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SUSTAINABLE FINANCING OF MICRO, SMALL AND MEDUIM ENTRISE (MSMEs) THROUGH ISLAMIC BANKING PRODUCTS IN NIGERIA, KATSINA STATE

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ABSTRACT

The Micro, Small and Medium Enterprises (MSMEs) play important role on employment creation, manpower and skills development, industrial development, poverty reduction and economic growth and thereby recognized as engine for socio-economic transformation in both developing and emerging economies of Africa and Asia respectively. However, these enterprises are facing pyramid of problems, several among them though not exhaustive include: inadequate capital, managerial inefficiency and inaccessible credit facilities from formal financial institution. The problems of inadequate capital and inaccessible credit facilities from the conventional banking sector are the most critical. The MSMEs are lacking access to institutional credit at both commercial and development financial institutions; considered high credit risks by the financial institutions. Conventional banks are also characterized with the receipt and payment of interest; associated with non-Shari'ah compliant financial products. Hence, the need for ethical banking system; considered competitive and alternative to conventional banking products, more responsive to the environment of the study (Katsina state), which is referred to Islamic banking. This paper is motivated to discuss the Islamic banking products and their efficacy towards attainment of sustainable financing of MSMSEs in Nigeria, Katsina state. The tools of the research are basically analysis on the subject matter of the study with a collection from secondary data. Furthermore, the research paper is relevant to Islamic (commercial and micro finance banks, saving and credit multipurpose cooperative societies) financial institutions. The knowledge, skill and abilities of the management and staff of those institution as well as other stakeholders will be enhanced. It is also serve as a good reference for academics and therefore, advancing the frontier of knowledge in the field of study.

1.0 INTRODUCTION

The population of Katsina state is predominantly Muslim and was once a centre of education (both Islamic and western) as well as centre for commerce at pre-colonial period. It was described as a gate way to Trans- sahara trade from North Africa through West Africa axis. In fact, Katsina was the main attraction of any trans-sahara trade in the central Sudan in the early nineteenth century (Sani, 2012). Agriculture, general

merchandize, transportation and petroleum dealership are some of the major economic activities in the state. The employment capacity and asset ownership of those businesses rightly classified them into Micro, Small and Medium Enterprises (MSMEs). The MSMEs play important role on employment creation, manpower and skills development, industrial development, poverty reduction and economic growth (Oyelaran, 2013, Odunta, 2014, Sanusi, 2011, Anigbo, 2014,) and thereby recognized as engine for socio-economic transformation of the developing nations (Yoshino & Hesary, 2018). In Nigeria, MSMEs are defined on the bases of their employment capacity and asset base. For instance, Micro enterprises are those employing less than 10 people with assets (excluding land and buildings) of less than N5 million. While those engaging between 10 – 49 employees and possess assets between N5 - N50 million are considered as small enterprises. In contrast, Medium enterprises are those engaging between 50 and 199 employees and have assets of about N50 – N500 million (SMEDAN, 2017). In view of the above, MSMEs are dominant and of economic importance to the developing economies like Nigeria and Katsina state in particular.

The MSMEs are facing pyramid of problems, several among them though not exhaustive include: inadequate capital, managerial inefficiency and inaccessible credit facilities from formal financial institution (Ekpenyong 1997, Utomi 1997). The problems of inadequate capital and inaccessible credit facilities from formal financial institution are the most critical. The commercial banks which retained liquidity levels in excess of regulation have shown reluctance in financing them (Sacerdoti, 2005), this leads to their inefficient growth and development in the country. They are lacking access to institutional credit at both commercial and development financial institutions; considered high credit risks by the financial institutions. In addition to the above mentioned technical and economic problems, some MSMEs are voluntarily excluded from conventional banking finance services on religious or cultural reasons (Abdullahi, et al, 2020). Conventional banks are characterized with the receipt and payment of interest as well as dealing into other business and financial transactions repugnant to the norms and value system of Islam; associated with non-Shari'ah compliant financial products and services. Hence, the need for a banking system working within the norms and value

system of the Shari'ah framework which simply refers to Islamic bank.

Islamic bank is also a financial intermediary institution like its conventional counterpart, however, it provides its financial intermediary services in compliance to Shari'ah principles. It is therefore, an application of Islamic principles, law and tradition in banking activity (Karwai, 2005, Razi, 2008, Ahmad, 2010, Dutsinma, 2010, Sodangi, 2010 and Abdullahi, et al, 2020). Those banking products are considered competitive and alternative to conventional banking products, more responsive to the environment of the study (Katsina state) than its conventional counterpart and could be less risky in investment because of its profits and loss sharing policy. This paper is motivated to discuss the Islamic banking products and their efficacy towards attainment of sustainable financing of MSMSEs in Nigeria, Katsina state. Thus, the paper is divided into five sections. Section one, is the above introduction. The nature and scope of Islamic banking is highlighted in section two. Section three, is analytical framework of Islamic banking products. While section four dwells on Islamic banking products and financing of the MSMEs. The paper submitted conclusion and recommendations in section five.

2.0 NATURE AND SCOPE OF ISLAMIC BANKING

Islamic banking refers to a system of banking or banking activity that is consistent with the principles of Islamic law (Shari'ah) and its practical application through the development of Islamic economics (Ringim, 2012, Karwai, 2005). The Shari'ah principles forbid ambiguity, exploitation, deceit and fraud (Venardos, 2006), receipt and payment of interest and any Haram (fording act by the Shari'ah) financing activity. Islamic banking, therefore deals with deposit mobilization from the surplus unit, project financing to deficit unit as well as other banking services that are permissible under the principles, law and tradition of the Shari'ah. The products of the banking system must be morally sounded, ethically bounded and legally endorsed by the Shari'ah (Chapra: 1985, 2000& 2010, Karwai, 2005, Dawud & Adebayo: 2013, Yusuf: 2009), passing through Islamic moral, ethical and legal filters to ensure compliance with the ethical, norms and values of the Islamic doctrine of investment financing, deposit mobilization and provision other banking services (Chapra, 1985, Lamido, 2014, Rahman, 2014). In this vein, business activities like gambling, dealing in pork and alcoholic beverage trade, pornography,

prostitution and other related products, goods and services are disapproved, as such should neither be allowed for deposit mobilization nor project financing by Islamic bank as they have contravened the Shari'ah injunctions.

In view of the above, Islamic banking distinguished itself from the conventional counter part by not only avoiding payment and receipt of interest, but also rejecting any banking product and services that are not Shari'ah compliant. It is therefore imperative to draw an explicit line of difference between Islamic banking and Interest free banking as the former is wider and general and the latter is narrower and specific in scope. Islamic bank is banking in consonance with the ethos and value system of Islam, while Interest free banking is denoting a number of banking instruments or operations which avoids interest (Omar & Abdel Haq, 1996). Islamic banking is a specialized financial intermediary institution that provides its services on the principles, law, tradition and ideals of Islamic doctrines; considered as alternative forms of financial intermediation that differs from the conventional finance structure.

In Islamic banking, project financing for instance are provided either on equity (investment) or sales (trade) financing structures as stipulated by the Shari'ah codes of finance. In contrast to conventional banking, project financing are on debt rather than trade/sales financing characterized with receipt and payment of interest, being unlawful and illegal in the Shari'ah finance code and invariably, the Shari'ah system. The conventional equity finance structure may also not necessarily observe Shari'ah provisions on such financing and businesses related matters. The equity structure may process and approved business proposal related to gambling, alcoholic beverage and pork production. Summarily, the modes of project financing and other activities by Islamic bank (Ahmad 1983, Ahmad 2014, Obaidullah, 2005) are broadly categorized as follows:

a) Investment financing through *Musharaka* and *Mudaraba* based on estimated rate of return or negotiable rate as the case may be;

b) Trade financing through *Murabaha* (markup sales), *Ijarah* (leasing and/or hire-purchase) and letter of credit;

c) Lending services which is treated as *Qard hasan* i.e. non-cost loan and

overdraft for needy people because lending is not considered business and;

d) Services through money transfers, bill collections and trade in foreign currencies based on commissions or charges.

Islamic banking is built on the principle of no-interest and/ or financing any *Haram* (fording act by the *Shari'ah*) activity. The receipt or payment of interest on deposit or lending, at fixed or fluctuating rates as well as either small or big in nature is proscribed (*Al- Baqara*: 278-279) and must be avoided accordingly. The banking system is based on the concept of sharing risks and profits, direct investment and agency services (Lamido, 2014, Muhammad, 2019). It further stressed on asset-based transaction linked to real economic activities to stimulate real sector of the economy (Mustafa, 2011& Sanusi, 2011 and Muhammad, 2019). Furthermore, the principles of Islamic banking are built on moral dimension rooted in the Islamic value system like fairness, transparency, prudency, justice, accountability in the hereafter and objectivity (*Al- Baqara*: 188, *Al- Ma'ida*: 8, *Al-Qasas*: 77, *Al-Zulzilat*: 7-8). It is opposed to the conventional method which is characterized by the institution of interest, speculation, exploitation of one party to another (Chapra, 1985, 2000& 2010, Razi, 2008). The objectives of Islamic banking as (Karwai, 2005) stressed, citing (Khan, 1983) is summarily depicted: "The objectives of Islamic banks, in general, is to promote, foster and develop the application of Islamic principles (of justice), law and tradition to the transaction of financial, banking and related business affairs and to promote investment companies, enterprises which shall themselves be engaged in business activities as are accepted and consistent with Islamic principles, law and traditions and in no event engage in alcoholic beverage trade, the receipt of interest forbidden by Islam, the gambling industry or pork meat or in any other un-Islamic activity".

2.1 Operational Definition of Key Terms

Islamic Banking

Islamic banking can be viewed as a financial system that offers banking services, products and instruments in accordance to Islamic doctrine which in the Islamic jurisprudence refers to *Shari'ah*. It is therefore, a system of banking or banking activity that is consistent with the principles of Islamic law (*Shari'ah*) and its practical application through the

development of Islamic economics (Ringim, 2012, Karwai, 2005). The *Shari'ah* principles forbid ambiguity, exploitation, deceit and fraud (Venardos, 2006), receipt and payment of interest and any *Haram* (fording act by the *Shari'ah*) financing activity.

Micro, Small and Medium Enterprises (MSMSEs)

The definition and scope of the MSMEs varies from one country to another, in Nigeria MSMEs are defined on the bases of their employment capacity and capital base. For instance, Micro enterprises are enterprises employing less than 10 people with assets (excluding land and buildings) of less than N5 million. The Small enterprises on the other hand are those engaging between 10 – 49 employees and possess assets between N5 - N50 million. In contrast, Medium enterprises are those engaging between 50 and 199 employees and have assets of about N50 – N500 million (SMEDAN, 2017). This revealed economic advantages and importance of the MSMEs to the developing economies like Nigeria.

3.0 ANALYTICAL FRAMEWORK OF ISLAMIC BANKING PRODUCTTS

Banking and financial institutions have emerged to meet genuine human needs. Specifically, banks are financial intermediary institution between providers of funds (depositors/ surplus unit) and entrepreneurs (investors/ deficit unit) to foster national economic development (Yusuf, 2003). In conventional banking practice, money are products and thus treated as commodity; can be bought and sold at a price/rate, the price is called *interest*. The surplus unit are paid a premium by a bank for the investor/entrepreneur using the surplus funds of the depositor; known as *deposit rate*. On the other hand, the bank receives higher premium from the investors for borrowing the depositor's funds as *lending rate.* The difference between the deposit rate and the lending rate paid to and received by the bank respectively is called *interest rate*.

In Islamic banking practice, both the act of receiving and payment of interest is *haram* (illegal and illegitimate) in any form of business and financial transactions (Suratu-al-Rum: 30, Suratu-aali-Imrana: 130, Suratu-al-Baqara: 278-279), thus Islamic bank do employ certain banking products that are unique and different from the conventional bank. In this case, the dividing line between Islamic and conventional bank is on the principles, law and tradition governing their operations. Islamic bank rejects the interest payment and any non-*Shari'ah* compliant

banking services in business and finance transactions. Thus, Islamic banking products replaces the non- *Shari'ah* compliant of the conventional banking services with certain banking products and services that are in consonance with *Shari'ah* business and finance codes. The Islamic banking products are classified into depository savings and project financing. However, the paper intends to discuss the project financing products and their effectiveness for sustainable financing of MSMEs in Nigeria, Katsina state.

3.1 Islamic Banking Project Financing Products

Shari'ah financial code recognizes economic process of ownership of wealth and its utilization by individual(s), corporate entities and government within the limit stipulated by the *Shari'ah*. Such economic process should be on fairness, transparency, accountability and economic justice for all (*Al- Baqara*: 188, *Al- Ma'ida*: 8, *Al-Qasas*: 77, *Al-Zulzilat*: 7-8) to attain prosperity in the hereafter. Businesses are financed by Islamic bank either through equity (investment) or sales (trade) financing structures. The equity (investment) financing structure is based on profit/loss sharing, while the sales (trade) based financing is on profit margin or mark up. These two financing structures are considered as competitive and alternative to conventional financing structures and are discussed below:

3.1.1 Equity financing: This financing instrument involves mutual sharing of risks and profits, depending on the performance of the investment project. It is considered more competitive and better alternative to conventional credit finance being characterized with interest rate which is repugnant to Islamic finance code (Sapuan, 2015, Yusuf, 2003& 2009). Therefore, Islamic bank adopts corporate finance strategy to ensure effective utilization of their mobilized deposit funds on equity finance.

The equity finance is treated as fiduciary contracts (*'uqud al amanah*) in the *fiqh al Mu'amalat* literature, where honesty, fairness and fear of Allah are of paramount importance. Anything short of fairness, justice and equity is a serious violation to the ethical, norms and value system of Islam. The partners in the investment are expected to exhibit high degree of honesty and sincerity towards fulfillment of the contract (*Al-Ma'ida*: 1), any act of betrayal of trust for deriving personal benefit or income by a partner is absolutely condemned by the *Shari'ah* (*Al- Anfal*: 27).The word *al-'uqud* is the plural of *al-'aqad* and is synonymous

with the English word contract meaning an obligation or tie. It is an act of putting a tie to a bargain. When two parties enter into contract, it is called *al-in'qad,* that is joining or tying up the offer and acceptance together. The obligations thus arising out of contract are called *'Uqud* (Doi, 1984). The Qur'an instructed believers to fulfill their obligations: 'O you who believe, fulfill all obligations' (*Al- ma'ida:*1).The equity finance structure is basically classified into *Musharaka* and *Mudarabah* and can be applied to both commercial, agricultural and other enterprises accordingly. The two modes of financing can elucidated below:

Musharaka: This also called *Shirkah* or *Sharikah* and literally refers partnership between two or more persons. It is therefore an Arabic term which simply means partnership. The word *Shirkah* has appeared in some places in the Qur'an. Prophet Musa (Peace of Allah be upoun him) prays to Allah to make Harun, his brother, his partner in his great mission to Pharaoh: Harun (is) my brother; add to my strength through him and make him share my task…" (Taha: 30-32). Also Allah (SWTA) says: "But if (they are) more two, they are partners in the one third (share)…" (Nisa'i: 12).

This mode of *Musharaka* investment financing must operate under specified terms and conditions that are in compliance with the principles of the *Shari'ah* which include: avoidance of *Riba* (interest) and *Gharar* (uncertainty) based transactions, *haram* (unlawful and illegal) business activities against the *Shari'ah* legal code like phonography, deceit, injustice, excessive exploitation, consumption and sales of any harmful commodity. Conceptually, *Sharikah*, *Shirkah* or *Musharaka* may be of two kinds: *Shirkah al milk* (non- contractual) and *Shirkah al 'uqud* (contractual) and could be more understood with aid of a diagram as highlighted by the edited work of Ghazali (2005).

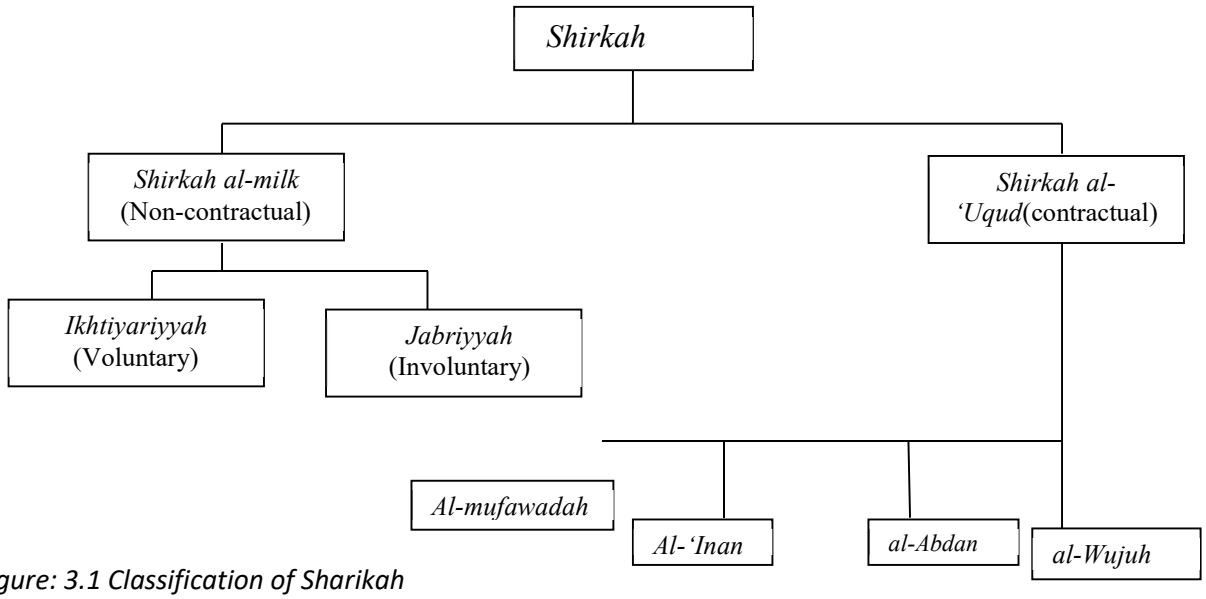


Figure: 3.1 Classification of Sharikah

Shirkah al milk is a joint ownership that comes into existence when two or more persons happen to have a joint ownership of an asset without having entered into a formal partnership agreement; for example, two persons receiving an inheritance or gift of a land or property which may or may not be divisible. If the asset, property, or the gift can be divided each according to his share and yet the partners decide to remain together willfully the *Shirkah al- milk* is termed *Al-ikhtiyariyyah* (voluntary). On the other hand, if it is indivisible and they are constrained to stay together, the *Shirkah al milk* is characterized as *Al-jabriyyah* (involuntary). The *Shirakah al-milk* appears more in principles than practice because even in the classical *fiqh* literature is discussed as peripheral aspect of Islamic finance. It received secondary attention in the classical *fiqh* finance discussion because it has not come into existence by mutual agreement to share profits and risks.

Sharikah al-'uqud (contractual partnership) on the other hand appears more technical and relevant to Islamic finance discussion as there is mutual and willful agreement between the parties to pool resources for joint investment to share profits and risks. The agreement needs not necessarily be formal and written; it could be informal and oral. However, it is important to formalized the partnership by a written agreement with proper witnesses specifying the agreed terms and conditions as encouraged by the longest verse in the longest section of the *Qur'an* (*Al-Baqara:*282-283) on matters related to debt,

finance and other important business transactions. The profits are shared as equitably agreed prior to the commencement of the business, loss however if any, must be shared in proportion to capital contribution. According to Ghazali (2005) *Shirkah al – 'uqud* has been divided in the *fiqh* books into four kinds: *al- Mufawada* (full authority and obligation); *al- Inan* (restricted authority and obligation); *al- Abdan* (labour, skills and management); and *al-Wujuh* (goodwill, credit-worthiness and contacts).

The *Sharikah al-Mufawada* requires the partners are adult, equal in their capital contribution and equal responsibility in the business, profits and losses, authority to act on behalf of others and are joint and severally responsible for the liabilities of their partnership business, provided that such liabilities have been incurred in the ordinary course of business. Thus, each partner can act as an agent (*wakil*) for the partnership business and stand as a surety or guarantor (*kafi*) for the other partners. On the alternative, *Sharikah al- 'Inan* implies that all partners need not be adult or have an equal share in the capital. They are not equally responsible for the management of the business. Accordingly, their share in profits may be unequal, but this must be stated clearly in the partnership contract and of course losses must be shared in proportion to capital contribution of the partners Ghazali (2005).

In contrast, *Shirkah al Abdan* is a type of partnership arrangement whereby contributions by the business partners is on skills and effort to the management of the business without contributing money capital. While in *Shirkah al Wujuh* the partners use their goodwill, their credit worthiness and their contact for promoting their business without contributing to the capital. It is important to note in the two forms of partnership, where the partners do not contribute any capital, would remained confined essentially to small-scale businesses only.

Furthermore, *Musharaka* could be a permanent (fixed), timed (variable) and diminishing in nature. The fixed (permanent) *Musharaka* is a type in which there is no time limit stated on the contract. The capital contribution by the partners, profit and loss also remained fixed during the period of Musharaka contract. On the other hand a timed (variable) *Musharaka* as the name suggest, the project ends at a certain period and the capital contributions may vary during

the *Musharaka* engagement. The diminishing *Musharaka* explains that the capital contribution of a partner is allowed to diminish, sold to a partner or third party. Thus the profit and loss diminishes proportionately (Kurfi, 2002, Saleh, 2003).

Mudaraba: The term *Mudaraba* (labour capital partnership) is derived from *al-darb al-ard* which means "traveling through the land" as mentioned in the following verse of the *al-Quran*: "….others traveling the land seeking of Allah's bounty" (*Al-Muzammil*: 20). It is a business organization whereby one of the contracting parties provides funds and other provides business idea, labor, skills and management (Ahmad, 1983 Doi, 1984, Saleh, 2003, Khan, 2008). *Mudaraba* (labour capital partnership) is one of the earliest forms of business used by the Arabs for trade activities even before the coming of Islam as history proved that Prophet (SAW) was engaged into *Mudaraba* contract with Nana Khadijah (May Allah be pleased with her) before she got married to him (SAW). Later this mode of trade was confirmed and approved legal and legitimate by the *Shari'ah* and was therefore, employed by the early Muslims to conduct trade. There is a *Hadith*(saying/ or words of the Prophet SAW) which supports this partnership arrangement and thereby confirmed its approval by the Prophet SAW : "Ibn Abbas (May Allah be pleased with him) reported that: "When Abbas Ibn Abd al-Muttalib gave his property to someone for *Mudaraba* (labour capital partnership), he stipulated conditions for his partner not to bring the capital onto the sea; and not to bring with him the capital crossing a valley; and not to buy livestock with the capital; and if his partner violates the conditions, he should guarantee the loss occurred. These conditions have been brought to the attention of Prophet Muhammad (peace be upon him) and he (SAW) approved them". (Narrated by Al-Bayhaqi in Al Sunan al-Kubra, as cited in Abdul Rahman, 2012).

Traditionally, *Mudaraba*h has been applied to commercial activities of short term duration. The provider of funds is called *Sahib al mal* or *Rabb al maal* (provider of funds), provides specified amount of capital and acts like a sleeping or dormant partner, while the other party called *Mudarib* (entrepreneur or manager of funds), provides entrepreneurship and management for carrying on any venture, trade, industry or service. The manager of the funds serves dual roles of trustee and agent of the business, expected to manage the business with prudence and in good faith and

responsible for any loss incurred due to his willful negligence. He must ensure compliance to the principles, terms and conditions governed by the *Shari'ah* regarding the *Mudaraba* business in particular and trade contract in general. The two parties enter into contractual agreement on the bases of labour- capital partnership understanding. This is another form of equity finance, however, on labour- capital partnership.

Muzara'ah: This is another form of *Mudaraba* contract related to Agricultural financing. It is an Arabic word and its root is derived from the word *Zara'a* meaning planting, cultivating or cropping. Therefore, the word *Muzara'ah* is an Arabic term which literally means crop sharing.

Muzara'ah is a union in Agriculture embracing the landowner and the farmer, typically a person who has the know-how skills in cultivation of crops. The owner the surrenders the land to a farmer and later the sharing of the fruited efforts through monetary yield is considered (Amin, 2020). The rate of the sharing is based on their deals and ultimate consensus. Furthermore, in this arrangement, the landowner provides capital in form of lands and seed, while the farmer puts in his farming skills, experience, time and energy for agricultural output. The output is later shared on the agreed ratio unanimously accepted by the parties prior to the commencement of the farming activity. Theoretically, three scenario can be deduced in *Muzara'ah* contract accordingly:

a) A farmer or Agricultural entrepreneur owns ideas, skills and expertise, without a land and thus, land is provided to him. The landowner owns land-capital and the Agricultural entrepreneur provides labour. The landowner is the provider of capital or funds and the Agricultural entrepreneur is the fund manager.
b) The landowner provides the required land and capital, the farmer combines his knowledge and experience as labour for the crop production. The landowner is still the provider of capital however, land and capital are provided simultaneously, and farmer engage into provision of labour service.
c) An institutional arrangement whereby the bank purchase necessary farming equipment and seed as capital to the farmer and the farmer provides land and labour. The bank

becomes provider of capital and farmer is the manager of the capital.

3.1.2 Sales Financing: Sales is the process of exchange of a valuable thing against a valuable thing with a mutual consent of both parties (Shafiq-ur Rahman, 2010). The process should be voluntarily, with consent and no exploitation or bearing of unilateral risk by one party against the other. The contract should be with fairness and socio-economic justice, mutual benefit between or among parties involved, avoidance of *gharar* (speculative and uncertain transaction).

Islamic scholars and finance experts (Doi, 1984, Karwai, 2005, Shafiq-ur Rahman, 2010, Lamido, 2014, Muhammad, 2019) emphasized on some conditions for the validity of sales contract as it affects the item of the sales, the buyer, the seller and thus the terms of the contract include: The subject of the sale should be evidently in existence, possession and ownership of the seller. The seller should have the possession of the subject of the sale either in physical or constructive terms. This is to avoid *gharar* (speculative and uncertain or gambling) transaction, disallowed by the *Shari'ah*. The subject of exchange should also be valuable and recognized as sale from the *Shari'ah* perspective. Therefore, economic activities like gambling, phonography, trading of pork and abuse substance must be avoided being prohibited by the *Shari'ah*. The price of the item should be fixed, known and free from interest and voidable conditions. However, the sale of *Salam* (future commodity sale) and *Istisna'* (Manufacture sale) are exempted from some of these conditions (existence, possession and ownership of the item) due to their peculiarity.

Islamic bank has a range of sales contracts that are considered permissible by the *Shari'ah* and such include: cost- plus – sale (M*urabaha*), lease (*Ijarah*) sales, deferred payment sale (*Bay' Bi-thaman Ajil*) future commodity sale (*Bay' al- salam*), manufacturing sale (*Bay' al-istisna'*) and several others (Ashour, 1999, Ahmad, 2012). In general terms, the legitimacy and legality of any of the above listed trade financing instruments in the Islamic finance are deduced from the primary sources of the *Shari'ah* ie the *Qur'an* and the *Sunnah* of the Prophet Muhammad (SAW) as well as from the secondary source including the *Ijma'* (the majority opinion of Muslim jurists) and *Qiyas* (analogy) and *Ijtihad*. The *Qur'an* says to the effect: "…and Allah permitted trade and prohibited usury" *Al- Baqara:* 282).

Furthermore, it was reported the Prophet Muhammad (SAW) to have said: "The best earning is what man earns with his own hands and from a permissible trade" (Narrated by Hakim n.d). The legality, permissibility and legitimacy on any trading activity as it appears in the *fiqh al Mu'amalat* (Islamic rules on transaction) literatures is vested on the general opinion by the majority of the Muslim Jurists based on jurisprudence rule: Any (contracts and stipulations) is legitimate and lawful, unless there is an explicit text (from *al-Qur'an*, the *Sunnah* and consensus) or a *Qiyas*, proving its prohibition and voiding. In this case the researcher is to discuss two major sale contracts ie the Murabaha and *Ijarah* (lease) contracts. Those sales/ trade products are hereby discussed below:

***Murabaha* Sales Financing**: Murabaha is derived from Arabic word *Ribh* and simply means profit. It is a cost-plus financing as replacement to interest- charging transaction prohibited by the *Shari'ah* (Suratu-al-Rum: 39, Suratu –al-Aal- Imrana: 130, Suratu-al-Baqara: 275- 276). Murabaha is therefore, an Islamic financing structure whereby the seller and buyer agree on the cost and mark-up of an asset. Murabaha sales contract is of two types: the classical/ conventional and the contemporary and also known as Murabaha Purchase Order (MPO).

Under the classical views of the *Murabaha*, the seller purchases the goods for *Murabaha* sale from a vendor, owned the product, pays for it and later enters into a *Murabaha* sale contract with a customer in need of that commodity at a mutually agreed cost- plus or profit margin and deliver the same to the customer. The customer pays the seller on installments bases over period agreed by the parties in the trade. On the other hand, the contemporary scholars and Islamic finance experts (Obaidullahi, 2005, Shafiq-ur Rahman, 2010) discussed the contemporary *Murabaha* as a process in which the customer places an order with Islamic bank to purchase goods with the promise (may be binding or non-binding) by the customer to purchase, the Islamic bank purchase and pays for the goods from the vendor, executes a *Murabaha* sale contract with the customer and delivers the goods. The customer pays for the goods on an installment basis to the bank as earlier agreed at the commencement of the contract.

The contemporary *Murabaha* is also called *Murabaha for Purchase Order* (MPO). In both perspectives of the *Murabaha* modes of financing that is the classical and MPO, the

seller purchases goods and then sells those goods to the buyer at a mark-up or profit margin mutually agreed by the parties prior to the execution of sale activity. However, both the classical and MPO can be distinguished from one another by execution process. In case of the former, the seller needs not to receive purchase order from the buyer for the purchase of the product, but in the later there is the placement of order by the customer with the promise to purchase the product bought from the vendor. Contemporary *Murabaha* is practiced by the modern day Islamic banks. Both the classical and contemporary Murabaha (MPO) contracts could further be elucidated with an illustrated diagram below: -

Murabaha Transaction – Classical Perspective

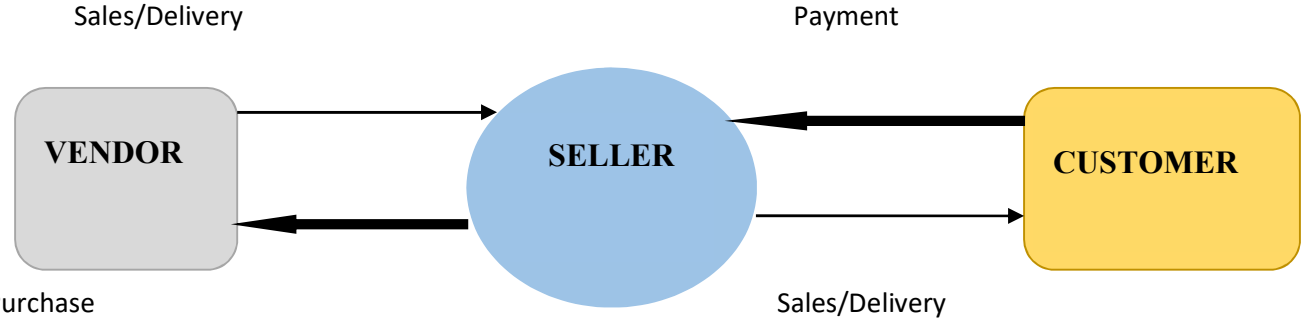
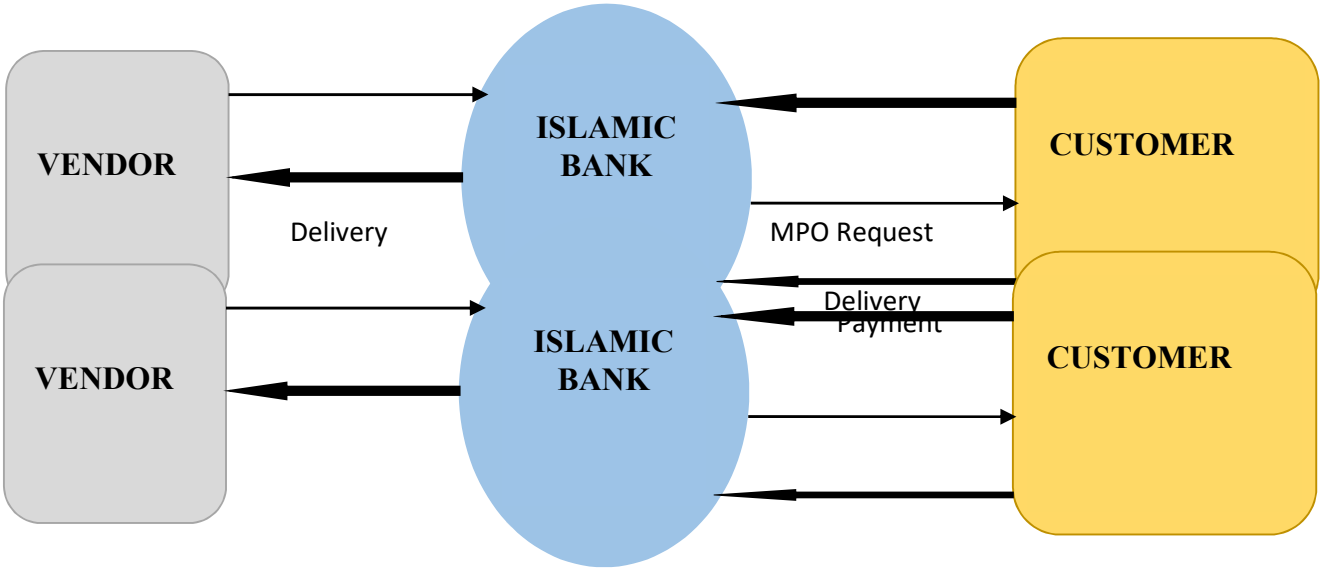


Figure 3.2: Classical *Murabaha* Model

Source: Adapted works of Obaidullahi (2005) and Shafiq ur Rahman (2010).

The transaction dynamics of the classical Murabaha model could be clearly understood as depicted by the above diagram and thus explained as follows: Seller purchases a product from the vendor, and the products are sold/delivered to him. The seller engages into *Murabaha* sales contract with the customer and goods are sold or delivered accordingly. Customer initiate payment to the seller either on installment or at lump sum as mutually agreed between them.

Murabaha for Purchase Order (MPO) – Contemporary Perspective of Murabah



Source: Adapted works of Obaidullahi (2005) and Shafiq ur Rahman (2010).

The contemporary *Murabaha* as discussed in figure 2.3 above the customer places MPO request with Islamic bank, the bank procures the specified goods from a third party (vendor) against payment. Immediately upon the transfer of ownership of the goods, the bank sells these goods to the customer at the purchase price and agreed fixed profit margin. The customer then takes physical possession of the goods and undertakes to pay the price to the bank either on installments or in a lump sum, at an agreed later date. The major line of difference between the classical and contemporary perspectives on *Murabaha* sales contract is the placement order by the customer to the bank with a promise (might be binding/ not binding) to purchase the product ordered by the customer.

Ijarah (lease) sales financing*:* The concept of *Ijarah* (leasing) is an Arabic term which literally means providing services and goods temporarily for wage. The legitimacy of Islamic lease or Ijarah is derived from the Qur'an (Al-Qasas: 25-28) and specifically which Allah says: "…and said one of them (the two women): O my father! Hire him! Verily, the best of men for you to hire is the strong, the trustworthy). Ijarah is a contract where one party transfers the right to use an item he owns to another party for a specified period in exchange for agreed consideration.

Ijarah is often called Islamic leasing. It is also a term in *fiqh* (Islamic jurisprudence) and a product of Islamic banking and finance and thus, technically defined as a contract or agreement whereby a lessor *(Mu'aajir*) leases physical asset or property to a lessee *(Musta'jir*) and receives the benefits associated with ownership of the asset against payment of predetermined rentals (*Ujrah*). *Ijarah* therefore, is an arrangement between and/ or among the parties in the contract for a specified period of time called *Ijarah* period (*Waqatul-Ijarah*).

In the *Shari'ah* finance principles, the *Ijarah* contract is either on the hiring of human or provision of services. The Ijarah on the hiring of human service is further classified into the hiring of his hours (*Ijarah 'Alal waqat*) or hiring his services (*Ijarah 'Alal Amal*). In the former, the lessee is paid on periodic bases such as monthly salary, in the later, he is paid on the services provided like reward on hiring a porter at airport, a computer services at the business centre. The *Ijarah* on property is hire service on items like real estates, buildings, equipment, machineries, computers, motor vehicles.

The *Ijarah* sale contract could serve as alternative and competitive mode of financing by Islamic banks to provide the customers with short to medium-terms financing. The lease of such items may include: real estates, buildings, equipment, machineries, computers, motor vehicles, and other acceptable (not *haram* or forbidden) assets. An Islamic finance institution like bank purchases property or capital equipment, leases it to a customer. The bank may rent the property/equipment and receive the rent or invest it in the business and get a share of profit. However, Ijarah contract distinct itself to conventional lease in the nature of contract between them. In Ijarah, there are two separate contracts, contract of sales and lease, while the conventional leasing contract is built on a single contract including sales and lease.

4.0 Islamic Banking Products and Financing of the MSMEs

The above discussed Islamic banking products could stand as alternative and sustainable strategy for financing MSMEs in Katsina state especially in the area of general merchandize, agriculture and petroleum services. The need for initiating and introducing Islamic banking mode of finance among MSMEs is imperative for three reasons: One, generally MSMSEs are

discriminated by the conventional banks in view of their informal nature of operations; secondly, the conventional banks charges exorbitant interest rate; thirdly, the MSMEs within the area of study avoids dealing with conventional banks on religious ground, the financing considered unethical and repugnant their norms, values and belief system. The paper proposes a below Islamic mode of finance model for a sustainable financing of MSMEs:

4.1 Financing of the MSMEs General Merchandize

This form of business is common among Micro and Small enterprises as the business requires little capital for startup or expansion of their existing businesses. A Murabaha Purchase Order (MPO) mode of financing can competitively be used by Islamic (micro or commercial) bank for the growth and development of MSMEs into general merchandize services.

As discussed earlier, MPO has a three tier transaction process. At the initial stage, the customer approaches Islamic (micro or commercial) bank with a business (MPO) financing request, then the bank proceeds to process and procure the specified goods by its customer from a third party (vendor) against payment accordingly. The bank makes instant payment to the vendor and takes ownership of the specified goods for further sales agreement with the customer. Immediately upon the transfer of ownership of the goods, the bank enters into Murabaha sales contract on these goods with the customer. The purchase price and the fixed profit margin are clearly disclosed to the customer by the bank. However, it is important to note, the transfer of ownership of the goods by the vendor to the bank is a necessary condition as the *Shari'ah* business principles disallow selling of goods not in possession by the seller.

The customer of the bank then takes physical possession of the goods and undertakes to pay the price to the bank either in installments or in a lump sum, at an agreed later date. The MPO sales contract therefore, is the placement order by the customer to the bank with a promise (might be binding/ not binding) to purchase the product ordered by the customer.

4.2 Financing of the MSMEs Agricultural Services.

Agriculture services as an economic activity covers areas of land cultivation for rainy and dry seasons farming as well as livestock. In this case, *Muzara'ah* mode of financing is appropriately competitive for agriculture

especially, land cultivation for rainy and/ or irrigation farming. *Muzara'ah* as mentioned earlier, is another form of *Mudaraba* contract related to Agricultural financing. It is an Arabic term with the meaning of planting, cultivating or cropping or simply otherwise means crop sharing.

The *Mudaraba* related to Agriculture or rather popularly known as *Muzara'ah* is also an equity mode of finance involving two parties, one as provider of funds or capital and the other as entrepreneur or manager of funds for short term business financing like agricultural enterprises. This equity mode of finance could be composed in three scenario:

a) A farmer without a land and the land is therefore provided to him accordingly. In this case, the landowner becomes land-capital provider and the farmer provides labour or managerial skills for the crop production. At the end of the farming activity, sharing of the fruited efforts through monetary yield is considered according to the ratio agreed prior to the commencement of the farming enterprises.
b) A farmer without land and capital, he requires both the land and capital and thus, the two are provided simultaneously. The farmer combines his knowledge and experience as labour for the crop production. The landowner is still the provider of capital and the farmer engages into provision of labour service and thereby becomes manager of the funds.
c) A farmer owns a land and already possess knowledge and skills for the crop production, however, lacking farming equipment and seed as capital.

The first two options are convenient at non institutional and informal arrangement and the last scenario is conveniently manage through institutional arrangement. Under this institutional setting Islamic (micro or commercial) bank purchases necessary farming equipment and seed as capital to the farmer and the farmer provides land and labour. The bank becomes provider of capital and farmer is the manager of the capital. The returns from the farming investment is shared according to the agreed proportion unanimously and collectively accepted by the provider and manager of funds appropriately.

4.3 Financing of the Petroleum MSMEs Service

Many of these businesses can be classified into medium entries considering the nature and scope of their asset and employment capacity. They may require medium term financing period than the micro and small enterprises. Ijarah sale mode of finance can satisfactorily meet the financing request of the petroleum MSMEs to Islamic bank. The mode provides short to medium-terms financing and as alternative and competitive mode of financing to the one provided by conventional bank.

The Ijarah service could be on items which may include: real estates, buildings, equipment, machineries, computers, motor vehicles, and other acceptable (not *haram* or forbidden) assets. On the other hand, Petroleum MSMEs require many operational facilities such as building construction of filling station(s), equipment and machines like reservoir tanks, pump machines, trucks for supply of the petroleum product and the main petroleum product.

An Islamic bank purchases property or capital equipment requested by a customer, leases it to him. The sale contract is usually on *Ijarah* with *Musharaka* or *Mudaraba* bases whereby the bank and the customer contribute to the equity of the partnership in a certain ratio. It is *Ijarah-Musharaka* finance as the asset is jointly owned by the bank and the customer as each partner contribute specified amount as stipulated by the finance contract. The contract is also considered as *Ijarah- Mudaraba* financing, because the bank again acts as the agent-manager of the partnership. Therefore, the bank has a share in the *Ijarah- Musharaka* financing and at the same time acts as manager of the investment. The partnership then purchases the property and leases it to the customer against known periodic rentals. The proportion of rental accruing from the customer is used to redeem part of the bank's stake in the property. This results is a decrease in the bank's stake over time. Eventually, the bank's stake in the property reduces to zero and the customer becomes the full owner of the property. This business financing strategy that uses diminishing *Musharaka* or *Mudaraba* in combination with *Ijarah* is a recent innovation in Islamic banking and finance.

5.0 Conclusion and Recommendation

Islamic banking is an application of Islamic principles, law and tradition in banking activity. Its transactions, instruments and contracts must pass through Islamic moral,

ethical and legal filters to ensure compliance with the ethical, norms and values of the Islamic doctrine of deposit mobilization, investment financing and provision other banking services(Chapra,1985, Lamido, 2014,Rahman, 2014).

Islamic bank is exposed with alternatives mode of financing businesses either through equity or sale contracts. Thus, an opportunity to serve the needs of their clients especially those interest on ethical finance leveraging on the optional financing. Any or combinations of the above discussed Islamic banking products can be employed appropriately. Islam encourages equity or sales financing, and requires all parties involved to be fair and avoid cheating one another. The Qur'an declares: "*... Help you one another in righteousness and piety, but help you not one another in sin and rancour...*" (*Al-ma'ida*:2). In a Hadith *Al-Qudsi* reported by Abu-Hurayrah: The messenger of Allah (peace be upon him) was reported to have said: "Allah, Most High says 'I make a third with two partners as long as one of them does not cheat the other, but when he cheats him, I depart from them". Consequently, the paper is submitting the following recommendations:

Islamic banking has been in operations for a decade in Nigeria and it has been receiving an applausive response, especially among the Muslim-majority society like Katsina state, even though there is general misconception, low level of awareness and interest in some part of the country with a Muslim-minority population. Therefore, there is the need to clarify such misconception in those areas, to understand this banking system is competitive, convenient and alternative banking especially among MSMEs. It has many modes of financing for the realization of sustainability of the MSMEs businesses.

Furthermore, the paper is recommended to Islamic commercial banks like Jaiz and *Taj* Banks, and other financial institution such as Lotus capital, micro finance banks and *Shari'ah* compliant saving and credit cooperative societies. The mode of Islamic banking discussed are important tool to competitively finance individual households and other business firms like MSMEs for their growth and development.

There is also lack of awareness about the nature and scope of Islamic banking by the general public and thus, suggested as a key challenge even in the Muslim-majority areas. For instance, some specific financial terms

applicable in Islamic banking practice like *Mudarabah* and *Musharaka* sound new and ambiguous to them. Those concepts are clearly defined and discussed in the paper, it is therefore, a tool for capacity building to the management and staff of Islamic financial institutions as well as for boasting the level of awareness about the products and services of Islamic banking. This improves the level of Islamic finance education, financial literacy and financial inclusion in the society.

The bank should also note we are today living in a global and borderless market, whereby numerous factors such as awareness and customers' satisfaction are the key factors for the successful survival of any business organization. Hence, in addition to the creation of awareness, Islamic financial institutions should ensure quality delivery service to its customers to retain the existing ones, capture the market scope of those that involuntarily avoiding Islamic banking on the ground that such financial services are meant to service Muslim-faithful.

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