RURAL DEVELOPMENT AND ISLAMIC BANKS

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The Nature of Rural Development

Rural development is a complex phenomenon. It involves changing the life-style of people living in rural areas on a sustainable basis by raising their productive abilities and earning capacities. According to *World Development Report 1990*, there are over one billion poor people in the developing world and the majority of them live in rural areas. Their problems are multifarious. They belong to three main categories: the landless, tenants, and small landholders. All have certain things in common. For example, they do not have enough to sustain a minimum standard of living. They do not have access to social services like health, education, clean water, sewerage, roads, electricity and telephones. They suffer from malnutrition, lack of proper shelter and helplessness in the event of natural calamities. However each of the categories needs to be approached differently to solve its basic problems. For example, the small farmer may need support in getting access to credit while the landless will not benefit from such a scheme. He needs, perhaps, employment. Similarly, the tenant may need better tenancy terms rather than employment opportunity.

Profile of the Rural Poor

A typical profile of poor people living in rural areas of developing countries is:

- They do not have access to improved technology, irrigation water, improved seeds, fertilisers, agricultural machinery and pesticides. They are too poor to buy or hire these inputs. They also do not have access to credit.

- They do not have access to public organisations. Their affairs are decided in urban-based offices they cannot reach easily. As a result they do not enjoy their basic rights, their motivation is injured, they are marginalised.
- They do not have the protection of the law. They spend a lot of time in litigation and seeking justice because of the wrongs done to them by the rich and powerful.
- They are victims of widespread corruption which is used to keep them depressed with the collusion of urban bureaucracy and the rich of rural areas.

Reasons for Poverty

The reasons for poverty are complex and historical. The social and cultural forces which define the asset-holding and power structure are major contributors to rural poverty. But in a large number of cases the economic policies of the state have also contributed to the intensity of the problem. For example, support for urban industrialisation has often led to the transfer of resources from rural to urban areas. Similarly, policies which were intended to improve the lot of the poor in rural areas operated in such a manner that the only beneficiaries were a small, rich class. The problem of underdeveloped financial structures also perpetuated poverty in rural areas. The few poor people who had the potential to save could not channelise their savings into productive uses and those who needed finance could not obtain it due to the absence of developed financial markets in rural areas.

A Comprehensive Programme of Change

Rural development is not a programme of change in economic variables only. It requires a multi-pronged attack on poverty from various aspects. The question has been widely discussed by economists, social scientists, social workers, donor agencies, rural credit institutions and governments. There seems to be a consensus on at least two things:

First, the productive ability of the poor should be developed through policies which provide market-based incentives and build social infrastructure in rural areas. The rural areas should be provided with roads, educational institutions, health care centres, drinking water, sanitation, sewerage, and a fair marketing system.

Second, there should be a programme to provide on-farm improvements. Besides making improved farm inputs available, the results of scientific and technological research should be readily available to the farmer.

Obstacles

It has not been easy to put this general recipe into practice, there being at least six reasons for this:

One, it ignores the landless poor which itself is a significant segment of the poor class.

Two, it has not been possible to find a viable solution for financing the build-up of infrastructure. The real problem is that the poor countries do not have the necessary resources. An additional problem is to operate and maintain the basic infrastructure on a sustained basis. Those who use these facilities should be able to pay for them, even when the government funds the building of basic facilities. But a significant proportion of the rural population is too poor to pay for these services.

Three, generating employment for the rural poor requires investment in industry and commerce. So far, the private sector has been reluctant in most poor countries to invest in rural areas. The incentives are inadequate and the climate for investment not congenial.

Four, there are deeper issues of participation, management, responsibility and accountability. In low-income countries, the social and political institutions are not developed enough to involve local people who, consequently, remain isolated and survive on the margin.

Five, rural development programmes, generally, do not touch the groups for whom they are intended. The beneficiaries of such schemes are, quite often, the non-poor.

Six, land tenancy systems are a major obstacle. They are mostly exploitative and discourage motivation and enterprise on the part of the tenant. The rural power structure does not allow the poor to participate in programmes of self-improvement. The tenancy system raises obstacles in the way of education, health and roads – the three most important ingredients of any rural development programme.

Scope of the Study

This study discusses the role Islamic banks could play in promoting rural development. Islamic banks operate in an interest-free environment. They accept deposits and provide finance on the basis of several modes permitted by the *Sharī'ah*. The most prominent of these are *mushārakah, muḍārabah, ijārah, ijārah wa iktinā, qarḍ hasan, bai' murābahah, bai' salam,* and *bai' mu'ajjal*. This study explores the possibility of collaboration of Islamic banks in rural development, an area which has traditionally been considered to be the responsibility of the government. But the experience of more than a century of efforts by several governments has shown that they are unable to provide the necessary finance for rural uplift. There is a need to look for other sources of finance for this purpose. Commercial banks have traditionally operated in the urban environment and provided short-term finance to firms and industries. But they have very little experience of operating in the rural environment. For Islamic banks to enter this field would require a lot of preparatory work by way of risk assessment, financial planning, operating procedures and monitoring arrangements. It would also require strong legal support.

Rural Development and Rural Finance

In this section we will discuss the objectives of rural finance which all financial institutions operating in rural areas are expected to achieve. We will show that various traditional approaches to achieve the primary objective of rural finance have not been successful and there is a need to re-think its basic framework.

The Objectives of Rural Finance

The primary objective of rural finance is to improve the living conditions of the rural poor in developing countries. However the rural financial institutions interact with the economically better off population as well. By doing so they indirectly serve the cause of the poor. For example, when a rural financial institution provides finance to a wealthy entrepreneur or a well-off farmer, it may be helping to generate employment opportunities for the poor in the area.

The primary objective of rural finance can be achieved by locating financial institutions in rural areas. These institutions can play an effective role in improving the conditions of the poor in the following manner:

- One, mobilise the savings of the poor segments of the population which have hitherto remained untapped.
- Two, train the target population in dealing with the financial institutions and inform them about the services they offer.

- Three, finance income-generating and job-creating investments which the poor could not undertake earlier.
- Four, provide such business services as market information, preparation of feasibility studies, technology information, etc. to business firms in rural areas.
- Five, mobilise the funds of voluntary saving societies.
- Six, mobilise the savings of wealthier individuals which earlier moved to urban areas.
- Seven, provide finance to municipal committees and local bodies for building infrastructure.

Traditional Approaches to Rural Finance

Several countries have experimented with different models of rural finance.[1] The essence of these models has been some sort of subsidy to the poor. But none of the models has achieved its objective. According to *World Development Report 1990*, 'only 5 per cent of farms in Africa and 15 per cent in Asia and Latin America had access to rural credit. . . . Cheap credit has become a transfer programme for the non-poor . . . In addition, artificially low interest rates and credit regulations distort the allocation of resources and lend themselves to patronage and corruption . . . Studies of formal subsidised credit programmes in Sub-Saharan Africa, the Middle East, and Latin America have found that loans in arrears range from 30 to 95 per cent.'[2]

Another approach has been to provide finance to large farmers who can afford modern technology, and improved farm inputs. The belief was that the benefits of this investment would 'trickle down' to the rural poor by way of greater employment opportunities or through demonstration effect. But experience has shown that this did not happen.[3]

The Need for a New Approach

Lack of Adequate Incentive for Financial Institutions

The traditional approaches tried to intervene in the open market process. Concessional interest rates demotivated the financial institutions who then considered rural loans to be risky and unremunerative. As a result, financial institutions became lukewarm in their efforts to achieve the objective of rural development, their main concern being to safeguard their capital. Therefore, they often chose to advance loans to those clients who had adequate collateral and so resources were siphoned off to the non-poor. Simultaneously, the poor were discouraged from contacting the financial institutions because of lengthy procedures, long waiting times and heavy bank charges. Corruption in these institutions was an additional deterrent for the poor.

The Burden of Interest

A very important factor in the failure of rural finance to achieve its primary objective has been interest on loans. Interest-bearing finance adds to the cost of production. As most poor people do not have ready access to formal financial institutions, they have tended to seek informal credit from moneylenders which is very exploitative. According to *World Development Report 1991* (p.76), the real interest rate from moneylenders often exceeds 80%. According to another estimate, interest rates of 10% per day are not unusual.[4] The interest rate is a severe limiting factor on the investment opportunities available to the poor. The investment is inversely correlated to the rate of interest. The higher the rate of interest the lower the volume of investment because it lowers the overall profitability of the business enterprise. If we increase the volume of investment we shall have to find a solution to the problem of interest.

It is ironic that most economic thinking on the subject recognises this limiting role of interest on investment. But instead of trying to find an alternative to interest it recommends that the rate of interest should be the market rate and not a subsidised one, since a subsidy would inculcate a sense of irresponsibility among the poor and would make the financiers' business unremunerative. Furthermore, current thinking opposes subsidy on interest because it has either not reached the poor or not motivated him adequately. It has, however, affected the incentive of the financial institutions.[5] It is unfortunate that contemporary thinking has not transcended the basic framework of interest-bearing finance. The experience of the last half century bears testimony to the fact that we need to depart radically from the existing framework of rural credit. Islamic finance offers such an opportunity for our consideration. It operates on the following basic assumptions:

- Interest on loan capital is exploitative whatever the form or rate. Therefore, it should be dispensed with.
- Financial institutions should operate in an open market competitive environment. Subsidy should not be a normal way of life. This would maintain the banks' incentive and allow market forces to play fair.
- The return on capital provided by the financial institutions should be directly related to productivity of the capital in the real sector.
- The safety of capital should be provided by suitable social, legal and cultural support and not necessarily by collateral.
- Finance should be available for farm and non-farm needs. The needs of rural businesses, agro-industries and local bodies for the construction of infrastructure should also be met.

In the following discussion we will show how Islamic banks can play an active role in achieving the primary objective of rural finance.

The Role of Islamic Banks in Rural Development

Mobilisation of Rural Savings

There is a general misconception that the rural population does not have the ability to save. In fact, there is a great unused financial potential in rural areas. Even poorer members of the population have some savings either in the form of real assets or monetary savings. But because of the lack of a reliable financial infrastructure, these savings are not channelised into productive use. They are often squandered on social and cultural customs and traditions. It is ironical that on the one hand, rural economies are starved of productive funds, and on the other, savings remain hoarded and unused. We believe that in this area Islamic banks have an important role to play.

However, before Islamic banks enter the field for collecting savings from rural households, they would need legal and administrative support from their governments. A suitable legal framework would be necessary for:

- One, creating and regulating saving societies at village level. In some countries, cooperative societies already exist but they are either dormant or are not properly regulated. Therefore, they do not enjoy the confidence of the people. This confidence would have to be ensured before any meaningful campaign was launched to collect rural savings.

- Two, organising the work of cooperative or saving societies on a profit-loss-sharing basis. In all probability, the savings would be mobilised on two accounts: current account, which does not earn any return; and investment account, which participates in the profit or loss of the society.

It would not be possible, of course, for Islamic banks to open branches in every village. But they should be able to establish links with village cooperative societies, or saving societies. The banks could encourage these societies to place their funds with them on a profit-loss-sharing (PLS) basis. This would also bring some return to the savers.

Setting Up Rural Investment Trusts

Islamic banks could take the initiative in setting up Rural Investment Trusts. These trusts would hold funds on behalf of the rural population and issue Investment Trust Certificates. These certificates would be readily encashable at the banks' branches. The banks would invest these funds in agro-businesses and rural industries, as we shall discuss later. Investment Trusts are not new. They are already in vogue in many countries. The only innovation is that Islamic banks should move into the rural sector and persuade people to deposit their funds with them for investment purposes. The Investment Trusts would provide the hitherto untapped financial resources for investment in rural areas.

Managing Remittances from Abroad

A number of countries receive regular remittances from their citizens employed abroad. These remittances remain deployed in urban areas although most of the people who send these funds belong to rural areas. Islamic banks could offer to provide quick remittances to workers' families locally. They could either organise their branches in market towns or, with the help of post offices, arrange for the quick withdrawal of funds by workers' families. Of course, Islamic banks would also have to establish contacts with the remitting banks abroad. Islamic banks could further persuade workers to remit money through them by announcing that these funds would be used for uplift of the very areas to which these workers belong. For their part, Islamic banks could set up Remittance Funds to finance and refinance, on a PLS basis, commercial and industrial projects in rural areas. The remittances would, thus, also earn a return from these investments.

Managing Small Industries Fund for Rural Areas

There is a great need to promote small-scale industries in rural areas. These areas produce most of the raw materials for industries but processing of the raw materials is done in urban centres. To encourage location of industries in rural areas, financial support, and the wherewithal, is necessary. Islamic banks could establish Rural Industries Funds where rural people could deposit their savings for investment in rural industries on the basis of PLS. The savers would be able to earn a return on their deposits and have the satisfaction of knowing that their funds will be invested in their own areas. It would have the effect of generating employment opportunities in rural areas. The initiative to pool rural savings for investment in rural areas would also overcome a historical injustice as regards the rural population. It has been estimated that approximately 25% of the rural population's savings remain in rural areas, the remainder flows to national and international commercial banks.[1] However, the banks do not provide credit to rural people easily as, according to them, 'they do not have good projects or adequate collateral'. Thus rural savings are at present a mechanism to further benefit the urban rich.

Financing for Agricultural Inputs

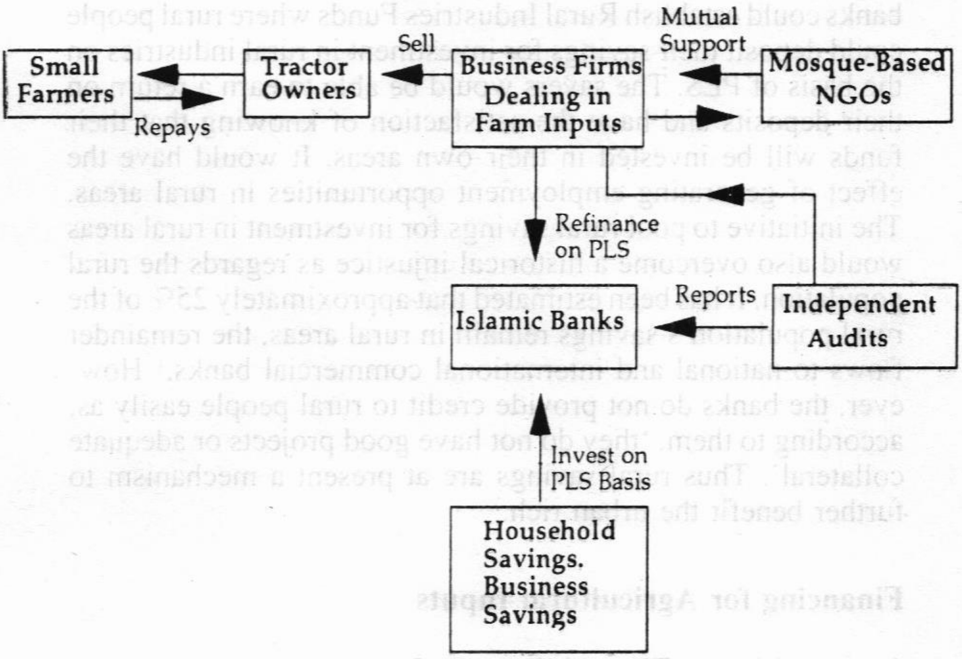
Improved Inputs Through Tractor Owners

One of the problems of the rural economy is that small farmers do not have access to improved farm inputs like seeds, fertilisers, and pesticides. Islamic banks could play an active role in providing these inputs to small farmers. The following proposal illustrates the *modus operandi*:

- Islamic banks could operate through a hierarchy of linkages. At the apex would be the Islamic banks who could provide refinance to the business firms or manufa-

Fig.I

Financing for Farm Inputs Through Commercial Companies



cturers of farm inputs. These firms would be large-scale corporations, preferably public limited companies, whose shares are quoted on the stock exchange. These corporations are managed by professional managers and their accounts audited by independent public auditors. It is possible that presently these firms do not exist in or do not have the necessary wherewithal in rural areas. In this case, the government would have to create the necessary legal and economic support. These corporations would deal in farm inputs like machinery, seeds, fertilisers and pesticides.

- These firms would develop a distribution network at market town level. They would operate through the tractor owners of each village who would act as their agents. The tractor owners would mortgage their land or some other assets with the business firms. The firms would sell farm input to farmers through tractor owners on an interest-free credit basis. *The price of inputs on credit would be the same as for cash. This is essential to prevent the entry of interest through the back door.*
- The tractor owners would receive a commission for their services. These would include intermediation between the farmer and the firms, helping the latter in recovery of dues and promoting their sales. The cost of commission to tractor owners would be offset against reduced expenditure on advertisements of farm inputs. (It is also one of our proposals that the government should regulate the cost of advertisements by fixing a maximum limit on advertisement expenses as a proportion of the cost of the farm inputs. This would also necessitate a change in the audit scope of these firms.)
- The tractor owners would be responsible for collecting the cost of all inputs sold to farmers at harvest time. Since the tractor owners are usually people of means and since they live in those villages, it would be far simpler for them to recover these dues at harvest time than for the financial institutions to do so.
- An additional arrangement could be that the business

firms agree to buy the farm produce from their customers at harvest time. This could be regulated under the Islamic business law of *bai' salam*. Under this law, a person can agree to supply something in the future provided the time, amount, and the price are settled in advance and the full price paid in advance. In this case, the farm inputs would be provided by the business firms on credit; the price of these inputs specified in money to be treated as the sum paid in advance for outputs to be supplied later by the farmers. However, such an arrangement would have to be made with great caution. *The price of farm produce should not be negotiated and settled by business firms in such a manner that the entire deal contains an element of concealed interest. It further means that if such deals were to become common, a market in bai' salam prices of various products would have to emerge and information on prices of that market be disseminated widely, preferably by an independent agency.*

- In some countries, governments announce a support price for main farm outputs. It would be necessary, in the case of *bai' salam*, that the business firms *do not buy farm output at a price which is lower than the government support price, as this would carry an element of disguised interest.*
- An important plank of the proposal is that the business firms would be able to get refinance facilities from Islamic banks, cooperative banks, commercial banks, investment corporations, *Zakāh* Trusts (to be discussed later) on a PLS basis. This refinance could be equal to a substantial part (say 70–80%) of the credit extended by the business firms to farmers through tractor owners.
- The banks would provide refinance from out of the saving deposits maintained by them for investment purposes, as discussed in a previous section.
- The government would have to enact the necessary laws to provide legal support to the scheme.
- A mosque-based non-government organisation (NGO)

would certify to the satisfaction of the business firms the creditworthiness and other antecedents of the farmers seeking credit sales from the business firms.

We add a caveat at this point. Financing schemes which try to provide inputs rather than finance are open to gross misuse. In several countries they have become a mechanism for corruption, kick-backs, commissions and outright thievery.[2] Therefore, the above scheme would have to operate within a framework of sound and reliable internal controls. Islamic banks would have to devise a mechanism to ensure that claims of credit sales to the rural poor, being presented by business enterprises seeking refinance from them, were genuine. They would need the support of the government as well as NGOs.

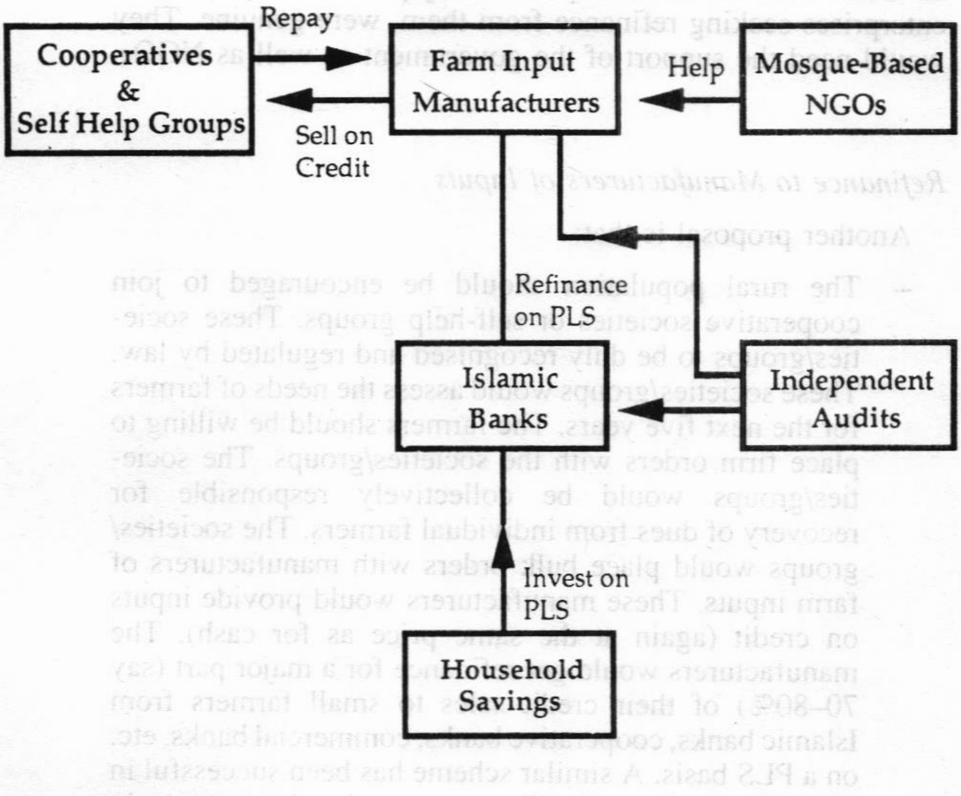
Refinance to Manufacturers of Inputs

Another proposal is that:

- The rural population should be encouraged to join cooperative societies or self-help groups. These societies/groups to be duly recognised and regulated by law. These societies/groups would assess the needs of farmers for the next five years. The farmers should be willing to place firm orders with the societies/groups. The societies/groups would be collectively responsible for recovery of dues from individual farmers. The societies/groups would place bulk orders with manufacturers of farm inputs. These manufacturers would provide inputs on credit (again at the same price as for cash). The manufacturers would get refinance for a major part (say 70–80%) of their credit sales to small farmers from Islamic banks, cooperative banks, commercial banks, etc. on a PLS basis. A similar scheme has been successful in Zimbabwe where fertiliser companies have actively cooperated with saving societies. The saving societies were offered agricultural packages with sale of fertiliser as a major input. The societies place bulk orders on behalf of their members with sureties for payment from out of their members' savings.[3]

Fig.II

Financing for Farm Inputs Through Manufacturers



- The banks would provide refinance from out of saving deposits maintained by them on account of investment.
- The government would provide the necessary legal backing to help firms recover their dues and obtain refinance from banks.

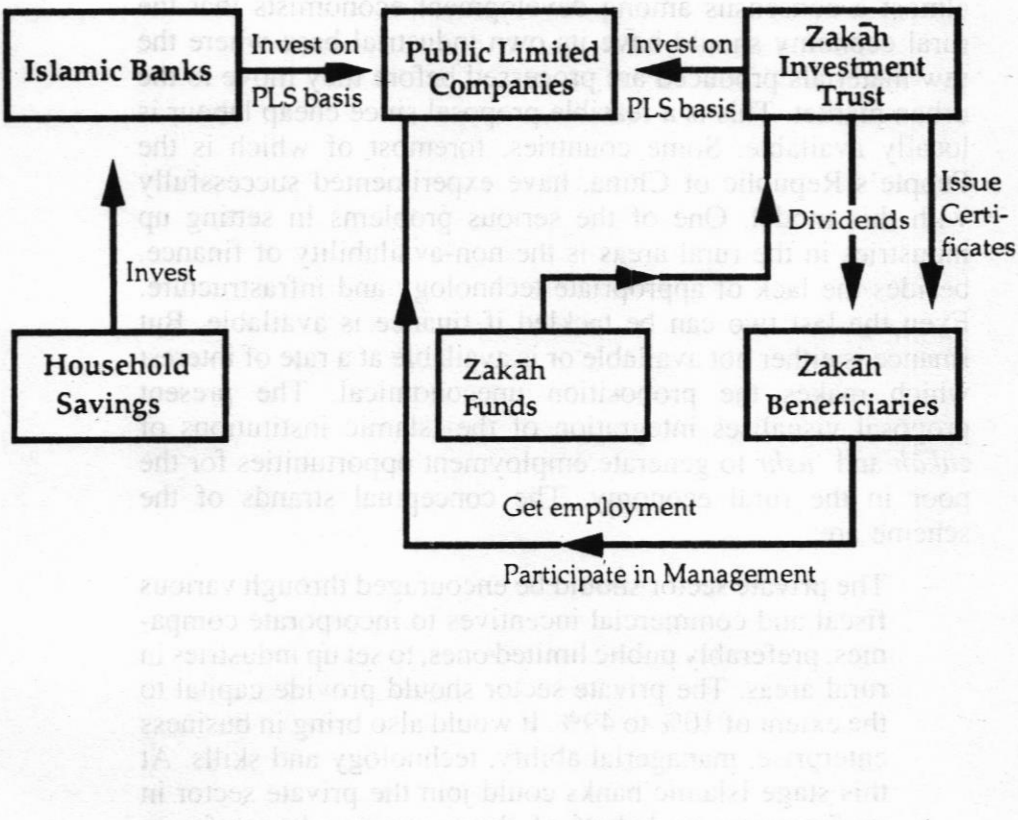
Financing for Agro-based Industries

One of the most urgent needs of the rural economy is to generate employment opportunities for those who have neither land nor livestock. They have only their labour to sell. There is almost a consensus among development economists that the rural economy should have its own industrial base where the raw materials produced are processed before they move to the urban market. This is a feasible proposal since cheap labour is locally available. Some countries, foremost of which is the People's Republic of China, have experimented successfully with this model. One of the serious problems in setting up industries in the rural areas is the non-availability of finance, besides the lack of appropriate technology and infrastructure. Even the last two can be tackled if finance is available. But finance is either not available or is available at a rate of interest which makes the proposition uneconomical. The present proposal visualises integration of the Islamic institutions of *zakāh* and *'ushr* to generate employment opportunities for the poor in the rural economy. The conceptual strands of the scheme are:

- The private sector should be encouraged through various fiscal and commercial incentives to incorporate companies, preferably public limited ones, to set up industries in rural areas. The private sector should provide capital to the extent of 10% to 49%. It would also bring in business enterprise, managerial ability, technology and skills. At this stage Islamic banks could join the private sector in co-financing on behalf of those savers who prefer to invest their funds in industry. The mode of participation could be purchase of equity, underwriting of equity issue or refinance to a certain extent on a PLS basis.

Fig.III

Financing for Agro-based Industries



– The balance of the capital would be provided by *Zakāh* Investment Trusts. These Trusts would be another innovation of the present-day Islamic economy. While a more elaborate discussion of these institutions must wait for a while, suffice to say that these Trusts would issue *zakāh* certificates to deserving people in return for the *zakāh* fund contributed by official *zakāh*-collecting agencies.

– The *zakāh* certificate holders, being part owners of these industries would also be represented on the industries' management committees.

The scheme visualises the creation of employment opportunities for landless labourers. It also suggests an innovative way to deploy *zakāh* funds for industrial development and thus overcome the problem of *tamlīk*.[4] The *zakāh* beneficiaries would also be entitled to dividends from these industries. Since they would also be working for these industries as part owners, productivity and profitability would be higher than for an industry which employs only wage-labour, other things being equal.

Financing Milk Plants Through Livestock Support Scheme

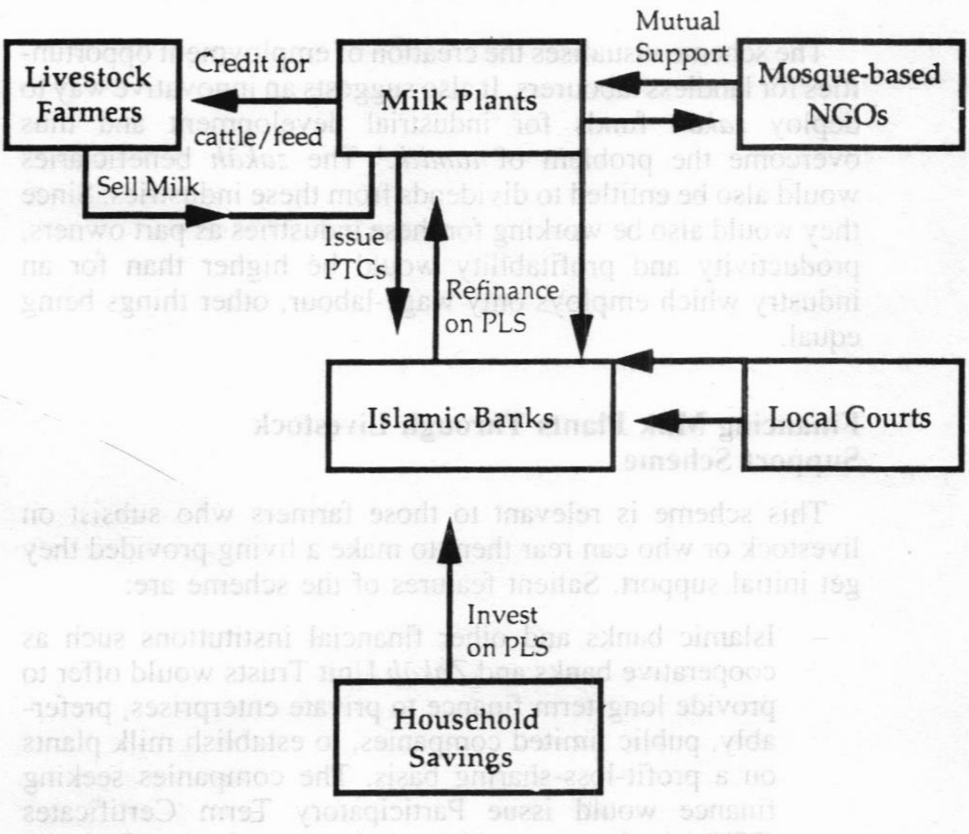
This scheme is relevant to those farmers who subsist on livestock or who can rear them to make a living provided they get initial support. Salient features of the scheme are:

– Islamic banks and other financial institutions such as cooperative banks and *Zakāh* Unit Trusts would offer to provide long-term finance to private enterprises, preferably, public limited companies, to establish milk plants on a profit-loss-sharing basis. The companies seeking finance would issue Participatory Term Certificates (PTCs) in the name of Islamic banks and other financial institutions.

– The milk plants would provide farmers with cash advances to buy cattle and feed.

Fig.IV

Financing for Milk Plants



- A mosque-based NGO would certify the creditworthiness of the farmers and help the milk plants recover their dues.
- The farmers would enter into a contract of *bai' salam* with the milk plants. Under this contract the farmers would agree to sell milk to the plants at an agreed price and in stated quantities.
- The milk plants would agree to adjust part of the milk price toward a cash advance provided for purchase of cattle and feed. The farmers would need some cash for subsistence; therefore, cash advances would be adjusted gradually. Eventually, the livestock farmers would become freehold owners of their cattle.
- It is also visualised that to overcome cash-flow problems, the milk plants could get refinance from Islamic banks and other financial institutions on a PLS basis, to a certain extent, of the credit extended by them to the livestock farmers.
- As a safety measure the milk plants could insist on some sort of collateral from contract farmers or the village NGOs would collectively give a surety. Future supply of funds for feed could also be conditional upon clearing past dues.

It is important to note that because of the large-scale illiteracy among the rural population and their inability to deal with financial institutions directly, some intermediate organisations to provide services to and ensure easy access of farmers to these institutions would be necessary. The exact nature and role of such organisations would have to be spelt out as well as the legal cover for their regulation and management.

Financing for Woollen Mills, Meat Plants, Tanneries and Related Industries

A scheme similar to the one above for milk plants can be visualised for the development of industries based on sheep, goats and cows reared for meat. Again, an intermediate organisation acting as liaison and a surety for the financial institutions would be an essential condition for the successful operation of the scheme.

In this scheme Islamic banks and financial institutions would provide long-term finance for setting up livestock-based industries such as leather tanneries, meat-packing plants, and woollen yarn and products industries. These units would provide finance to contract farmers for purchase of livestock and also for their feed under the *bai' salam* contract. The farmers would, in turn, agree to sell the livestock or their wool or skins to these plants in part repayment of the initial credit they had received. The industrial units could get part of this credit by way of refinance from Islamic banks on a PLS basis.

A secondary benefit of this scheme would be generation of employment opportunities in the rural areas.

Financing for Farm Machinery Assembly Plants

This scheme is relevant to village landless labourers and artisans. Its main features are:

- Islamic banks and other financial institutions would offer long-term finance to the private sector for setting up assembly plants for farm machinery in rural areas. This finance would be in lieu of PTCs issued on a PLS basis.

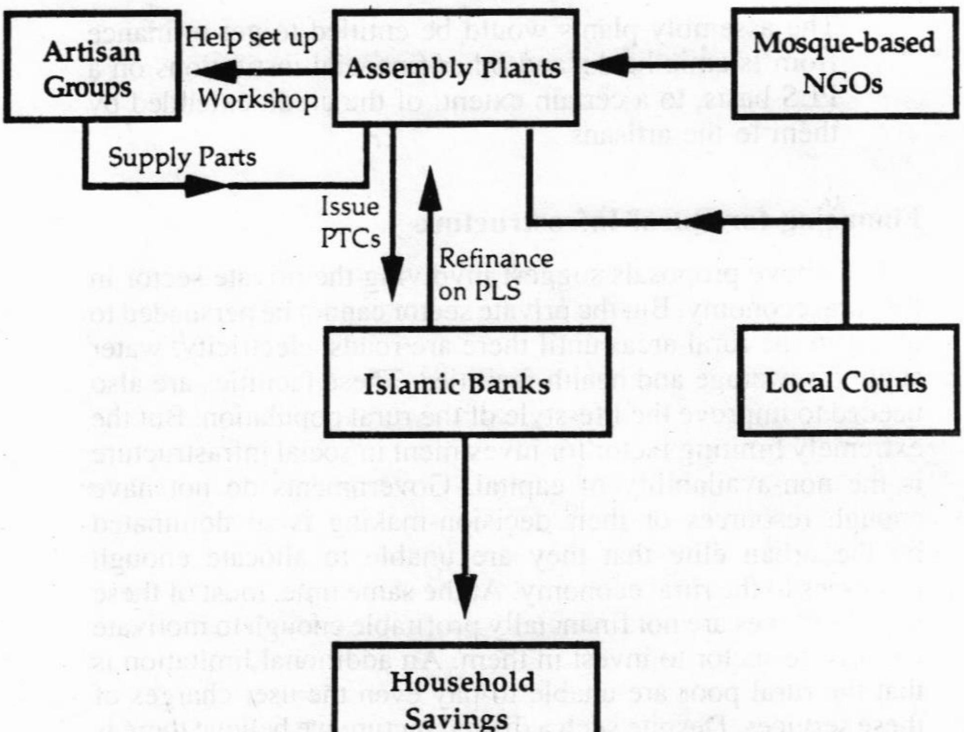
- These plants would provide interest-free finance to village artisans to buy machinery, tools and implements and to set up small workshops. Preferably, the artisans would form small groups to get the greatest benefit from this facility. The groups would be recognised and regulated by law.

- The plants would also offer appropriate technology and training to these small workshop owners.

- The workshop owners would agree to supply specified parts to the assembly plants within the *bai' salam* framework, the price, quantity and time of supply being specified.

Fig.V

Financing for Farm Machinery Plants



- The assembly plants would adjust part of the price of these parts towards the initial credit provided by them to the artisans.
- The creditworthiness and suitability of the artisans would be certified by the mosque-based NGOs.
- The assembly plants would provide initial finance in small amounts and that too by way of paying for the purchase of machinery and tools rather than in cash. This would ensure that the funds are not used for any other purpose. The assembly plants could also ask for suitable collateral for the credit they extended.
- The assembly plants would be entitled to get refinance from Islamic banks and other financial institutions on a PLS basis, to a certain extent, of the credit extended by them to the artisans.

Financing for Rural Infrastructure

The above proposals suggest involving the private sector in the rural economy. But the private sector cannot be persuaded to invest in the rural areas until there are roads, electricity, water supply, sewerage and health facilities. These facilities are also needed to improve the life-style of the rural population. But the extremely limiting factor for investment in social infrastructure is the non-availability of capital. Governments do not have enough resources or their decision-making is so dominated by the urban élite that they are unable to allocate enough resources to the rural economy. At the same time, most of these social services are not financially profitable enough to motivate the private sector to invest in them. An additional limitation is that the rural poor are unable to pay even the user charges of these services. Despite such a dismal picture we believe there is some scope for a positive role by Islamic financial institutions.

Financing for Education

There is no denying the fact that an ultimate shift in the life-style of the rural poor depends upon the speed with which they can acquire a decent education. Education increases earning ability. Therefore, the first priority in the social infrastructure field should be to establish schools and colleges. The primary responsibility for financing this activity, of course, lies with the government, but Islamic banks can also play an active role, in the following manner:

- Islamic banks can offer, through construction firms, to build schools and equip them with furniture, laboratories and libraries. They can then offer to lease these schools along with their equipment and furnishings to the private sector, NGOs or local bodies.

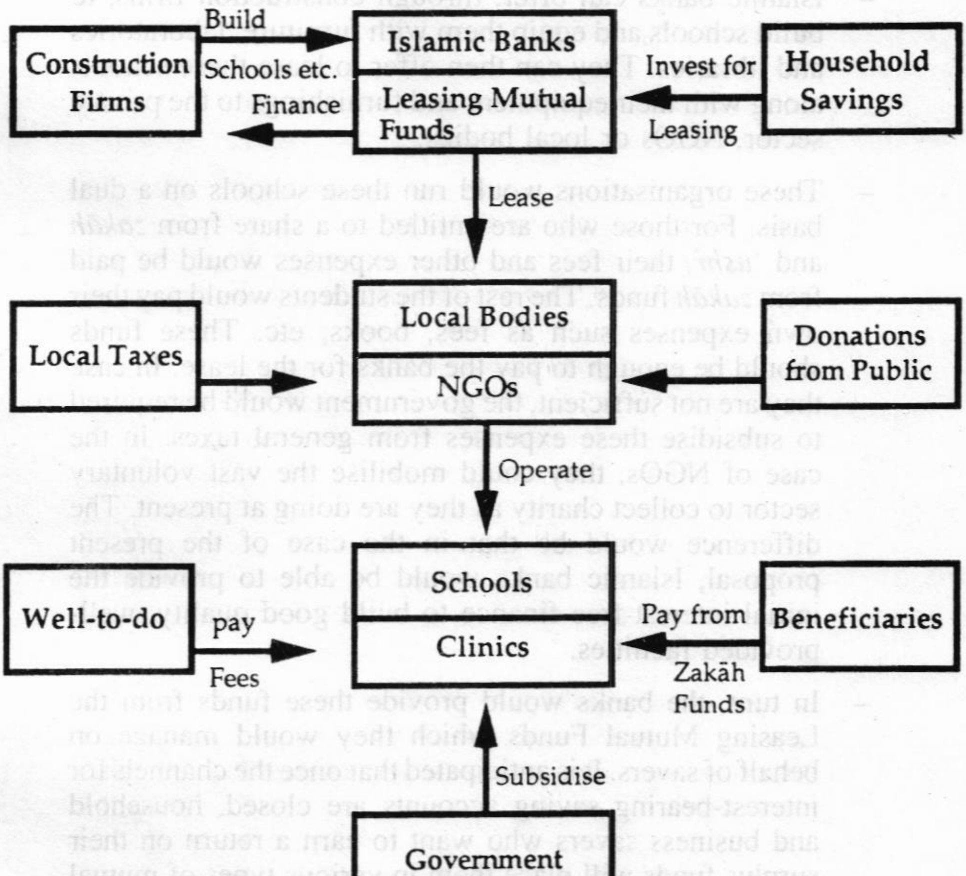
- These organisations would run these schools on a dual basis. For those who are entitled to a share from *zakāh* and *'ushr,* their fees and other expenses would be paid from *zakāh* funds. The rest of the students would pay their own expenses such as fees, books, etc. These funds should be enough to pay the banks for the lease. In case they are not sufficient, the government would be required to subsidise these expenses from general taxes. In the case of NGOs, they could mobilise the vast voluntary sector to collect charity as they are doing at present. The difference would be that in the case of the present proposal, Islamic banks would be able to provide the initial interest-free finance to build good quality, well-provided facilities.

- In turn, the banks would provide these funds from the Leasing Mutual Funds which they would manage on behalf of savers. It is anticipated that once the channels for interest-bearing saving accounts are closed, household and business savers who want to earn a return on their surplus funds will place them in various types of mutual funds. Leasing Mutual Funds would be one such type.

- It would be possible for local bodies, NGOs or the private sector to buy these facilities from the banks later on.

Fig.VI

Financing for Education and Health



Financing for Health

Similar to the above proposal is a suggestion for building basic health facilities in rural areas:

- Islamic banks could take the initiative to offer, through construction companies, to build small clinics and dispensaries in rural areas. They could also provide the initial finance for furnishings and equipment. The banks could then lease these clinics and dispensaries to private doctors, local bodies or NGOs.
- These groups or organisations could run these clinics on a private-practice basis. Those who were unable to pay for their treatment, could get a subsidy from *zakāh* and *'ushr* funds. Still further subsidies could be obtained through local bodies or the government from general taxes if the NGOs were unable to pay for their expenses. As in the case of education, the NGOs could invoke public help through voluntary donations for treatment of the poor. The Islamic banks could build good quality facilities and the NGOs would be able to repay the banks later on.
- It would also be possible for doctors, NGOs and local bodies to buy these facilities later on.

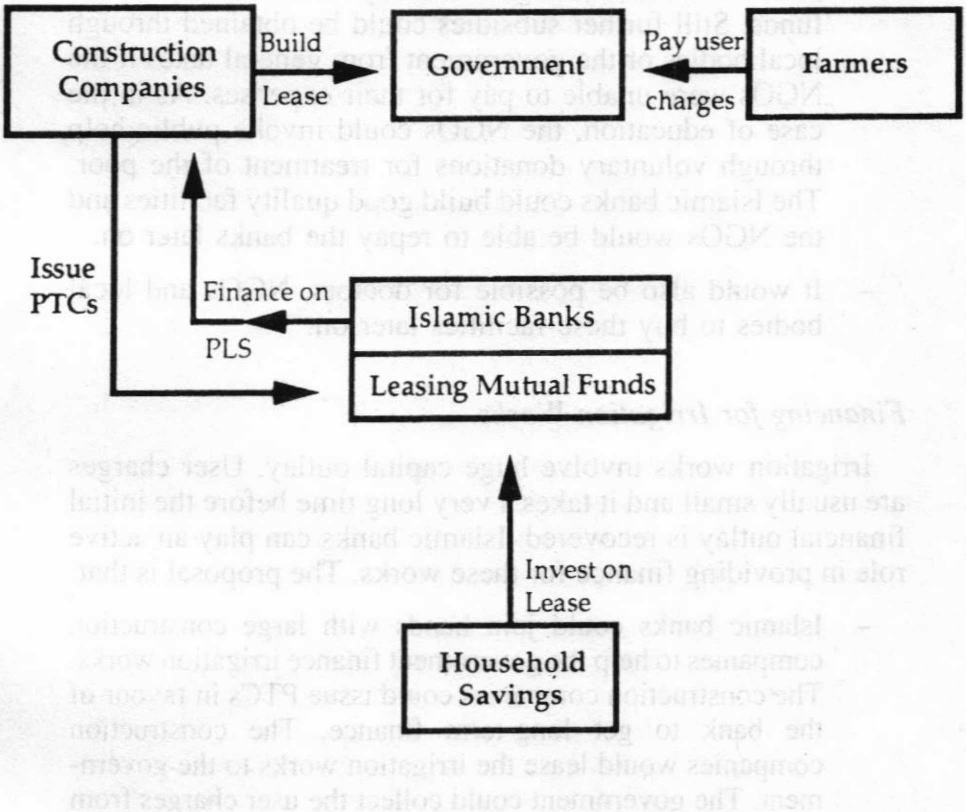
Financing for Irrigation Works

Irrigation works involve huge capital outlay. User charges are usually small and it takes a very long time before the initial financial outlay is recovered. Islamic banks can play an active role in providing finance for these works. The proposal is that:

- Islamic banks could join hands with large construction companies to help the government finance irrigation works. The construction companies could issue PTCs in favour of the bank to get long-term finance. The construction companies would lease the irrigation works to the government. The government could collect the user charges from farmers as it does at present and pay for the lease. The profit and loss of the construction company would be shared by the Islamic banks. The source of funds for the Islamic banks would be the Leasing Mutual Funds of savers.

Fig. VII

Financing for Irrigation Works



In this area the question of user charges is very important. The government would not, in every case be able to recover the total cost of such facilities because it might cause economic hardship. Therefore, it is possible that some of the costs would have to be subsidised.[5] The other question is about the rate at which the private company would lease the work to the government. There is a danger that interest might enter into the transaction through the back door. The banks may be tempted to quote lease charges with reference to the market rate of interest. This question needs careful consideration.

In fact there is usually no leasing market in this area. Most probably, the situation, of a company constructing a project on these terms, would be unique. In such a situation how do we decide upon the lease rate? One possibility is that the government agrees to pay the lease at the average rate of return of construction companies of a similar size but operating in the private sector. Another consideration could be the lease being paid by the government at the same rate as similar works at other locations. This rate of return would be subject to review periodically. The construction companies as lessors would be responsible for the maintenance and upkeep of irrigation works. However, this is a pithy question which needs further thinking and research.

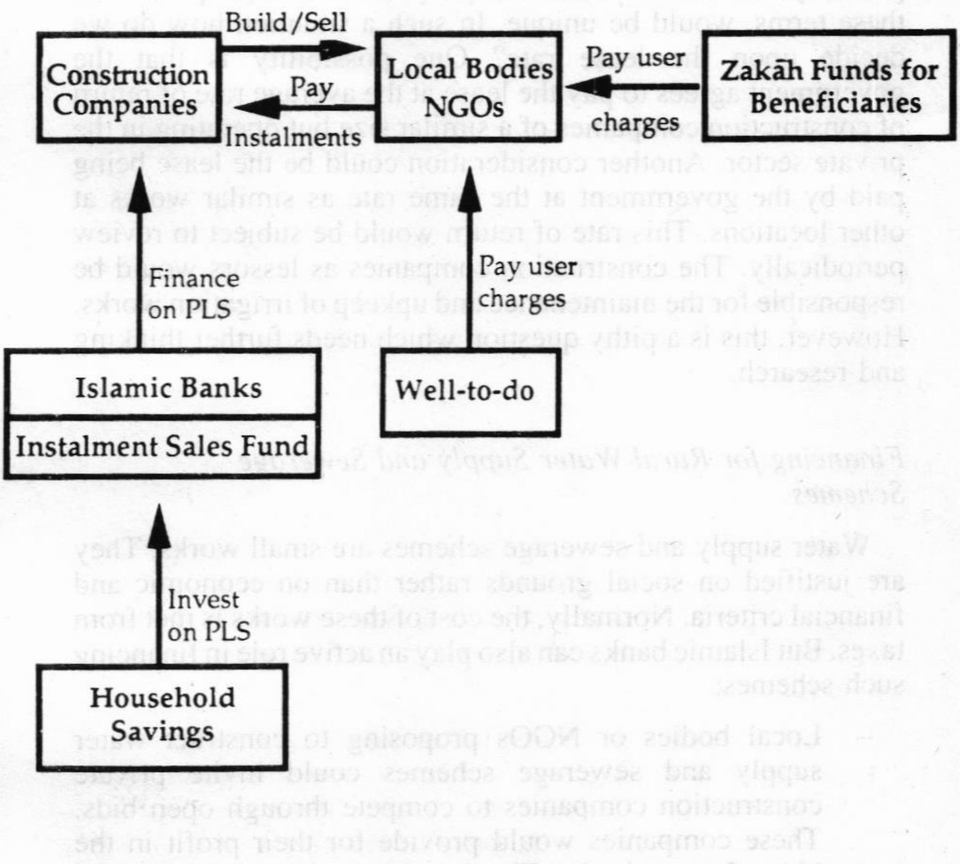
Financing for Rural Water Supply and Sewerage Schemes

Water supply and sewerage schemes are small works. They are justified on social grounds rather than on economic and financial criteria. Normally, the cost of these works is met from taxes. But Islamic banks can also play an active role in financing such schemes:

- Local bodies or NGOs proposing to construct water supply and sewerage schemes could invite private construction companies to compete through open bids. These companies would provide for their profit in the bids they submit. The sponsoring agencies would evaluate the bids and award the work to the most suitable contenders. The aim would be that the companies

Fig.VIII

Financing for Rural Water Supply, Electricity Supply & Rural Roads



construct these works and transfer their ownership to local bodies over a number of years during which the local bodies would pay agreed instalment costs.

- The maintenance and operational costs would be met by local bodies and construction companies on the basis of the capital investment of each party. Gradually, the capital of the local bodies would increase and also the share of maintenance and operation costs. On termination of the contract, the local body would wholly own the water supply and sewerage works.
- Islamic banks could join private construction companies in providing finance on a PLS basis from out of the Instalment Sales Mutual Funds managed by them on behalf of savers. It is anticipated that after interest-bearing saving schemes are abolished, the banks will promote and manage various types of investment mutual funds on behalf of savers. Savers who prefer to invest in instalment sales schemes are likely to put their funds in Instalment Sales Mutual Funds.
- Local bodies sponsoring such schemes would levy user charges to meet the cost of the works over a number of years. But in the case of those individuals and families who cannot pay user charges, *zakāh* funds would be contributed in proportion to the number of beneficiaries.

Financing for Electricity Schemes

A scheme similar to the water supply scheme stated above, for construction of electricity distribution works to rural areas, could be launched by the government. Islamic banks could contribute finance on a PLS basis through power construction companies in the private sector. These companies would construct facilities and sell to the government on an instalment sales basis. Since each contract would be awarded after competitive bidding, there would be a market for such works. The banks and companies would share in the profit or loss. During the period that local bodies or the government is paying for the works, the maintenance and operational charges would be shared. Similarly, those poor people who could not pay their electricity bills would be helped from *zakāh* funds.

Financing for Rural Roads

The above proposal is equally applicable to the construction of rural roads. The only difference is that it would not be possible for local bodies to collect any user charges for these roads. In this case, the whole cost of the roads would have to be met from general taxes. Of course, some assistance could be obtained from *zakāh* funds to the extent of the population entitled to benefit from these funds and living in the areas directly connected by these roads. The rest of the scheme is the same as stated in the case of electricity above.

Complementary Services by Islamic Banks

Islamic banks would have to operate in an expanded framework of rural finance to make a dent in rural poverty. The above proposals visualise an expansion in the rural economy by industrialisation and commerce. But mere availability of finance would not be enough. They would have to provide some complementary services as well. The precise nature of these services would differ from country to country but some general services are as below:

Technical Assistance for Project Management

Project management is a technical area and most developing countries do not have enough skilled persons to conceive, plan, implement, operate and control industrial and infrastructure construction projects. Islamic banks would have to provide technical assistance to prospective entrepreneurs in preparing feasibility studies, planning, coordinating and controlling projects. These services could be provided on an actual cost basis. The banks would benefit from them indirectly; they would be more confident about the profitability of proposed investments.

The importance of proper project preparation and control is recognised in an interest-bearing-finance regime as well. But it is much more vital for the success of Islamic banks which rely on the actual profit or loss of an enterprise. The conventional banks perform this function, but perfunctorily, since they are more interested in safeguarding the principal sum lent and an assured interest on it. This they assess from the availability of collateral and the past record of the entrepreneur. But Islamic banks would be looking for a share in the actual operating results of the enterprise. Even when they had collateral they would have to invoke a stake in the business. Therefore, they would need to assess very carefully the investment proposal.

It is possible that Islamic banks could take the lead in setting up training institutes for new entrepreneurs. These institutes, with government collaboration and some NGOs could provide such services as market information, training in project management, basic finance and accountancy, marketing skills in rural areas and training in rural social structures. These services could be provided by the banks for a service fee and also be subsidised by them. The indirect benefits from these services would bring rich long-term dividends to the banks.

Collaborating with NGOs for Skills Training

Another potential area for Islamic banks' operations would be to collaborate with rural NGOs in skills training of the rural poor. With the introduction of industry and other development projects, landless labourers would need training in various skills. This would provide them opportunities for employment nearer to their homes. But most probably, the private sector would not be willing to train people at its own cost. Rural NGOs would therefore have to take the initiative in starting various programmes in skills training. Islamic banks could contribute in this area either by loaning services of technical staff, by cash donations, or by extending interest-free loans to NGOs or scholarships to trainees. This investment would repay the banks in the long term when these trained people work in the rural economy and add value to the various projects in which the banks had put their funds.

Managing Zakāh and 'Ushr Funds

Islamic banks could also offer to manage *zakāh* and *'ushr* funds on behalf of the local community and government. They could collect, disburse, invest, and control *zakāh* funds. This would reduce the cost of managing these funds for the local community. Although the banks could charge for their services, where possible they could provide these services free.

Problems of Islamic Banks

Rural finance is a new area for Islamic banks. Their experience has been in the trade and industry sectors. Therefore they are likely to face several problems. The following discussion will illustrate the nature of these problems.

Access to Target Groups

The biggest problem Islamic banks are likely to face is one of access. They need to reach target groups effectively but the experience of other financial institutions shows they may not be able to do so easily. Quite often, the financial institutions serve the non-poor, and for purposes other than rural development or even strictly agricultural ones. The reasons are myriad. For example, the financial institutions may not have a rural presence and hence have no direct contact with the target population. Even where the institutions have branches in rural areas, the conditions of collateral, loaning procedures, language and behaviour of the bank staff, social and cultural barriers, location and design of bank offices, and the awe-inspiring atmosphere of banks, generally tend to keep the poor away. The burden of interest on loans is another deterring factor but is not often mentioned in conventional theories of rural finance.

Islamic banks face a great challenge to overcome these barriers. First, they need to establish a local presence. Obviously, they cannot open branches in all villages. Therefore, they may have to develop linkages with the target population through various means such as *mobile banking* (like the Habib Bank in Pakistan and the Grameen Bank in Bangladesh), *group organisers* (like those of the Agricultural Development Bank of

Nepal),[6] *contact through mediators,* like mosque-based NGOs as proposed in this paper or church-based NGOs as tried in Kenya,[7] or involve influential villagers to introduce the poor to the bank. A campaign by the banks to collect savings from the poor through informal saving societies and cooperatives could also afford opportunities for introduction of the banks' business.

Second, the problem of collateral needs to be addressed from a fresh angle. While the banks cannot risk losing their depositors' funds by advancing finance to dishonest and incompetent persons, at the same time they need to consider the effectiveness of their business for rural development. In all probability, the genuine poor will not be in a position to present any assets as collateral. Many countries have tried different methods to overcome this difficulty. One approach has been to provide finance through groups to groups or through groups to an individual, the whole group being responsible for repaying the group or individual loan. Experience has shown that financing through a group not only reduces the cost of credit management but also ensures better recovery prospects.[8] Another approach has been to investigate the personal character of the debtor thoroughly before extending the loan. NGOs have also helped in identifying deserving and reliable clients. Experience has shown that 'human qualities and mutual trust are a better guarantee in credit business with the poor than real assets'.[9] Banks have also tied the loan to opening a saving account by the individual seeking the loan or by another person. Personal sureties, of course, have been the most common alternatives. Another possibility is that the Islamic banks build guarantee funds from out of their profits to offset any future losses. But the existence of such guarantee funds should not be known to the persons or groups seeking finance from the banks, otherwise it would act as an incentive for defaulting on repayment.

Islamic banks may try all or some of these methods. But one essential difference is that Islamic banks do not provide finance as loans. They provide it on the basis of the Islamic modes of finance as discussed in this paper. These modes of finance presume that those who want to earn a profit on their savings should also be willing to accept the possibility of loss. Having said this, it does not remove the possibility of 'moral hazard' where an individual may try to get finance for an exceptionally risky project since part of the risk will be borne by the bank. Though such possibilities cannot be ruled out, they also suggest the need for a more careful project appraisal. Moreover, the proposals in this paper have a built-in feature of security of the banks' capital. For example, the proposal for operating through large-scale public limited companies, through tractor owners, through mosque-based NGOs, or through local bodies, to a large extent takes care of the problem of collateral. However, if in the final analysis Islamic banks are not sure that their capital is adequately safeguarded, they may ask for some collateral.

Third, Islamic banks do not provide finance on interest. This takes care of the last deterring factor against the access problem. The involvement of the bank as a partner rather than as a lender or financier gives entrepreneurs a genuine confidence and removes the barrier against access to the target groups.

Fourth, another problem is the political pressure and interference of influential people in the work of Islamic banks. This is a complex issue. On the one hand, the banks need the help of socially-powerful people to reach their target groups and to recover the banks' dues. On the other hand, these very people can be a threat to the banks' business. They can interfere in the banks' objective assessment. They can also pressurize the banks to provide finance to non-genuine persons and for invalid purposes. There is no easy solution to this problem. The banks have to proceed cautiously and firmly. The legal framework of the country and the social structure need to change. But some persons in the government could prove a real obstacle to change. Normally, the stronger the feudal traditions of the society the harder it is to overcome such difficulties. The government should legislate to grant complete autonomy to Islamic banks in their operations.

Utilisation of Finance

Another difficulty is that the banks' clients do not always use the finance for the purpose for which they obtained it. They sometimes spend money on various social customs and traditions which are often unproductive. Knowing that a true statement of their needs will not entitle them to the banks' finance, they make a false statement and often get the endorsement of some influential person. This problem cannot be eliminated entirely. However, Islamic banks can reduce its incidence. Firstly, as suggested earlier, some of the financing can take the form of kind rather than cash. For example, the banks can pay directly for seeds, fertilisers, pesticides, livestock, cattle feed, etc. on behalf of the farmers. Such an approach reduces mis-utilisation of finance. But it discourages people from contacting the bank for finance. Instead they get into the hands of moneylenders who are not so concerned about utilisation. Secondly, the banks can institute a system of monitoring utilisation of funds and tie the release of future instalments to previous satisfactory reports. Of course, this could be effective but it would increase the banks' costs. Thirdly, Islamic banks may involve mosque-based NGOs to help them identify improper utilisation of banks' funds and to influence users of the funds as to their proper use.

Repayment of Finance

For Islamic banks, repayment of the finance advanced to the rural poor or rural businessmen is of greater concern than for conventional banks. Because Islamic banks do not deal in interest, they are at greater risk than conventional banks. They would therefore need to try some or all of the conventional methods of recovery. For example, they would need to develop personal long-term relationships with their clients. Without such an approach all funds remain insecure. They would need to involve NGOs, cooperatives, informal groups, local bodies and the banks' savers to get various types of assurances for recovery of their dues. Another possibility would be to sanction finance on various projects in favour of various persons in public. Experience has shown that credit procedures that take place in the open are particularly successful.[10] The banks could hold meetings where all the important people of the village attend and many witness the fact that the bank has extended finance to a particular person. This would build social pressure against the defaulters. 'The existence of creative leader personalities has always proved to be an important prerequisite for the successful development and use of target-group-oriented financing instruments.'[11] Another approach would be to declare the entire group a defaulter if any one member defaults.[12] In this way, the reputation of a particular group is affected and they try to help the bank in recovery. Encashment of collateral, if the bank has taken one, is the last resort. But in the final analysis, they have recourse to local courts. The government would have to strengthen the powers and jurisdiction of local courts to support the banks and other financial institutions.

Experience of savings and cooperative credit in Germany has shown that the repayment rate of credit is high where the liability of the peasant or borrower is unlimited.[13] The Islamic concept of liability for credit is the same. The borrower has to repay the debt even though it be from his estate after death. But it is important to note that Islamic banks would not be lending money directly. They would be entering into various operations of trade and investment. But still the client would owe the bank the principal along with any profit or loss. Thus the concept of unlimited liability would be helpful.

Administrative Costs

The cost of finance for Islamic banks is another problem. To the extent that they have to carry out extensive investigations about the creditworthiness of the borrower and the profitability and risk of the investment proposal they would obviously incur some extra cost. Similarly, they might have to monitor utilisation of the finance and this would also be an extra burden.

One possibility is that Islamic banks develop a close liaison with the mosque-based NGOs. The NGOs should be willing to absorb part of the cost of the financing operations. For example, the NGOs could keep detailed accounts of members' savings and money taken by each member from the bulk financed by the bank. Islamic banks could deal with the NGOs only. In this way some of the detailed book-keeping and individual accounts of finance taken and repaid by members of the NGOs would be done by the NGOs themselves.[14] In our proposal, we have suggested that Islamic banks operate through tractor owners or large-scale public limited companies who would get refinance from the banks. This would cut the cost of banking operations considerably. Islamic banks, thus, would not come across the problem of cost which rural financial institutions often face since they deal directly with large numbers of poor people.

Another important point is that Islamic banks would not extend loans on a fixed-interest basis. They would participate in real sector business operations and if they chose projects carefully their profit share would also be higher than the traditional interest rate. Thus they would have a greater capability to absorb additional costs.

An implication of cost considerations for Islamic banks is that they would have to increase their operational efficiency by cutting costs in other areas to remain competitive.

*** Reprinted from chapters 1 to 3 of "Rural Development and Islamic Banks" by Dr. Muhammad Akram Khan**