# BRIEFING NOTE

Approaches to Islamic agri-microfinance

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## Approaches to Islamic agri-microfinance

## Islamic agrifinance

Agricultural finance, or **agrifinance**, is a model that assists vulnerable and rural smallholder farmers to reduce risk and increase investment in their farms, leading to increased yields and higher income.

Typically this includes:

- credit products such as Murabaha (cost-plus sales)
- lease (Ijarah) for land and machinery
- value chain support through Salam (forward sales) or Muzara'ah (share-cropping) and/or
- crop and livestock Takaful (insurance).

## Why work with smallholder farmers?

Smallholders are predominant in many frontier and emerging markets making them a vital part of food supply chains. Therefore supporting small-scale agriculture can help reduce poverty, raise incomes and improve food security for 80% of the world's 800 million poor, who live in rural areas and work mainly in farming (World Bank Group, 2018).

The promotion and actualization of more sustainable, resilient and productive smallholding agribusinesses can therefore have a substantial development impact.

### ISLAMIC FINANCE AT A GLANCE: PRINCIPLES

All Islamic finance products must adhere to the basic principles that avoid:

- **Riba** – this is usually translated as 'interest', although strictly it has a much wider meaning. **Shariah** regards the charging of interest on financial transactions as a form of exploitation, in that reward is earned without effort or risk;
- **Gharar** – excessive uncertainty. There is a very high standard regarding certainty in all contractual matters from the outset of an agreement, including price and subject matter;
- **Maysir** – speculation. Shariah-compliant financial products should not profit from pure chance, as opposed to ordinary commercial risks such as risks of ownership;
- **Qimar** – gambling. This is considered similar to Maysir and is prohibited for the same reason;
- **Ihtikar** – hoarding or price manipulation. Since money is treated as a means of exchange only and not an end in itself, Shariah encourages people to put their money to work for the benefit of the community;
- **Haram** – an object or purpose which is haram is one that is unethical or unlawful. The subject of an investment cannot be a business dealing with something prohibited by Shariah; including pork products, alcohol, armaments or gambling.

## ISLAMIC FINANCE AT A GLANCE: PRODUCTS

To adhere to Islamic financing principles a range of products have been developed. The most wide-spread are:

- ***Murabaha:*** This is used for short term finance, and involves the MFI purchasing and paying for a product on behalf of a client. The MFI is liable for the goods until the client takes possession, and in return for holding this risk charges the client a pre-declared mark-up on the goods.
- ***Mudaraba:*** This involves a financial investment in the business of an entrepreneur who provides their skills and effort. The profits are shared with the MFI according to a prearranged ratio.
- ***Musharaka***: This means partnership, so that both parties contribute to a joint venture sharing in profits or losses related to the proportion of the commitment.
- ***Ijara:*** This is the Islamic equivalent of leasing, and is little different from the conventional use of the term. The client pays regular instalments to pay for goods bought by the MFI.
- ***Qard Hassan:*** This is essentially an interest-free loan although under Islamic finance rules, commercial providers can recover the direct cost involved in the delivery.

# Key Islamic agrifinance products and services

The main focus of agrifinance is to make smallholding farmers more productive, sustainable and resilient to external shocks. This combination can lead to a critical transformation of the smallholding sector and Islamic agrifinance has to play a catalytic role.


## Financing smallholder productivity

Typically credit products have been used to enable smallholders to invest in crop diversification, irrigation and also limited mechanization. Islamic agrifinance can achieve this through:

- Murabaha (cost-plus sales) for farm inputs
- Ijarah (lease) for land and Ijarah Muntahiyah bi Tamleek (hire & purchase) for agricultural machinery
- Salam (forward sale) making the FSP share the market risk whilst utilizing value chains for the benefit of the smallholder

## Supporting sustainability

Islamic finance should have a strong focus on environmental stewardship with its focus on the prohibition of financing social harm - which by analogy is extended to destructive farming techniques such as “slash-and-burn” or off-farm activities such as the production of charcoal from unstainable wood sources potentially leading to de-forestation and desertification.

This means Islamic financial service providers (FSP) must not just include an environmental dimension into their Sharia-compliance screens of agrifinance applications from smallholders but also actively promote sustainable farming practices by providing where possible business development support that focuses on helping farmers overcome negative coping mechanisms.

Islamic FSPs can also offer products such as Mudaraba (investment) and Musharaka (partnership) financing to become direct stakeholders in micro and small agribusinesses and thereby drive change from within.

## Investing in resilience

Climate change has highlighted the vulnerability of most smallholders who do not even have the means to return to the status quo, let alone to build back better when disaster strikes. In the Muslim world their vulnerability is further exacerbated by a very significant insurance gap. Loss and damage or livestock or crop insurance, however, can be provided through Takaful (mutual insurance), in addition to diversification of agribusiness income streams.

# Case studies

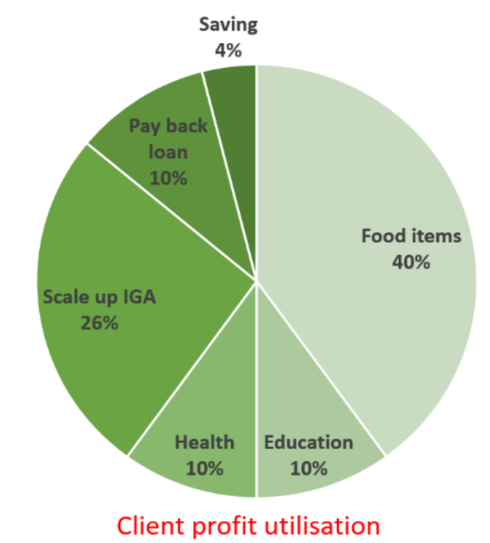
**Salam** financing is an advance purchase agreement against future delivery of a crop. It is well adapted to farmers’ needs and innovative in several ways:

- The Islamic FSP provides financing in cash, and gets reimbursed in crops at harvest time. The transaction price is set at the time of financing and is negotiated between the farmer and the FSP based on the previous year’s price and weather forecast.

- The farmer is able to choose seeds and fertilizers of higher quality, at the time and from retailers of their choice. Yield increases as a result, reportedly by at least 15% to 30%.
- At harvest, the farmer delivers to the FSP a volume of crops equivalent to the financing amount, at the negotiated price. He then sells whatever remains on the open market. The FSP sells the crops when prices have increased, deriving its profits from the open market.
- Farmers keep at least half of the expected yield, contributing to food security

The benefits of Salam financing are sufficient to allow farmers to build assets and sustain themselves above the poverty line within five financing cycles, or roughly three years. Salam is mainly offered for wheat and rice, because of their relatively predictable price and easy storage.

**Sharaka bil Mawashi:** in Niger where like in many countries, livestock is for poor and rich people a store of value and a source of income generation. In a Muslim setting, the ritual sacrifice during Eid ul Adha - the Qurbani or Udhiyya – is the peak period in the value chain. However, this often does not benefit the local economy or the very poor. However, the barriers for poor people to get a 'foot onto the livestock' ladder are significant. The key constraints usually are first and foremost the ability to afford livestock, but also access to veterinary services to improve livestock health and feed and water to ensure quality meat and dairy products. But limited access to markets also means that most profit is made by "middlemen" rather than benefit the poor small scale breeder or directly the local economy.




To overcome this, we developed a Muzara'ah product applied to livestock, which then becomes a livestock partnership - Sharaka bil Mawashi. Clients receive two goats and one sheep on a share-"cropping" basis a few months before Eid. To ensure that animals stay healthy, a number of clients were trained up as para-veterinaries. The animals were sold with significant profits and other economic inclusion benefits for the clients, allowing them scale-up their own income generation activities (IGA), invest in educating their children and even pay-off loans to other microfinance providers.

## MEET YASIR TARIQ, GEMICRO'S AGRIFINANCE LEAD EXPERT

Yasir is GEMicro's Head of Operations and has extensive experience managing Islamic microfinance programmes, including development and deployment of innovative and award winning Islamic financial products.

Yasir was previously appointed by the Ministry of Finance of Pakistan to the Committee for the development of the Prime Minister's Interest Free Loan scheme, which aimed to provide over £300m in social finance over a period of five years. He has also served as the Chief Operating Officer of the Wasil Foundation, where he developed innovative products including a Master Salam product, for which the Wasil Foundation won the CGAP 'Islamic Microfinance Challenge' in 2014. Yasir has worked with microfinance in west.

**GEMicro Group**
80-83 Long Lane
London
EC1A 9ET
www.gemicro.com