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PRIMARY RESEARCH

Issues in Existing Agricultural Credit and Scope of *Bay' al-Salam* as an Alternative

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Abstract. This study focuses on issues in agricultural finance in Pakistan and suggests the use of *bay' al-Salam*, the forward contract as allowed in Islamic law of contracts. Despite vital importance, the agriculture sector in Pakistan hasn't been able to make the case to gain attention on the Government's priority list. A number of negatively impacting elements can be pointed out, but the standalone interest based system of agricultural credit can be termed as the most harmful for farmers, agriculture sector and the national economy. Major problems include insufficient institutional credit, exorbitant rate of interest, non-availability of collateral and the cumbersome procedures. This situation creates a credit gap which is filled by the non-institutional sources like middlemen, shopkeepers and money lenders who too exploit the poor farmers. However, they still borrow from private sources as the access is easier. The concerns are growing about the existing interest based credit system and voices are also raised for an alternative system that is easy to access as also compliant with the Sharī'ah principles. *Salam* financing for the purchase of crops initiated by Sudanese banks couldn't create desired impact fully. Similarly, *Salam* financing offered by First Islamic Bank of Indonesia faced serious Sharī'ah compliance issues. However, a private body namely Wasil Foundation's *bay' al-Salam* initiative in Pakistan seems comparatively a successful story. A relatively better response and wider acceptance by the stakeholders to *Salam* financing offered by Wasil indicates that banks (both conventional and Islamic) cannot apply *Salam* efficiently due to non-availability of required infrastructure. Although *Salam* financing is highly instrumental mode of finance for agriculture, but could fail if managed through the Islamic banks in obtaining the desired outcome. This study, based on the literature and expert opinion collected through a survey, proposes a separate body to handle *Salam* financing to agriculture in Pakistan.

KAUJIE Classification: K7, V12, H44
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INTRODUCTION

The agriculture sector of Pakistan contributes significantly in GDP, employment generation, food security and exports (PES, 2017-18). Pakistan ranks among top ten producers of cotton, wheat, mango, sugarcane, kinnow, dates, oranges, and 13th in the rice production (Food and Agriculture Organization, 2016). The country is equipped with abundant natural resources including rivers, range of seasons, vast irrigation system, lakes, mountains, and a tillable agriculture sector (Abdullah, Khan, Jebran, and Ali, 2015). However, the performance of agriculture has not been commendable for last two decades and it has deteriorated further during last few years. Resultantly, not only the socio-economic conditions of a vast majority of small and poor farmers remained miserable, but the agriculture growth has also been affected. According to Ministry of Finance economic Survey (2013-14), the sector is producing around 50% below the potential. State Bank of Pakistan Anual Report (2015-16) also acknowledged that the agriculture sector remained under stress for last several years. The growth rate plummeted from 3.5% in 2008-09 to (-) 0.19% in 2015-16 (PES, 2015-16). Due to reduced production, the reliance on the import of agro foods is increasing rapidly. Moreover, the budget allocation for agriculture and irrigation decreased from Rs. 37.9 billion in FY 2017-18 to Rs.31.1 billion in FY 2018-19 (PES, 2018).

The major factors responsible for the miseries of farmers and poor performance of agriculture are the deficiencies in formal agricultural credit, difficult access to formal credit, exorbitant interest rates, costly inputs, shortage of irrigation water and olden methods of cultivation (Haq *et al*., 2013; Qadir, 2005). The current system of credit is not only *Sharīʻah* non-compliant, non-productive but also exploitative. As a whole, it has created inefficiencies and has failed to fulfill the credit needs of farmers. To address the credit needs of farmers in *Sharīʻah* compliant manner *Bayʻ al-Salam*, a time tested specific financial tool, is available as a suitable alternative. *Bayʻ al-Salam* has served the purpose successfully for centuries, and in the modern era its application is possible (Chapra & Khan, 2000; Udovitch, 2011). However, keeping in view the lower than expected performance of *salam* based financing by Sudanese and an Indonesian bank (Mohammed & Hussien, 2012. Putri and Dewi, (2011), *salam* initiation at vast scale would need proper institutional support, planning and preparation.

This paper aims to review briefly the issues of agriculture credit and scope of *bayʻ al-Salam* as an alternative managed through any separate body other than banks. Along with review of literature expert opinion has been obtained from a sample of 40 respondents including scholars, banker, farmers and parliamentarians. The paper highlights importance of credit for farmers, major issues and negative impact of interest based credit on farmers. It discusses *bayʻ al-Salam* as an alternative to existing system of credit, current practices of *salam* and issues, socio-economic benefits and in the end suggests an institutional arrangement for managing *bayʻ al-Salam* for the purchase of agricultural products in Pakistan.

PROBLEMS OF EXISTING AGRICULTURAL CREDIT

Availability of sufficient and timely interest free credit improves socio-economic conditions of farmers, boosts production, creates jobs and helps modernizing agriculture (Bashir & Azeem, 2008; Khandker & Faruqee, 2003; Olowa & Olowa, 2011). Hence, the credit is the lifeline for farmers and without exploitation free sufficient credit it is difficult to uplift the conditions of poor farmers and develop the agriculture sector.

However, there are serious issues in the agricultural credit supplied by the institutional and non-institutional sources in Pakistan. First of all, there is a credit gap as the share of institutional sources currently stands between 30-45 percent (SBP Handbook on Best Practices in Agri/Rural Finance). Major chunk of credit is provided by the non-institutional sources like middlemen, shopkeepers, professional money lenders, relatives and friends (Mahmood & Hussain, 2004). Out of 6.6 million farmers, 2.3 million have the access to the institutional credit (Development Finance Review 2015). In fact there is a more reliance on private sources particularly middleman as the procedure is simple and security is not demanded from farmers in most of the cases (Zuberi, 1989). Nonetheless, the farming community has no choice except to depend on middleman and other informal sources to meet their financial needs despite the existence of factor of exploitation.

In addition to the credit gap, involvement of interest, exorbitant interest rates, lengthy and complicated procedures aggravate the problems (Arifeen, 2012; Haq *et al.*, 2013; Qadir, 2005). The involvement of interest keeps 80 percent population of Pakistan unbanked and a vast majority of farmers remain away from credit schemes (World Bank Group, 2017). Houtman (2006) acknowledges stiff resistance against interest in more conservative countries like Iran, Pakistan and Afghanistan and there are doubts about current practices of IBs and IFIs. Moreover, the impact of Islamic modes of finance offered by IBs is also not impressive and appealing as Siddiqi (2006) noted *murābaḥah*, *mu'ajjal*, *salam*, *istiṣnā*', *ijārah* and *ju*'*ālah* cannot either remove injustices nor can contribute in achieving the socio-economic justice. Naser, Jamal and Al-Khatib (1999), Metawa and Almossawi (1998) found that the major decisive factor for people to opt Islamic banking was banks' adherence to *Sharī*'*ah* principles; people would approach IBs if they find that businesses are run purely on Islamic principles. Khan, Hassan, and Shahid (2008) found religion as the top most important factor for making decision to opt Islamic banks by the people. Hasanuzzaman (1991) noted that IBs might not be in position to offer Islamic modes of finance strictly in line with the Sharī'ah tenets.

The higher rate of interest is also one of the major problems faced by the farmers while different banks charge different rates. For example, the Punjab Provincial Cooperative Bank Ltd (PPCBL) charged 18 percent mark-up on individuals loans, whereas, for societies it charged 16 percent rate of mark-up on agriculture production loans (PPCBL). ZTBL, in addition to the prevailing rate of mark-up adds several other charges like loan case file Rs.200, postal charges Rs.250 and 1 percent and 2 percent for loan up to Rs.50, 000 and above Rs.50,000 respectively as appraisal fee (Annual Report 2013, ZTBL). Amjad and Hasnu (2007) noted that the effective rate of interest was about 21 percent for the smallest landholders and about 14 percent for the largest farm-size group.

The finance provided by the Islamic banks is also very costly and various banks charge different profit rates. As indicated by Saeed and Rana (2013) The client also has to pay Legal Report Charges, Property Valuation Charges, Income Estimation Charges and FED on processing charges @ 16% to the bank (ibid). Moreover, bribery, cumbersome process and collaterals makes the access to institutional credit further difficult (Khan, 2008; Qadir, 2005).

On the other hand, the borrowing from private sources although easy to access, involves exploitation. As noted by Haq *et al*. (2013) interest rate charged ranged between 62% to 80%, to Zuberi (1989) 120% a year, and according to Aleem (1990) the average interest rate was over 78%. The poor farmers thus suffer in shape of unending indebtedness, compromises on quality and prices and repayment of loan with high interest rates. According to Haq *et al*. (2013) borrowers have also to compromise on prices of commodities. The borrowing from private sources costs them a lot, hardly allows them to flourish and, therefore, they are unable to break the shackles of poverty and debt.

NEGATIVE IMPACTS OF INTEREST-BASED CREDIT

Various studies and empirical evidence confirm that the interest based credit has created serious socio-economic problems for the poor farmers. The higher interest rates upset the farmers, growth rates and the national economy (Arifeen, 2012). The farmers of various countries including Pakistan have been facing severe hardships as noted by Farkas, (2014), Yadav and Sharma (2015) due to the higher rate. According to Farkas (2014), the suicide among the farmers is a reality although the rates of suicide vary from country to country. Small and marginal farmers' condition is vulnerable and suicides are very common in developing countries (Yadav & Sharma, 2015). India is on the top with nearly 18 thousand farmers committing suicide every year and according to the National Crime Records Bureau of India during last two decades about 300,000 farmers committed suicide. The pressure of indebtedness has been found as the major reason behind the suicide of majority of farmers (Farkas, 2014). In Kenya, more than 2,000 suicides are reported per year (Rogers, 2010). In Pakistan the negative impact of poor performance of agriculture is appearing in shape of increasing trade deficit. Due to decreasing crop production, the reliance on the import of agro food items is increasing, thus putting heavy pressure on foreign exchange reserves. Resultantly, the trade deficit of Pakistan has deteriorated during last few years (PES, 2018-19).

Burch *et al*. (2007) emphasized on the exploitation free financial innovations to facilitate the smallholders (World Development Report, 2008-"Agriculture for Development"). United Nation Food and Agriculture Organization (UNFAO) recommend *salam* in Afghanistan for wheat and potato crops to address the credit issues (Houtman, 2006). In Pakistan, the Council of Islamic Ideology (CII), Federal Sharia'‘t Court, Ministry of National Food Security & Research (MNFSR) and also a number of studies recommend interest free system of credit for farmers (Ahmad, 2010; Council of Islamic Ideology, 2002; Ministry of National Food Security and Research, 2013).

BAY' AL-SALAM AS AN ALTERNATIVE MODE OF FINANCE FOR FARMERS

The discussion reveals that the existing credit system is *Sharīʻah* non-compliant, exploitative and has failed to provide relief to the farmers and also not capable to uplift the ailing agriculture sector. The financial system in vogue could not succeed to do justice and to create harmonious societies (Ayub, 2018). Islam has not only prohibited interest, but also provided a more efficient and interest & exploitation free financial system. *Bay' al-Salam* or forward contract is a particular mode of finance that has been allowed as an exception by *Sharīʻah* to facilitate the needy farmers. *Bay' al-Salam* is such a trade where price is paid immediately for delivery of goods later (Kasani, 1997). When Holy Prophet (PBUH) came to Madinah *bay' al-Salam* was prevalent; however, the element of *gharar* was there. The Holy Prophet (PBUH) allowed *salam* but made it *Sharīʻah* compliant with following conditions: "Whoever wishes to enter into a contract of *salam* he must affect the *salam* according to the specified measure, specified weight and specified time or date of delivery" (*Ṣaḥīḥ al-Bukhari ḥadīth No. 2240*). Further, the full payment of price has to be made in advance to avoid *bay' al-dayn*, and also to facilitate the seller in production process. "As the commodity to be delivered in future against prompt payment becomes a debt on the seller, the transaction is termed as *salaf* and implies a loan without any benefit (Ayub, 2007).

Current Practices of *Salam*

In the contemporary world there are few examples of *salam* financing for the purchase of crops. Sudan is on top, where institutional *salam* financing in agriculture sector is in practice since 1980s (Elhiraika, 2003). As a whole, the *salam* financing in Sudan has been useful for stakeholders; in good seasons banks earned healthy profits and enabled the farmers to have access to interest free credit. However, various issues have also been noted. For example, the Beneficence Clause in the *salam* contract has created problems. According to this clause an affected party may be compensated if prices change more than 33% (Elhiraika, 2003). It has created the repayments issues as the price levels vary in each region; moreover, the sellers generally want readjustments in the conditions of contract. This clause is also against the spirit of the Islamic law regarding *salam*. Further, no such clause for compensation of any party is included in other modes of finance. Elhiraika (2003) noted issues like delinquency especially when harvest price is much higher than the contract price, no clear guidelines for determining *salam* price and high costs of collection, storage, marketing and the quality related risks. Mohammed and Hussien (2012), while indicating issues relating to repayments, noted that the farmers were generally unsatisfied, and in 90 percent of cases farmers did not pay despite having the ability to pay. Other issue is related to rain-fed areas where borrowers are not able to provide acceptable collaterals because of extreme poverty. Another problem relates to the improper Sharīʻah interpretation by the bank staff as pointed out by Gulaid (1995). Lack of training and skills of the bank staff have been causing irritation among the clients. It can be concluded that *salam* financing in Sudan has been beneficial but the issues like lack of training, absence of an exclusive managing body, vague pricing policy and the compensation clause reduced its benefits.

In Indonesia, First Islamic Rural Bank BPRS Dana Mulia offered *salam* based financing for agriculture sector in 2010 (Putri & Dewi, 2011; Udovitch, 2011). However, *salam* financing involved *gharar* and *ribā* (Putri & Dewi, 2011). The client pays monthly installment since the start of agreement to the bank on the basis of expected profit, does not include details of commodity and there is no clear-cut policy in case of defaults (ibid). Thus, *salam* offered by BPRS Dana Mulia is objectionable as the basic spirit of Islamic teachings is being violated.

In Pakistan, Salam has not been adopted at vast scale for the purchase of crops from farmers. At institutional level in fact a few Islamic banks introduced *salam* at small scale with sugar mills, poultry feed producers, etc; but it could not create a substantial impact due to some Sharī'ah and process related issues, and also because it has not offered to the farmers.

In private sector, Wasil Foundation introduced *salam* product in district Gojra (Punjab) in 2009, paid Rs 2.3 million to 43 clients and purchased 2530 Maund of wheat from farmers (Wasil Foundation, n.d.). The number reached to 430 farmers in a few years the Wasil built its own warehouses having the capacity to store up to 800 tons of crops, with potential to expand to 2,300 tons (Chehade, 2016). It has been noted that Wasil's *Salam* financing gained more popularity and produced better outcome as compared to banks. Major reason for poor outcome of banks is the lack of trust of majority in current Islamic banking on religious grounds Naser *et al.* (1999) and Metawa and Almossawi (1998). Wasil's model was better and Sharī'ah compliant; it built own storage houses which allowed it to dispose of the crops at proper time and to earn good profits. In this scenario there is no option for Islamic banks (IBs) except to provide funds to the farmers in advance, and adopt real Islamic principles of *salam* to get profit or loss based on the movement of prices in the market. The advice of Usmani (2012) asking Islamic banks to change the existing approach and establish cells to deal in commodities, and adopt Sharī'ah compliant way of dealing with purchased commodity is very useful and relevant.

Socio-Economic Benefits

Bay' al-Salam is a centuries old mode of finance to fulfill the financial needs of poor farmers. Islamic jurists also call it *bay' al-maḥāwīj* the trade of the needy and *bay' al-mafālīs* trade of poor or resource deficient (Mahmood, Tirmizi, & Anas, 1989). According to Zuhayli (2012), economic factor is the most relevant for the permissibility of *bay' al-Salam* as a short sale. Similalrly, Ali, Shirazi and Nabi (2013) and Ayub (2007) favor the *salam* as farmers get rid of traditional interest based system of credit. Kaleem and Abdul Wajid (2009) recommend the banks to opt *Salam* as an Islamic mode of finance to solve the credit problems faced by the farmers. Udovitch (2011) endorsed the usefulness of this Islamic modes of Finance for farmers. In this regard it is worth mentioning that the Food and Agriculture Organization of UN had recommend *bay' al-Salam* for wheat and potato crops in Afghanistan to address the credit issues of farmers (Dhumale & Sapcanin, 1999). Ali *et al.* (2013) recommend *Salam* for the cotton sector in Tajikistan. Rahman (2003) indicated about *Salam*, "certainly on both demand and supply side it can ensure stable market with fairly perfect competition". Ishtiaq and Mukhtar (2015) believe that *Salam* has the ability to eradicate the exploitative role of middleman. According to Gulaid (1995), *bay‘ al-Salam* satisfies many needs in field of finance, investment, production and marketing and along with other Islamic financing techniques, it constitutes a vast field of operations for Islamic banks. He further says that *bay‘ al-Salam* has great financial potential, countering to inflationary pressures, it leads towards just distribution, enhanced and stabile production, generation of employment, minimization of production costs, etc.

The experience of Wasil Foundation has shown promising future of *Salam* financing for agriculture sector (Chehade, 2016). In short span of time, it made a fast progress as the number of farmers increased rapidly. Based on its impressive performance in *Salam* financing, the Wasil won the Islamic Microfinance Challenge Award 2013. Chehade (2016) pointed out that the rate of return was attractive and enough to sustainably expand the *Salam* portfolio, which is currently 10 percent of Wasil Foundation's total assets. The discussion with some of the beneficiary farmers revealed some important facts (Wasil, n.d.). The farmers welcomed this mode of financing and day by day their number was increasing. The *Salam* financing also enabled the farmers to gain self-sufficiency and to get rid of middleman's exploitation. They can run their kitchen more comfortably, purchase inputs of good quality and at lower prices and now they are able to save some thing for their families. The farmers are no more slaves to middleman and shopkeepers and they are more satisfied while using Islamic mode of finance. The outcome is encouraging and indicates great scope of *Salam* in the agriculture sector and large segment of small and poor farmers in the country would welcome such an alternative.

The application of *Salam* at expanded level in the country would have greater positive impact. It would enhance the production, bring stability in demand and supply markets and lesser the reliance on imported agro food items thus reducing the burden on foreign exchange reserves. It will also provide Sharī‘ah compliant investment opportunities to Islamic financial institutions who due to lake of clean Sharī‘ah compliant investment opportunities, invest surplus funds in dubious or at least problematic modes. The above mentioned arguments and evidences suggest that *Salam* financing carries a number of benefits to the stake holders and national economy and there is a wide scope if applied in any suitable institutional arrangement as per the Sharī‘ah principles.

Suitable Institutional Arrangement for *Bay‘ al-Salam*

This is very important aspect which needs to be taken care of for application of *Salam* in the country. So far, conventional or Islamic banks have not been able to attract or cover a vast majority of the agricultural community. Whereas, in case of Wasil the farmers and the Foundation both are satisfied which indicates that *Salam* financing can be successful if managed properly by a body other than IBs. The main factors behind the success of Wasil Foundation have been the trust of farmers, interest free and easy mode of payment. Moreover, the construction of own warehouses has enabled the Foundation to earn profits. On the other hand the Agricultural financing by conventional banks could not be much successful for reasons like a vast majority of people remained away from traditional banking on religious grounds (Demirgüç-Kunt, Klapper, Singer, & Van Oudheusden, 2015) and (Houtman, 2006). In this regard, based on the above mentioned facts and the respondents' opinion the study proposes the creation of a separate body like "*Salam* Authority Pakistan" (SAP). The proposed wings of SAP will be Sharī'ah/policy, salam pricing, training & research, grievances redressal and monitoring and coordination. Main structure of *Salam* Authority Pakistan (SAP) is presented in the Figures 1 and 2.

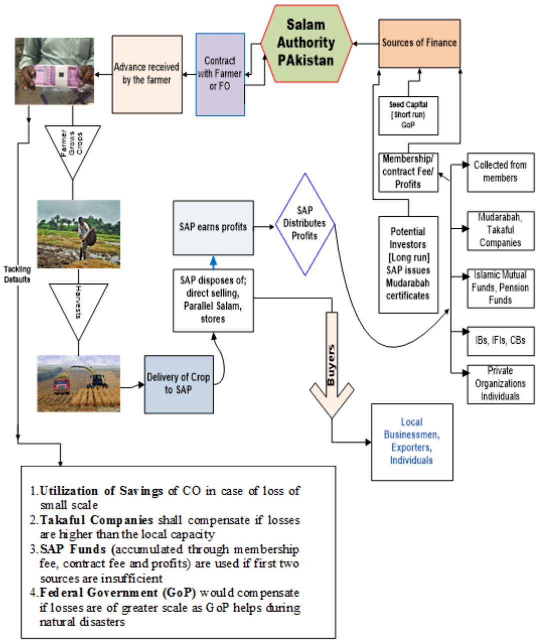

FIGURE 1. Graphical representation of proposed salam model

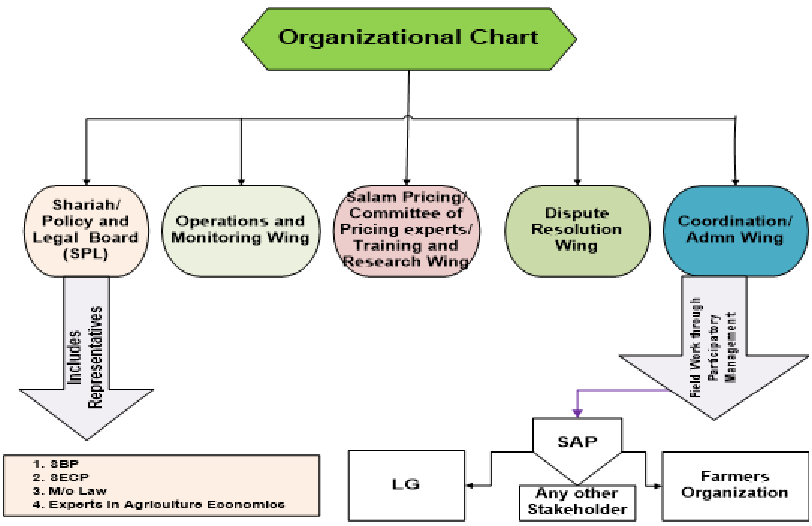

FIGURE 2. Organizational Chart

For initiation of the *Salam* financing the seed capital would be provided by the government of Pakistan. However, in the long-run SAP would be able to generate its own financial resources through offering *muḍārabah* certificates to potential institutions and individual investors. Moreover, levying of a membership and per contract fee is also suggested. With the passage of time as more players would join and financing shall expand, this would become a reliable source of income for SAP. Major features and the challenges are discussed below:

Tackling defaults under SAP structure

Keeping in view socio-economic background of the country and respondents' feedback the study proposes the idea of "Group *Salam* Financing" (GSF) to tackle the issue of collaterals and guarantees in a different way. Under the GSF, a farmers' group (FG) comprising of 5-15 members including a member from Local Government (LG) would be framed. The FG will maintain a saving account and group members will contribute a nominal amount on monthly/yearly or crop season bases. The LG representative will play the role of a guarantor and coordinator between FG and SAP. The involvement of LG representative would help minimizing the moral hazards problems. It is worth mentioning that local elites, political dignitaries and village elders have been playing vital role in Palestine during 18th and 19th centuries as the guarantors between investors and farmers (Johansen, n.d.). Moreover, Akhuwat Foundation and Helping Hand for Rural Development in Pakistan have also set good examples of utilizing the strength of social capital effectively.

In the case of default of a farmer or whole group of farmers, the study suggests i) utilizing the savings of farmers in case of small loss, or ii) agreement with takaful companies, or iii) utilizing the SAP funds. If in remotely possible cases the losses are of greater scale and not possible to cover through above said sources then government would compensate as it compensates in cases of natural calamities.

Salam pricing

Salam pricing is an important feature thus a vague or Sharīʻah non-complaint *Salam* pricing method can undermine the outcome, as has been noted in Sudan and Indonesia. Therefore, paper suggests a different *Salam* pricing mechanism mainly based on cost of 'production of *Salam* crop' to be estimated by SAP on regular basis. This method would be cleaner, Sharīʻah compliant and more acceptable thus would create win-win situation for the stakeholders.

Pilot project-a careful start

The paper on the bases of experience of Sudan and also the expert opinion gathered from respondents, suggests initiation of *bayʻ al-Salam* through a pilot project in the short run. Thus, *salam* may be started for the period 3-5 years as a pilot project, to minimize the possible risks and to learn from the experiences. The pilot project will help managing the risks, validate the benefits and provide opportunity for necessary modifications.

The profits of SAP will greatly depend on building of its own storage houses; it will help SAP to dispose of crops in Sharīʻah compliant and more comfortable way. The sustainability and success of SAP will also depend on presence of clear-cut rules. The guidelines given by the jurists like Marghinani (1990), Kasani (1997) and Sarakhsi (1978), Zuhayli (2012) the AAOIFI's standard on *Salam* and also the contemporary scholars can be helpful for framing the *Salam* rules. Similarly, other enabling factors include; SAP must work as an independent institution, regular trainings and research, along with strong support from the government.

CONCLUSION

The existing agricultural credit structure has not only failed to uplift the poor farmers, but has rather increased their plight. *Bay' al-Salam* has the potential to help needy farmers, empowering them financially, enhance production and generate employment. However, the Islamic banking institutions in their current shape failed to attract a vast majority of Muslim clients looking for pure Sharī'ah compliant financial services. It has been noted that the *Salam* financing by banks might not create healthy impact particularly in respect of strict Sharī'ah compliance, wider acceptance and the best outcome. The study finds *salam* as a suitable financial tool compliant to the principles of *Sharī'ah* with potential to address the credit issues of farmers in more efficient way. However, there is a need for a separate interest free system of agricultural credit - *Salam* needs to be initiated and managed by a separate body other than banks for wider acceptance by the public and higher socio-economic benefits.

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