
- Islamic bank must obtain the document of purchase (receipts, delivery notes etc.) from the sugar cane grower (AAOIFI, 2003).

5. How can the Islamic Bank Avoid Risk if the Sugar Mill Owner Refuses to Purchase, or does not Pay Installments?

In *Murābaha* contract there is always a possibility that the customer may refuse to buy the commodity after the Islamic bank purchases it from the original supplier. The bank, however, cannot go the court of law to enforce this transaction; since at this stage it is a mere promise to buy and not a legal contract enforceable by the court of law. This view is held by a majority of jurists such as Imām Abu Hanifa, Imām al-Shafī, Imām Ahmad and some Malikī Jurists. Some scholars namely Ibni Shubrumah, Ibn-al-Arabī, Ibn-al-Shat and Imām Al-Ghazālī hold the view that a promise is mandatory and the promisor is under moral and legal obligation to fulfil it. Most Jurists, however, do not support the mandatory nature of promises (Usmani, 2008). Hamish Jiddiya (earnest money) and *'Arbuwn* (advance payment) are the two concepts of Islamic commercial law which can duly aid the bank in this situation. The former is taken before the contractual stage, while the latter is paid after the actual contract of sale (AAOIFI, 2003). In case of the former, the Islamic bank can ask the sugar mill owner to pay a sum of money as *Hāmish*

Jiddiyyaha (earnest money), which will ensure his financial capacity. Subsequently, in case of default, the bank will have the recourse of deducting from this amount the actual damages suffered by it.

One may wonder whether demand for such security before the *Murābaha* transaction is permissible in Islamic law. Some Islamic scholars are of the view that it is permissible for a creditor to ask a debtor to pledge property before the loan transaction (Kāsānī, 1996; Samdani, 2008).

The second legal tool from the perspective of Islamic financial system, for the bank to protect it self from the risk of refusal of repurchase by the sugar mill owner, is to ask for the provision of Urboon (down payment). This tool is accepted by a majority of contemporary jurists like Wahba al Zuhaylī, Muhammad Taqi Usmani (AAOIFI, 2003). The matter, however, is controversial among the classical Muslim Jurists. The sugar mill owner, therefore, will have to pay a certain sum of money to be considered as ~~a~~ part of the price. This amount is usually one third of the original price, although there is no strict rule and any amount can be paid in this regard. If the sugar mill owner at a later date purchases the commodity as per the agreed terms, the same gets adjusted in the price. On the other hand, if he refuses then the Islamic bank can retain the whole amount, although preferably it should only deduct its actual damages (AAOIFI, 2003)

6.Implementation of Securities in Sugar Industry

The Islamic banks and other Islamic financial institutions can ask the sugar mill owner for the provision of securities. As discussed above, ~~t~~aking such guarantees to ensure the payment of price is permissible in Islamic law. According to a well renowned Muslim Jurist Sarakhsī (2002), the price becomes debt on the buyer in the sale contract from the time when it is not paid, and taking securities for the protection of debt is permitted by Islamic law. Samdani (2008) is of the view that an Islamic bank can even demand security before the actual contract. Hence, the Islamic banks and other Islamic financial institutions may ask the sugar mill owner to provide security in the contract of *Murābaha* transaction which may be in the shape of a third party guarantee, or a pledge of investment account, or any of his other movable property, or mortgage of his immovable

property (AAOIFI, 2003). The best among these is the receiving of guarantee in the shape of mortgage of a property (in case of immovable property) or pledge (in case of movable property) owned by the sugar mill owner as both are easy to be handled.

7.Benefits of *Murābaha* for Islamic Financial Institutions

The transaction of *Murābaha* is beneficial for Islamic banks and other Islamic financial institutions in the following ways:

1. An Islamic bank, buying the commodity from a grower and then selling it to the sugar mill owner with mark up,
2. It is very likely that the grower who sells his crop to an Islamic bank would become its (bank's) permanent customer and gradually start using bank's other services. He will continue taking services from Islamic bank and become its permanent customer.
3. Business relations so developed with farmers will provide an opportunity for Islamic banks to promote and expand their network to the rural areas and offer their services to new and potential customers.
4. Similarly, the relations established with the sugar mills may result in a demand for much wider range of banking and financial services like *Murābaha* or *Ijārah* (lease contract) for industrial machinery, Salam (advance payment sale) for raw material, or *Istisna'* (manufacturing contract) for manufacturing purposes. Thus the increased business of Islamic banks will lead to greater profits for them.

8. Benefits for Sugar Industry

The sugar industry, as a whole, stands to gain from the *Murābaha* Islamic banks. Some of the potential benefits are as follows:

1. The sugarcane grower will get the reasonable price of his yield in cash by dealing with an Islamic bank.

2. The purchase by an Islamic bank, or its duly appointed agent, will most likely be carried out at the growers' farm and thus will save him the cost and hassle of transportation.
3. The sugar mill owner will be assured of good quality product and its timely delivery as an Islamic bank would be more reliable in meeting its contractual obligations as compared to an individual or private business man.
4. The sugar mill, normally buying from the local market, is required to pay the price in cash. Due to a time lag between buying the raw material (sugarcane) and processing it to a refined product (the sugar), sugar mills often face liquidity problems. By dealing with Islamic banks on deferred payment basis, they can overcome the problem of liquidity crunch.

Conclusion

Sugar is one of the basic necessities of every house hold. It is also used in a number of other economic sectors like confectionary, dairy, beverages etc. The demand for sugar is steadily increasing with the increase in world population and the trend is likely to continue. The poor and developing counties in Asia and Africa, though relying on agro-based economies, are particularly faced with shortage of sugar. The farmers in these countries are generally poor and unable to resort to mechanized farming to increase the per acre yield from their usually small land holdings. The sugarcane crop owing to its relatively longer cultivation cycle is even more expensive for them to undertake. Furthermore, due to an underdeveloped market infrastructure in these countries, the farmers usually do not get the right price and prompt payment for their crop.

Sugar industry, on the other hand, have a seasonal requirement of finances for procuring the raw material for their mills i.e., during the sugarcane harvesting period. Islamic banks can play an effective role by becoming a conduit between the farmer and the sugar mills. This can be achieved by adopting the *Murābaha* based model. Under the *Murābaha* arrangement, the bank will purchase the given quantity of sugarcane directly from the farmer and sell the same, after adding its own mark up to the cost, to the sugar mill owner on deferred payment. All the three parties stand to benefit from this arrangement. The farmer will get the price of his crop promptly and at its farmland, sugar mill will secure

the required quantity of raw material (sugarcane) without any immediate cash outflow, and the Islamic bank will earn a reasonable profit, in the form of mark up, from this transaction. If the whole transaction is concluded strictly in accordance with the principles and conditions applicable to *Murābaha* as discussed in the body of this paper, the accrued benefits to the parties involved will also remain Sharī 'ah compliant and will not involve *Ribā* or any other *Harām* (forbidden) business practices. A large section of Muslim mill owners and farmers, who are reluctant to deal with conventional banks due to *Ribā* can thus rely on Islamic banks for developing the sugar industry thereby allowing a better performance of their respective roles.

Limitations and Future Research Directions

The authors have confined the discussion, in this paper, to the conceptual level for developing a theoretical framework for application of *Murābaha* to sugar industry. An empirical study can henceforth be conducted to test the viability of the suggested approach. Such research will not only refine the given model further, but may also address the issues that may arise when the model is adopted by the Islamic banks, and applied to the sugar industry.

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